SUPPLEMENTARY FOR JUNE 2023 TERM OF EXAMINATION

PAPER - 17

SYLLABUS - 2016

SUPPLEMENTARY_PAPER 17_FOR JUNE 2023 TERM OF EXAMINATION_SYLLABUS 2016

Paper 17 : CORPORATE FINANCIAL REPORTING

Study Note - 1

ACCOUNTING STANDARDS

1.1 Generally Accepted Accounting Principles in India (Amendments)

QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS AS PER CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING [under IFRS (2018) and Ind AS (2021)]

The qualitative characteristics of useful financial reporting identify the types of information are likely to be most useful to users in making decisions about the reporting entity on the basis of information in its financial report.
Financial information is useful when it is relevant and represents faithfully what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

• **The fundamental qualitative characteristics are *relevance* and *faithful representation*.**

• **Relevance:** Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both. (**Predictive value** helps users in **predicting** or anticipating future outcomes. **Confirmatory value** enables users to check and confirm earlier predictions or evaluations).
Materiality is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity's financial report.

• **Faithful representation:** It would be ***complete, neutral* and *free from error***. A neutral depiction is supported by the exercise of ***prudence***. *Prudence* is the exercise of *caution* when making judgements under conditions of *uncertainty*.

• **Enhancing Qualitative Characteristics: *Comparability, verifiability, timeliness and understandability*** *are qualitative c*haracteristics that enhance the usefulness of information that is relevant and faithfully represented.

• **Comparability:** Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

• **Verifiability**: Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

• **Understandability**: Classifying, characterising and presenting information clearly and concisely makes it *understandable*. While some phenomena are inherently complex and cannot be made easy to understand, to exclude such information would make financial reports incomplete and potentially misleading. Financial reports

are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information with diligence.
Applying the enhancing qualitative characteristics: Enhancing qualitative characteristics should be maximised to the extent necessary. However, enhancing qualitative characteristics (either individually or collectively) cannot render information useful if that information is irrelevant or not represented faithfully.

1.2 Overview of Accounting Standards (AS) (Amendments)

Applicability of Accounting Standards:

The Companies (Indian Accounting Standards) Rules, 2015 (and subsequent amendments to the Rules) made Ind AS applicable to the specified entities, leaving AS [as per the Companies (Accounting Standards) Rules, 2021 (replacing the Companies (Accounting Standards) Rules, 2006)] applicable to other entities.

Accounting Standards. - (1) The Central Government hereby specifies Accounting Standards 1 to 5, 7 and 9 to 29 as recommended by the Institute of Chartered Accountants of India, which are specified in the Annexure to these rules. (2) The Accounting Standards shall come into effect in respect of accounting periods commencing on or after the 1st day of April, 2021.

Obligation to comply with Accounting Standards. - (1) Every company, other than companies on which Indian Accounting Standards as notified under Companies (Indian Accounting Standards) Rules, 2015 are applicable, and its auditor(s) shall comply with the Accounting Standards in the manner specified in the Annexure. (2) The Accounting Standards shall be applied in the preparation of Financial Statements.
As notified by the Central Government in consultation with the National Advisory Committee on Accounting Standards, the Central Government issued the 'Criteria for Classification of Entities and Applicability of Accounting Standards' **for the companies**. The Government classified the companies into two levels: Small and Medium-sized Companies (SMCs) as defined in the Companies (Accounting Standards) Rules, 2021 and companies other than SMCs (Non-SMCs). Non-SMCs are required to comply with all the Accounting Standards in their entirety, while exemptions/relaxations have been granted to SMCs.

Under the new Companies (Accounting Standards) Rules, 2021, a Small and Medium-Sized Company (SMC) is defined as follows:

An SMC is a company:

1. Whose equity/debt securities aren't listed or not in the process of being listed on any stock market in India or abroad,
2. Which is neither a bank, a financial institution, nor an insurance firm,
3. Whose turnover (excluding other income) in the previous accounting year was not more than 250 crore rupees,
4. Which does not have any loans/borrowings (including public deposits) in excess of 50 crore rupees at any point during the previous accounting year, and
5. Which is not a holding company or a subsidiary of a company that is not a small or medium-sized company.

According to law, a company qualifies as a Small and Medium-Sized Company if all of the conditions listed above are met at the end of the relevant accounting period.

Exemption or relaxation to SMCs

There are many exemptions available to small & medium-sized companies that are not available to other companies.

Accounting Standard – 3 'Cash flow statement' and Accounting Standard – 17 'Segment reporting' are not applicable to SMCs. SMCs are exempt from them. However, the exemption of Accounting Standard 3 will apply only to companies with a paid-up capital of up to ₹50 lacs and a turnover of up to ₹2 crores. Beyond these limits, Section 2(40) of the Companies Act 2013 requires the preparation of a cash flow statement.

SMCs are also given some relaxation from detailed disclosures that are required to be made by the Accounting Standard 15 – 'Employee Benefits'. Further, they are also granted certain relaxations from detailed disclosures with regards to an operating lease as well as a finance lease.

In addition, the disclosure of diluted earnings per share (DPS) is not needed for SMCs. If all options to convert other securities into shares are executed, diluted earnings per share reflect a company's earnings per share.

SMCs can also give an estimated value in the use of assets on their balance sheets, and they aren't obligated to employ present value procedures to do so. The present value of future cash flow flowing from the continuous use of an asset & its disposal at the end of its useful life is referred to as the asset's value in use. Larger enterprises, on the other hand, must utilize present value approaches and disclose the discount rates used to calculate an asset's worth in use.

Management estimates might be used instead of present value methodologies for the purposes of impairment provision. In many circumstances, this will also save money on the services of an expert or a valuer.

[Note: For Non-company entities (Enterprises) the Council of the ICAI considered applicability of Accounting Standards by classifying them into four categories. Level I entities are large size entities, which are required to comply in full with all the Accounting Standards. Level II entities are medium size, Level III small size and Level IV are micro entities, [referred to as Micro, Small and Medium size entities (MSMEs), for which certain relaxations/ exemptions have been granted.]

1.4 Applicability of Indian Accounting Standards (Matters added for more clarity)

Ind AS has become applicable in following phases

Companies (Indian Accounting Standards) Rules, 2015 notified Indian Accounting Standards (Ind-AS) on 16th February, 2015. The Rules 2015 shall come into force from 1st day of April, 2015. Ind-ASs are in the process of being implemented in phases.

Application of Ind ASs has been implemented for the companies as categorised in groups A, B and is in the process of being implemented for the companies as categorised in groups C and D.

A. For Companies other than banks, NBFC, and Insurance companies:

Phase I voluntarily – accounting periods beginning on or after 1st April, 2015

– Voluntary Basis for all companies (with comparatives)

Phase II mandatorily – accounting periods beginning on or after 1st April, 2016

1. Companies listed/in process of listing on Stock Exchange in India or outside India having net worth greater than or equal to INR 5 Billion.

2. Unlisted companies having net worth greater than or equal to INR 5 Billion.

3. Parent, Subsidiary, Associate and Joint Venture of above

Phase III mandatorily – accounting periods beginning on or after 1st April, 2017

1. All Companies which are listed/or in process of listing inside or outside India on Stock Exchanges (other than companies listed on SME Exchanges).

2. Unlisted companies having net worth between INR 2.5 Billion and INR 5 billion.

3. Parent, Subsidiary, Associate, and Joint Venture of above

Note 1: Companies listed on SME Exchanges not required to apply IND AS

Note 2: Once IND AS are applied voluntarily, an entity should be required to follow IND AS for all the subsequent financial statements mandatorily.

B. For Non-Banking Financial Companies (NBFC)

PHASE-I: From 1st April,2018 (with comparatives)

1. NBFC (whether listed or unlisted) having net worth 500 crores or more

2. Holding, Subsidiary, JV and Associate companies of above NBFC other than those already covered above corporate roadmap shall also apply from said date.

PHASE-II: From 1st April,2019 (with comparatives)

1. NBFC whose equity and/or debt securities are listed or are in process of listing on any stock exchange in India or outside India and having net worth less than 500 crores.

2. NBFC that are unlisted having net worth between 250 crores and 500 crores

3. Holding, Subsidiary, JV and Associate companies of above NBFC other than those already covered above corporate roadmap shall also apply from said date.

Note 3. Applicable for both Consolidated and Individual Financial Statements.

Note 4. Unlisted NBFC having net worth below 250 crores shall not apply IND AS.

Note 5. Adoption of IND AS is allowed only when required as per roadmap.

Note 6. Voluntary Adoption of IND AS is not allowed.

C. For Scheduled Commercial Banks (excluding RRBs) and Insurers/Insurance companies Ind AS application has not yet been implemented.

The Banking Companies and Insurance Companies shall apply the Ind ASs as notified by the Reserve Bank of India (RBI) and Insurance Regulatory Development Authority (IRDA) respectively.

RBI through its notification dated March 22, 2019 has deferred the implementation of Ind AS to all scheduled commercial banks till further notice.

The Insurance Regulatory and Development Authority (IRDA) has deferred the date of implementation of Indian Accounting Standard (Ind-AS) for the insurance sector from FY20-21 till further notice.

D. Companies not covered by the above shall continue to apply existing Accounting standards notified in Companies (Accounting Standards) Rules, 2006.

The applicability of Ind AS is summarised below in tabular form.

Mandatory application of Ind AS

Types of Companies/entities	Threshold Limit of Net worth (INR)	Applicable from	Ind AS applicability on 01/04/21
Listed Companies/ Companies in process of Listing in India or outside India or Parent, Subsidiary, Associate, and Joint Venture of above	500 Cr or more	01/04/2016	Applicable
	< 500 Cr	01/04/2017	Applicable
Unlisted Companies/ Pvt. Ltd. Companies	=> 500 Cr	01/04/2016	Applicable
	250 and 500 Cr	01/04/2017	Applicable
	< 250 Cr		Not Applicable
Companies listed in SME			Not Applicable
NBFC – Listed	>= 500 Cr	01/04/2018	Applicable
	< 500 Cr	01/04/2019	Applicable
NBFC – Unlisted	>= 500 Cr	01/04/2018	Applicable
	250 and 500 Cr	01/04/2019	Applicable
	< 250 Cr		Not Applicable
Banks.			Not Applicable (Implementation deferred)
Insurance co			Not Applicable (Implementation deferred)
Urban Cooperative Bank			Not Applicable
Rural Regional Bank			Not Applicable

As on 01-04-2021 MCA has notified 42 Ind ASs out of which 3 were omitted leaving 39 in application at present.

The full list is presented below:

Ind AS 101	First-time adoption of Ind AS
Ind AS 102	Share Based payments
Ind AS 103	Business Combination
Ind AS 104	Insurance Contracts
Ind AS 105	Non-Current Assets Held for Sale and Discontinued Operations
Ind AS 106	Exploration for and Evaluation of Mineral Resources
Ind AS 107	Financial Instruments: Disclosures
Ind AS 108	Operating Segments
Ind AS 109	Financial Instruments
Ind AS 110	Consolidated Financial Statements
Ind AS 111	Joint Arrangements
Ind AS 112	Disclosure of Interests in Other Entities
Ind AS 113	Fair Value Measurement
Ind AS 114	Regulatory Deferral Accounts
Ind AS 115	Revenue from Contracts with Customers (Ind AS 11 and Ind AS 18 replaced)
Ind AS 116	Leases (Ind AS 18 replaced)
Ind AS 1	Presentation of Financial Statements
Ind AS 2	Inventories Accounting
Ind AS 7	Statement of Cash Flows
Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
Ind AS 10	Events after Reporting Period
Ind AS 12	Income Taxes
Ind AS 16	Property, Plant and Equipment
Ind AS 19	Employee Benefits
Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
Ind AS 21	The Effects of Changes in Foreign Exchange Rates
Ind AS 23	Borrowing Costs
Ind AS 24	Related Party Disclosures

Ind AS 27	Separate Financial Statements
Ind AS 28	Investments in Associates and Joint Ventures
Ind AS 29	Financial Reporting in Hyperinflationary Economies
Ind AS 32	Financial Instruments: Presentation
Ind AS 33	Earnings per Share
Ind AS 34	Interim Financial Reporting
Ind AS 36	Impairment of Assets
Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
Ind AS 38	Intangible Assets
Ind AS 40	Investment Property
Ind AS 41	Agriculture

Study Note - 4

RECENT TRENDS IN FINANCIAL REPORTING

4.10 Corporate Social Responsibility Reporting (CSR Reporting) (Amended)

What is CSR?

World Business Council for Sustainable Development (WBCSD) defines Corporate Social Responsibility (CSR) as "the continuing commitment by business to contribute to economic development while improving the quality of life of the workforce and their families as well as of the community and society at large." As mentioned by United Nations Industrial Development Organization (UNIDO), "Corporate social responsibility is a management concept whereby companies integrate social and environmental concerns in their business operations and interactions with their stakeholders. CSR is generally understood as being the way through which a company achieves a balance of economic, environmental and social imperatives ("Triple-Bottom-Line-Approach"), while at the same time addressing the expectations of shareholders and stakeholders."

CSR in India:

In India, the Companies Act, 2013 has introduced the idea of CSR to the forefront. The Ministry of Corporate Affairs, Government of India notified the Section 135 of the Companies Act, 2013 along with Companies (Corporate Social Responsibility Policy) Rules, 2014 "hereinafter CSR Rules" and other notifications related thereto which makes it mandatory (with effect from 1st April, 2014) for certain companies who fulfill the criteria as mentioned under Sub Section 1 of Section 135 to comply with the provisions relevant to Corporate Social Responsibility. As per the said section, the companies having Net worth of INR 500 crore or more; or Turnover of INR 1000 crore or more; or Net Profit of INR 5 crore or more during any financial year shall be required to constitute a Corporate Social Responsibility Committee of the Board "hereinafter CSR Committee" with effect from 1st April, 2014. The above provision requires every company having such prescribed Net worth or Turnover or Net Profit shall be covered within the ambit of CSR provisions. The section has used the word "companies" which connotes a wider meaning and shall include the foreign companies having branch or project offices in India.

What a company covered under CSR needs to do?

Once a company is covered under the ambit of the CSR, it shall be required to comply with the provisions of the CSR. The companies covered under the Sub section 1 of Section 135 shall be required to do the following activities:

I. As provided under Section 135(1) itself, the companies shall be required to constitute CSR Committee. The CSR Committee shall be comprised of 3 or more directors, out of which at least one director shall be an independent director.
II. The Board's report shall disclose the compositions of the CSR Committee.
III. All such companies shall spend, in every financial year, **at least two per cent of the average net profits** of the company made during the three immediately preceding financial years, in pursuance of its Corporate Social Responsibility Policy. It has been clarified that the average net profits shall be calculated in accordance with the provisions of Section 198 of the Companies Act, 2013. Also, proviso to the Rule provide 3(1) of the CSR Rules that the net worth, turnover or net profit of a foreign company of the Act shall be computed in accordance with balance sheet and profit and loss account of such company prepared in accordance with the provisions of clause (a) of sub-section (1) of section 381 and section 198 of the Companies Act, 2013.
Corporate Social Responsibility Reporting (CSR Reporting)
IV. To submit CSR 1 for registration and CSR 2 for CSR reporting annually.

Activities may be included by the company in their CSR Policy as per Schedule VII of the Companies Act, 2013 **(According to the Companies (CSR Policy) Amendment Rules, 2021):**

(i) Eradicating hunger, poverty and malnutrition, promoting health care including preventive health care and sanitation including contribution to the Swach Bharat Kosh set-up by the Central Government for the promotion of sanitation and making available safe drinking water.
(ii) Promoting education, including special education and employment enhancing vocation skills especially among children, women, elderly and the differently abled and livelihood enhancement projects.
(iii) Promoting gender equality, empowering women, setting up homes and hostels for women and orphans; setting up old age homes, day care centres and such other facilities for senior citizens and measures for reducing inequalities faced by socially and economically backward groups.
(iv) Ensuring environmental sustainability, ecological balance, protection of flora and fauna, animal welfare, agroforestry, conservation of natural resources and maintaining quality of soil, air and water including contribution to the Clean Ganga Fund set-up by the Central Government for rejuvenation of river Ganga.
(v) Protection of national heritage, art and culture including restoration of buildings and sites of historical importance and works of art; setting up public libraries; promotion and development of traditional art and handicrafts;
(vi) Measures for the benefit of armed forces veterans, war widows and their dependents;
(vii) Training to promote rural sports, nationally recognised sports, paralympic sports and olympic sports
(viii) Contribution to the prime minister's national relief fund or any other fund set up by the central govt. for socio economic development and relief and welfare of the schedule caste, tribes, other backward classes, minorities and women;
(ix) Contribution to incubators funded by Central Government or State Government or any agency or Public Sector Undertaking of Central Government or State Government, and contributions to public funded Universities, Indian Institute of Technology (IITs), National Laboratories and Autonomous Bodies

(established under the auspices of Indian Council of Agricultural Research (ICAR), Indian Council of Medical Research (ICMR), Council of Scientific and Industrial Research (CSIR), Department of Atomic Energy (DAE), Defence Research and Development Organisation (DRDO), Department of Biotechnology (DBT), Department of Science and Technology (DST), Ministry of Electronics and Information Technology) engaged in conducting research in science, technology, engineering and medicine aimed at promoting Sustainable Development Goals (SDGs);

(x) Rural development projects

(xi) Slum area development.

(xii) Disaster management, including relief, rehabilitation and reconstruction activities.

Rule 7: CSR Expenditure

According to the Companies (CSR Policy) Amendment Rules, 2021, the administrative overheads should not exceed five per cent of the total CSR expenditure of the company for the financial year

The CSR amount may be spent by a company for the creation or acquisition of a capital asset, which shall be held by the following firms:

- **A company established under section 8 of the Act**
- **Registered Public Trust or Registered Society, having charitable objects and CSR Registration Number**
- **Beneficiaries of the said CSR project, in the form of self-help groups, collectives, entities**
  A public authority

Rule 8: CSR Reporting:

Rule 8 of the CSR Rules provides that the companies, upon which the CSR Rules are applicable shall be required to incorporate in its Board's report an annual report on CSR containing the following particulars:

- A brief outline of the company's CSR Policy, including overview of projects or programs proposed to be undertaken and a reference to the web-link to the CSR policy and projects or programs;
- The composition of the CSR Committee;
- Average net profit of the company for last three financial years;
- Prescribed CSR Expenditure (2% of the amount of the net profit for the last 3 financial years);
- Details of CSR Spent during the financial year;
- In case the company has failed to spend the 2% of the average net profit of the last three financial year reasons thereof;
- A responsibility statement of the CSR Committee that the implementation and monitoring of CSR Policy, is in compliance with CSR objectives and Policy of the company.
- In case of a foreign company, the balance sheet shall contain an annual report on CSR
- Every company having average CSR obligation of `10 Crore or more in the three immediately preceding financial years, shall undertake impact assessment, through an independent agency, of their CSR projects having outlays of ₹1 Crore or more, and which have been completed not less than one year before undertaking the impact study.
- The impact assessment reports need to be placed before the Board and shall be annexed to the annual report on CSR

  Rule 9: Website Disclosure

  The Board of Directors of the Company need to mandatorily disclose the composition of the CSR Committee, and CSR Policy and Projects approved by the Board on their website for public access.

  Rule 10: Transfer of unspent CSR

The unspent CSR amount will be transferred by the company to any fund included in schedule VII of the Companies Act.

Every entity who intends to undertake any CSR activity needs to register itself with the Central Government by filing the form CSR-1 electronically with the Registrar, with effect from 01.04.2021.

4.13 Business Responsibility Reporting (Amended)

Introduction

In 2012, the Securities Exchange Board of India (SEBI) passed a circular amongst the top 100 companies based on market capitalization, making it mandatory for firms to report their environmental, social and governance initiatives. This report, Business Responsibility Report (BRR), has to be filed as part of their annual reports based on nine principles of National Voluntary Guidelines (NVG). At the time of introduction, only the top-100 BSE-listed firms were required to present BRRs as part of annual reports. In 2016, after signing a memorandum of understanding (MoU) with Global Reporting Initiative, the mandate was extended to top-500 BSE listed companies. Against this backdrop, SEBI vide its gazette notification1 dated 26.12.2019 issued Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Fifth Amendment) Regulations, 2019 extending the applicability of BRR to top 1000 listed entities based on market capitalization from the present requirement of top 500 listed entities. The proposal was approved by SEBI in its meeting held on November 20, 2019.

Currently, top 1,000 listed companies in India are required to furnish a Business Responsibility Report (BRR) to the stock exchanges as a part of their annual reports. The BRR should describe the initiatives taken by the listed companies from an Environmental, Social and Governance (ESG) perspective, in the format as specified by the Securities and Exchange Board of India (SEBI). Other listed companies may submit the BRR voluntarily.

New development

SEBI through a notification dated 5 May 2021 has made amendments to certain provisions of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (LODR). Among various amendments, one relates to discontinuance of the requirement of submitting BRR by listed companies after FY2021-22. As per the notification, companies would be required to submit a new report on ESG parameters, namely Business Responsibility and Sustainability Report (BRSR) in the following manner

- **Mandatory from FY2022-23**: For top 1,000 listed companies by market capitalisation
- **Voluntary for FY2021-22:** For top 1,000 listed companies by market capitalisation
- **Voluntary for other companies:** Listed companies (other than top 1,000) and companies which have listed their specified securities on the Small and Medium Enterprises (SME) exchange may voluntarily submit BRSR in place of BRR effective FY2021-22 onwards.

Additionally, SEBI through a notification dated 10 May 2021 has prescribed the format of new report, BRSR along with the guidance note to enable companies to interpret the scope of disclosures required to be made in the report.

Those listed entities which prepare and disclose sustainability reports (as part of annual report) based on internationally accepted reporting frameworks such as Climate Disclosure Standards Board (CDSB), the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB), can cross-reference the disclosures made under such framework to the disclosures sought under the BRSR. Further, in case the data sought in the reporting format is already disclosed in the annual report, the listed entity can provide a cross-reference to the same.

Thus, an entity need not disclose the same information twice in the annual report. However, the entity should specifically mention the page number of the annual report or sustainability report where the information sought under the BRSR format is disclosed as part of the report prepared based on internationally accepted reporting framework.

Business Responsibility and Sustainability Report (BRSR)

There are three sections (A, B and C) in the suggested format and guidance note. [ANNEXURE I and II to SEBI Circular]

SECTION A: General Disclosures

I. Details of the listed entity

II. Products/services

III. Operations

IV. Employees

V. Holding, Subsidiary and Associate Companies (including joint ventures)

VI. CSR Details

VII. Transparency and Disclosures Compliances

SECTION B: MANAGEMENT AND PROCESS DISCLOSURES

This section is aimed at helping businesses demonstrate the structures, policies and processes put in place towards adopting the NGRBC (The National Guidelines on Responsible Business. Conduct, 2018) Principles and Core Elements.

SECTION C: PRINCIPLE WISE PERFORMANCE DISCLOSURE

This section is aimed at helping entities demonstrate their performance in integrating the Principles and Core Elements with key processes and decisions. The information sought is categorized as “Essential” and “Leadership”. While the essential indicators are expected to be disclosed by every entity that is mandated to file this report, the leadership indicators may be voluntarily disclosed by entities which aspire to progress to a higher level in their quest to be socially, environmentally and ethically responsible.

PRINCIPLE 1: Businesses should conduct and govern themselves with integrity, and in a manner that is Ethical, Transparent and Accountable.

PRINCIPLE 2: Businesses should provide goods and services in a manner that is sustainable and safe

PRINCIPLE 3: Businesses should respect and promote the well-being of all employees, including those in their value chains

PRINCIPLE 4: Businesses should respect the interests of and be responsive to all its stakeholders

PRINCIPLE 5: Businesses should respect and promote human rights

PRINCIPLE 6: Businesses should respect and make efforts to protect and restore the environment

PRINCIPLE 7: Businesses, when engaging in influencing public and regulatory policy, should do so in a manner that is responsible and transparent

PRINCIPLE 8: Businesses should promote inclusive growth and equitable development.

PRINCIPLE 9: Businesses should engage with and provide value to their consumers in a responsible manner.

Study Note - 5

VALUATION, ACCOUNTING AND REPORTING OF FINANCIAL INSTRUMENTS AND OTHERS

5.1 Recognition & Valuation Financial Instruments (Ind AS)

5.2 GST Accounting (Matters added for updation and more clarity)

5.3 NBFC – Provisioning Norms and Accounting

5.4 Valuation of Shares (Addendum)

5.5 Valuation of Goodwill

5.2 Goods and Services Tax (GST) Accounting (Matters added for updation and more clarity)

GST: Input Tax Credit adjustment against Output Tax liability

1. **To pay IGST –** First IGST credit will be used followed by CGST or SGST as per the taxpayer's preference.
2. **For paying CGST –** Starting from CGST credit and then IGST credit will be used
3. **To pay SGST – First** SGST credit and the IGST credit will be used

5.4 Valuation of Shares (Addendum)

For valuation of Business and shares two new approaches are presented below:

4. Discounted Cash Flow (DCF) model

5. Market Approach

4. Discounted Cash Flow (DCF) model

It indicates the fair market value of a business (or Equity) based on the value of cash flows that the business (or Equity) is expected to earn in future. This method involves the estimation of Net Operating Profits Adjusted Tax (NOPAT) for the projected period, the business's requirement of reinvestment in terms of capital expenditure and incremental working capital and appropriate cost of capital that reflects the risks of the corresponding return.

(a) Merits of DCF model:

(i) Cash flows are unaffected by any differences of accounting policies, principles, conventions and methods.

(ii) It provides the intrinsic or economic value unaffected by market forces.

(b) De-merits of DCF model:

It is hard

(i) to estimate future cash flows, and

(ii) to apply appropriate rate of discounting

(c) Computation of value per share = Value of Equity/ No. of equity shares

Value of Equity = Value of the business less value of Debt Capital

Value of business = Aggregate of future cash flows (or Free Cash flows) discounted at its present worth

(d) Let us see how cash flows are computed so that future cash flows can be projected.

a. Cash Flows (CF) = NOPAT + Depreciation, amortisation, impairment etc. (non-cash expenses charged against profits) + (-) Decrease (Increase) in non-cash working capital

Net Operating Profits Adjusted Tax (NOPAT) = EBIT×(1 - t)

EBIT (Earnings Before Interest and Tax) is Net Operating Profits.

t = Tax Rate = Tax expenses/Earning Before Tax (EBT)

b. Free Cash Flows are of two types: (1) Free Cash Flows to the Firm (FCFF) and (2) Free Cash Flows to the Equity (FCFE)

b1. FCFF = CF – Capex (Capex means capital expenditures made within the business for expansion, replacement etc.)

b2. FCFE {Free Cash Flow to the Equity} = FCFE = Net Income – Increase in non-cash WC – Net Capex + Net Debt Issue

Or, FCFE = FCFF – Interest net of tax + Net Debt Issued

Interest net of tax = Interest × (1 – t)

(e) Terminal Value or continuing value:

As business is a going concern, at the end of the limited period for which future cash flows (CF, FCFF or FCFE) are projected, the terminal value has to be computed by aggregating the discounted cash flows from that moment till infinity. Thus, Terminal Value = ΣDCF commencing from the end of projection period continued up to infinity.

(i) Two assumptions are made for finding terminal value for business valuation:

a. There is an infinite series of cash flows (CF, FCFF or FCFE)

b. Cash flows are either (a) constant or (b) growing at a constant rate

(f) Value of business = Aggregate of future cash flows (or Free Cash flows) discounted at its present worth = ΣDCF (for the period future cash flows are projected) + Terminal Value (Continuing Value) discounted at its present worth

Terminal Value (Continuing Value) at constant cash flows assumption = TV_n = CF(n+1)/k, where, k is the discounting rate

Terminal Value (Continuing Value) at constant growth rate of cash flows assumption

= TV_n

= CF(n+1)/ (k – g), where, k = WACC is the discounting rate, g = growth rate in cash flows.

(g) Value of Equity = Value of Business – Debt Capital [based on CF or FCFF]

Alternatively, the value obtained by aggregating FCFE discounted at cost of equity.

Illustrative examples of Discounted Cash Flow (DCF) model:

Illustration 1

Yr.	2018	2019	2020	2021	2022 ………..
CF (₹)	2,000	2,400	2,500	3,000	3,000 continued at 3,000

(a) Find value of the business on 01.01.2021, given that WACC = 12%.

(b) Find value of the business on 01.01.2020, given that WACC = 12%.

(c) Find value of the business on 01.01.2019, given that WACC = 12%.

Solution:

(a) From the date of valuation all future cash flows are constant at ₹800. Thus, in accordance with the formula of Continuing value is (V_0 = CF1/k) : V1-1-21 = CF2021/WACC = 3,000/12% = ₹25,000

(b) From the date of valuation future cash flows for 2020 is projected at ₹2,500 and on 01.01.2021 we may apply the formula of Terminal Value which we already found in part (a) at ₹ 25,000. Thus, in accordance with the formula, business value is

V_1-1-20 = ₹2,500/(1.1) + ₹25,000/(1.1) [DCF for 2020 + PV of the Terminal Value] = ₹2,232 + ₹22,321 = ₹24,554

(c) From the date of valuation future cash flows for 2019 and 2020 are projected at ₹2,400 and ₹2,500 and on 01.01.2021 we may apply the formula of Terminal Value which we already found in part (a) at ₹25,000. Thus, in accordance with the formula, business value is

V_1-1-19 = ₹2,400/(1.1) + ₹2,500/(1.1)^2 + ₹25,000/(1.1)^2 [DCF for 2019 and 2020 + PV of the Terminal Value]

= ₹2,143 + ₹1,993 + ₹19,930 = **₹24,066 (Approx.)**

Workings:

(₹ in Lakh)

	Particulars	01.01.2019	2019	2020	2021 onwards continued to infinity
	CF		2,400	2,500	3,000
	Terminal Value (TV)			25,000	
	DCF of 2019	2,143			
	DCF of 2020	1,993			
	TV on 01.01.2021			25,000	
	PV of TV	19,930			
(c)	$V_0$1.01.2019	24,066			
(b)	$V_0$1.01.2020				
	PV of TV		22,321		
	DCF of 2020		2,232		
	$V_0$1.01.2020		24,554		
(a)	$V_0$1.01.2021			25,000	

Illustration 2.

Forest Ltd. is contemplating to acquire an equity stake in Tree Ltd. and requires to know the intrinsic value of its shares on 01.04.2019 based on FCFF.

The following data of Twilight Ltd. are available:

(₹' 000)

Year	2018-19	2019-20	2020-21	2021-22
Actual/projected EBIT	500	600	800	1,000
Interest	75	75	100	100
Depreciation	100	120	125	130
Increase in Current Assets	95	110	100	120
Increase in Current Liabilities	15	20	30	40
Capital Expenditure	140	150	160	170
Debt Capital at the end of the year	3,000	3,000	4,000	4,000
Number of equity shares outstanding = 100000; WACC = 10%; Cost of equity = 15%; Effective tax rate = 25%; FCFF is expected to grow at (I) 0% and at (II)3% p.a. for infinite time from the year 2022-23.				

Solution:

(₹'000)

Year	2018-19	2019-20	2020-21	2021-22
NOPAT [EBIT*(1 – t)]	375	450	600	750
Cash Flow [NOPAT + Dep – Increase in WC]	395	480	655	1035
FCFF [Cash Flow – Capex]	255	330	495	630
DCF at 01.04.2019		295	395	
Terminal Value at zero growth			5,250	
Terminal Value at 3% growth			7,000	
PV of TV (zero growth)	4,185			
PV of TV (3% growth)	5,580			
Value of Business (zero growth)	4,875			
Value of Business (3% growth)	6,270			
Value of Equity (zero growth)	1,875			
Value of Equity (3% growth)	3,270			
Value per share zero growth	18.75			
Value per share 3% growth	32.70			

Note: Past FCFF, Interest and K_e are not relevant. Terminal Value (TV) at 31.03.2021 at zero growth = 630/12%; at 3% growth = 630/(12% - 3%)

B. Market Approach

Under market approach, value of equity is determined by applying relative or multiple to the base value of the company. Relative or multiple is the ratio of market price to some accounting variable of the company taken as the base value.

Most common multiples are price-earnings (P/E) ratio, price-sales (P/S) ratio, price-cash flow from operations (P/CFO) ratio etc. Important point is the relatives have to be computed for the peer group of companies to find the average relationship between the base value and market price. After obtaining the average relationship through relative or multiple, the company finds its calculated market price by applying the average relative to its base value.

The steps involved to find value per share based on market approach:

1. Market capitalisation of each of the peer group of companies is related to any fundamental element of that company (called base value such as Profits, Cash Flows, Net assets, Sales). The ratio obtained is called relative or multiple.
2. To decide what will be the base value on which multiple will be applied. More than one multiple is usually considered in practice.
3. To compute the average of the multiples of the peer group of companies (we call it as Comparator) for each base value.
4. To apply the average multiple (Comparator) to a particular base value of the required company for valuation of its equity for that base. Then to find average of the different equity values based on different base values.
5. To divide average value of equity by the no. of shares in order to find value per share.

Market capitalisation is the product of market price of shares and the no. of shares outstanding. Thus, it represents market value of equity. In computation of relative we may find some popular ratios also such as Price Earnings ratio where base value is Earnings and Market to Book Value ratio where base value is Net Assets. But in all circumstances the base values are related to market value of equity.

Relative or multiple = Market Capitalisation/Base value. [where, alternative base values are EAT, EBIT, NOPAT, CF, FCFF, FCFE, Net Assets, Enterprise Value, Sales, or any other fundamental variable]

Problem 3.

X Ltd. has EPS ₹ 15 and no. of shares 1,200. Its CF ₹ 15,600 and Sales ₹ 90,000. Find value per share of X Ltd. using simple average of market values based on three base values (PAT, CF and Sales) of similar other companies as provided below:

Companies	PAT (₹)	CF (₹)	Sales (₹)	MC (₹)
A	24,000	30,000	1,50,000	1,80,000
B	18,000	20,000	1,80,000	2,16,000
C	30,000	36,000	1,60,000	1,80,000
D	20,000	25,000	1,50,000	1,80,000

Solution:

PAT of X Ltd. = EPS* No. of shares = ₹15*1200 = ₹18,000

For the 4 companies in the peer group Relatives are computed as MC/ Base Value

For PAT as base value M_1 is the multiple.

For CF as base value M_2 is the multiple.

For Sales as base value M_3 is the multiple.

Comparator is the average value of the multiples for the 4 companies.

Value of equity of X for each base = Base Value of X*Comparator

					Multiples		
Companies	**PAT (₹)**	**CF (₹)**	**Sales (₹)**	**MC (₹)**	**M_1=MC/PAT**	**M_1=MC/CF**	**M_1=MC/Sales**
A	24,000	30,000	1,50,000	1,80,000	7.5	6	1.2
B	18,000	20,000	1,80,000	2,16,000	12	10.8	1.2
C	30,000	36,000	1,60,000	1,80,000	6	5	1.125
D	20,000	25,000	1,50,000	1,80,000	9	7.2	1.2
Comparator					8.625	7.25	1.18125
Baser Value of X					18,000	15,600	90,000
Value of equity of X					1,55,250	1,13,100	1,06,312.5
No. of equity shares					1,200	1,200	1,200
Value per share based on Base Value					129.375	94.25	88.59375
Average value per share					104.072917		

Calculated market value of Equity of X = Comparator × Base Value of X.