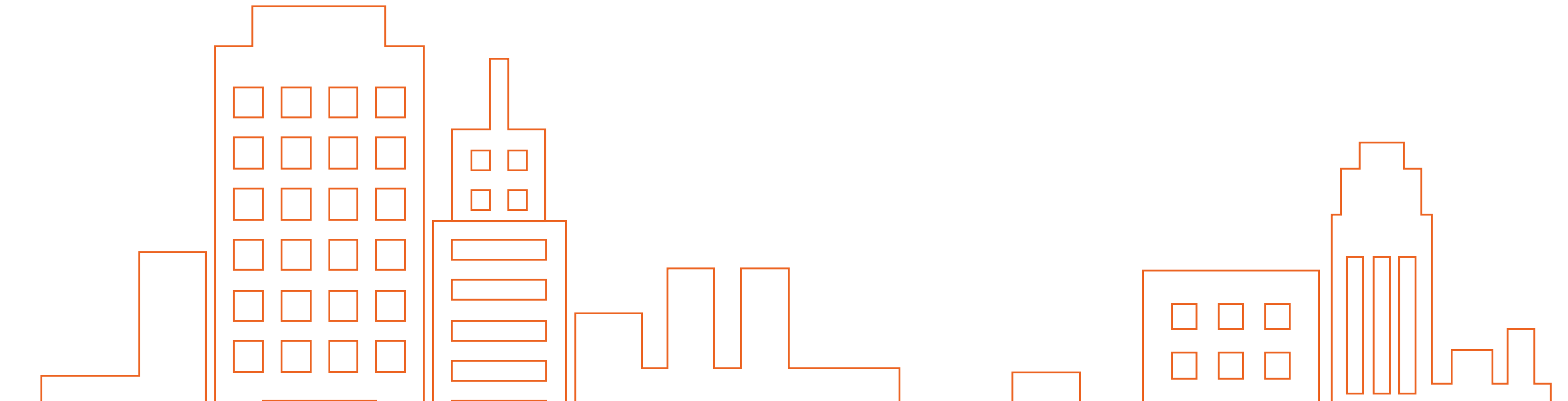
Transfer pricing:
Impact of Ind AS



Foreword

In recent years, the use of International Financial Reporting Standards (IFRS) as a common language for financial reporting has gained wide acceptance in almost 140 countries across the globe. In 2015, the Ministry of Corporate Affairs (MCA) notified the roadmap for the implementation of Indian Accounting Standards (Ind AS), which are substantially converged with IFRS.

The phase-wise adoption of Ind AS, beginning 1 April 2016, carries significant impact across industries such as IT services/technology, pharmaceuticals, infrastructure and telecom. ***Companies analysed in PwC's Ind AS impact analysis[1] reported an increase in revenues of 26.5%.***

The impact of Ind AS pervades taxation, corporate governance, internal controls and stakeholder communication. Although transfer pricing (TP) is likely to be one of the areas which will benefit from the implementation of Ind AS, the transition is likely to pose certain challenges.

This paper seeks to highlight certain areas where Ind AS may have an impact on TP and identifies the key areas that companies should review from the perspective of TP policy, planning and documentation.

We hope you find this paper informative and that it helps us remain connected with you in a meaningful way.

[1] PwC. (2016). PwC Ind AS impact analysis. Retrieved from http://www.pwc.in/assets/pdfs/publications/2016/pwc-ind-as-impact-analysis.pdf
For the purposes of the report, interim financial information under Ind AS released by 75 companies listed on National Stock Exchange (NSE) and included in NIFTY 50 and NIFTY NEXT 50 benchmark indices were evaluated.

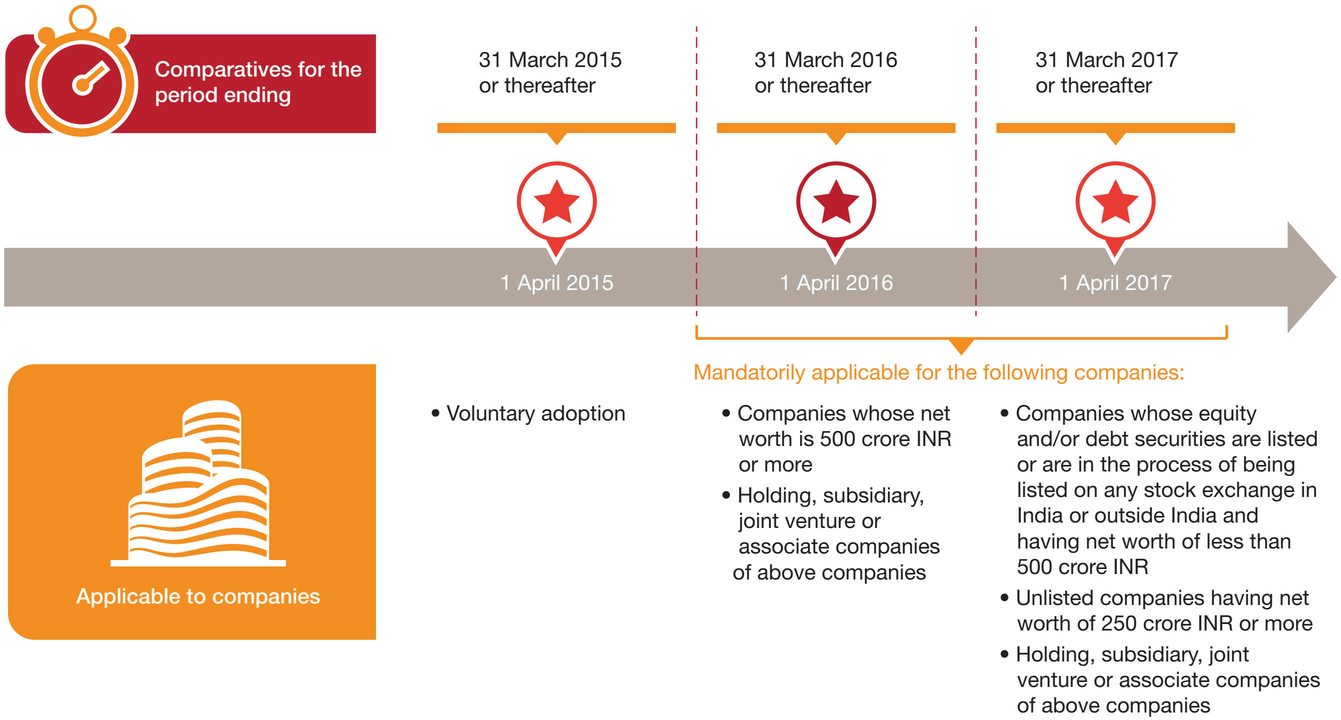
Substance and transparency

The adoption of Ind AS places India at the centre of high-quality and transparent financial reporting. The phase-wise adoption of Ind AS will ensure that more and more Indian businesses apply comprehensive accounting standards which can be consistently followed, and facilitate comparability across companies and jurisdictions.

At a conceptual level, Ind AS focuses on substance rather than legal form. Therefore, it is possible that in certain scenarios, existing legal form based accounting may need to transition to substance-driven accounting under Ind AS to reflect the underlying substance/business economics of the transaction. From a transparency perspective, with the higher level of disclosures in Ind AS, companies will be required to share more information on qualitative aspects.

TP has always placed emphasis upon 'substance over form' while benchmarking transactions. OECD's Base Erosion and Profit Shifting (BEPS) Action Plans 8-10 provide TP guidance on intangibles, allocation of risks and characterisation of transactions, with a view to ensuring that TP outcomes are aligned with value creation. BEPS Action Plan 13 aims to increase transparency by mandating additional disclosures through a three-tiered approach to documentation involving the Country-by-Country Reporting (CbCR), Master File and Local File.

Roadmap to Ind AS adoption



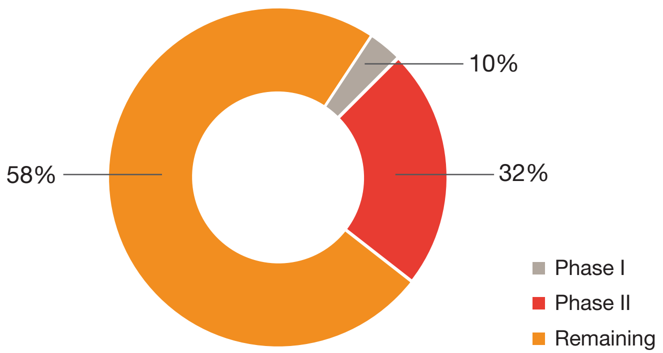
Source: PwC analysis

India's TP landscape has evolved significantly over the last 15 years and now broadly aligns with global best practices. The converging focus of Ind AS and TP on substance and transparency will ensure that allocation of profit outcomes between companies closely mirrors business and economic realities.

Key impact areas

Ind AS implementation in India will be undertaken in a phased manner. As per the database of 2017, out of the 10,459[2] companies (excluding insurance, banking and non-banking finance companies), approximately 10% will fall under Phase I and 32% companies will fall under Phase II.[3] The remaining 58% companies are presently not under Ind AS Phase I and Phase II transition.

Companies covered under Ind AS



PwC's Ind AS impact analysis report[4] revealed that a majority of Ind AS adjustments were on account of taxes, financial instruments and revenue recognition. Additionally, retirement benefit obligations, share-based payments, and business combination and consolidation were also identified to be common Ind AS adjustments.

[2] Latest financial data available for companies in ProwessIQ™ database updated as on 24 May 2017 (mostly companies reporting financial data for financial year (FY) 2015–16). The applicability of Ind AS may change when companies are extracted from a different version of the database.
[3] This count may not include all the holding, subsidiaries, joint ventures or associates of these companies.
[4] Released in September 2016, this report evaluated interim financial information released by 75 companies listed on NSE and included in the NIFTY50 and NIFTY NEXT 50 benchmark indices.

Key impact area	Revenue and expense accounting	Contractual arrangements	Financial transactions	Comparability analysis	CbCR	Other significant areas
TP perspective	The determination of whether an item of income or expense is operating or not has been the subject matter of significant TP litigation. The changes in accounting treatment pursuant to the adoption of Ind AS could lead to fresh questions on the issue. Companies will have to undertake a thorough analysis to assess whether the TP treatment of revenue/expense items as operating or non-operating will undergo a change from the TP perspective.	Ind AS seeks to align financial reporting with the underlying substance of a transaction. This may lead to certain arrangements being accounted for differently under Ind AS than before—for instance, the gross margin earned by a Stripped Risk Distributor (SRD) being accounted for as service income, an arrangement that conveys a right to use an asset in return for a series of payments (but which do not take the legal form of a lease) being accounted for as a lease, etc. The TP impact of such accounting changes needs to be evaluated in greater detail.	Ind AS has also prescribed re-characterising financial instruments such as redeemable preference shares, perpetual debentures, etc., in certain circumstances. Whether this will affect the TP analysis of contractual payouts (interest/dividends) on such instruments needs to be reviewed.	The implementation of Ind AS in a phased manner will result in inconsistent accounting standards being followed by various companies. Some companies will continue to follow Indian Generally Accepted Accounting Principles (IGAAP), while others will transition to Ind AS. This will pose significant practical challenges in undertaking comparability analysis.	CbCR provisions have been introduced in India with effect from FY 2016–17. Ind AS could have a twofold impact in this regard—(a) coverage of parties considered under CbCR and (b) CbCR reporting parameters.	Ind AS has made changes to the concept of control. Pursuant to this, how control should be construed under TP for the purpose of determining an associated enterprise relationship will need to be evaluated. Advance pricing agreements (APAs) are also likely to be impacted as Ind AS may impact the underlying TP methodologies and critical assumptions.

Revenue and expense accounting

Revenue is one of the most important financial statement measures for both preparers and users of financial statements. Currently, Accounting Standard 9, ‘Revenue recognition’, under IGAAP does not provide comprehensive guidance on certain aspects, resulting at times in a diversity of accounting practices. Ind AS 18, ‘Revenue’, provides comprehensive principles for recognising revenue, which will affect mostly all companies that apply Ind AS.

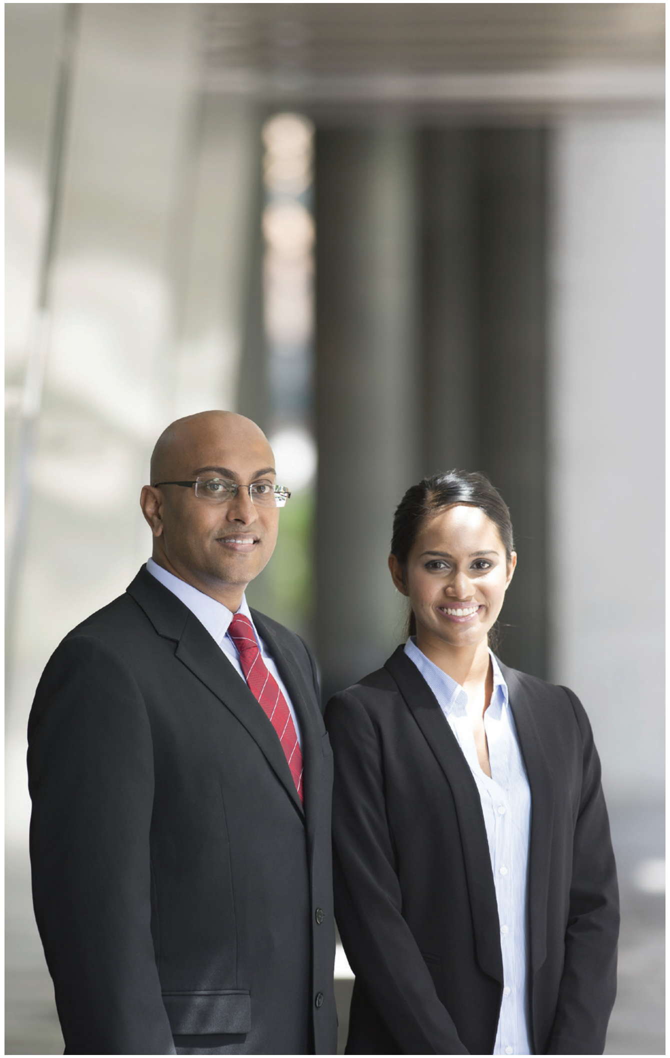
Some of the key differences in revenue accounting between IGAAP and Ind AS include multiple element arrangements, linked transactions, gross vs net presentation (excise duty, etc.), presentation of revenue net of discounts, volume rebates, incentives to customers, etc., treatment of financing benefits, extended warranties, etc. On the expense side, certain changes in Ind AS will result in reporting of higher expenses upon adoption of Ind AS. For example, the mandatory disclosure of excise duty in the cost will lead to an increase in the reported revenue of companies under Ind AS, since under IGAAP, excise duty was netted off against the revenue.

Further, unlike IGAAP, the Ind AS income statement is prepared under two parts—one is the component of the statement of profit and loss and the other is other comprehensive income (OCI). The components of OCI are items of income and expense (including reclassification adjustments) that are specifically required or permitted by other Ind AS to be included in OCI and are not recognised in profit and loss. Together, profit and loss and OCI make up the total comprehensive income.

Ind AS: Impact on revenue and expenses[5]

Major sectors impacted	The oil and gas sector had the highest increase in revenue on account of gross up due to excise duty presentation. Retail and consumer and automotive are the other two sectors which noticed an increase in revenue on gross up due to excise duty presentation.	The metals sector had the highest decrease in revenue, followed by the automotive and power and mining sectors.	By industry sector, the highest impact on net income was in metals, followed by the power and mining and capital projects and infrastructure sectors. Technology showed the highest net increase in reported income, followed by industrial manufacturing and pharmaceuticals, life sciences and healthcare.
Effect due to Ind AS	*Average increase of* ***3.9%*** *in revenue*	*Average decrease of* ***1.4%*** *in revenue*	*Average decrease of* ***0.6%*** *in net income*
Item of revenue and expense	Revenue gross up due to excise duty presentation	Decrease in revenue due to Ind AS adjustments (excluding the impact of revenue gross up due to excise duty presentation)	Actuarial gains and losses on retirement benefit obligation (on account of gains and losses being reclassified to OCI)

[5] PwC. (2016). PwC Ind AS impact analysis. Retrieved from http://www.pwc.in/assets/pdfs/publications/2016/pwc-ind-as-impact-analysis.pdf



Setting the TP context

Accurate measurement of operating profit (after analysing whether or not the various income and expense items are operating in nature) is fundamental to the application of profit-based TP methods such as the resale price method, transactional net margin method or the profit split method (PSM).

Operating expenses include costs incurred in relation to a transaction during the normal course of operations, including depreciation and amortisation expenses relating to the assets used, but do not include financial expenses, extraordinary expenses and loss on transfer of fixed assets. Likewise, operating revenue includes revenue earned during the normal course of operations but does not include income from financing activities, extraordinary income and gain on transfer of fixed assets.

For profit-based TP methods, reliance[6] is placed on profits as per accounting records. Profits computed as per the Income-tax Act, 1961 (IT Act) [including after application of the Income Computation and Disclosure Standards[7] (ICDS)], are typically not relevant from the TP perspective. However, the company needs to be cognisant of ICDS treatment of the key items where there are inconsistencies with the Ind AS treatment.

[6] This view has been upheld by tax courts and has also been endorsed in APAs.
[7] ICDS were issued with the aim of bringing uniformity in accounting policies governing computation of income in accordance with tax-related provisions and also of reducing the irregularities amongst them.

Items	Extended warranty on sales[8]	Financing benefits on sales[9]	Excise duty (gross vs net presentation)[10]	Discounts, volume rebates, sales incentives, etc.[11]	Interest-free security deposits[12]
Ind AS treatment	The income component relating to extended warranty will be deferred from the sales amount. The extended warranty income will be recognised proportionately over the period over which the services related to extended warranty will be rendered.	In an event where the credit period extends beyond a year, resulting in a significant lag between the time goods or services are provided/rendered and when consideration is received, the time value of money should also be taken into account. The deferred payments may indicate that there is both a sale and a financing arrangement. If there is a financing element involved, it may be necessary to discount the consideration to present value in order to arrive at fair value of consideration.	Sales are required to be presented on a gross basis, i.e. before deduction of excise duty, vis-à-vis on a net sales basis under IGAAP.	Cash discounts, volume rebates, sales incentives, etc., which earlier formed a part of the advertisement, marketing and promotion (AMP) expenses will now be netted off from sales and will not be separately reported in the statement of profit and loss.	Tenants will have to recognise a notional rent expense in respect of interest-free deposits placed with the owner, which will be offset by a notional interest income on the deposit.
Impact on determining operating profit for TP purposes	The treatment of extended warranty income for TP purposes will follow its treatment in Ind AS. In other words, to the extent that the extended warranty income is deferred for accounting purposes, it may impact the margin of the taxpayer in the initial years, but the impact may even out over the term of the contract.	While the income attributable to any extended credit period may under certain circumstances be recognised as interest under Ind AS, whether or not such income would be regarded as operating or non-operating for TP purposes needs to be evaluated based on the facts and circumstances of the case.	Where companies historically computed their margin percentage (profitability indicator) for TP analysis as a percentage of net sales, the margin percentage would undergo a change under Ind AS.	Operating profitability indicator with sales as the denominator will be affected. Ratios involving AMP expenses (e.g. AMP/sales) for TP analysis will also be impacted.	Since notional rent expenses and interest income are being recognised merely for better presentation of the economics of the transaction, ignoring both for TP analysis seems to be a better view.

[8] Ind AS 18
[9] Ind AS 18
[10] Ind AS 18
[11] Ind AS 18
[12] Ind AS 109

Impairment of intangibles[13]

Under Ind AS, indefinite life intangibles will only be tested for impairment annually and not amortised. Under IGAAP, there is no concept of indefinite life intangible and an intangible is amortised over the period of its life. However, if the useful life of the intangible is estimated to be more than 10 years, it has to be amortised as well as tested for impairment each year. Intangibles with a finite life will be amortised annually as per both Ind AS and IGAAP.

As impairment of indefinite period intangible assets is akin to a write-off, there may be an issue about whether it should be considered as operating or non-operating in nature based on the facts and circumstances of the case.

Share-based payments

Share-based payment arrangements (including employee stock ownership plans [ESOPs]) would need to be measured at fair value and recognised over the vesting period. This will also include awards granted by the parent company to the employees of its subsidiary. This will result in reporting higher expenses upon the adoption of Ind AS.

Expenses relating to share-based payments are akin to any other employee benefit expenses and would be treated as operating in nature. Captive companies which operate on full cost plus markup need to pay attention to such an increase in expenses under Ind AS.

Government grant[14]

Under Ind AS, grants such as sales tax exemption, which are embedded in the sale price, will be recognised separately as ‘other income’. Further, grants related to assets are presented as deferred income in the balance sheet. Non-monetary grants are required to be accounted for at fair value.

Whether such grants, when accounted for separately, will be treated as operating or non-operating for TP analysis will need to be evaluated based on the nature of the grant and the facts and circumstances of the case.

Re-measurement of defined benefit plans

Ind AS specifically requires actuarial-related re-measurements on provision of gratuity, etc., to be booked under OCI. These were earlier recorded as part of the employee benefit expenses in the statement of profit and loss under IGAAP.

The nature of the expense has not changed under Ind AS. Accordingly, this component of OCI may be considered as part of normal ‘employee benefit expenses’ and treated as operating in nature.

This also aligns with the treatment of this item for the purpose of computing book profit under the provisions of Minimum Alternate Tax (Section 115JB of the IT Act).

Other OCI components[15]

Ind AS mandates that these components be included as part of OCI and not be recognised in profit and loss.

A better view seems to be that revaluation, being notional in nature, will be considered as non-operating. Gain/loss from investments, being capital in nature, should also be considered as non-operating. This also aligns with the treatment of these items for the purpose of computing book profit under the provisions of Minimum Alternate Tax (Section 115JB of the IT Act).

[13] Ind AS 38
[14] Aimed at supporting certain regions or sectors—for example, sales tax exemption. Refer to Ind AS 20.
[15] Revaluation components relating to property, plant and equipment and intangible assets, b) gains/losses from investments, c) cumulative translation differences of foreign operations on consolidation

Ind AS has brought about certain significant changes in the recognition and presentation of various items in the financial statements. The concept of fair valuation is now extensively applied. These changes are in line with the global standards.

During the transition years, the change in the disclosure and accounting norms may have seemed overwhelming. However, the key to an appropriate analysis would be to adhere to the basic principles of TP. By analysing various parameters such as the underlying nexus of the income/expense with business operations and notional or cash income/expense, companies will have to undertake a thorough analysis to determine whether or not the change in revenue/expense accounting is operating in nature from the TP perspective.

Contractual arrangements

The focus of Ind AS on substance over form may lead to re-characterisation of certain contractual arrangements. Two illustrative situations where Ind AS may require the accounting of an arrangement to be based on the substance rather than the legal form of the arrangement are SRDs[16] and lease arrangements.[17] These situations have been analysed below from the TP perspective.

SRDs

Ind AS position

As per Ind AS, revenue includes only the gross inflows of economic benefits received or receivable by a company on its own account. In an agency relationship, the amounts collected from the customers on behalf of the principal are not in the nature of revenue. Instead, the revenue will be in the form of commission/service income for the performance of agency functions.

TP perspective

While the principles provided under Ind AS for certain companies to effectively record only service income (say commission) in the books has acceptability under TP, we have discussed below how this guidance may apply in the case of certain specific TP business models:

i. SRDs;

ii. Low-risk distributors;

iii. Contract manufacturers.

SRDs may not effectively bear normal risks of distribution such as inventory or credit risks, since such risks may have been contractually allocated to the principal company, or the relevant risks may not exist per se in the value chain (for instance, high sea sales where flash title is taken and given to other parties, or where goods are sold against letters of credit or full advance payments).

From the TP perspective, the return earned by such a company would typically be measured as a percentage of costs incurred to perform the agency functions, as opposed to a return on the volume of sales effected.

Similarly, in certain contract manufacturing arrangements, where the contract manufacturer assumes the title to inventory of raw material and finished goods but does not perform the related procurement or inventory management functions (which may be performed by an overseas principal), inventory risk may not be allocated to such a company in line with TP principles. Such a company may be rewarded with a return on the conversion costs incurred, plus an appropriate return on the working capital invested in the inventory.

The substance over form concept under Ind AS and the accounting treatment are therefore likely to support the functional characterisation for TP purposes.

However, it may be noted that low-risk distributors who actually assume risks associated with their own functions (however low such risks may be) should not be treated as akin to service providers for TP purposes, but should be benchmarked as distribution companies.

Companies should also consider the impact of the accounting treatment under Ind AS (SRDs accounted for as service providers or contract manufacturers accounted for as job workers) from the perspective of any agency permanent establishment exposure under applicable tax treaties.

[16] Ind AS 18
[17] Ind AS 17

Lease arrangements

Ind AS position

Arrangements which may not be 'leases' in legal form but in substance entail the granting of the 'right to use the underlying asset' may now get accounted for as leases, if the following tests are satisfied:

(a) Fulfilment of the arrangement is dependent on the use of the asset; and

(b) The arrangement conveys a right to use the asset.

For instance, it appears that certain types of long-term arrangements in the energy sector and outsourcing contracts for goods or services may potentially get accounted for as lease arrangements under Ind AS.

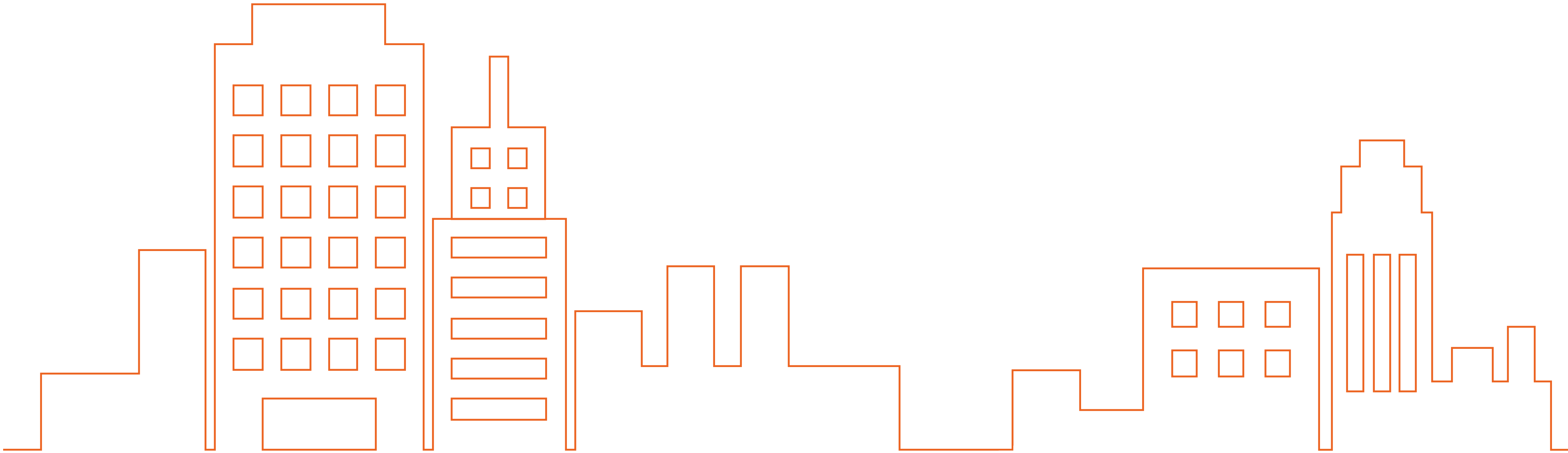
TP perspective

Applying the TP guidance under BEPS Action Plan 8-10, the ability to control the risk and financial capacity to assume the risk are the two conditions that determine which party to the contract assumes the risks and subsequently the rewards.

Companies should assess their long-term arrangements to determine whether they are likely to be accounted for as leases under Ind AS, and in such situations, the consequential impact on the functional characterisation and economic analysis undertaken from the TP perspective will need to be evaluated.

Companies should also consider the impact of the yet to be finalised ICDS on leases.

Re-characterisation of arrangements may have significant TP implications. One may need to revisit the legal form and substance of the arrangement to ascertain whether the correct pricing policy is being followed at the start of the year and aligned with the functions, assets and risk analysis. Given the BEPS Action Plans, alignment of such arrangements with substance is timely.



Financial instruments

Ind AS position

Under Ind AS, the classification of financial instruments as either debt or equity is based on the substance of the contractual arrangements underlying the instrument rather than their legal form. Financial instruments which may potentially get impacted, depending upon the facts and circumstances, are as under:

- A redeemable preference share, which is economically similar to a bond/debenture, could be accounted for as a liability rather than an equity even though, legally, it is a share of the issuer.
- A perpetual debenture or a compulsorily convertible debenture, which is economically similar to an equity share, based on facts and circumstances, may be accounted for as capital rather than liability.
- An analysis of the terms of each instrument in light of the detailed classification requirements is necessary, particularly as some financial instruments contain both liability and equity features. Such hybrid instruments—for example, optionally convertible bonds/debentures that are convertible into a fixed number of equity shares—are accounted for as separate liability and equity components.
- The treatment of interest, dividends, losses and gains in the income statement follows the classification of the related instrument.
- In the case of a loan from a parent to a subsidiary that pays interest at less than the market rate, under Ind AS, the parent has an accounting policy choice of whether to recognise the difference between the loan amount and fair value in the statement of profit and loss or to treat this as an addition to the investment in the subsidiary. Further, the issue of a guarantee by a parent for a loan taken by its group company will result in the parent recognising a financial liability and subsequent income amortisation under Ind AS vis-à-vis generally only a disclosure under IGAAP. The accounting treatment prescribed under Ind AS for loans and guarantees between parent and subsidiary will need to be reviewed from a TP perspective in cases where the parent does not charge an arm's length price for loans and guarantees, either as a quasi-equity/shareholder function.

TP perspective

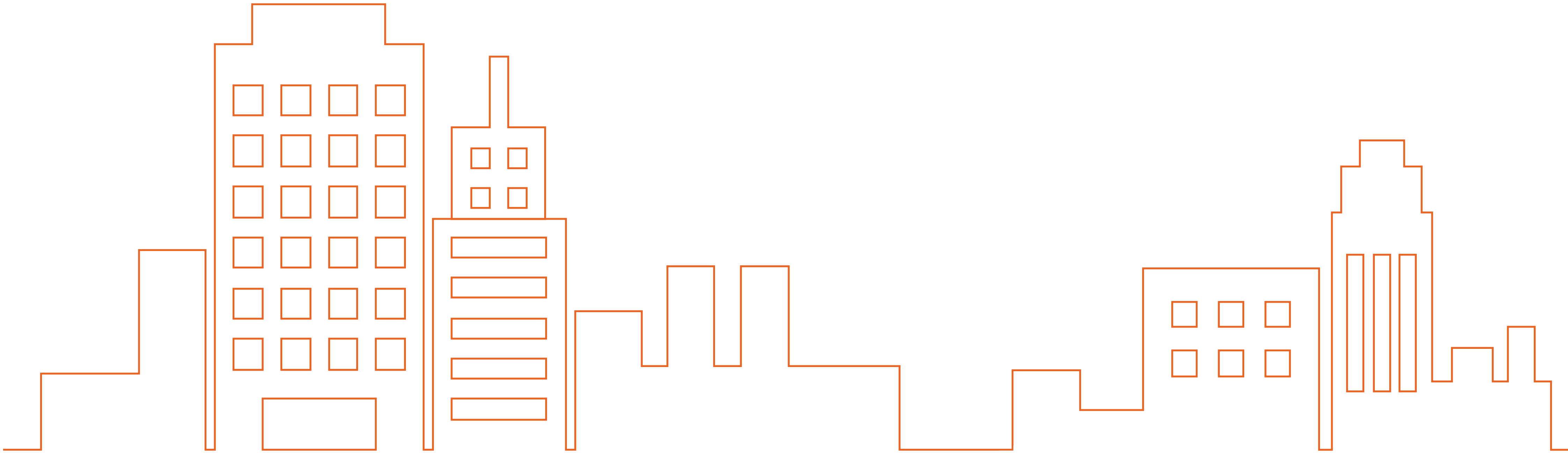
- The role of TP analysis is to determine the arm's length value of interest paid on a debt instrument taking into account the TP methods. Under the IT Act, the terms 'interest' and 'dividend' are explicitly defined[18] and do not lean on treatment for accounting purposes. For example, return on redeemable preference shares will be treated as dividend for tax purposes, which is a below the line item while computing taxable income. Also, return on perpetual debentures will qualify as interest for tax purposes. Accordingly, the TP analysis may be limited to benchmarking for an arm's length rate of interest.
- Whether recast of financial information under Ind AS (which impacts net worth, debt servicing ratios, provide better disclosures, etc.) will impact the underlying credit analysis for determining the arm's length rate of interest will depend upon the facts and circumstances of each case.
- Further, in the case of hybrid instruments such as optionally/convertible bond/debentures, the conversion option is typically valued and appropriately adjusted while computing the interest rate required to be benchmarked from the TP standpoint. Accordingly, alignment between TP and accounting at the time of undertaking such valuations will ensure a comprehensive arm's length analysis.

The General Anti-Avoidance Rules (GAAR) perspective

The GAAR are included in Chapter X-A of the IT Act and are in force from 1 April 2017. These provisions empower the Indian Revenue Authorities to declare an arrangement as an 'impermissible avoidance arrangement' if the main purpose of the arrangement is to obtain a 'tax benefit" and the arrangement lacks or is deemed to lack commercial substance. The fact that a financial instrument such as a compulsorily convertible debenture generates an interest deduction for tax purposes but is re-characterised as equity for Ind AS purposes will increase scrutiny around the commercial substance of such instruments under GAAR. Further, the quantum of debt and its impact on the adequacy of debt capital ratio could be questioned. Also, with the introduction of Section 94B in the IT Act, the deduction for interest paid to associated enterprises will be capped at 30% of EBITDA in a specified manner. Accordingly, these aspects will need to be considered as well.

TP is likely to lean on tax principles in characterising financial instruments as debt or equity. The commercial rationale for issuing such instruments will need to be documented, especially from a GAAR perspective.

[18] Section 2 of the IT Act



Comparability analysis

As mentioned in section 2 (Key impact areas, the implementation of Ind AS in India will be undertaken in a phased manner. This phase-wise implementation of Ind AS will result in inconsistent accounting policies being followed by various companies.

This inconsistency is likely to pose significant practical challenges in undertaking comparability analysis, especially to achieve a 'like-to-like' comparison. Different accounting policies followed by comparables with insufficient information to make comparability adjustments could become another litigation area in future TP audits. Further, additional/amended disclosures under Ind AS may provide relevant information about potential comparables, which may assist companies in undertaking a more refined economic analysis.

Phased implementation of Ind AS could result in an inconsistency in the accounting treatment between the company and the comparables. There is a practical difficulty in mapping the differences and making due adjustments for the same. The flexibility to use a wide range of prior year data for comparables as well as for the company could be one of the feasible options to neutralise the accounting differences. However, this would require an amendment to the IT Act by the government.

The table analyses aspects around economic analysis that will be impacted by Ind AS.

Area	Comparability analysis[19]
Impact of Ind AS	• While identifying comparables, one would rely on the financial statements of comparables for FY 2016–17 and the previous two years. Based on general experience, it has been observed that at the time of conducting contemporaneous search analysis, data for a majority of comparables is not available for the FY under consideration, i.e. 2016–17 in this case. Accordingly, for a majority of the comparables, only financial data with respect to FY 2015–16 and FY 2014–15 would be available and the same would be based on IGAAP. • Even if Ind AS compliant financial statements for certain comparables are available for FY 2016–17 (with FY 2015–16 comparative figures restated as per Ind AS), the financial statements of comparables for FY 2014–15 would be as per IGAAP. Thus, the financial data of comparables would be prepared under two different accounting standards for the three years to be considered for economic analysis. • Timing differences in accounting of expenses as required under Ind AS may distort the profitability as compared to the past. For example, Ind AS requires the general category of spares to be expensed out when they are 'ready to use' as opposed to IGAAP, which relies on the principle of 'put to use'.
TP perspective	• For companies applying Ind AS, where the available financials for most of the comparables are as per IGAAP, the companies may evaluate adjusting their Ind AS financial statements to IGAAP for FY 16–17 (reverse of the exercise done for FY 15–16) for TP testing purposes. This would be an additional burden on the company preparing financial statements under Ind AS. • Some of the differences between IGAAP and Ind AS are timing differences and could be neutralised by using multiple year data for comparability analysis. Though the regulations provide for use of prior two year data for the comparables, to achieve the above neutrality, the averaging period needs to be as wide as four to five years. The neutralising effect would be more pronounced going forward when more and more comparables are covered by Ind AS. Similarly, the financial data of the company for multiple years, as opposed to only the relevant year under consideration, needs to be considered. However, the above aspects would require specific amendments to the IT Act by the government. • Considering the materiality, quantum and impact of Ind AS on TP analysis, companies may also evaluate if a specific economic adjustment is warranted to address the accounting differences in the facts and circumstances of the case.

[19] FY 2016–17, the first year to see the TP impact of Ind AS, is considered as the relevant year for the purpose of explaining the implications.

Area	Segment reporting	Use of PSM	Cost-sharing agreements (CSA)	Additional disclosures
Impact of Ind AS	• Ind AS requires segmental information to be provided based on how the chief operating decision-maker (CODM) evaluates the financial information for the purposes of allocating resources and assessing performance. This would enable users of the financial statements to evaluate the nature and financial effects of the business activities and the economic environment through the eyes of management.	• The convergence of Ind AS with IFRS will result in global harmonisation of accounts. IFRS has gained wide acceptance in almost 140 countries across the globe.	• As discussed in the preceding sections, the manner of accounting revenues and expenses under Ind AS would undergo a change.	• Requirement relating to disclosure of non-financial items such as company's financial risk, management objectives and its policies • Disclosure of intangible assets with bifurcation of a) internally generated and b) acquired assets • Disclosure of significant judgments and assumptions for reporting of associates, joint ventures, subsidiaries and other companies in which there is control
TP perspective	• Segmentation of companies' operations for TP purposes may not always align with segmentation based on CODM parameters under Ind AS. For instance, CODM parameters may view the manufacturing and trading operations as one composite business vertical; however, from the TP perspective, it may sometimes be necessary to carve out segments along functional lines.	• Aligning the accounting treatment with global standards would facilitate the use of PSM on account of uniform accounting treatment. Though Ind AS is largely aligned with IFRS, treatment of OCI in computing profits to be split amongst group companies will require further evaluation. Unlike IFRS, which provides an option, Ind AS requires a separate disclosure for items forming part of OCI.	• Typically, in a CSA, the costs incurred are shared based on some pre-agreed allocation basis, namely revenue or costs or profit. Change in accounting, with a consequential impact on revenue or cost or profit base, would alter the cost-sharing ratio.	• This will help companies undertake a more robust analysis of potential comparables for comparability analysis. • Such a disclosure would indicate if companies are assuming the research and development function and related risks for generating intangibles. • Companies would have to assess the 'control test' under TP for identifying associated enterprises in the context of disclosures made under Ind AS (this aspect is discussed in detail in a subsequent section).

Country by country reporting

In accordance with BEPS Action Plan 13, Indian outbound groups are required to prepare and file/maintain CbCR and master files for FY 2016–17 by 30 November 2017. The CbCR requirement applies to Indian groups with a consolidated turnover exceeding 5,395 crore INR (approximately 750 million EUR) in FY 2015–16.

CbCR requires Indian groups to disclose financial and other information relating to their constituent entities. A company which is consolidated on a line-by-line basis with its parent company for the purpose of preparing consolidated financial statements will qualify as a constituent entity. Further, master files will also need to be prepared in respect of transactions undertaken with constituent entities.

The principles related to consolidated financial statements under Ind AS are set out in Ind AS 110, 'Consolidated financial statements'. Ind AS 110 has a single definition of control and lists the requirements for when a company needs to prepare consolidated financial statements, defines the principles of control and explains how to apply them.

Changes due to Ind AS will impact CbCR applicability as well as coverage of companies by impacting certain reporting parameters. These have been analysed below.

Impact on coverage

Area	Identification of subsidiaries—departure from the simple bright-line definition of control under IGAAP	Consolidation of joint ventures	Comparative Ind AS financials for FY 2015–16
Change due to Ind AS and the CbCR perspective	Generally, subsidiaries are consolidated on a line-by-line basis and, as such qualify as constituent entities. The evaluation of whether a company would qualify as a subsidiary or not is dependent upon the accounting standards. Under IGAAP, a parent company consolidates a company which it controls either through ownership of more than 50% voting power or composition of the governing board. Under Ind AS, while the above two factors play an important role in evaluation of control, there are other indicators which have to be considered. Ind AS provides a single mode of control, which in itself is very broad.[20] It requires the evaluation of power of one company over the other company, exposure to variable returns (positive or negative) and the ability to use the power to affect returns of that other company. Hence, the definition under Ind AS varies from the existing simple bright-line definition of control under IGAAP. Accordingly, more companies may qualify as subsidiaries under Ind AS and get consolidated on a line-by-line basis, thereby increasing the number of constituent entities to be reported under CbCR.	Under IGAAP, venture partners consolidate their share in joint ventures using a proportionate line-by-line consolidation. Accordingly, under IGAAP, joint ventures qualify as constituent entities and need to be reported in the CbCR and master file. Under Ind AS, joint ventures are consolidated using the equity method as opposed to proportionate line-by-line basis. Accordingly, under Ind AS, joint ventures would not qualify as constituent entities.	The Ind AS financial statements for FY 2016–17 will also disclose comparative numbers for FY 2015–16. The comparative financials for FY 2015–16 prepared using Ind AS will differ from the IGAAP financial statements prepared for the same period for various reasons discussed in earlier sections. For example, the consolidated revenue for FY 2015–16 under Ind AS may be lower than the 750 million EUR threshold limit prescribed for CbCR, whereas under IGAAP, the consolidated revenue for FY 2015–16 could be higher than the 750 million EUR threshold. This may be due to the shift in revenue recognition from 'gross' basis to 'net' basis. In such situations, one needs to evaluate whether Ind AS or IGAAP revenue will need to be considered for determining the applicability of CbCR

[20] Ind AS 110

Impact on reporting parameters

Area	Financial statements of overseas subsidiaries	Main business activity	Stated capital	Treatment of OCI
Change due to Ind AS and the CbCR perspective	An overseas subsidiary—an associate or joint venture of an Indian company—is not required to prepare its standalone financial statements as per Ind AS, and instead, may continue with its jurisdictional requirements. However, these companies will still have to report their Ind AS adjusted numbers for their Indian parent company to prepare consolidated Ind AS accounts. For the purpose of disclosing information in CbCR, Indian parent companies may use the Ind AS numbers provided by overseas subsidiaries. This will facilitate a reconciliation of the data reported in the CbCR with the audited consolidated Ind AS financial statements.	Ind AS requires segmental information to be provided based on how the CODM evaluates financial information for the purposes of allocating resources and assessing performance. This should be considered while reporting the main business activity conducted by the constituent entity in the CbCR.	For the purpose of reporting stated capital under CbCR, one would follow the treatment adopted for accounting purposes and not lean on tax for characterisation. For example, instruments such as perpetual debentures, which will be accounted for as equity under Ind AS, will form part of the stated capital despite their treatment as debt for tax purposes.	OCI will be presented as a separate section in a single statement of profit and loss and a question arises whether net profit before or after OCI should be considered for CbCR reporting purposes. One may have to evaluate each element under OCI to form a view about the operating or non-operating nature of the elements.

The coverage of CbCR will be expanded by Ind AS application of the control test used to identify subsidiaries and will be impacted by the use of the equity method for consolidating joint ventures. Reporting of various items in CbCR should be aligned with Ind AS after due analysis.

Coverage of related parties

Ind AS has made significant changes to the concept of control, helping to bring in certain new principles while evaluating the related party relationship between companies. To understand the interplay between Ind AS and TP, when it comes to ascertaining control, it is important to understand what these regulations have prescribed and their interplay for TP purposes.

Control test under Ind AS

Under Ind AS,[21] control exists and consolidation is required only if the investor possesses power over the investee, has exposure to variable returns from its involvement with the investee and has the ability to use its power over the investee to affect its returns.

The core principle is that a consolidated company presents a parent company and its subsidiaries as if they are a single economic company. Ind AS provides guidance on the following issues when determining who has control:

- Assessment of the purpose and design of an investee;
- Relevant activities and power to direct those activities;
- Nature of rights—whether they are substantive or merely protective in nature;
- Assessment of voting rights and potential voting rights;
- Whether an investor is a principal or an agent while exercising its controlling power;
- Relationship between investors and how they affect control;
- Existence of power over specified assets only.

Ind AS does not provide 'bright lines' and requires assessment of control on a continuous basis.

Control test under TP

The scope of associated enterprises for TP purposes is dependent upon two limbs:[22]

- The first limb treats de facto participation in control, capital and management of another company as triggering an associated enterprise relationship without mentioning any 'bright lines'.
- The second limb provides 'bright lines' in respect of what could be construed as participation in control, capital or management. It suggests 'bright lines' with reference to voting rights, the ability to elect members of the governing board, appoint executive directors, loans advanced, etc.

In determining the scope of 'associated enterprises', there has been a divergence in judicial views[23] on whether the first limb can operate independent of the second limb or whether the second limb restricts the scope of the first limb. A better view is that the situations provided in the second limb are exhaustive and restrict the scope of the first limb. The Memorandum to the Finance Bill, 2002, also supports the above view.

However, in case the first limb of the associated enterprises test under the IT Act is treated as independent of the second limb, the scope and coverage of companies qualifying as 'associated enterprises' under the IT Act would expand significantly. This has been explained with a few examples below.

[21] IInd AS 110
[22] As per Section 92A(1) and (2) of the IT Act
[23] Diageo India Pvt Ltd, Sanchez Capital Services Pvt Ltd, Kaybee Pvt Ltd, Hospira Healthcare India Pvt Ltd, Orchid Pharma Ltd, Page Industries Ltd.

Example A: De facto control

Company A holds 25% of the voting rights of company B; the remaining 75% of voting rights of company B are widely held by thousands of shareholders (none of whom hold more than 5% of the voting rights).

Under Ind AS, company A may have control over company B because company A has a dominant voting interest (based on the absolute size of its holding, and relative to other shareholders) and a large number of shareholders would have to agree to outvote company A.

While determining whether an investor has de facto control over an investee, it must also consider all the relevant facts and circumstances.

Under TP, if one interprets the first limb to operate independent of the second limb, company A and B would qualify as associated enterprises. However, if one restricts the scope of the first limb to situations illustrated in the second limb, company A and B would not qualify as associated enterprises.

Example B: Potential voting rights, options and convertible instruments

Ind AS requires a reporting company to assess whether its power to obtain voting rights achieved from holding options or convertible instruments gives it the power to direct the activities of another company. For example, an option or conversion agreement with potential voting rights may give the reporting company particular rights relating to strategic operating and financial policies. There are no barriers that prevent the reporting company from exercising such an option and thus, this option may be considered as being substantive in determining control. If these potential voting rights enable the reporting company to have the power to direct the activities of the company, it will need to consolidate the other company (i.e. the company that has issued such options and convertible instruments).

Similar to example A, under TP, potential voting rights are not considered in applying the tests under the second limb. However, this may undergo a change if the first limb is sought to be applied independently.

The concept of control under Ind AS will require qualitative judgements because of the lack of 'bright lines'. Making a judgement in this area will require inputs from internal stakeholders such as the management, operations and legal teams as well as external stakeholders such as the audit committee and statutory auditors. The interplay of this concept with TP should be carefully considered by companies to determine the coverage of related parties and undertake necessary TP compliances under the IT Act.

Advance pricing agreements

The APA programme was introduced by the Indian Government in 2012 to help companies avoid litigation associated with TP issues and get upfront certainty. Subsequently, with the introduction of roll-back provisions, companies can achieve certainty for up to nine years under an APA. In 2017, India's APA programme completed five years and has been very successfully giving companies upfront certainty on largely routine transactions.[24]

With the phased adoption of Ind AS, past years covered by an APA (including roll-back years) will fall under IGAAP and future years, under Ind AS. The differences between Ind AS and IGAAP may impact APA positions and underlying critical assumptions, as illustrated below.

Operating expenses and operating revenue

A company's TP policy and intercompany agreements typically provide that operating expenses and revenues be based on financial statements prepared based on 'prevailing accounting standards'. This may also cover inclusion or exclusion of specific items based on the group's TP policy or negotiations between related parties. APAs may have been filed or concluded to get upfront certainty on the same. Adoption of Ind AS is likely to impact the revenue and expense items, as discussed in section on revenue and expense accounting.

Companies would accordingly need to analyse the impact applicable to different years covered by APAs. For example, under Ind AS, in case of upfront agreed credit terms extending beyond a year, the company will have to recognise revenue by splitting the sale consideration into sale of goods and interest income. Such accounting treatment may result in the reduction of operating income on account of the interest income being considered as non-operating income. Companies should carefully examine the degree of impact of such accounting treatment on their TP analysis and seek clarity from the APA authorities.

Critical assumptions

APAs are valid subject to the satisfaction of critical assumptions. These assumptions are business and economic criteria that form the basis of a company's proposed TP methodology. One of the standard critical assumptions that is often included in APAs is that *'financial accounting methods shall remain materially the same as described in a company's request for this APA'*.

Companies should evaluate the impact of Ind AS across the areas discussed in detail in the earlier sections and evaluate whether they are likely to face challenges in satisfying critical assumptions or any changes are necessitated to APAs on account of the impact. For example, an SRD may have agreed to an assured return on sales as the APA methodology. On account of the re-characterisation discussed in the earlier section, the company would not be in a position to implement the APA methodology and may need to revise its APA appropriately.

Secondary adjustments[25]

Secondary adjustment requires TP adjustments arising in specific circumstances (such as APA, safe harbor provisions and mutual agreement procedures) to be recorded in the books of account. From an Ind AS perspective, one would need to assess whether such secondary adjustment is a result of omission/error or other factors, such as difference in interpretation of law. In the event that the secondary adjustment arises on account of omission/error, financial statements for the relevant year may be restated to record such an error/omission.

From a TP perspective, one may need to evaluate whether the secondary adjustment is a consequence of omission/error or other factors, such as difference in interpretation of law.

[24] As per the CBDT press release dated 31 March 2017, 800+ applications were filed, with 141 unilateral and 11 bilateral APAs signed till 31 March 2017.
[25] Section 92CE was introduced in the IT Act by the Finance Act, 2017.

Companies need to review their TP policy, intercompany agreements and APA filings or APA agreement (in case of concluded APAs) to determine the impact of the various changes discussed in earlier sections. Immediate steps to revise an APA (as permitted by Rule 10Q of the Income-tax Rules, 1962) may need to be taken after considering the facts and circumstances of the case. Separately, for APAs which are pending conclusion, companies should review whether the financial projections submitted during the APA discussions are aligned to Ind AS adoption.

Call to action

To conclude, Ind AS will have a significant impact which will need adequate consideration from the TP perspective. Companies need to consider action in various areas to address the impact of adopting Ind AS on TP and align substance and transparency across tax and accounting.

TP policies

- Do existing TP policies need to be revised?
- Do intercompany agreements reflect the actual allocation of functions and risks or do they need to be updated?

TP documentation

- How does the convergence of related parties for TP interplay with the new control test under Ind AS?
- Do the master files and local files reflect the actual allocation of functions, assets and risks aligned with Ind AS?
- Do enhanced disclosures in Ind AS need consideration in the master file?
- Does the economic analysis need to be updated to incorporate changes on account of Ind AS?

Dispute resolution and APA

- What will the impact of additional disclosures and accounting treatments under Ind AS on key positions adopted during TP audits/ litigations be?
- Do we need to revisit critical assumptions under APAs?

Interplay with other tax areas

- How will Ind AS accounting interplay with ICDS?
- How will enhanced disclosures under Ind AS interplay with substance requirements under GAAR?

Notes

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The phase-wise adoption of Ind AS has created multiple challenges for companies, including on transfer pricing aspects. I would like to thank **Kunj Vaidya, National Leader, Transfer Pricing (+91 996 209 5555)**, and **Darpan Mehta, Partner, Transfer Pricing (+91 976 924 9148) at Price Waterhouse & Co LLP** for providing their technical inputs on this white paper which will help companies proactively address their issues related to transfer pricing.

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