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PwC Ind AS Outlook Survey

www.pwc.in

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. On 16 February 2015, the Ministry of Corporate Affairs (MCA) notified the roadmap for Indian Accounting Standards (Ind AS) implementation. Ind AS are substantially converged with IFRS.

The adoption of Ind AS beginning 1 April 2016 is likely to have a significant impact on the financial statements of Indian companies, since Ind AS are relatively more prescriptive and elaborate in many areas compared to the current Indian generally accepted accounting principles (Indian GAAP). The extent of impact can vary across industries such as IT services/technology, pharmaceuticals, infrastructure and telecom.

Further, accounting for mergers and acquisitions, consolidation, share-based payments, financial instruments, revenue recognition, taxes and fair value are some of the topics that are likely to pose interpretation and implementation challenges under Ind AS.

The need for evaluating the impact of Ind AS and preparing for its adoption goes beyond financial reporting, requiring significant organisational changes. Therefore, it is not surprising that Ind AS is the most widely discussed topic across the boardrooms of corporate India today.

In the midst of this critical change, we sought to gather companies' views on the transition, benefits, challenges and preparedness to implement Ind AS. To accomplish this, we conducted a survey of finance executives and other stakeholders.

This report summarises the survey findings and aims to provide insights to companies in gauging the key implications of Ind AS implementation. This will be particularly helpful to Phase II companies, who will be preparing for Ind AS adoption beginning 1 April 2017.

We would like to thank all our participants who contributed to this survey.

We hope you find this publication informative and help us remain connected with you in a meaningful way.

For a variety of additional resources offering more in-depth perspectives on the timing, impact and other aspects of Ind AS, please visit our website at www.pwc.in

Ind AS: Convergence with IFRS

Soon after the long-awaited roadmap for implementing Ind AS was announced in January 2015, the Ministry of Corporate Affairs (MCA) notified its phase-wise roadmap for its adoption. The MCA then issued a notification on 16 February 2015, announcing the Companies (Indian Accounting Standards) Rules, 2015, for the application of Ind AS.

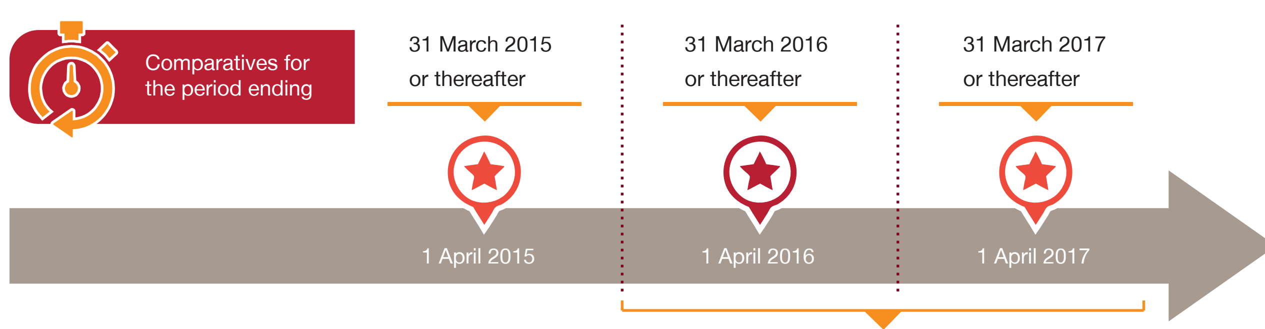
The application of Ind AS is based on the listing status and net worth of a company. Ind AS will first apply to companies with a net worth equal to or exceeding 500 crore INR beginning 1 April 2016. This will require comparative Ind AS information for the period of 1 April 2015 to 31 March 2016.

Listed companies as well as others with a net worth equal to or exceeding 250 crore INR will follow these new accounting norms from 1 April 2017 onwards.

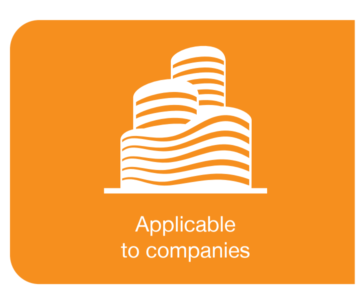
It is important to note that Ind AS will also apply to subsidiaries, joint ventures (JVs), associates as well as holding companies of the entities covered in the roadmap. Ind AS apply to both consolidated and stand-alone financial statements.

The notification clarifies that the option to prepare financial statements as per IFRS issued by the International Accounting Standards Board (IASB) is not available.

Roadmap to Ind AS adoption



Mandatorily applicable for the following companies



1 April 2015:
- Voluntary adoption

1 April 2016:
- Companies whose net worth is 500 crore INR or more
- Holding, subsidiary, joint venture or associate companies of above companies

1 April 2017:
- Companies whose equity and/or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India and having net worth of less than 500 crore INR
- Unlisted companies having net worth of 250 crore INR or more
- Holding, subsidiary, joint venture or associate companies of above companies

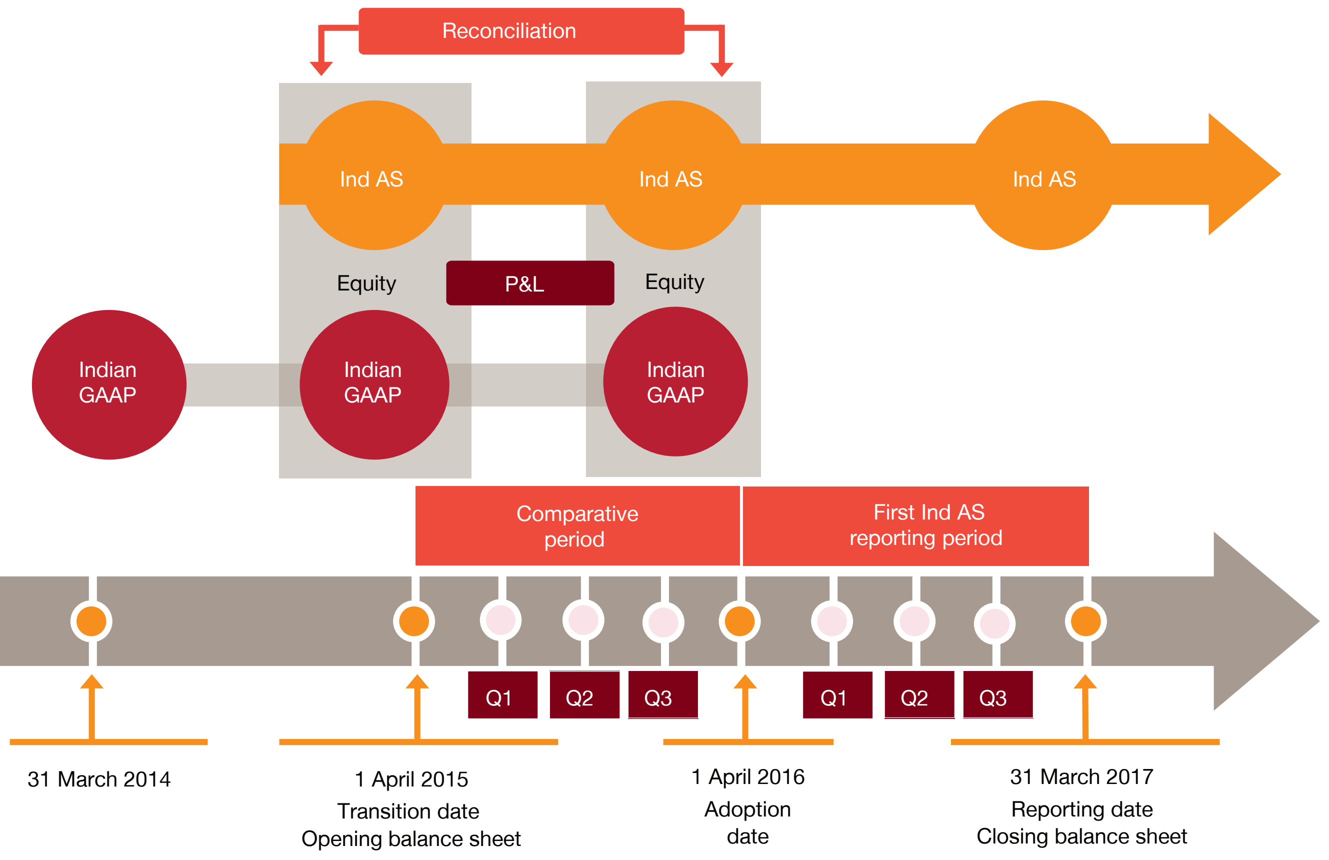
What this means for you

Companies will have to follow a step-by-step approach for a smooth transition to Ind AS.

The impact of Ind AS adoption cascades beyond accounting. For example, implementing Ind AS is likely to impact key performance metrics, thus requiring thoughtful communication with the board of directors, shareholders and other stakeholders. Internally, Ind AS implementation can have a wide-ranging impact on a company's budgeting and reporting processes, IT systems, internal control systems, income taxes and contractual arrangements. Other areas to focus on include credit rating, compliance with debt covenants, dividend distribution, employee KPI and incentive programmes, and managerial remuneration.

Successful Ind AS implementation requires a thorough strategic assessment, a robust step-by-step plan, alignment of resources and training, effective project management as well as smooth integration of the various changes into the company's normal business operations.

Finally, the Ind AS implementation exercise needs to establish sustainable processes to continue to produce meaningful information long after the conversion exercise is completed. At the end, it is important that all changes brought by Ind AS adoption are embedded into the company's processes and systems. The goal should be to embrace the transformation and achieve a stage of 'business as usual' for the company.



Examining the implications

When businesses were simple and transactions were local, accounting standards were simple and local GAAP was sufficient. Today, businesses have become complex and a globalised world needs comprehensive accounting standards that can be consistently applied and facilitate comparability across companies and jurisdictions. Ind AS are not just good to have but the need of the hour for India in an interconnected world.

The adoption of Ind AS requires the retroactive restatement of certain historical period information presented within a company's first set of Ind AS-based financial statements. These restated periods will show a variety of changes to a company's key metrics, including reported top line, bottom line, financial position and net worth.

At a very fundamental level, Ind AS focusses on substance rather than legal form, and the risks and rewards of the underlying transactions. This potentially breaks away from the existing legal structure-based accounting to more substance-driven accounting. The adoption of Ind AS is also expected to result in accounting which more closely reflects the underlying business rationale and true economics of transactions.

In general, we believe more entities will be consolidated under Ind AS, as a parent would consolidate based on control over the investee having exposure or rights to variable returns from its involvement and not based on the existing simple bright line definition of control under Indian GAAP. This difference could have a fundamental impact on financial statements as a whole.

The conclusion as to whether a financial instrument is accounted for as debt or equity can vary significantly under the two frameworks. Also, certain hybrid financing instruments will need to be split into their debt and equity components. Upon adoption of Ind AS, these differences can have a profound effect on a company's capitalisation profile, reported earnings, net worth and debt covenants.

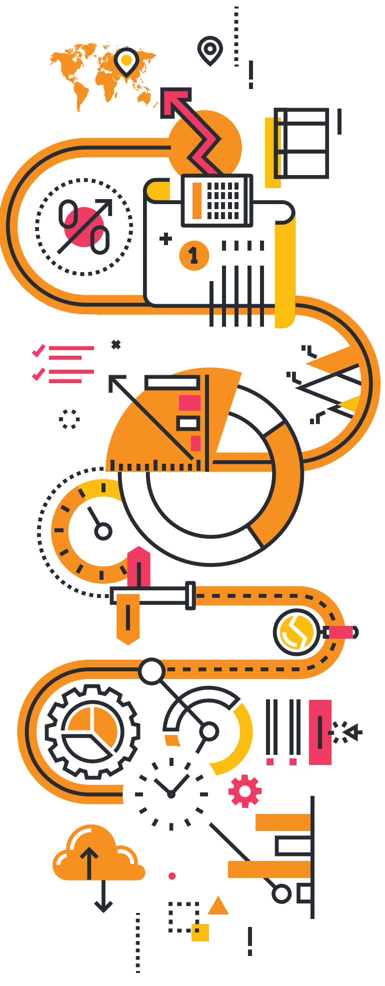
There is certainly a push towards the increased use of fair value-driven accounting under Ind AS. This will in turn require the adoption of appropriate accounting policies or else volatility could increase. The whole gamut of financial instruments comprising accounting for financial assets and liabilities will require a closer look with renewed vigour.

Accounting for revenue recognition, including multiple elements within an arrangement and mergers/business acquisitions, will not be the same going forward.

It is important to note that all of these differences can have a significant impact on a company's current and deferred tax positions, including minimum alternate tax (MAT) liabilities where applicable.

Finally, the quantum of disclosures will increase multifold. This will surely allow companies to tell their story to investors and also provide more meaningful information for informed users of financial information. However, companies will have to invest time and effort into preparing for the extensive data requirements and disclosures. They will have to start discussing significant judgments and estimates in more detail, including what goes behind the reported numbers.

The adoption of Ind AS puts India at the centre stage of high quality and transparent financial reporting; however, it also poses unique challenges. India will be adopting one of the most important accounting standards earlier than rest of the world. Globally, IFRS 9 Financial Instruments has a mandatory implementation date of 1 January 2018, while India will be adopting this standard effective 1 April 2015. The benefits will be a stable platform as India will not have to change accounting policies again for a few years in this important area. It will, however, not be able to learn from the experiences of countries that adopt these standards later. Nevertheless, we believe that the benefits outweigh potential challenges.

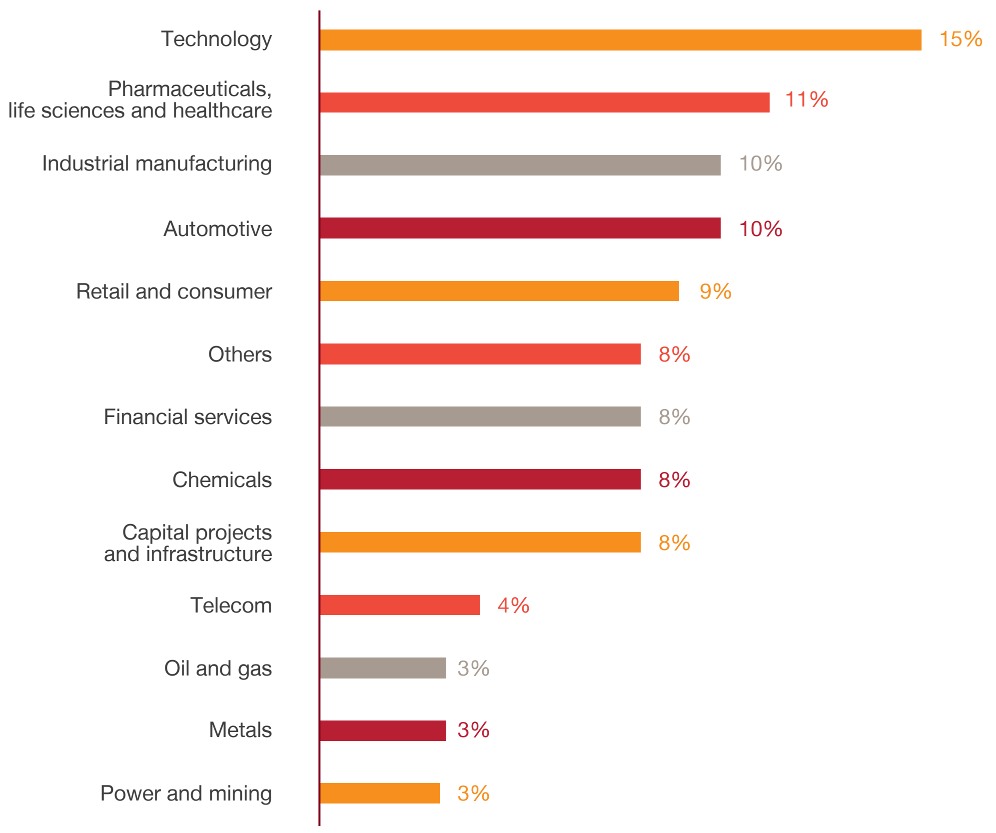


About the survey

During approximately three weeks starting 4 January 2016, PwC's Ind AS Outlook Survey gathered responses from more than 100 respondents across a variety of industry sectors and size of companies. The profile of survey respondents by industry sector is summarised below:

A majority (63%) of the respondents were covered under mandatory Phase I adoption of Ind AS, of which 61% were listed companies.

Further, 18% of the respondents were covered under mandatory Phase II adoption of Ind AS, of which 83% were unlisted companies.



Survey results

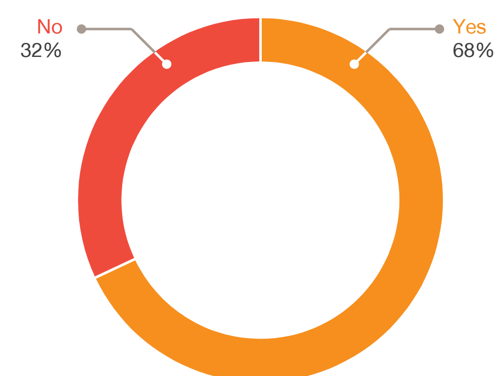
Do you believe the roadmap provided adequate time for the transition to Ind AS?

We began by asking the respondents if they believed that adequate time had been provided for the transition to Ind AS. A majority (68%) of the respondents answered in the affirmative. ***This is a positive result!***

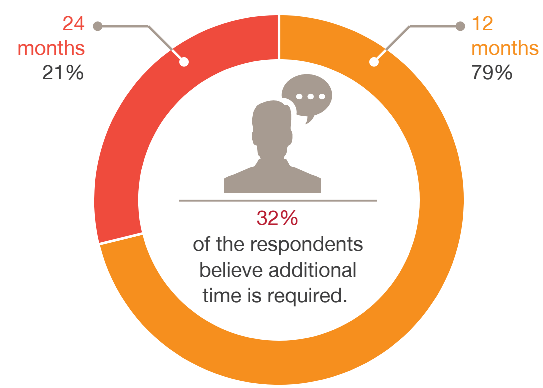
However, 32% of the respondents continue to believe that more time is required to transition to Ind AS. Of this group, 61% are covered under Phase I. Moreover, 85% of such Phase I respondents believe that an additional period of 12 months would be adequate to transition to Ind AS.

Ind AS is considerably different from the current Indian GAAP. For example, accounting for JVs, business combinations, income taxes, consolidation, financial instruments, revenue recognition, etc., are some of the areas that are likely to pose interpretation and implementation challenges. Therefore, it is not surprising that a fairly large population of companies still believes that more time is required to transition to Ind AS.

Do you believe the roadmap provided adequate time for the transition to Ind AS?



How much additional time is required to transition to Ind AS?



68% of the respondents believe that adequate time has been provided for the transition.

Convergence and carve-outs

India has chosen the path of IFRS convergence and not adoption. Although Ind AS has come a long way and is now quite close to IFRS, certain differences remain. We term these differences ***carve-outs or carve-ins***. A high-level snapshot of such differences between Ind AS and IFRS is provided below.

Presentation

Under Ind AS, the breach of a material provision of a long-term loan will be classified as current except where the lender had agreed not to demand payment as a consequence of the breach before the approval of the financial statement for issue. A similar exemption is unavailable in IFRS. Consequently, adjusting events under Ind AS 10 has been modified to include events where the lender has agreed not to demand payment as a result of the breach of a material provision of a long-term loan before the approval of the financial statement for issue. This is not in line with IFRS but accords with US GAAP.

The option to present other comprehensive income in a separate statement is not available under Ind AS. Accordingly, only one statement comprising both profit or loss and other comprehensive income will be presented. The single statement approach requires all items of income and expense to be recognised in the statement of comprehensive income, while the two-statement approach requires two statements to be prepared, one displaying components of profit or loss (separate income statement) and the other beginning with profit or loss and displaying components of other comprehensive income. IFRS provides an option to follow either the single-statement approach or the two-statement approach.

Ind AS also does not allow the presentation of expenses by function; only the classification of expense by 'nature' is permitted. Under IFRS, this is a policy election.

IFRS allows the option of presenting inflows and outflows of interest and dividends in the operating activities section of the cash flow statement. Ind AS does not have this option for non-financial entities. Interest and divided inflows and outflows are required to be reported in the investing and financing sections of the cash flow statement respectively.

Under IFRS, earnings per share (EPS) is not required in separate financial statements if both consolidated and separate financial statements are presented. Under Ind AS, the disclosure of EPS is required in both consolidated as well as separate financial statements.

Acquisitions

Under IFRS, bargain purchase gain or negative goodwill arising on business combinations is recognised in profit or loss. Under Ind AS, the bargain purchase gain can be recognised either in other comprehensive income (subject to certain conditions) or capital reserve but not in profit or loss. Similar to the case of business combination, bargain purchase gain on the acquisition of an associate is also not recognised in profit or loss.

Under Ind AS, common control transactions are to be accounted only on the basis of the book values of assets and liabilities transferred.

Leases

Under Ind AS, where the escalation of operating lease rentals is in line with the expected general inflation to compensate the lessor for expected inflationary cost, companies have an option of not recognising rentals as an expense on a straight-line basis (based on the exposure draft). Under IFRS, rent expense is recognised on a straight-line basis over the lease term unless it is linked to an index and considered as contingent rent.

Derivatives

Ind AS introduces an exception to the IFRS definition of a 'financial liability'. Ind AS classifies a conversion option embedded in a convertible bond denominated in a foreign currency as an equity instrument if it entitles the holder to acquire a fixed number of the entity's own equity instruments for a fixed amount of cash, and the exercise price is fixed in any currency. This is not provided in IFRS. Therefore, the embedded conversion option will not be required to be fair valued at each balance sheet date under Ind AS. Under IFRS, this conversion option is treated as a derivative liability and is to be fair valued at each reporting period. This is one of the most significant differences between Ind AS and IFRS.

Property, plant and equipment

Ind AS 101 provides an option to use previous GAAP, i.e. Indian GAAP carrying values at the date of transition for all its property, plant and equipment, investment properties, and intangible assets. The carrying amount for these assets on the date of transition becomes their deemed cost. This fact and accounting policy adopted shall be disclosed by the entity until such time that those items of property, plant and equipment, investment properties, or intangible assets, as the case may be, are significantly depreciated, impaired or derecognised from the entity's balance sheet. Companies may also decide to fair value these assets at the transition date or recompute as per Ind AS. The previous GAAP option is not available under IFRS, which is another significant carve-out in Ind AS.

Government grants

IFRS gives an option to measure non-monetary government grants related to assets (tangible and intangible) either at their fair value or at nominal value. Ind AS requires the measurement of such grants only at their fair value.

IFRS gives an option to present the grants related to assets either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset. Ind AS requires the presentation of such grants in the balance sheet as deferred income.

Related parties

Under IFRS, certain relationships are specifically mentioned and considered to meet the definition of close members of the family of a person. These relationships are expanded in Ind AS to include the brother, sister, father and mother of a person.

Under Ind AS, the related-party disclosures do not apply where providing such disclosures will conflict with the entity's duties of confidentiality provided under a statute or by a regulator or similar competent authority. IFRS does not provide such an exemption.

Associates

When it is impracticable, Ind AS 28 allows the exemption from use of uniform accounting policies to perform equity method accounting of associates. IFRS does not allow this option.

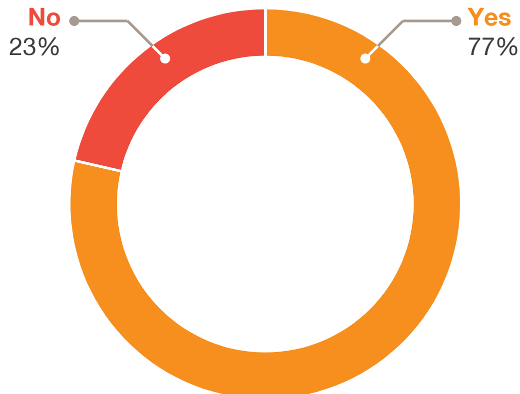
Others

Under IFRS, standards on segment information and EPS are applicable to only those companies which are listed or are in the process of being listed. Ind AS does not provide any such exemption for the applicability of standards. In the absence of any exemption under the Companies Act, 2013, and the rules made thereunder, all companies applying Ind AS will have to apply standards on segment information and EPS.

Companies will need to carefully evaluate the Ind AS transition provisions and accounting policy elections in case they wish to bring their Ind AS financial information closer to IFRS. This may be more important for those entities planning international fundraising or listing, as they may require IFRS-compliant financial statements for that purpose.

Do you believe companies in India should be given an option to adopt IFRS as issued by IASB?

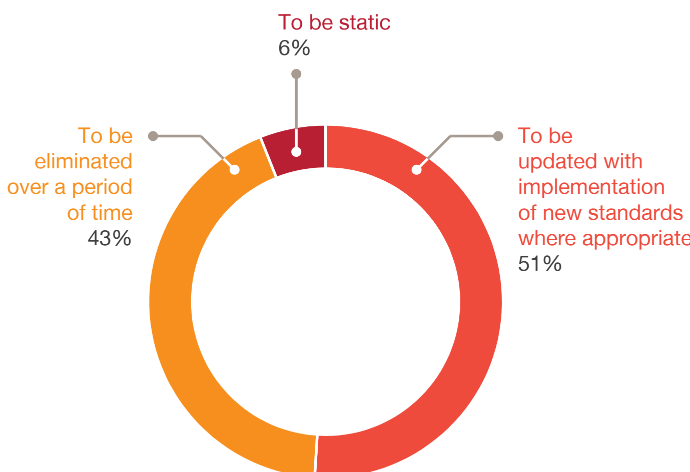
We asked respondents whether India should be given an option to adopt IFRS as issued by IASB. The response was largely favourable: 77% of the respondents continue to believe that the IFRS as issued by the IASB are a viable method for adoption. Regulators and standard setters in India may want to take note of this.



77% of the respondents continue to believe that the IFRS as issued by the IASB are a viable method for adoption.

When the respondents were asked if they would prefer the carve-outs provided under Ind AS, 51% of those surveyed believe carve-outs should be updated with the implementation of new standards and 43%, that carve-outs should be eliminated over a period of time.

Do you prefer the carve-outs provided under Ind AS?

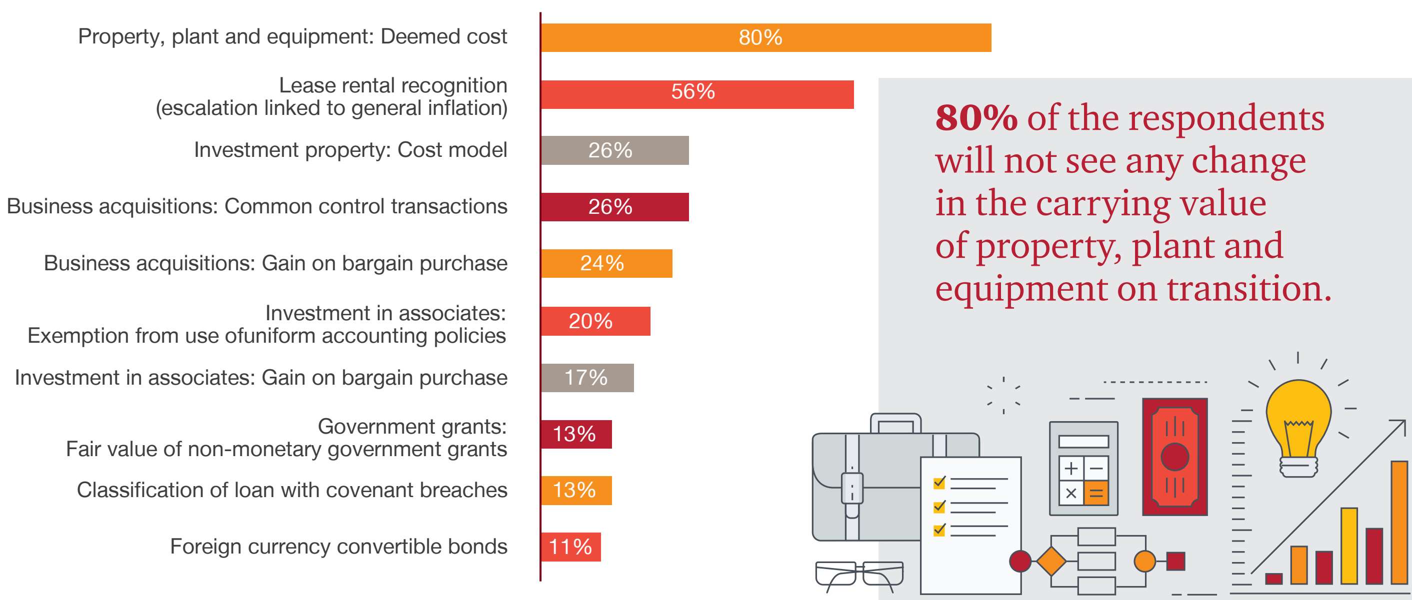


The opinion appears to be divided regarding updation of carve-outs vis-a-vis its elimination over a period of time.

We believe that having many carve-outs reduces the acceptability and comparability of financial statements globally and therefore it is important for the standard setters to consider either reducing the carve-outs over a period of time or eliminating them. From the survey, the opinion appears to be divided on this point.

When we asked the respondents which of the following carve-outs are applicable to/have been applied by them, 80% selected deemed cost exemption under property, plant and equipment, and 56% selected lease rental recognition. This is an interesting observation as both of these are optional carve-outs where companies have an option to be closer to IFRS, if they wish to. This survey also reveals that the other three mandatory carve-outs—i.e. gain on bargain purchase, foreign currency convertible bonds and classification of loans with breach of covenants—are not so widely applicable.

Which of the following carve-outs are applicable to you/have been applied by you?



Benefits and challenges of Ind AS

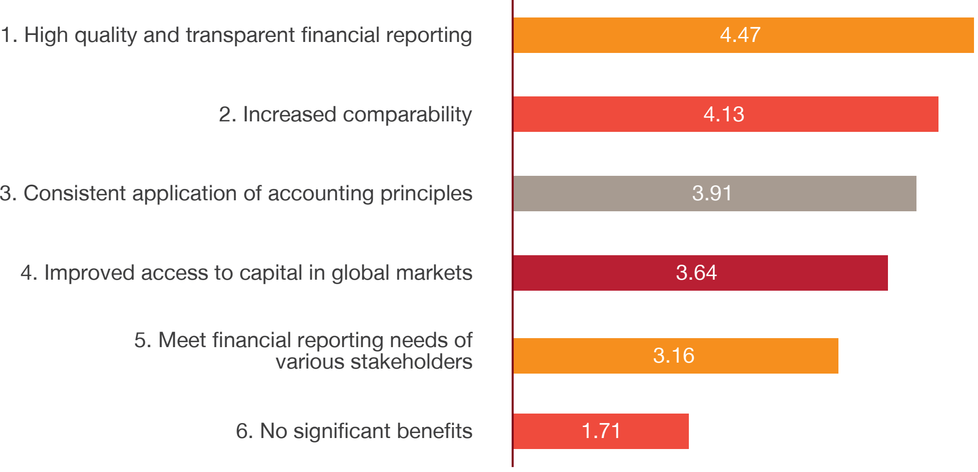
Benefits of Ind AS

The adoption of Ind AS offers various perceived benefits, and we wanted to know which ones stand out the most for companies. The respondents were able to select multiple areas, and in summary, 79% identified one or more benefits to the adoption of Ind AS. The most prevalent of these benefits was high quality and transparent financial reporting and increase in the comparability of business results.

We agree that this is a significant plus for many companies. However, we believe that the consistency of application of accounting principles is critical to ensure that real comparability can be achieved. We also note that comparability is linked to a second benefit, i.e. improved access to capital in global markets.

High quality and transparent financial reporting and increase in the comparability of business results are the top two important benefits of Ind AS adoption.

Which of the following do you perceive as potential benefits of incorporating Ind AS in India?



Weighted average rating based on a scale of 1-6

The respondents also believe that the adoption of Ind AS will meet the financial reporting needs of various stakeholders. Once the convergence is complete, for example, a company that operates in different sectors or territories will see a significant benefit, with fewer differences in financial information from various global companies.

Finally, relevant and improved disclosures will bring clarity and linkage across various elements of a company's management discussion and analysis.

Challenges of Ind AS

We could not ask about only the benefits and not inquire about the respondents' thoughts on the challenges associated with transitioning to Ind AS. A majority (82%) of the respondents believe that this move will give rise to major challenges. When asked about the problems they foresee, the top concerns were education and training, changes to IT systems and internal control over financial reporting.

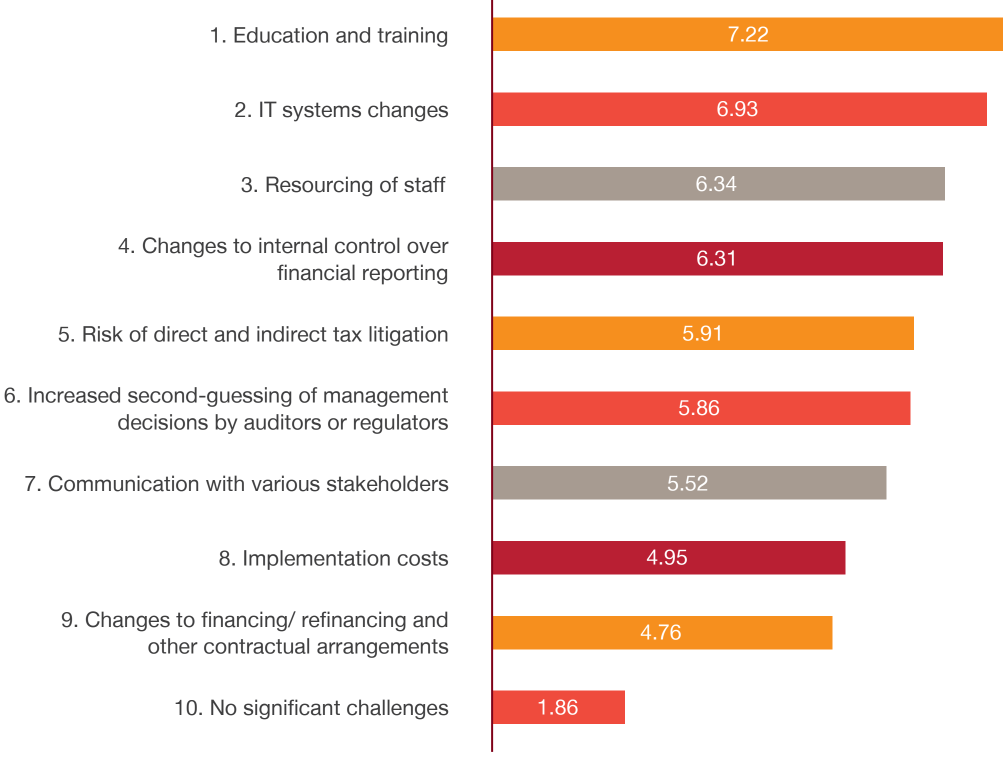
The respondents also believe identifying the level of resources required for the conversion is a challenge, as companies will need to either hire new staff, outsource or retrain current employees. Concerns about increase in second-guessing of management decisions by auditors or regulators, risk of direct and indirect tax litigation and communication with various stakeholders were also noted. Such a response is not surprising considering the significant use of estimates, judgements and fair value under Ind AS.

Implementation costs are likely to be significant, as the transition to Ind AS will impact the entire business, beyond accounting and financial reporting. Companies will need to evaluate carefully whether their IT systems can handle the new measurement and disclosure requirements under Ind AS. In some cases, new systems or major upgrades may be required.

It is noteworthy that Ind AS will lead to a moderate level of change to financing and contractual arrangements with customers, vendors, etc.

Education and training, changes to IT Systems and internal control over financial reporting are the top three concerns with respect to Ind AS adoption.

Which of the following do you perceive as potential challenges of incorporating Ind AS in India?



Weighted average rating based on a scale of 1-10

State of readiness for Ind AS

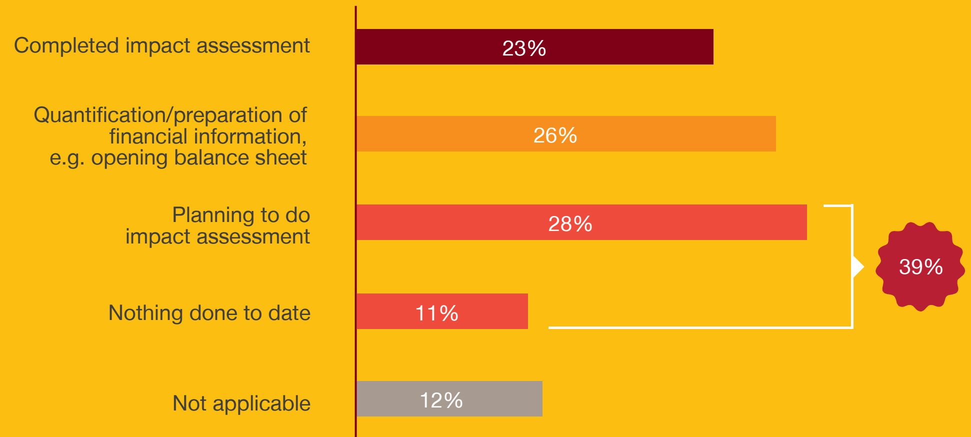
We also wanted to assess the current level of readiness of corporate India in preparing for the adoption of Ind AS.

Almost 23% of the respondents have completed their impact assessments and another 26% have quantified/prepared Ind AS financial information.

Strikingly, 39% of the respondents are yet to start/plan for the impact assessment of Ind AS adoption.

We believe that companies should plan and commence preparing for Ind AS ahead of the formal adoption date applicable to them. Though the level of impact of adopting Ind AS will vary by company and across sectors, better planning will enable companies to address some of the implementation challenges ahead of time.

Which of the following best describes your company's current state of readiness for Ind AS?



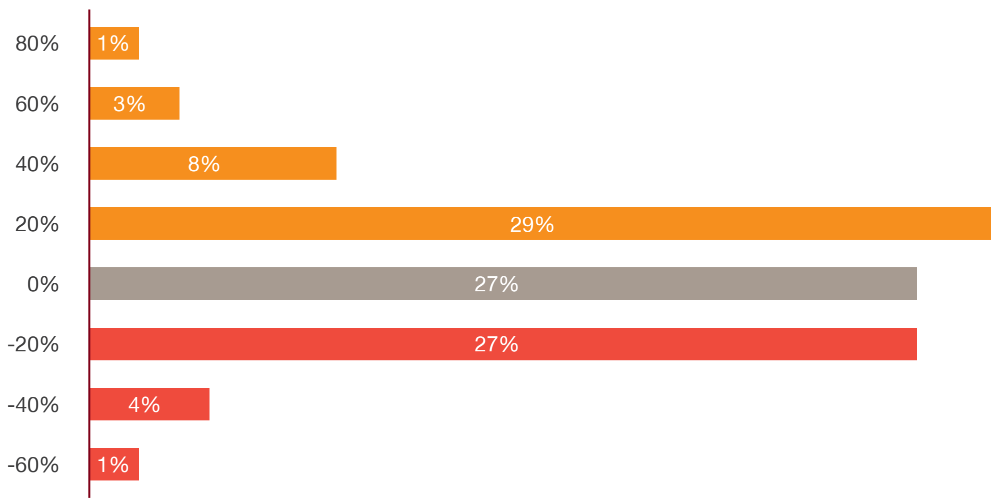
39% of the respondents said their companies are yet to start/plan for the impact assessment of Ind AS adoption.

Impact on net worth/net income

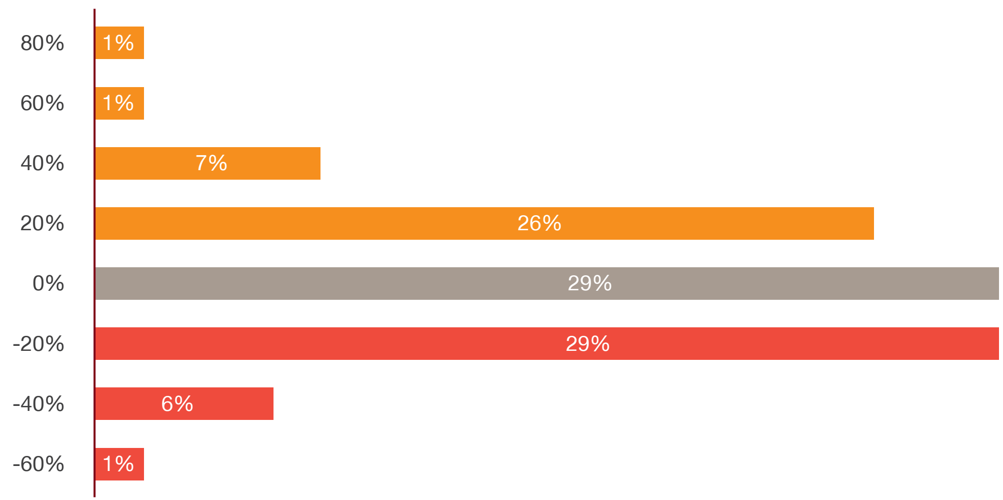
When we asked the respondents about the extent of the potential impact of Ind AS on net worth and net income, more than 70% said that Ind AS is likely to impact the two.

Fifty-five per cent of the respondents believe that both net worth and net income will have a potential impact of +/-20% on the adoption of Ind AS—***this is a significant observation***. Contrary to the apprehensions that the adoption of Ind AS will reduce the reported earnings or net worth of corporate India, this survey shows that almost an equal number of respondents expect an increase in the above-mentioned metrics. One important reason for this could be the use of fair value in accounting for financial assets, including derivatives.

What is the extent of the potential impact on net worth on the adoption of Ind AS?

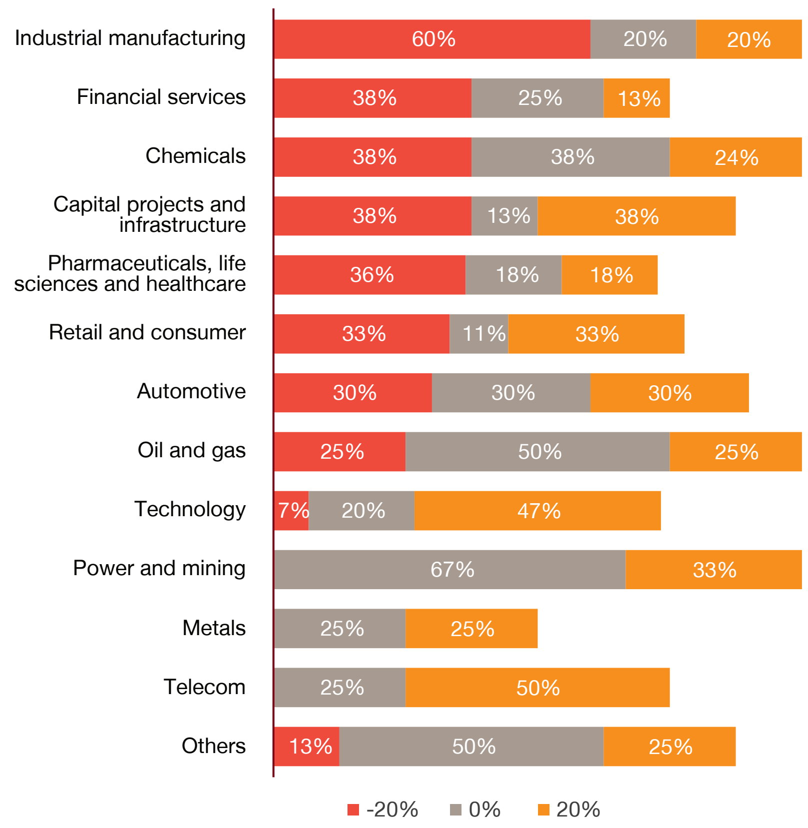


What is the extent of the potential impact on net income after the adoption of Ind AS?

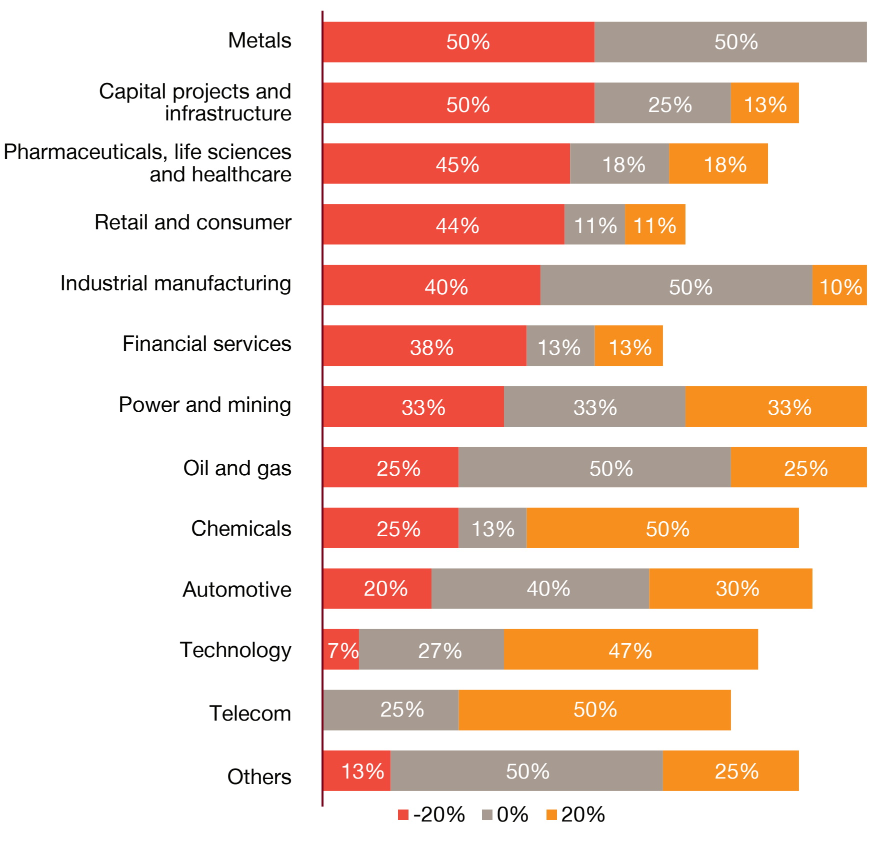


55% of the respondents believe that both net worth and net income will have a potential impact of +/- 20% on the adoption of Ind AS.

Industry sectors with +/- 20% potential impact on net worth on the adoption of Ind AS



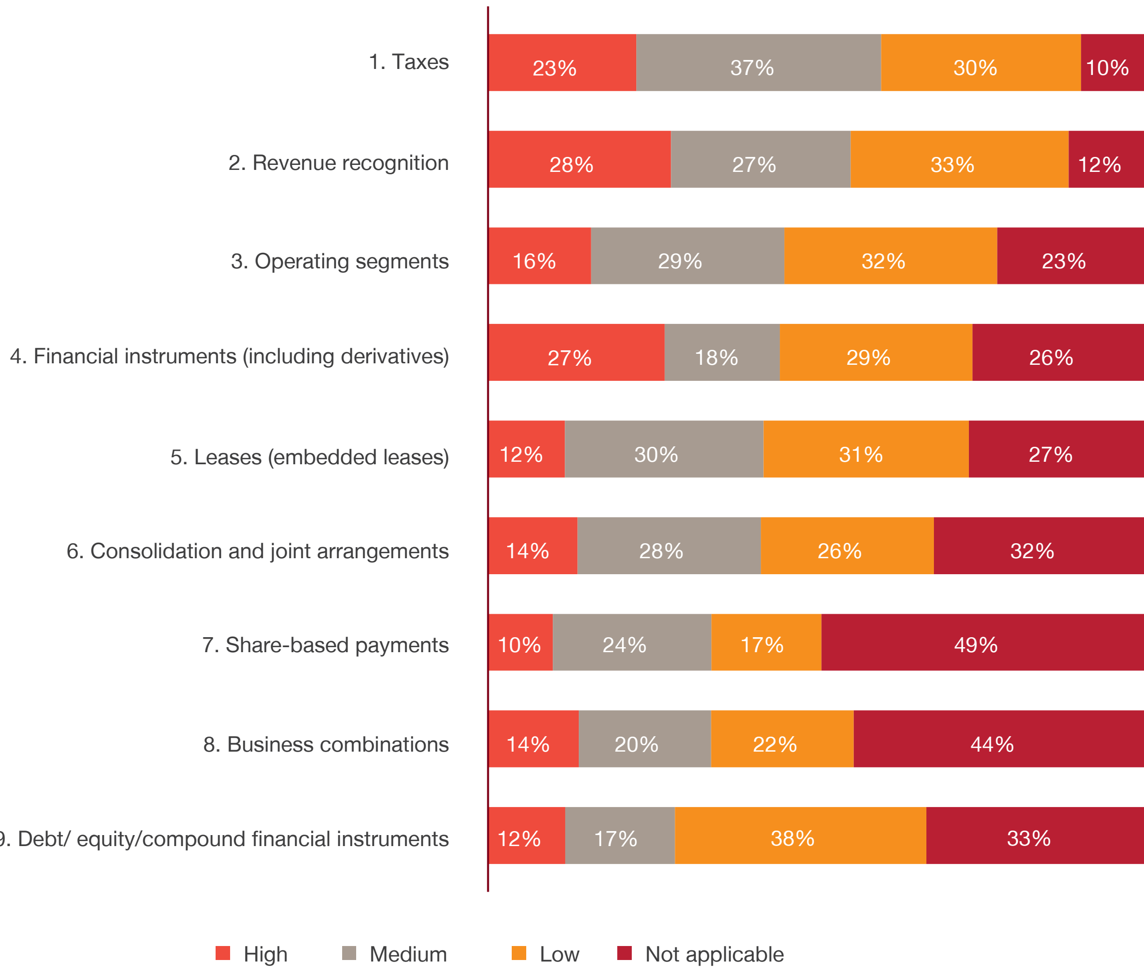
Industry sectors with +/-20% potential impact on net income after the adoption of Ind AS



Impact on financial reporting requirements

Taxes, revenue recognition and operating segments are the top three areas to have a significant impact on financial statements on the adoption of Ind AS.

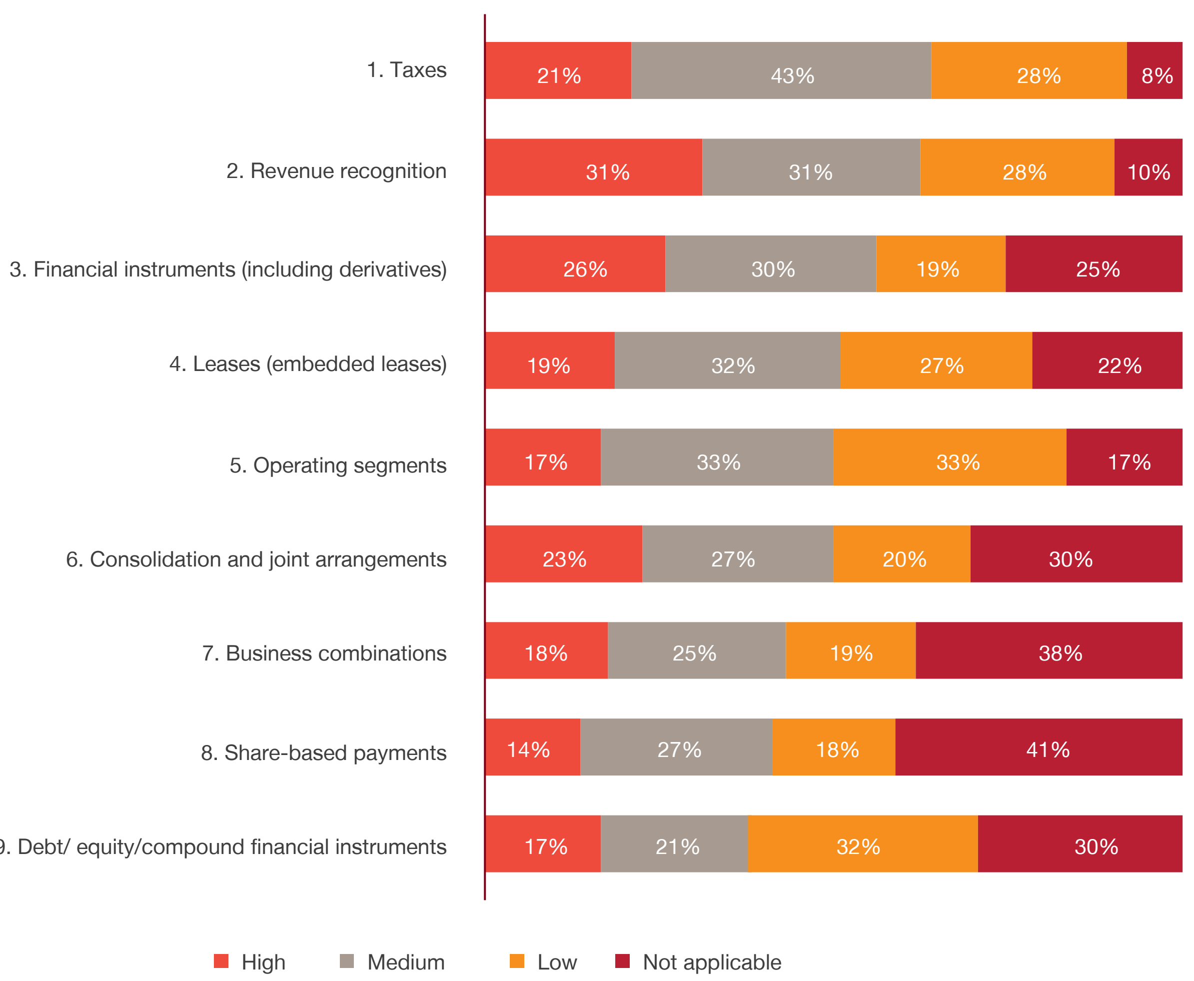
What is the extent of the impact of the following on your company's financial statements on the adoption of Ind AS?



The survey has revealed that the respondents expect taxes, revenue recognition, operating segments, financial instruments (including derivatives) and embedded leases to have a significant impact on financial statements. The respondents believe that the impact on these complex areas ranges from high to moderate. We also believe that companies may face implementation challenges in these areas, especially in financial instruments, where the new standard is being adopted by India ahead of its global adoption date—i.e. annual periods beginning on or after 1 January 2018. It is interesting to note that companies expect segment reporting (being a disclosure standard) to also have a significant impact. This is important as investors may now witness a change in the way segment information is reported—now it will be through the ***lens of management*** using the chief operating decision-maker (CODM) approach under Ind AS.

Taxes, revenue recognition and financial instruments (including derivatives) are the top three areas that will involve significant efforts during the transition to Ind AS.

What is the extent of the effort involved for the following during the transition to Ind AS?



Consistent with the impact of Ind AS on financial statements, the survey has revealed that respondents expect taxes, revenue recognition, financial instruments (including derivatives), embedded leases and operating segments to involve significant efforts during the transition to Ind AS. Additionally, respondents expect significant effort in the areas of consolidation and joint arrangements. They consider effort in these complex areas to range from high to moderate.

The volume and breadth of differences between Indian GAAP and Ind AS is enormous. Furthermore, the impact will vary by industry and for each company. Ind AS will impact every area—reported revenues, expenses, assets, liabilities and equity. In our view, companies will have to devote substantial amount of their time, especially in the following areas, while preparing for Ind AS adoption.

Taxes

Balance sheet approach

Ind AS 12 focusses on the use of the asset and liability method (balance sheet approach) to measure the deferred tax liability or asset. It is assumed that assets will be realised and liabilities will be settled at their carrying amounts. If the carrying amounts of the assets and liabilities differ from their corresponding tax bases, future tax effects will surface from the reversals of such book and tax basis differences. Accordingly, deferred taxes will be recorded based on the temporary difference (as opposed to timing differences under Indian GAAP). This approach under Ind AS is broader and likely to result in deferred taxes on more items, and also additional deferred taxes on some items.

Deferred tax asset assessment in case of carried forward losses

Under Ind AS 12, a deferred tax asset can be recognised on the carried forward unused tax losses to the extent that it is probable that future taxable profits will be available against which the unused tax losses can be utilised. This is a lower threshold compared to the virtual certainty supported by convincing evidence presently required to recognise deferred tax assets under Indian GAAP. This could result in reporting of higher deferred tax assets upon the adoption of Ind AS.

Taxes on consolidation

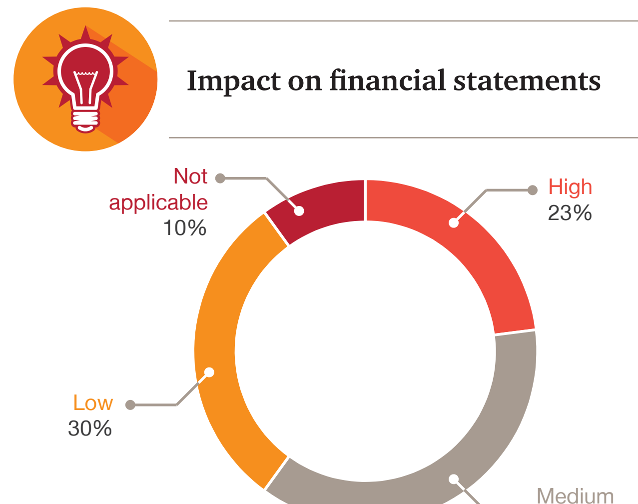
Indian GAAP prohibits any tax adjustment on consolidation, as it is a line-by-line consolidation of the tax expense of the parent and its subsidiaries. Ind AS 12 requires recording deferred taxes on elimination of unrealised intercompany profits.

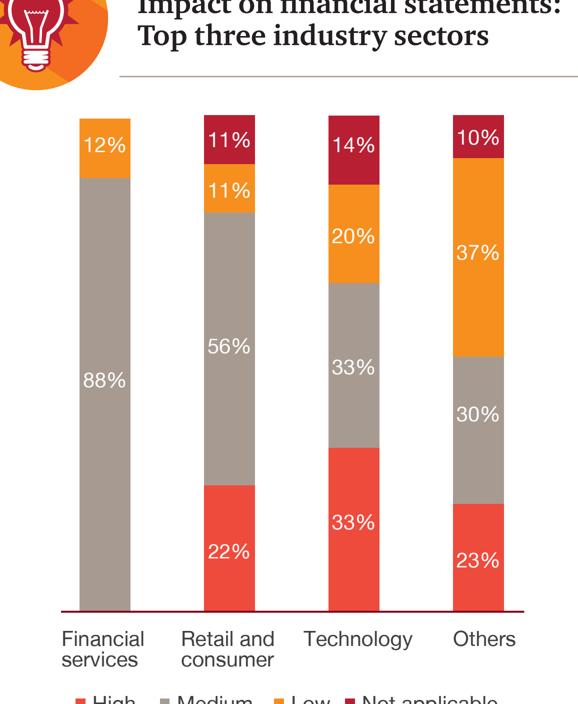
Under Ind AS, a deferred tax liability may also get recorded in the consolidated accounts of a parent entity, for example, if the distribution of unremitted earnings of its subsidiary will result in additional tax consequences. The impact of this can be quite significant in the Indian context due to the dividend distribution tax regime. Also, such dividend distribution tax will be recorded in the income statement and not in equity in the consolidated financial statements. This will reduce the reported net results when Ind AS is adopted.

Adoption of Ind AS will also require extensive disclosures in the area of income taxes. This includes a reconciliation of effective tax expense with the actual tax expense, deferred tax assets not recognised on losses, movement in deferred tax assets and liabilities balances, etc.

Survey results

The results are in line with our expectations. A majority (60%) of the respondents believe that with the adoption of Ind AS, accounting for income tax will have a significant impact on financial statements.





Taxes viewed as the No. 1 area to have a significant impact on Ind AS adoption.

Revenue recognition

Revenue is one of the most important financial statement measure for both preparers and users of the financial statements. It is therefore an accounting topic heavily scrutinised by investors and regulators. Currently, Accounting Standard (AS) 9, 'Revenue recognition', under Indian GAAP, does not provide comprehensive guidance for certain aspects, resulting in diversity in practices. Ind AS 18, 'Revenue', and Ind AS 11, 'Construction contracts' (exposure drafts), provides comprehensive principles for recognising revenue, which will affect mostly all entities that will apply Ind AS. Companies will be required to closely analyse their business practices within the revenue cycle to identify and evaluate potential GAAP differences.

Some of the key GAAP differences between Indian GAAP and Ind AS include the following:

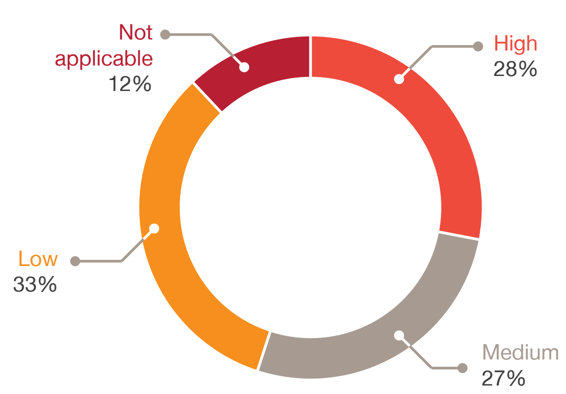
- Multiple element arrangement and linked transactions
- Gross vs net presentation (sales tax, excise tax, etc.)
- Financing benefits
- Service concession arrangements
- Extended warranties
- Customer loyalty programmes or incentive schemes
- Consideration paid to customers

Survey result

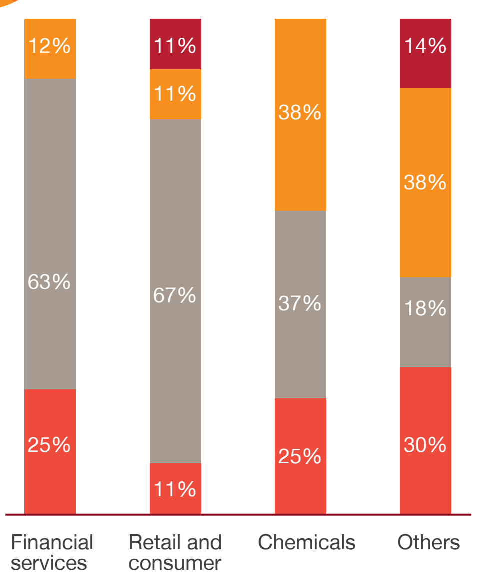
A majority (55%) of the respondents believe that changes to the revenue recognition requirement will have a significant impact on financial statements. Around 28% of the respondents consider revenue to be a high-impact area, while 27% believe it to be moderately impacted.

Financial services, retail and consumer, and chemicals are the top three industry sectors to be significantly impacted by the new revenue recognition rules under Ind AS.

Impact on financial statements



Impact on financial statements: Top three industry sectors



Operating segments

Under Ind AS, the segment guidance requires an entity to disclose information that enables 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 (***management approach***).

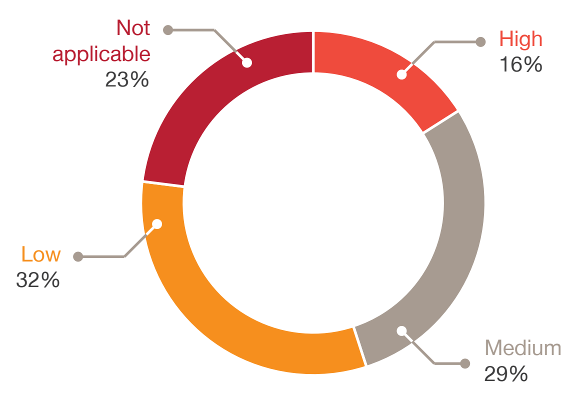
Under Indian GAAP, segmental information is disclosed based on business and geographical reporting—one as a primary segment and the other as secondary. Ind AS 108 requires segmental information to be provided based on how the CODM evaluates the financial information for the purposes of allocating resources and assessing performance. This may require certain companies to change the segment disclosures to keep them consistent with their internal reporting.

Survey results

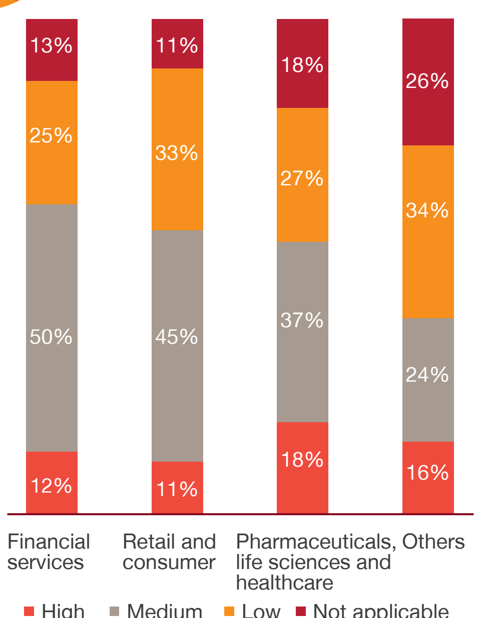
Forty-five per cent of the respondents believe operating segment disclosures to have a significant impact on financial statements.

We expect that ***management approach*** for the identification of segments to have a significant impact on the disclosures to be made by companies. This continues be an important disclosure for investors/stakeholders to judge the performance of business operations.

Impact on financial statements



Impact on financial statements: Top three industry sectors



45% of the respondents believe management approach for identification of segments will have a significant impact on the disclosures made by companies.

Financial instruments (including derivatives)

India has decided to be the first to adopt IFRS 9 equivalent—the new standard on financial instruments. This standard will be globally effective in 2018, and is expected to have a wide-ranging impact on companies. It is a myth that this standard will only impact financial institutions. Based on our observations, the impact of this standard on other companies and industries could also be substantial. At a high level, the use of fair value and present value in recording financial instruments will increase.

Ind AS 109 provides extensive guidance on identification, classification, recognition and measurement of financial instruments. Additionally, it provides guidance on de-recognition of financial instruments and hedge accounting, and has extensive disclosure requirements. Presently, there is no comprehensive mandatory guidance on financial instruments under Indian GAAP.

Classification, recognition, and measurement principles and certain disclosure requirements for financial instruments are addressed in three standards:

- Ind AS 107, 'Financial instruments: Disclosure', which contains disclosure requirements
- Ind AS 32, 'Financial instruments: Presentation', which deals with distinguishing debt from equity, and provides guidance on netting of financial instruments
- Ind AS 109, 'Financial instruments', which contains classification, recognition and measurement, hedge accounting and impairment requirements

The objective of these three standards is to establish requirements for all aspects of accounting for financial instruments.

Derivatives and hedge accounting

Under Indian GAAP, there is diversity in practice in accounting for derivative contracts. Ind AS will bring in consistency in accounting of derivative contracts, including any embedded derivatives. Under Ind AS, all derivatives will be fair valued and recorded in the balance sheet. Further, both positive gains and negative losses resulting from changes in fair value of derivatives will get recognised. Whether the change in fair value gets recognised in profit or loss, or other comprehensive income (OCI), will depend on whether hedge accounting has been followed and also on the nature of the underlying derivative instruments.

Hedge accounting principles of Ind AS 109 are fairly similar to the basic principles of AS 30 under Indian GAAP. However, the range of situations to which hedge accounting can be applied under Ind AS 109 has widened, including the use of hedging instruments. It also allows hedging a risk component of a non-financial item, if that component is separately identifiable and measurable. Finally, hedge effectiveness testing has also been simplified by making it more principle based and removing numerical thresholds (80-125% rule).

Investment in debt instruments

Now, Ind AS 109 provides three categories for classifying debt instruments—amortised cost, fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVPL). This classification of debt instruments is driven by the entity's business model for managing financial assets and their contractual cash flow characteristics.

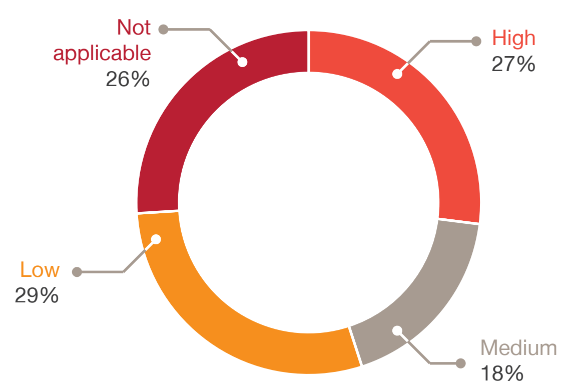
Investment in equity instruments

Upon adoption of Ind AS, investments in equity instruments will always be measured at fair value. This will be a big change from the current practice. Equity instruments are those that meet the definition of 'equity' from the perspective of the issuer as defined in Ind AS 32. Equity instruments held for trading will be classified at FVPL. For all other equities, the management has the ability to make an irrevocable election on the initial recognition, on an instrument-by-instrument basis, to present the changes in fair value in OCI rather than profit or loss. If this election is made, all fair value changes, excluding dividends that are a return on investment, will be included in OCI. There will neither be any recycling of amounts from OCI to profit and loss (e.g. on sale of an equity investment), nor will there be any impairment requirements. However, the entity might transfer the cumulative gain or loss within equity.

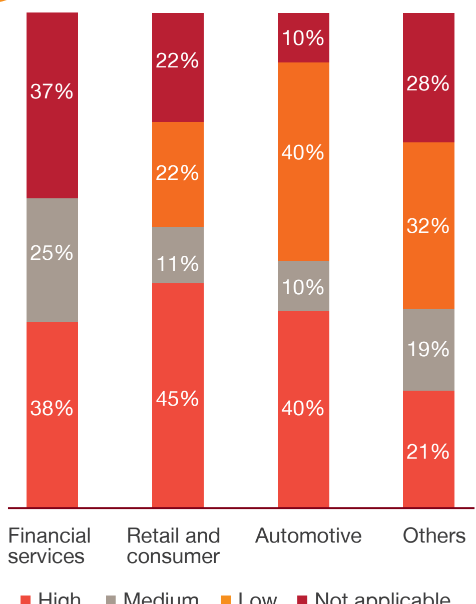
Survey result

Forty-five per cent of the respondents expect that financial instruments will have a significant impact on financial statements on the adoption of Ind AS.

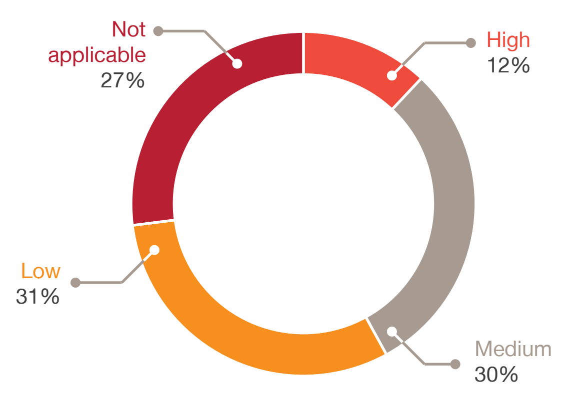
Impact on financial statements



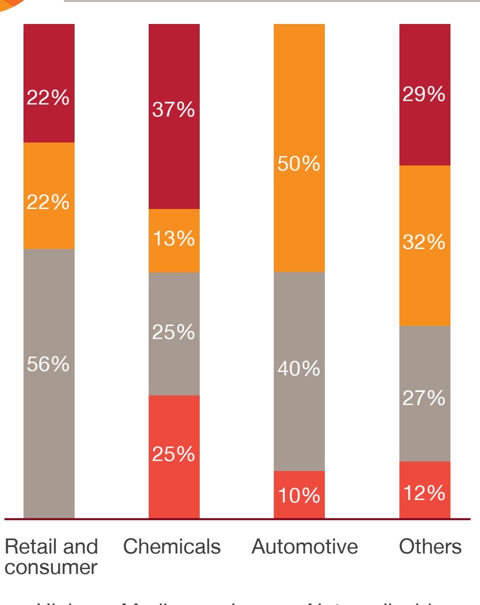
Impact on financial statements: Top three industry sectors



Impact on financial statements



Impact on financial statements: Top three industry sectors



Leases (embedded leases)

Ind AS has more explicit guidance on arrangements in the nature of lease. Arrangements that may not have been legally termed as leases but in substance are right to use underlying assets will now get accounted as leases using this guidance. For example, accounting for power purchase agreements (PPA), IT outsourcing contracts, toll manufacturing arrangements (take or pay type of contracts), etc., may potentially get accounted as a lease arrangement under Ind AS.

Survey results

About 42% of the respondents believe that guidance on embedded leases can have significant impact on their transactions/contractual arrangements.

We believe that companies will need to carefully evaluate and analyse their contractual arrangement with suppliers, job workers, tolling entities and outsourcing agencies. These arrangements can have significant implications on financial statements, and companies will need to reassess such arrangements on a go-forward basis. Certain industries where the impact may be more significant include retail and consumer, chemicals, and automotive.

42% of the respondents believe that companies are expected to be significantly impacted by leases, with retail and consumer, chemicals, and automotive sectors leading the pack..

Consolidation and joint arrangements

Consolidation

The Companies Act, 2013, requires all companies to prepare and present consolidated financial statements, which are in line with the global requirements, including those of Securities and Exchange Board of India (SEBI) for listed companies. Additionally, companies will continue to prepare and present their stand-alone financial statements to be used for the purpose of dividend distribution, managerial remuneration, income taxes, etc.

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 sets out the requirements for when an entity needs to prepare consolidated financial statements, defines the principles of control, and explains how to apply the principles of control and the accounting requirements for preparing consolidated financial statements.

Under Ind AS, 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 entity presents a parent and its subsidiaries as if they are a single economic entity. Ind AS 110 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
- Nature of rights—whether 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
- Relationships between investors and how they affect control
- Existence of power over specified assets only

Ind AS 110 will affect some entities more than others. The consolidation conclusion is not expected to change for most straightforward entities. However, changes can result where there are complex group structures or where structured entities are involved. Entities that are most likely to be affected potentially include investors in the following categories:

- Entities with a dominant investor that does not possess a majority voting interest, where the remaining votes are held by widely dispersed shareholders (de facto control)
- Structured entities, also known as special purpose entities
- Entities that issue or hold significant potential voting rights
- Asset management entities

In difficult situations, the specific facts and circumstances will affect the analysis under Ind AS 110. Ind AS 110 does not provide 'bright lines' and requires consideration of many factors, such as the existence of contractual arrangements and rights held by other parties, in order to assess control.

Upon adoption of Ind AS, this new guidance can result in consolidation of entities which may not have been previously consolidated under Indian GAAP, and may also result in deconsolidation of certain entities going forward. Depending on the facts and circumstances of specific entities, certain special purpose structures or vehicles may no longer remain outside the consolidated group—which in turn could significantly impact the reported net worth and performance of certain groups.

Joint arrangements

A joint arrangement is a contractual arrangement where at least two parties agree to share control over the activities of the arrangement. Unanimous consent on decisions about relevant activities between the parties sharing control is a requirement to meet the definition of joint control.

Joint arrangements can be joint operations or JVs. The classification is principle based and depends on the parties' exposure in relation to the arrangement.

When the parties' exposure to the arrangement only extends to the net assets of the arrangement, the arrangement is a JV.

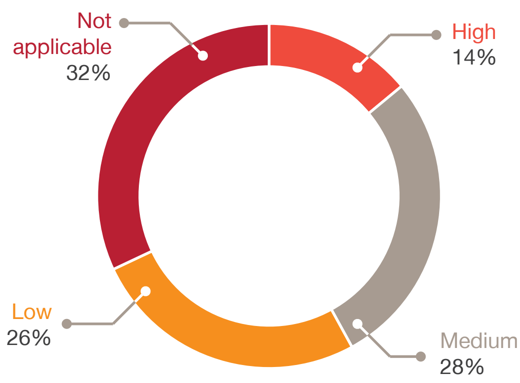
In contrast, joint operators have rights to assets and obligations for liabilities. Joint operations are often not structured through separate vehicles. When a joint arrangement is separated from the parties and included in a separate vehicle, it can be either a joint operation or a JV. In such cases, further analysis is required on the legal form of the separate vehicle, the terms and conditions included in the contractual agreement, and sometimes, other facts and circumstances. This is because in practice, the latter two can override the principles derived from the legal form of the separate vehicle.

Joint operators account for their rights to assets and obligations for liabilities. JVs account for their interest by using the equity method of accounting.

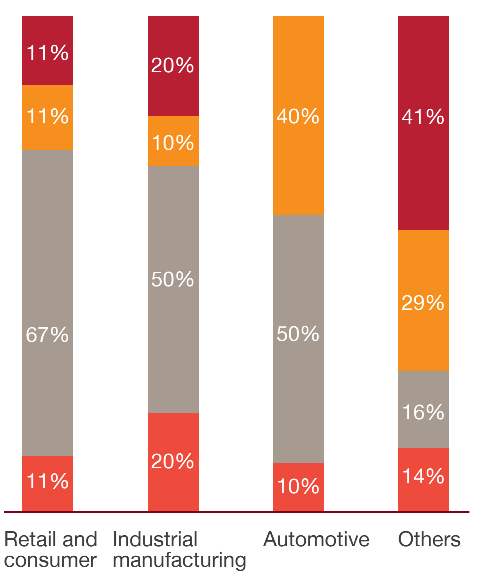
Indian GAAP requires JVs to be consolidated proportionately, whereas under Ind AS 111, with certain exceptions, consolidation is done using the equity method of accounting.

Many companies could be impacted by this change, as they will have to move from proportionate consolidation to the equity method of accounting. This will effectively change the gross totals of reported assets and liabilities, revenue and expenses, including other performance measures, though it may not change the reported net assets and net results.

Impact on financial statements



Impact on financial statements: Top three industry sectors



Survey result

When asked about the extent of the impact on a company's financial statements, 42% of the respondents expect that consolidation and joint arrangements will have a significant impact on financial statements on the adoption of Ind AS.

We believe that the transition from rule-based evaluation of control to a model which is based on judgement (substance over legal form) will involve careful analysis and evaluation.

42% of the respondents expect that consolidation and joint arrangements will have a significant impact. The new guidance can result in consolidation of entities which may not have been previously consolidated under Indian GAAP and may also result in deconsolidation of certain entities going forward.

Share-based payments

Ind AS 102 provides comprehensive guidance for accounting for all types of share-based arrangements to employees and others. Under Indian GAAP, a company could have used the intrinsic value method or the fair value method. However, the adoption of Ind AS requires all types of share-based payment arrangements 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—which may be a big change for certain subsidiary companies.

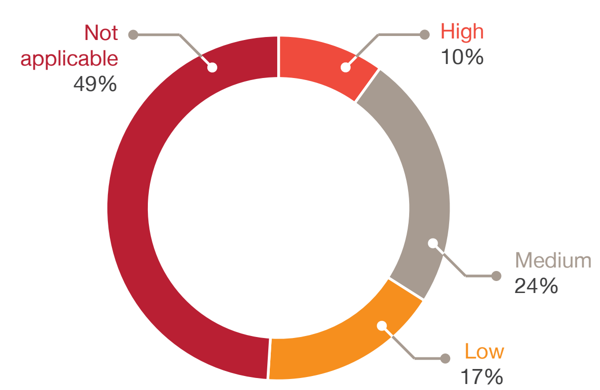
Additionally, costs with respect to awards granted with graded vesting will have to be recognised on an accelerated basis. All of this will result in reporting higher expenses upon the adoption of Ind AS.

The most common application of this standard is noted in employee share schemes such as share option plans. However, entities sometimes also pay for other expenses such as professional services, and for the purchase of assets using share-based payment arrangements.

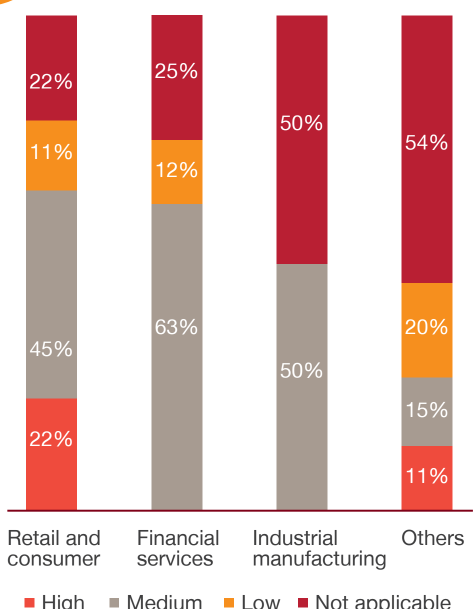
The accounting treatment under Ind AS 102 is based on the fair value of the instruments. Both the valuation and accounting for share-based awards can sometimes be difficult due to the complex models that may need to be used to calculate the fair value of the underlying awards, and also due to the variety and complexity of certain terms in share-based arrangements. In addition, the standard requires extensive disclosures.

Survey result

Impact on financial statements



Impact on financial statements: Top three industry sectors



Around 34% of the respondents are of the opinion that share-based payments will have a significant impact on financial statements on the adoption of Ind AS.

Accounting for share-based arrangements can be challenging for complex plans, especially when there is any modification or cancellation of existing arrangements. Given that fair value of the awards will be recognised through the profit and loss account, companies may re-evaluate the attractiveness of such plans going forward. Preparers will also need to closely evaluate the provisions of group share-based arrangements in accordance with the new guidance.

Business combinations

A business combination involves the bringing together of separate entities or businesses into one reporting entity. The most common type of business combination is where one of the combining entities purchases the equity of another entity. Another example is where one entity purchases a group of net assets of another entity.

Currently, this is another area where there is diversity in practice under Indian GAAP. Depending on the legal form or structure of the acquisition, accounting results could significantly vary. For example, acquisition of a business (without the legal entity) gets accounted under AS 10, 'Fixed assets', whereas amalgamation of legal entities is accounted under AS 14, 'Amalgamation'. Though from an economic perspective there may have been no difference in the two acquisitions, the accounting results differ just because of the different accounting standards. This has also have a consequential impact on the reported amounts of goodwill under Indian GAAP.

Ind AS 103 now fixes this and provides comprehensive guidance looking beyond the legal form of the transaction. Going forward, it will not matter whether the acquisition is of a legal entity or a group of net assets. So as long as what the investor entity is acquiring meets the definition of a business, ***the acquisition method*** will be used consistently. Also, the 'pooling of interest' method will not be permitted under Ind AS (except in limited circumstances of common control transactions).

Under Ind AS, all assets and liabilities acquired in a business acquisition will be measured and recorded at fair value. The difference between the fair value of purchase consideration and fair value of net assets acquired will be recognised as goodwill or capital reserve, as applicable.

Due to fair valuation, it is also expected that under Ind AS, goodwill could generally be lower compared to Indian GAAP mainly due to the recognition of intangibles. Though the resultant goodwill will not be amortised, it will be annually tested for impairment.

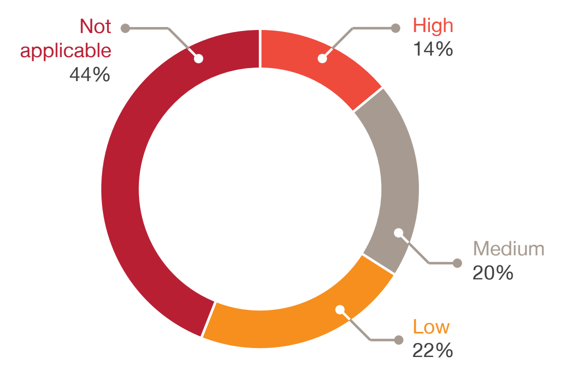
Due to the fair valuation and purchase price allocation exercise to be followed in acquisition accounting, many more intangibles, which may not have been previously recorded by the acquired entity or business, may now get separately recognised. Examples of such intangibles include customer contracts, trademarks and brands. These will now be amortised and charged to the income statement.

Another change in practice will be noted in the accounting of transaction costs. Under Ind AS, transaction costs related to business acquisitions will be charged to profit or loss, whereas under Indian GAAP, these are generally capitalised as part of investment, resulting in higher goodwill or lower capital reserve.

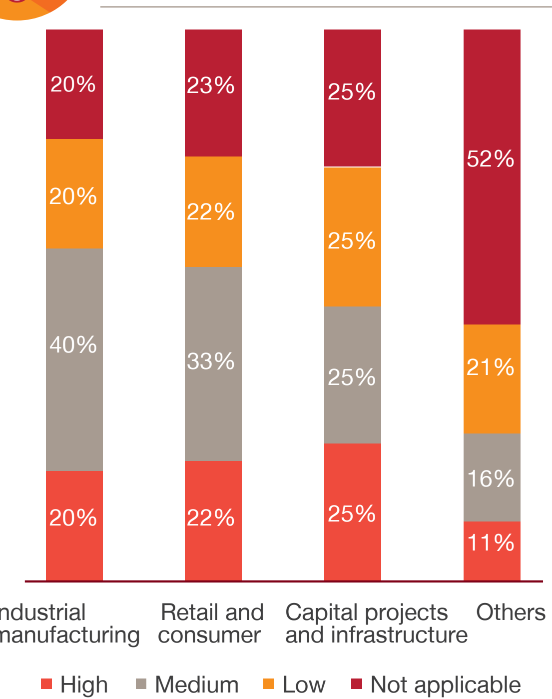
Ind AS 103 also includes detailed guidance for the definitions of business, control, date of acquisition, step acquisitions, contingent consideration, taxes, etc., which can result in significant differences compared to the current Indian GAAP.

Survey result

Impact on financial statements



Impact on financial statements: Top three industry sectors



Nearly 34% of the respondents expect business combinations to have a significant impact on financial statements on the adoption of Ind AS.

We believe that new guidance on business combinations will bring consistency in accounting of acquisitions. Preparers will need to closely evaluate these provisions as they plan future mergers and acquisitions, including those through court schemes.

Debt/equity/compound financial instruments

Under Ind AS, the classification of financial instruments as either debt or equity is based on the substance of the contractual arrangement underlying the instrument rather than its legal form. For example, a redeemable preference share, which is economically similar to a bond/debenture, will be accounted as a liability rather than an equity even though legally it is a share of the issuer.

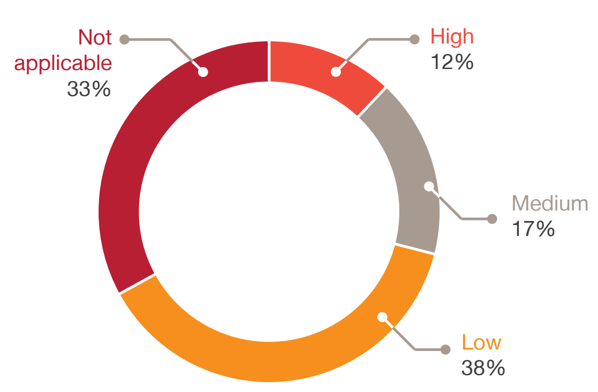
Other instruments may not be as straightforward. An analysis of the terms of each instrument in light of the detailed classification requirements is necessary, particularly as some financial instruments contain both liability and equity features. Such compound financial instruments—for example, bonds/debentures that are convertible into a fixed number of equity shares — are accounted for as separate liability and equity (given the option to convert if all the criteria for equity are met) components.

The treatment of interest, dividends, losses and gains in the income statement follows the classification of the related instrument. If a preference share is classified as a liability, its coupon (preference dividend) is shown as interest cost. However, the discretionary coupon on an instrument that is treated as equity is shown as a distribution within equity.

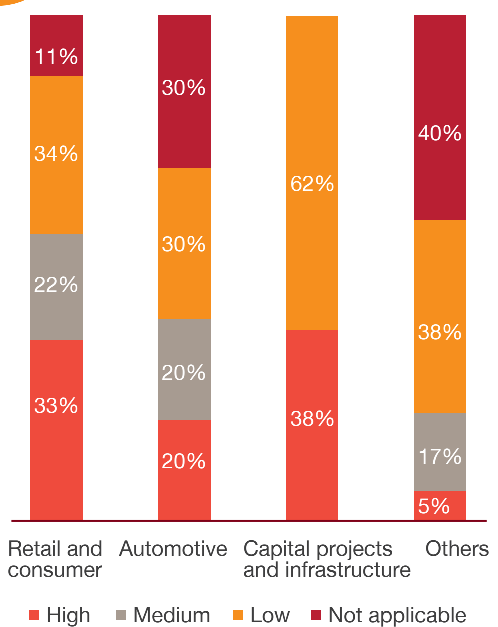
The impact can be quite significant for companies using such compound instruments in financing their operations, affecting the capitalisation profile, reported earnings, net worth and debt covenants.

Survey result

Impact on financial statements



Impact on financial statements: Top three industry sectors



Interestingly, only 29% of the respondents expect that debt/equity or compound financial instruments will have a significant impact on financial statements on the adoption of Ind AS.

Based on the survey results, it appears that a majority of the respondents may not have entered into such complex or compound financing arrangements. It may also be that certain arrangements may contain embedded derivatives features, the terms of which may not be apparent and therefore requiring closer scrutiny and detailed analysis.

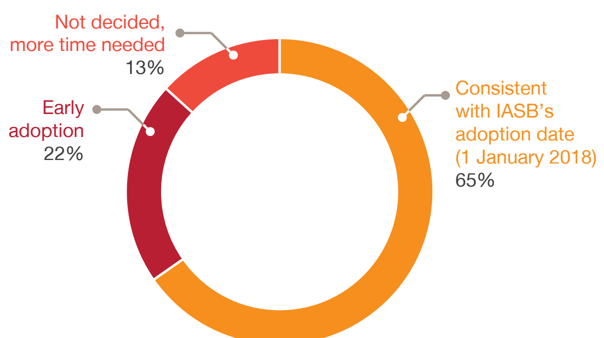
For example, certain private equity funding arrangements may contain put options and guaranteed returns, thus requiring a separation of equity and debt components.

Around one-third or less believe share-based payments, business combinations and debt/equity/compound financial instruments to have any significant impact on Ind AS adoption.

Revenue from contracts with customers

When asked when they think India should adopt Ind AS 115, 'Revenue from contracts with customers', 65 % of the respondents believe the adoption date of Ind AS 115 to be consistent with IASB's adoption date of IFRS 15, and only 22% of the respondents believe that Ind AS 115 should be adopted early.

When do you think India should adopt Ind AS 115, 'Revenue from contracts with customers'?



The difference between transfer of control vis-à-vis transfer of risk and reward can sometimes be subtle, requiring a detailed understanding of the accounting standard and customer contractual arrangements.

Initially, IASB and Financial Accounting Standards Board (FASB) jointly issued the new revenue standard in May 2014 with an effective date of 1 January 2017. Both IASB and FASB have agreed on deferral of the effective date of the standard to 2018 and are now providing clarifications/amendments to the standard to assist companies with its implementation.

The proposed deferral of Ind AS 115 in line with IASB's decision will assist companies in India to assess and fully understand the implication of the standard on its operations, and also ease the implementation process.

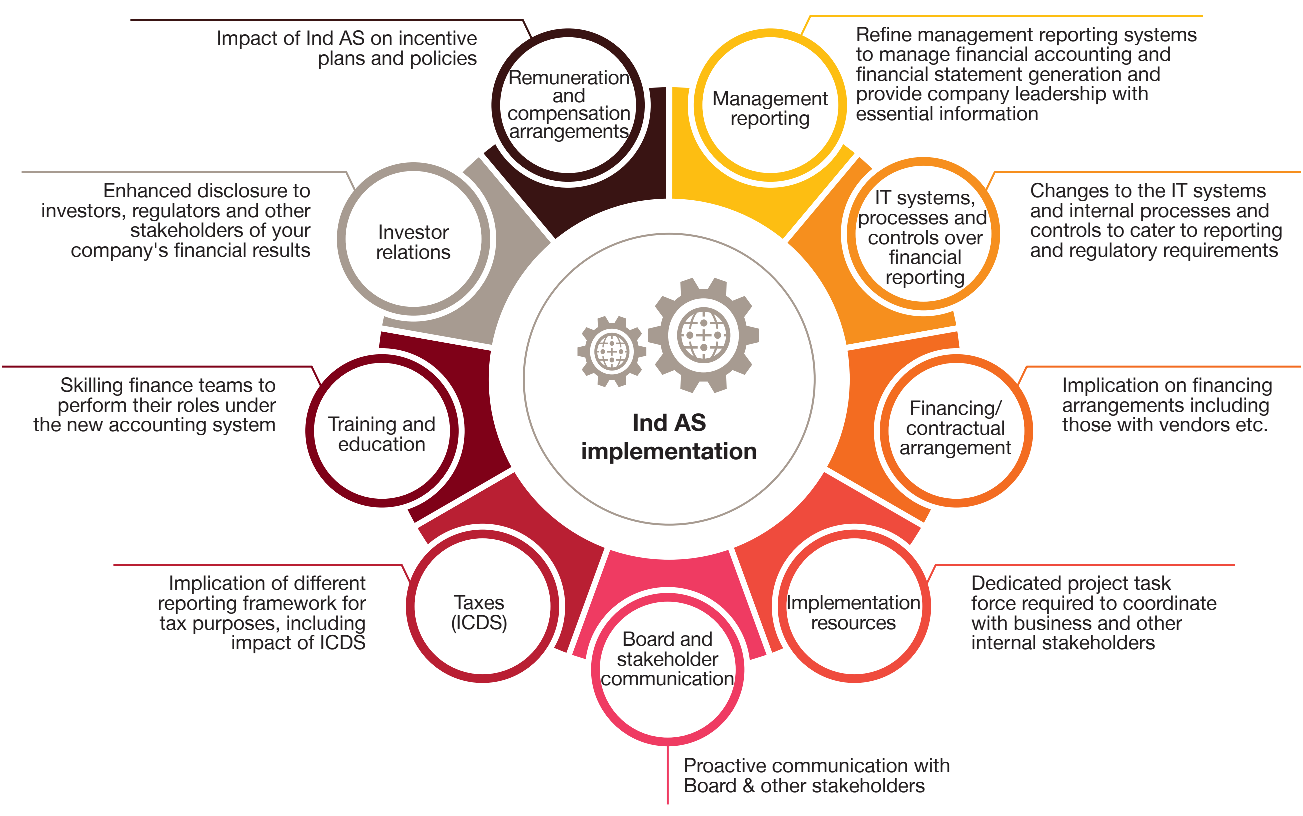
The survey indicates that industries such as chemicals, technology, automotive, industrial manufacturing, and pharmaceuticals and life sciences believe that the adoption of Ind AS 115 should be consistent with IASB's adoption date.

Under Ind AS 115, revenue is recognised when a customer obtains control of a good or service, while under Indian GAAP, revenue is recognised when there is a transfer of risk and rewards. A customer obtains control when it has the ability to direct the use of and obtain the benefits from the good or service. Transfer of control is neither same as transfer of risks and rewards nor similar to the culmination of an earnings process as may be understood today.

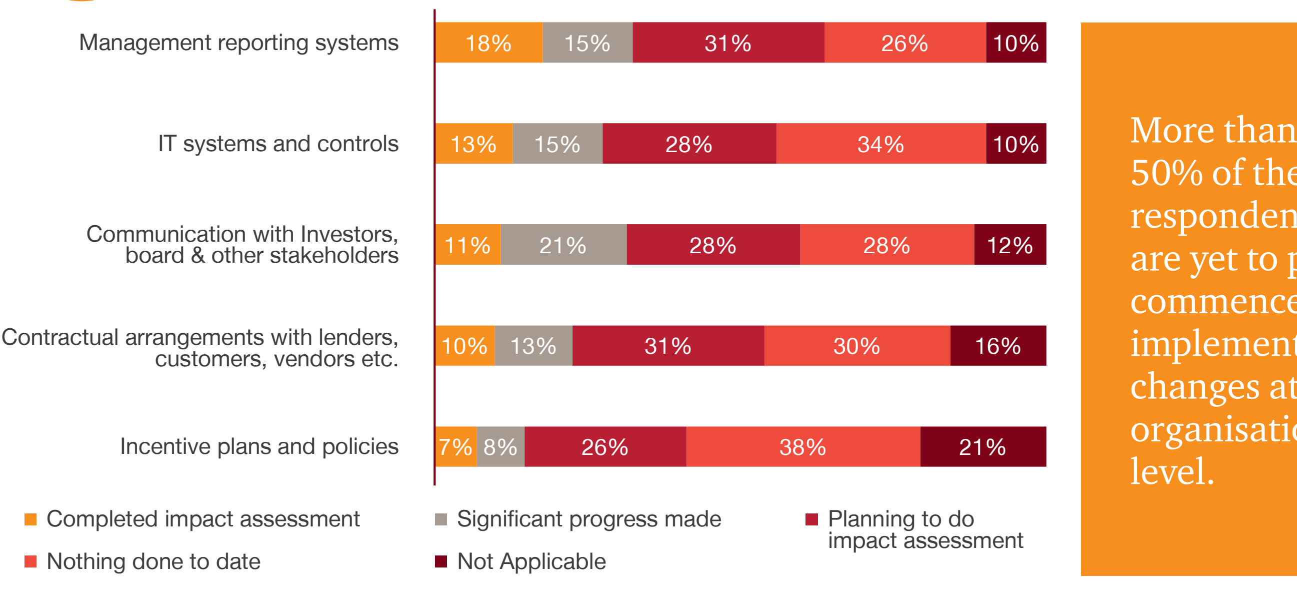
Entities will be required to apply the new guidance to determine whether revenue should be recognised 'over time' or 'at a point in time'. So, as the first step, a company will have to determine whether the control is transferred over time. If the answer to this question is negative, only then will revenue be recognised at a point in time.

65% of the respondents believe the adoption date of Ind AS 115 to be consistent with IASB's adoption date of IFRS 15.

Impact across the board



What is the state of preparedness for implementing changes to the following at an organisational level with the adoption of Ind AS?



	Completed impact assessment	Significant progress made	Planning to do impact assessment	Nothing done to date	Not Applicable
Management reporting systems	18%	15%	31%	26%	10%
IT systems and controls	13%	15%	28%	34%	10%
Communication with Investors, board & other stakeholders	11%	21%	28%	28%	12%
Contractual arrangements with lenders, customers, vendors etc.	10%	13%	31%	30%	16%
Incentive plans and policies	7%	8%	26%	38%	21%

More than 50% of the respondents are yet to plan/ commence implementing changes at an organisational level.

It is surprising to note that a majority of the respondents are yet to plan/commence implementing changes at an organisational level. Given that 1 April 2016 is less than two months away, we believe that companies should immediately plan and commence working on the changes at an organisational level. This will help them to address some of the implementation challenges discussed earlier.

This is also a good time for Phase II companies, including banks, NBFCs and insurance companies to start planning for Ind AS adoption.

Non-GAAP measures

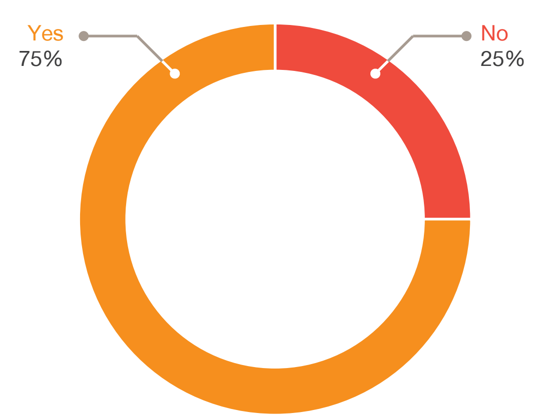
Companies often disclose non-GAAP financial measures to provide additional insight into the business. These measures adjust the reported GAAP results, to facilitate the users' understanding of a company's underlying operational performance, liquidity or financial position. This information may provide insights into a company's business, its past results and its potential for future prospects.

Although non-GAAP financial measures are commonly used, their comparability varies from one industry to another, as well as from one company to another. In addition, a lack of transparency regarding their determination, along with inconsistency in how the measures are calculated, may limit their efficacy. Further, the subjectivity inherent in how non-GAAP financial measures are calculated could make them susceptible to bias or misinterpretation without proper context and explanation.

Interestingly, the survey has revealed that 75% of the respondents expect reporting of additional non-GAAP financial measures on the transition to Ind AS.

We believe that non-GAAP financial measures are most effective when they are accompanied by clear and transparent disclosure of what is included or excluded from the measure, the supporting rationale and why management believes such measures to be useful and important. A robust discussion of how management uses non-GAAP financial measures, if applicable, and the context in which they should be considered increases their usefulness.

Do you believe Ind AS adoption may lead to reporting of additional non-GAAP (adjusted performance) measures?
(E.g. EBITDA, adjusted EBITDA or adjusted earnings)



A majority of the respondents who believe adoption of Ind AS may lead to the reporting of additional non-GAAP measures are from industries such as technology (14%), automotive (13%), retail and consumer (12%), industrial manufacturing (9%), capital projects and infrastructure (8%) and financial services (8%).

75% of the respondents expect reporting of additional non-GAAP financial measures on the transition to Ind AS.

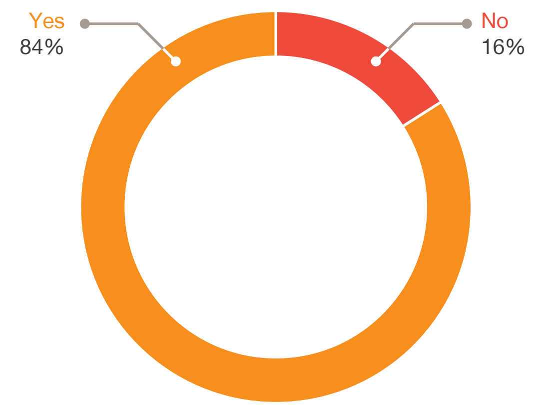
Investor/stakeholder analysis

Finally, we asked respondents whether Ind AS reporting will enhance investor/stakeholder analysis of financial information. A majority (84%) of the respondents believe that financial information analysis by investors/ stakeholders will improve.

We believe that the most important benefit of the transition to Ind AS will be high quality and transparent financial reporting and increase in comparability of business results. These benefits will enable investors/ stakeholders to better understand the company's business story and enable them to understand and link the performance more clearly.

We believe that companies should also integrate financial statement information with robust management discussion and analysis.

Do you believe reporting under Ind AS will enhance investor/stakeholder analysis of financial information?



84% of the respondents believe financial information analysis by investors/ stakeholders will improve.

The way forward

Ask the important questions now

When adopting Ind AS, companies need to carefully plan for their Ind AS transition strategy. There are important questions that companies should ask themselves and more importantly be prepared to answer with a clear action plan.

Communications with key stakeholders

- How are we preparing for the board communication and education process with respect to changes resulting from Ind AS, including the impact on key metrics historically communicated?
- How well are we engaging with the board and is the engagement timely?
- How will we communicate our findings to our shareholders, analysts and others?
- What are our competitors doing? How do we benchmark? How will others compare with us?
- What are the typical industry issues?

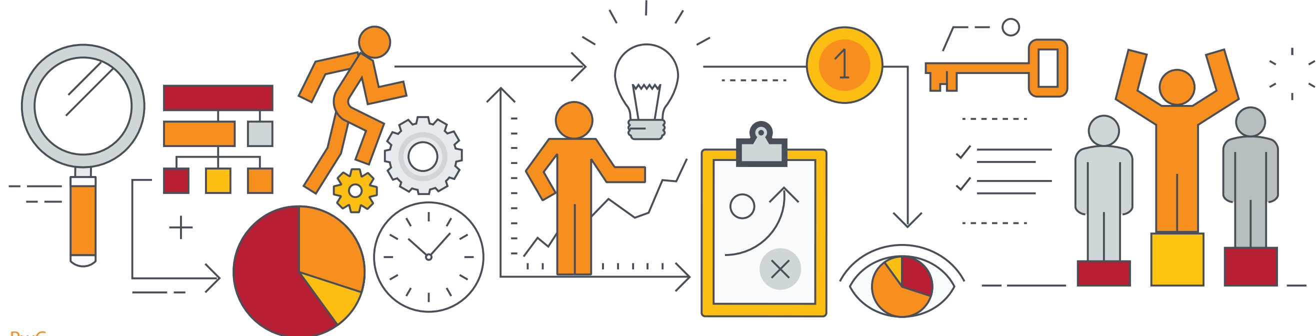
Operations, infrastructure and regulatory

- Are we considering the impact of Ind AS in our current negotiations and dealings with customers, vendors, lenders, etc?
- How should long-term contract discussions be shaped today keeping in mind the requirements of Ind AS?
- What change management structures are in place? Will they get the job done?
- Can we consolidate legacy IT systems and processes under Ind AS?
- Are we buying, modifying or implementing new IT systems based on an Indian GAAP world? Will they provide us with the information we need under Ind AS?
- Are we embedding the implications of Ind AS into our internal control systems?
- What implications does Ind AS have on our tax strategies?
- How will accounting under Ind AS coordinate with the requirements of the new income computation and disclosure standards (ICDS) under tax?
- How will adoption of Ind AS interact with the provisions of MAT?

Human capital strategies

- Are all appropriate functional disciplines and business locations sufficiently engaged?
- Have we set up an appropriate project framework and communication channels?
- What are the best incentives in ensuring a business-wide conversion?
- What level of in-house experience or expertise do we have?
- What types and extent of training will we require?
- How will we monitor milestones and progress?

By addressing these questions early, companies increase their chances of ensuring a smooth and effective conversion. This thorough approach can help companies to bake in rather than bolt-on Ind AS changes. Failure to do this may lead to ongoing conversion efforts, each aiming to correct the previous effort.



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Our offices

Ahmedabad
1st Floor, Plot No. 36, President Plaza
Opp Muktidham Derasar
Thaltej Cross Road, SG Highway
Ahmedabad, Gujarat 380 054
Phone: +91 79 3091 7000

Bengaluru
6th Floor, Millenia Tower D
1 & 2, Murphy Road, Ulsoor
Bengaluru, Karnataka 560 008
Phone: +91 80 4079 6000

Chennai
8th Floor, Prestige Palladium Bayan
129-140, Greams Road
Chennai, Tamil Nadu 600 006
Phone: +91 44 4228 5000

Hyderabad
Plot No. 77/A, 8-2-624/A/1
Road No. 10, Banjara Hills
Hyderabad, Telangana 500 034
Phone: +91 40 4424 6000

Kolkata
Plot No. Y-14, 5th Floor
Block-EP, Sector-V, Salt Lake
Kolkata, West Bengal 700 091
Phone: +91 33 2357 9100/2357 7200

Mumbai
252, Veer Savarkar Marg
Shivaji Park, Dadar
Mumbai, Maharashtra 400 028
Phone: +91 22 6669 1000

New Delhi/Gurgaon
Building No. 10, Tower C
17th and 18th Floor
DLF Cyber City,
Gurgaon, Haryana 122 002
Phone: +91 124 462 0000

Pune
7th Floor, Tower A – Wing 1
Business Bay, Airport Road
Yerwada, Pune 411 006
Phone: +91 20 4100 4444

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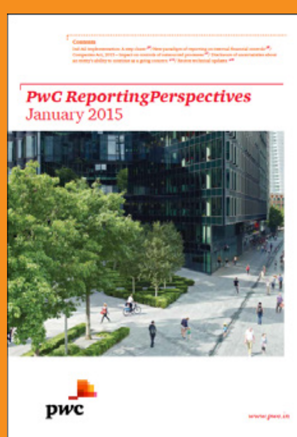

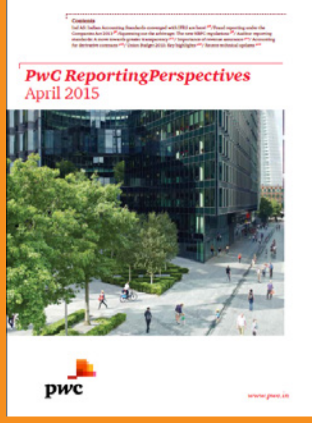

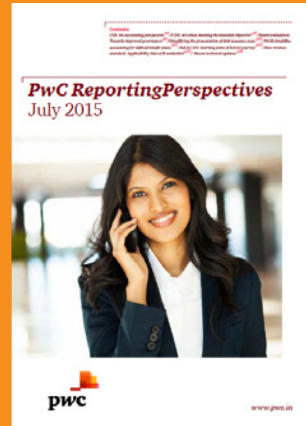

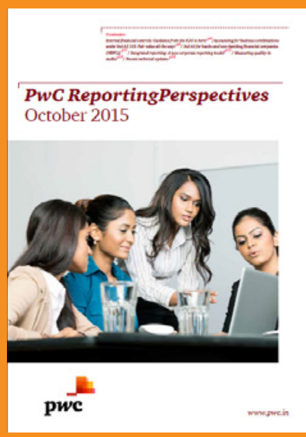

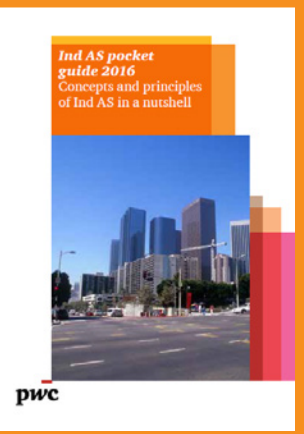

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