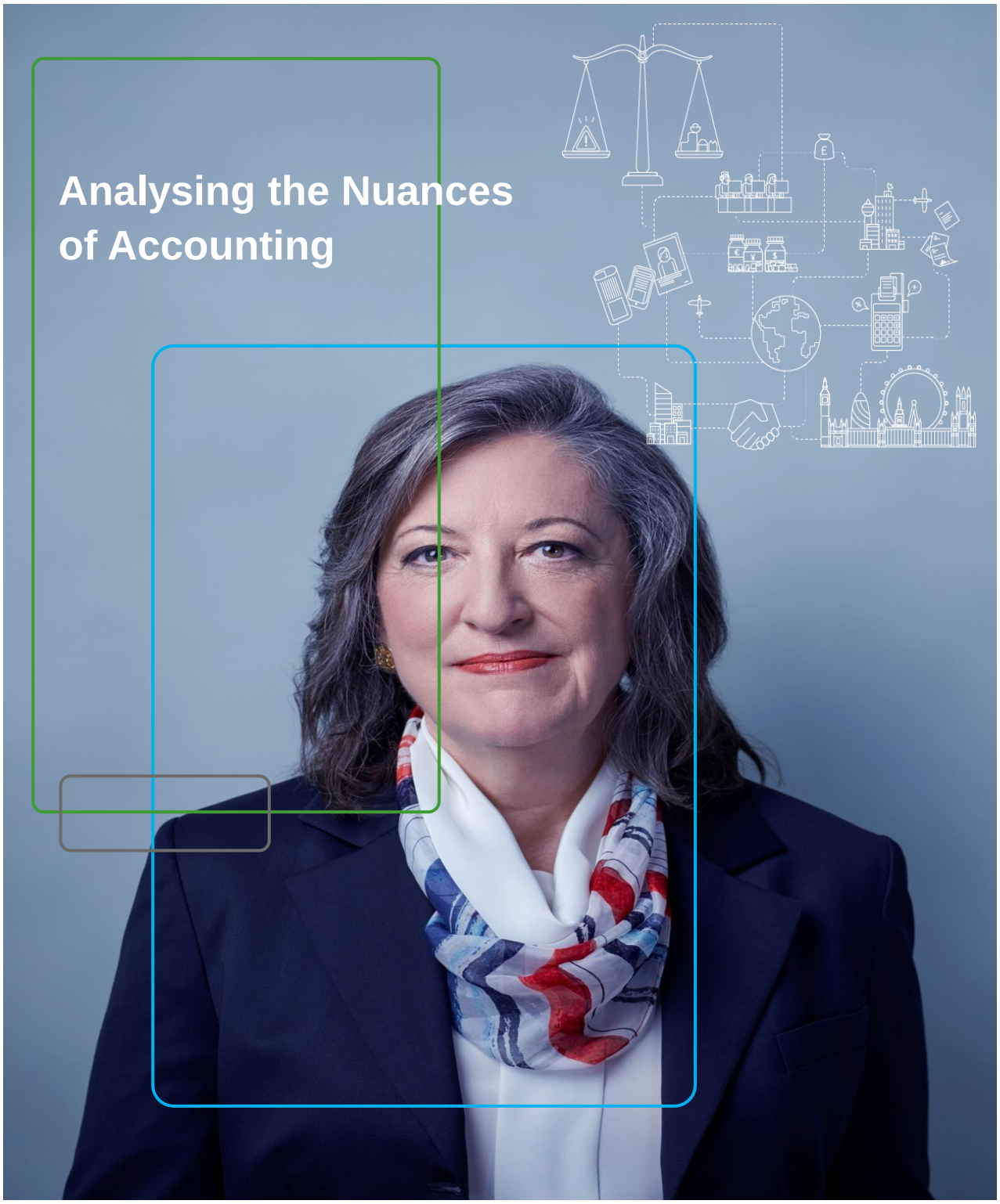


August 2022

Research Publication

Accounting Implications of Rupee Devaluation, Inflation and Current Geo-Political Scenario

THE POWER OF BEING UNDERSTOOD
AUDIT | TAX | CONSULTING

RSM

RSM IN INDIA

- RSM India (comprising of RSM Astute Consulting Group and affiliates) is consistently ranked amongst India's top 6 tax, accounting and consulting groups [International Accounting Bulletin, 2010-2022]
- Nationwide presence through offices in 12 key cities across India
- Multi-disciplinary personnel strength of over 2,250
- International delivery capabilities

rsmindia.in

RSM AROUND THE GLOBE

- Amongst world's leading provider of audit, tax and consulting services to entrepreneurial growth-focused organisations globally
- Annual combined fee income of US$ 7.26 billion
- Combined staff of over 51,000 in over 860 offices across more than 123 countries

rsm.global

Foreword

We are at present witnessing the most uncertain and volatile times due to a multitude of developments. The three most crucial developments are the current geo-political developments, huge increase in inflation and rising interest rates.

The current geo-political scenario across the world starting from Russia's conflict with Ukraine since February 2022 and the global reactions/sanctions as well as and the China – Taiwan developments have been affecting the economies and financial markets around the world. This has given rise to disruption in global supply chain, rise/volatility in prices of crude oil and several commodities, disruption in capital markets, and foreign exchange volatility and so on. Further, some of the neighboring countries have been witnessing severe economic and political emergencies, with depletion in foreign exchange reserves.

Supply chain disruption can cause inability to meet sales and production targets, higher freight and logistics costs, higher insurance costs, etc. These inefficiencies may cause increase in cost of production, raising prices for consumers. For example, the semiconductor supplies around the world, which were already strained, have been severely affected.

The devaluation in foreign exchange rates against US$ and extreme volatility in foreign exchange rates in several countries has resulted in impact on foreign currency borrowings, imports, exports and capital flows. The Indian rupee which has been stable over the past 3 - 4 years has witnessed a steep devaluation of over 6% to 8% in the recent months. Due to the steep decline of the Indian rupee and foreign exchange volatility, the financial performance is impacted significantly.

The other major global trend is increase in interest rates which would impact the repayment obligations, housing market, provisioning requirements and so on. It is inevitable that the broader impact of the current geo-political scenario and macroeconomic conditions would have impact on business, the extent of which may vary.

Business entities need to consider the accounting/ financial reporting impact that these developments may have on their financial statements/ results. In this publication, we have endeavored to present a summary of the key accounting aspects impacted by the current geo-political scenario, inflation and foreign exchange fluctuation under both, the under Companies (Accounting Standards) Rules, 2021 ("I GAAP") as well as Companies (Indian Accounting Standards) Rules, 2015 ("Ind AS").

In separate chapters, this publication covers the financial reporting considerations of

- Current geo-political scenario
- Devaluation in Indian Rupee and foreign exchange volatility
- Rise in inflation
- Key Disclosure Requirement in financial statements

The current scenario is evolving, and the geo-political scenario is constantly changing. The impact, and, therefore, the extent of accounting implications would differ across the world and across the business entities. This publication is not intended to identify each geo-political event specifically. The endeavor is to raise the awareness about the likely financial reporting implications of such events.

Table of Contents

Chapter 1: Accounting Implications of Current Geo-Political Scenario

The current geo-political scenario across the world starting from Russia's conflict with Ukraine since February 2022 and the global reactions/sanctions as well as the China – Taiwan developments have been affecting the economies and financial markets around the world. This has given rise to disruption in global supply chain, rise/volatility in prices of crude oil and several commodities, disruption in capital markets, and foreign exchange volatility and so on. Further, some of the neighboring countries have been witnessing severe economic and political emergencies, with depletion in foreign exchange reserves.

Supply chain disruption can cause inability to meet sales and production targets, higher freight and logistics costs, higher insurance costs, etc. These inefficiencies may cause increase in cost of production, raising prices for consumers. For example, the semiconductor supplies around the world, which were already strained, have been severely affected.

Several countries around the world are facing economic crises and/or recessionary trend. It is important for business entities to consider the financial reporting implications resulting from the resultant impact on their operations and activities. The direct implications would result from investments and assets located in affected geographies such as, Ukraine, Russia, etc., and impact of the volume of businesses and remittance from subsidiaries/ branches/ operations with and within those areas.

Significant accounting implications can also emerge due to indirect consequences associated with the global economic consequences, for example, the disruptions in supply and prices of commodities (crude oil, petrol, natural gas, cereals, steel, etc.) which may affect the overall business environment of business entities in general.

1.1 Asset Impairment

Both Ind AS 36 Impairment of Assets and AS 28 Impairment of Assets require an entity to assess, at the end of each reporting period, whether there is any impairment for an entity's non-financial assets. An entity is required to assess at each reporting date whether there are any indications of impairment (other than for goodwill and indefinite life intangible assets under Ind AS 36). Impairment test only has to be carried out if there are such indications. An asset is impaired when an entity is not able to recover it's carrying value, either by using it or selling it. Recoverable amount is the higher of the fair value less costs of disposal and the value in use. Value in use is defined as the present value of the future cash flows expected to be derived from an asset or cash-generating unit. The calculation of an asset's value in use incorporates an estimate of expected future cash flows and expectations about possible variations of such cash flows. Ind AS 36 requires goodwill and indefinite-lived intangible assets to be tested for impairment at a minimum every year,

and other non-financial assets whenever there is an indicator those assets might be impaired.

Direct or indirect impact of the geopolitical tensions may trigger a need for impairment assessment. Following are events that might indicate impairment:

- Supply chain disruption for critical inputs/ material;
- Breaches of long term supply/purchase contracts;
- Reduction in sales in Russian market or decisions by companies to discontinue Russian operations; and
- Physical damage as a result of the war.

1.2 Inventory

Supply chain issues and significant fluctuation in commodity prices may necessitate to consider whether a write down or provision for reduction in net realisable value of inventory is required. These could be on account of reduced turnover in inventory, inability in inventory or an increase in raw material cost and component cost to complete production due to disruptions or increased costs making a customer project unviable.

Both AS 2 and Ind AS 2 require determination of net realisable value at the reporting date considering all available information, including changes in product prices subsequent to the reporting date. On the other hand, if a specific event leading to loss of value of the inventory, e.g., disappearance of a market due to the outbreak of war that was not reasonably expected as of the reporting date, the net realizable value write down/ provision is recognized in the same period that the event occurred.

Further, AS 2 and Ind AS 2 require cost of inventory to be determined after considering the fixed production overheads based on normal production capacity. Decline in production level may affect the extent to which overheads can be absorbed in the cost of inventory.

1.3 Property, Plant & Equipment

The geopolitical crises might mean that fixed assets or property, plant and equipment are not fully utilized during a period, or that capital projects are suspended. Useful lives of assets may need to be reviewed. AS 10 Property, plant and equipment and Ind AS 16 Property, plant and equipment require depreciation to continue to be charged in the income statement while an asset is temporarily idle. AS 16 Borrowing costs Ind AS 23 Borrowing costs requires the capitalisation of interest to be suspended when development of an asset is suspended.

For example, if a company temporarily shuts a manufacturing facility with a long remaining useful life but intends to resume operations after military activities in the area abate, the facility has not been abandoned. Although temporarily idle long-lived asset may trigger an impairment of that asset, a company does not stop depreciating the asset while it is idle.

1.4 Revenue Recognition

The geo-political development may have impacted some companies' ability to trade in goods and services. There may be severe impact on companies dealing in commodities, such as, crude oil, LNG, cereals and tea which were supplied from the affected region. Further, supply chain disruptions and volatility in financial market may also affect the operations of many companies. All of this affects the revenue measurement under Ind AS 115 Revenue from Contracts with Customers and AS 9 Revenue Recognition and AS 7 Construction Contracts.

Supply chain disruptions may lead to increase in sales returns amongst certain companies. Fast moving consumer companies may have to look into their distributor incentive obligations due to increase in commodity prices and heightened competitive factors. Under Ind AS 115, any obligations towards customers (whether legal or constructive in nature) would have to be reduced from revenue.

For companies that follow percentage of completion method for revenue recognition, such as, engineering and construction companies that recognize revenue over a long period of time, the pattern of revenue recognition may change for delays in rendering services. Further the cost of completion of projects may have gone up significantly due to increase in commodity prices. Contract costs recovery of which is not probable are recognised as an expense immediately and can not be considered to be part of contract cost for the purpose of percentage of completion.

Entities in some of the significantly impacted sectors or otherwise, may consider renegotiating existing contractual arrangements with their customers with respect to product pricing, delivery schedule, logistics costs etc. in the revised scenario.

1.5 Expected Credit Loss Assessment under Ind AS 109

Ind AS 109 Financial Instruments requires an entity to incorporate reasonable and supportable information about past events, current conditions and the forecast of future economic conditions into the assessment of expected credit losses (ECL) for financial assets not measured at fair value through profit or loss. ECL is a probability weighted amount that is determined by evaluating a range of possible outcomes.

ECL is a probability weighted amount that is determined by evaluating a range of possible outcomes. The impact from the outbreak may vary depending on an entity's specific situation and its methodology in assessing ECL. Accordingly, management should ensure that there is reasonable and supportable consideration of past events, current conditions and forecast of future economic conditions when making that assessment.

When considering the Ind AS 109 requirements to incorporate the forecast of future economic conditions on a probability weighted basis, from a technical standpoint, an entity should evaluate the likelihood of the occurrence of an event (i.e., in this case its severity and the potential impact leading to an epidemic) if this would significantly affect the estimation of expected losses of financial assets. In assessing the expected credit loss, management should consider reasonable and supportable information at the reporting date.

The implications could vary depending on an entity's specific situation and its methodology in assessing ECL. For example, financial institutions may incorporate estimates of forward-looking macro-economic factors into multiple scenarios about the future economy.

Entities should provide qualitative and quantitative disclosure to enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. This includes the basis of inputs and assumptions and estimation techniques used, and how forward-looking information has been incorporated. If an entity considers it appropriate to incorporate in the ECL model an input or assumption or forward-looking adjustment associated with the geo-political condition, and if the effect of this is significant, or it is otherwise useful to understand the uncertainty of future cash flows, the entity should disclose such an input or assumption or forward-looking adjustment. If an entity changes its ECL methodology in order to better estimate the impact of the geo political condition in accordance with the requirements of Ind AS 109, the entity should disclose the change of the estimation technique and the reasons for its change.

1.6 Penalties Related to Termination of Contracts

Companies may incur significant penalties for terminating contracts. As an example, many conferences and events are being cancelled, which can result in loss of deposits and/or require penalties to be paid. These non-recurring costs will need to be appropriately recognized, measured, presented, and disclosed in financial statements. Even when an entity has not made a decision to cancel an event, consideration will have to be given to the issues related to deposits and potential penalties if the event cancellation is probable in the future. It's important that the contracts are reviewed for termination and force majeure clauses. Such assessment needs to be especially done as per Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets and AS 29 Provisions, Contingent Liabilities and Contingent Assets for all executory agreements that are likely to become onerous.

1.7 Subsidiaries, Associates or Joint Ventures in Affected Areas

Interests in subsidiaries, joint ventures and associates are tested for impairment under IGAAP as well as Ind AS. Management should consider whether the impact of the invasion is an indicator that an associate or joint venture is impaired. Under Ind AS, interests in subsidiaries, joint ventures and associates that are within the scope of Ind AS 109 Financial instruments, are subject to Expected credit loss provisioning as per that standard's impairment guidance.

The sanctions and local regulations could impact whether an investor continues to exercise significant influence or joint control over an investee located in affected region. For example, local regulation might require needing a meeting to remove a director from the board of directors. The investor might legally be unable to appoint any directors in the foreseeable future. This may impact the assessment of significant influence on the investee company. This needs to be carefully evaluated by the company.

Many multinational groups have voluntarily decided to stop their business activities and withdraw staff from operations affected areas such as, Russia and Ukraine. This could

impact the control, significant influence or joint control assessment under IGAAP and Ind AS.

Subsidiaries, associates, joint ventures and businesses in affected region might be disposed of in many different ways. The method of disposal will determine whether the disposal will fall within the scope of Ind AS 105 Non-current Assets Held for Sale and Discontinued Operations or AS 24 Discontinuing Operations.

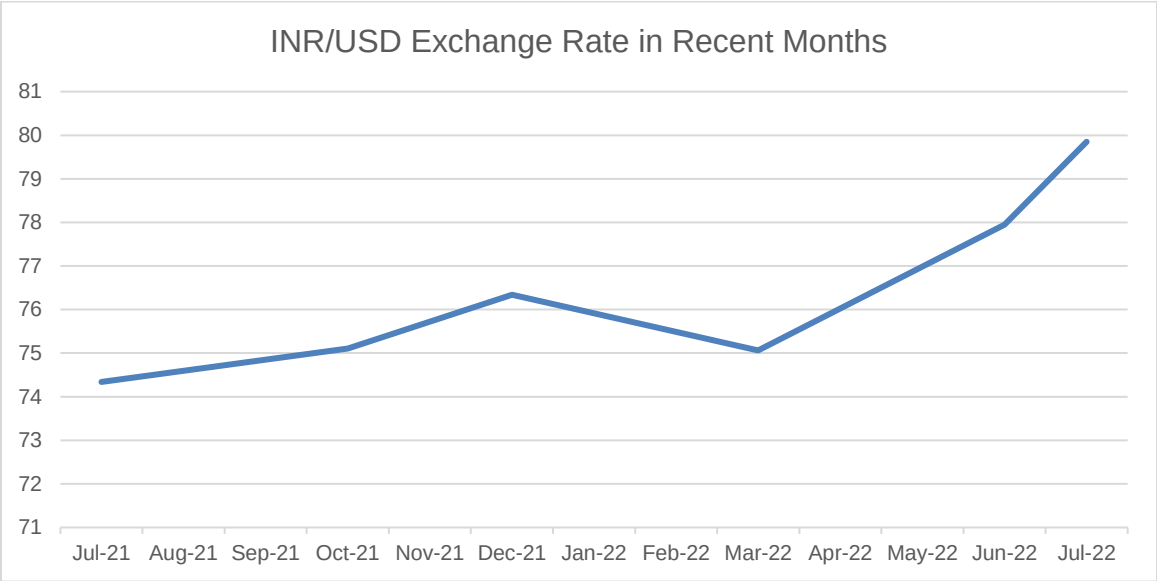
1.8 Restricted Bank Balances

Due to the sanctions and restrictions imposed on Russia, bank balances held by Russian subsidiaries or branches may be subjected to restrictions. The nature of such restriction may preclude free transferability and restrict remittance to other entities within the group. If significant cash and cash equivalent balances are restricted and therefore not available for use, both Ind AS 7 Statement of Cash Flows and AS 3 Cash Flow Statement require disclosure of the relevant amounts, along with a commentary on the nature of the restriction. Entities should continue to review the situation as the nature of the sanctions continue to evolve.

Chapter 2: Accounting Implications of Rupee Devaluation and Foreign Exchange Volatility

The Indian rupee which has been stable over the past 5 years prior to the current calendar year has witnessed a steep devaluation of 6 to 8% since the beginning of this calendar year. Due to the above steep decline of the Indian rupee and forex volatility, the financial performance of the business entities.

Before getting into the details of the accounting aspects, we have reproduced the following chart which represents the historical daily closing exchange rates between USD and Indian rupee from July 2021 to July 2022.



2.1 Accounting for Foreign Exchange Differences

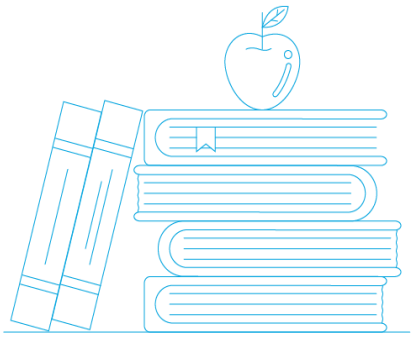
Under both I GAAP and Ind AS, a foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Exchange differences arising on change in the exchange rate between transaction date and the date of settlement of any monetary items[1] in foreign currency are recognized as income or expense in the period in which they arise. When the transaction is settled within the same accounting period, in which it occurred, all exchange difference is recognized in that period. When the transaction is settled in a subsequent accounting period, the exchange difference is recognized in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

Under Ind AS, a company needs to determine its functional currency, which may not necessarily be the currency of the country in which it is domiciled. Thus, it is possible that the functional currency of an Indian company may be a foreign currency. Functional currency is determined based on the primary economic environment in which the company operates. Ind AS provides guidance on the criteria to be considered in determining the functional currency. Factors used for determining the functional currency include the currency that determines the sales price, currency in which costs of providing goods and services are incurred, currency of the country whose competitive forces and regulations mainly determine the sales prices of goods and services, and currency in which funds are raised and retained.

Both I GAAP and Ind AS state that, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from, or required to disburse, such item at the balance sheet date.

2.2 Foreign Exchange on Borrowings



Foreign currency borrowings and loans are monetary items in nature. Therefore, the foreign exchange differences arising on such borrowings also have to be accounted for as income or expense in the statement of profit and loss as stated above.

However, under I GAAP, AS 11 paragraph 46/46A provides a limited period irrevocable option for corporate entities to capitalize exchange differences on long term foreign currency monetary items incurred for acquisition of depreciable capital assets and to amortise exchange differences on other long term foreign currency monetary items through 'Foreign Currency Monetary Item Translation Difference Account' in reserves.

This option to capital and defer exchange differences is not there under Ind AS. However, upon first time adoption of Ind AS, Ind AS 101 – First time Adoption of Indian Accounting Standards, an entity may continue the policy adopted for exchange differences arising

1 Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

from translation of long term foreign currency monetary items recognized in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per previous GAAP. However, for subsequent long term foreign currency monetary items, this option to continue with the previous GAAP accounting policy is not available. However, this option no longer exists under Ind AS or IGAAP since there was a sunset clause and there can be no deferral/capitalisation beyond 31 March 2021.

2.3 Translation of Foreign Operations

In order to consolidate or combine financial statements prepared in different currencies, a reporting entity must have financial statements of its foreign entities in its reporting currency to produce single currency, consolidated financial statements. This process is referred to as translation and is different than re-measuring foreign entity financial statements.

Under I GAAP, translation of foreign currency financial statements to the reporting currency of the parent depends on the classification of the foreign operations as either integral or non-integral. In the case of an integral foreign operation, monetary assets are translated at closing rate. Non-monetary items are translated at historical rate if they are valued at cost. Non-monetary items which are carried fair value or other similar valuation are reported using the exchange rates that existed when the values were determined. Income and expense items are translated at historical/ average rate. Exchange differences are taken to the statement of profit and loss. For non-integrated foreign operations, closing rate method should be followed. The resulting exchange difference is taken to reserve and is recycled to profit and loss on the disposal of non-integral foreign operation.

Under Ind AS, such a translation would be driven by the determination of the functional currency of the foreign operation. The translation principle for a foreign operation whose functional currency is the same as the parent company is similar to the translation of an integral foreign operation. Similarly, translation of a foreign operation whose functional currency is the different from the parent company is similar to the translation of a non-integral operation under current principles.

2.4 Accounting for Forward Contracts and other Derivatives Contracts

Under I GAAP, AS 11 is applicable to exchange differences on all forward exchange contracts including those entered into to hedge the foreign currency risk of existing assets and liabilities and is not applicable to the exchange difference arising on forward exchange contracts entered into to hedge the foreign currency risks of future transactions in respect of which firm commitments are made or which are highly probable forecast transactions. A ‘firm commitment’ is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates and a ‘forecast transaction’ is an uncommitted but anticipated future transaction.

In case of forward contracts not intended for trading or speculation purposes:

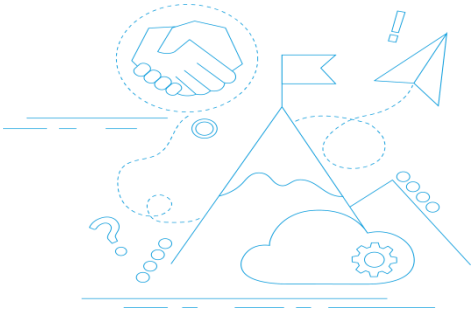
- Any premium or discount arising at the inception of a forward exchange contract is amortised as expense or income over the life of the contract
- Exchange differences on such a contract are recognized in the statement of profit and loss and loss in the reporting period in which the exchange rates change. Exchange differences on a forward exchange contract is the difference between i) the foreign currency amount of the contract translated at the exchange rate at the reporting date, or the settlement date where the transaction is settled during the reporting date, and ii) the same foreign currency amount translated at the latter of the date of inception of the forward exchange contract and the last reporting date.

Forward exchange contracts intended for trading or speculation purposes:

- The premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to market and the gain or loss on the contract is recognized in the statement of profit and loss.

Ind AS requires all derivatives, including forward contracts, to be measured at fair value with fair value gains and losses to be recognised in the profit and loss account, except when certain hedge accounting criteria have been met.

2.5 Hedge Accounting



ICAI Guidance Note on Derivatives and Ind AS 109 require all derivatives to be measured at fair value and any resulting fair value gains or losses to be recognized in the profit and loss account, unless if certain criteria for hedge accounting are met. Hedge accounting, which is optional, is intended to result in P&L matching i.e.. gains and losses on the hedging instrument being recognised in the profit and loss account in the same period as offsetting losses and gains on the hedged item. However, it should be noted that hedge accounting requires formal designation and documentation and effectiveness testing at the time of initial designation as well as during the tenure of the hedge relationship. If these conditions are not met, hedge accounting is not permissible.

I GAAP provides limited guidance on hedge accounting. AS 11 provides guidance on forward exchange contracts that are entered into for hedging purposes. It requires exchange differences based on changes in spot rates to be recognised in the profit and loss account (for the underlying debtor and the forward contract). Further, the premium or discount arising at the inception of the contract is required to be amortised through the profit and loss account over the life of the contract.

The ICAI's Guidance Note on Accounting for Derivative Contracts deals with foreign exchange forward contracts that are hedges of highly probable forecast transactions and firm commitments and other foreign currency derivatives such as cross-currency interest rate swaps and foreign currency futures that are not within the scope of AS 11. The

Guidance Note is in lines with the requirements Ind AS 109 and requires all derivatives within its scope to be measured at fair value through profit and loss, unless hedge accounting is applied.

Chapter 3: Accounting Impact of Inflation

The geo-economic scenario and conflict as well liberal monetary policy to counter pandemic has propelled inflationary environment across the world. Many countries are experiencing very high/ historically highest in various decade inflation rates. While inflation affects economies and entities differently, there are common factors related to the assessment of how inflationary trends may affect accounting and financial reporting.

Following table provides the retail inflation rates for June 2022 of major economies around the world.

June 2022 retail inflation rates of major economies

Country	Inflation	Country	Inflation	Country	Inflation
Saudi Arabia	2.3%	Singapore	6.7%	Euro Area	8.9%
Japan	2.4%	India	7.0%	United States	9.1%
China	2.5%	South Africa	7.4%	United Kingdom	9.4%
Switzerland	3.4%	Germany	7.5%	Spain	10.8%
Indonesia	4.4%	Italy	7.9%	Brazil	11.9%
South Korea	6.0%	Mexico	8.0%	Russia	15.9%
Australia	6.1%	Canada	8.1%	Argentina	64.0%
France	6.1%	Netherlands	8.6%	Turkey	78.6%
Source: Tradingeconomies.com					

3.1 Employee Cost and Post-Employment Defined Benefit Cost

Inflation may cause increase in employee benefit cost. Companies should also consider whether any of the estimates and assumptions used to measure employee benefits costs and employee share-based payments should be revisited. Under Ind AS 19 Employee Benefits and AS 15 Employee Benefits, require defined benefit obligations to be discounted based on long term government bonds of tenure similar to the benefits at the balance sheet date. Rise in inflation and increase in interest rates as a result of recent developments would increase the employee cost.

Similarly, companies should consider the impact of inflation in the terms of, for example, a share-based payment plan, to address the changes in the economic environment and the likelihood that performance conditions will be met. If the changes are benefitting the employees, they would be treated as modification and an additional charge in income statement.

3.2 Fair Valuation

Ind AS 113 Fair Value Measurement stated that that fair value measurement is an exit price estimate at the measurement date based on assumptions (including those about risks) that market participants would make under present market conditions. It is based on the assumptions that market participants would make based on all information obtained through usual and customary efforts. Fair value is determined by maximizing observable inputs, while the use of unobservable inputs is minimized.

Inflation, interest rates and vagaries in capital markets have significant impact on fair valuation. Valuation experts generally encourage the use of multiple valuation techniques such as, market multiple approach and discounted cash flow approach, for estimating fair values. In the current environment, entities may review the fair valuation methodologies or redistribution of weightage to individual fair valuation technique or valuation input, in order to make the fair valuation more representative in the circumstances. Such a change would not be change in an accounting policy but a change in accounting estimate.

Ind AS 113 also requires the disclosure of information that helps users of financial statements assess the valuation techniques and inputs used to develop recurring fair values at the reporting date, and therefore by implication the impact these fair value measurements will have on reported financial performance.

When making the critical assessments and judgements for measuring fair value, the entity should consider what conditions and the corresponding assumptions were known or knowable to market participants. The impact on fair value measurement would depend on the evaluation of whether the severity of the outbreak at the reporting date would have impacted market participants' valuation assumptions at that date. Accordingly, entities need to evaluate whether its severity, potential impact and the related valuation inputs were known or knowable by market participants by means of usual and customary due diligence performed up to that date.

3.3 Estimation of Recoverable Amount for Impairment testing

Under AS 28 Impairment of Assets and Ind AS 36 Impairment of Assets, the discount rate applied to the estimated cash flows should be reflective of the return that the entity would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those the entity expects to derive from the asset. Under Ind AS 36 a pre-tax discount rate is estimated as a rate that reflects the current market assessment of the time value of money, and the risks specific to the asset for which the future cash flow estimates have not been adjusted.

Impairment testing involving estimation and use of assumptions, such as, inflation rates, growth rates, profit margins, future capital expenditure and discount rates. These assumptions need to be reassessed and updated as appropriate due to the inflationary pressure and significant changes in economic and market conditions. Cash flow projection used should be updated to reflect the assumptions that market participants would use based on current market conditions and information available at the balance sheet date. Both AS 28 and Ind AS 26 require the discount rate used to discount the forecast cash flows for the purpose of both value-in use and fair value less cost of disposal may be affected due to the uncertainties and risks.

3.4 Revenue

Significant inflation may affect the costs associated with long-term projects / contracts that entities may not be able to pass on to customers through price rise. Inability to pass on the input prices under a long-term project/ contract, may lead to loss or a reduction in its estimated contract profitability. In extreme cases, there may be onerous contracts leading to the requirements for upfront provisioning. The margins of several fast-moving consumer goods have come under pressure due to inflation and rise in commodity prices.

In certain cases, under the current circumstances due to inflation and current geo-political situation, certain companies may be facing financial difficulties. Under Ind AS 115 as well as AS 9 / AS 7, if the customer's ability to pay is affected due to loss of business or there is loss of credit facilities or credit rating has deteriorated, all this indicate that there is a significant change in facts and circumstances requiring careful reassessment of the collectability condition. An entity needs to determine whether these conditions result into the conclusion that it is not probable that the entity will collect the consideration to which it will be entitled in exchange for the remaining goods that will be transferred to the customer.

3.5 Onerous Contract

Inflation often causes long-term contracts, such as, leases/supply/service agreements, to be renegotiated, which in turn may have consequential financial reporting implications. Terminating contracts often trigger penalties.

Under AS 29 and Ind AS 37, onerous contracts are those contracts for which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. Under both the standards, unavoidable costs under a contract are the least net cost of exiting the contract - the lower of the cost to exit or breach the contract and the cost of fulfilling it. Entities need to consider whether any of its long-term contracts have become onerous.

Chapter 4: Key Financial Statement Disclosures

One of the fundamental objectives of general-purpose financial statements is to provide information about the financial position, performance and cash flows of an entity. Several presentation alternatives in the financial statements may be considered in order to provide useful information in relation to the current geo-political scenario and other developments. This would ensure that presentation complies with Ind AS 1's requirements. It might be helpful to provide explanatory disclosures of the impact in the notes to accounts.

One of the leading fast moving consumer product company provided following disclosure in its board report for financial year ended 31 March 2022.

Risk from Supply Chain

Our supply chain network is exposed to potentially adverse events such as physical disruptions, environmental and industrial accidents, labour unrest, trade restrictions or disruptions at a key supplier, which could impact our ability to deliver orders to our customers. The cost of our products can be significantly affected by the cost of the underlying commodities and materials from which they are made. Fluctuations in these costs may negatively impact business especially if such movements are not effectively managed. Covid-19 and geopolitical uncertainty around the world has challenged and continues to challenge the resilience and continuity of our supply chain. Maintaining manufacturing and logistics operations will continue to require ongoing focus and flexibility.

Management of Risk

We have contingency plans designed to enable us to secure alternative key material supplies at short notice, to transfer or share production between manufacturing sites and to use substitute materials in our product formulations and recipes. Commodity price risk is actively managed through forward buying of traded commodities, other hedging mechanisms and product pricing. Trends are monitored and modelled regularly and integrated into our forecasting process. We have policies and procedures designed to ensure the health and safety of our employees and the products in our facilities, and to deal with major incidents including business continuity and disaster recovery.

One of the leading engineering companies provided following disclosure in its board report for financial year ended 31 March 2022.

"*In view of the consumers' extreme experience during the previous waves, their sentiments around the next wave were dampened yet again. This impacted Consumer Durable sales across the industry. Rising global geopolitical tensions added to the unrest in the consumers' minds. Furthermore, commodity prices continued to be on a rising trend, impacting margins across the industry."*

4.1 Debt Covenants

In extreme cases, companies may experience significant liquidity issues due to increase in interest rates, for example, debt/equity ratios and debt servicing ratios. This might call into question whether the company complies with its debt covenants. The current geo-

political situation may result in breach covenants on borrowings, or trigger material adverse change clauses.

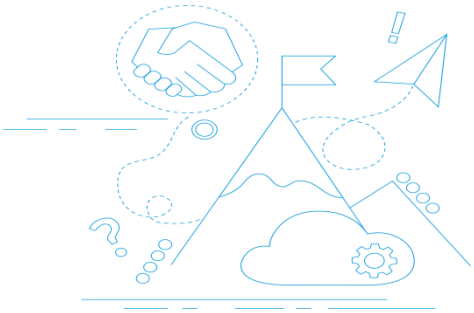
Breach of material debt covenants could result in changes in loan repayment terms and loans may possibly become repayable on demand. This may change the current / non-current classification. In extreme cases, the appropriateness of going concern assumption may need to be evaluated.

4.2 Disclosure as Material/Exceptional Event

When the items of income and expense are material, their nature and amount are required to be disclosed in the financial statements separately. However, under Ind AS, gains and losses should not be reported as extraordinary items, either on the face of the statement of comprehensive income (or income statement) or in the notes.

Ind AS 1 Presentation of Financial Statements requires disclosure of information about the assumptions concerning the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities, such as noncurrent assets subject to impairment, within the next financial year (with the exception of assets and liabilities measured at fair value based on recently observed market prices). The disclosures are required to be presented in a manner that helps users of financial statements to understand the judgements that management makes about the future and about other key sources of estimation uncertainty. The nature and extent of the information provided will vary according to the nature of the assumption and other circumstances.

Examples of the types of disclosures that an entity is required to make include:



- The nature of the assumption or other estimation uncertainty
- The sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity
- The expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected
- An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved

When it is impracticable to disclose the extent of the possible effects of an assumption or other source of estimation uncertainty at the end of a reporting period, the entity discloses that it is reasonably possible, based on existing knowledge, that outcomes within the next financial year that are different from assumptions used could require a material adjustment to the carrying amount of the asset or liability affected.

AS 5 *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies* requires that extraordinary items should be disclosed in the statement of profit

and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

4.3 Disclosure of Financial Instruments

Ind AS 107 Financial Instruments: Disclosures, requires disclosure of information about the nature and extent of risks arising from financial instruments. The requirements include disclosure about nature and extent of exposure to risks arising from financial instruments. Qualitative disclosures include:

- Risk exposure for each type of financial instrument, example, interest rate risk, credit risk, foreign exchange risk, etc.
- Objectives, policies and processes for risk management
- Changes in the current year as compared to previous year

Quantitative disclosures are required to provide information about the extent to which there is a risk exposure, based on internal information available with the entity's key management personnel. Such disclosures include:

- Summarised numerical data regarding exposure to each risk at the reporting date
- Description of credit risk, liquidity risk, and market risk (interest rate risk, foreign currency risk and equity risk) and how these risks are managed.

Credit risk is the risk that one party to a financial instrument will cause a loss for the other party by failing to pay for its obligation.

Disclosures about credit risk include maximum amount of exposure (before deducting the value of collateral), description of collateral, information about credit quality of financial assets that are neither past due nor impaired, and information about credit quality of financial assets whose terms have been renegotiated.

Liquidity risk is the risk that an entity will have difficulties in paying its financial liabilities. Disclosures about liquidity risk include:

- a maturity analysis of financial liabilities
- description of approach to risk management

Under Ind AS 107, market risk is defined as the risk that the fair value or cash flows of a financial instrument will fluctuate due to changes in market prices. Market risk includes interest rate risk, currency risk and other price risks.

Ind AS 107 requires disclosures about market risk include: a sensitivity analysis of each type of market risk (example, interest rate risk, foreign currency risk and equity risk) to which the entity is exposed.

4.4 Disclosure of Financial Risk Management

Financial statements are generally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. For the purpose of assessment whether an entity is a going concern Ind AS 1 Presentation of Financial Statements and AS 1 Disclosure of Accounting Policies, provide guidance. As per Ind AS 1, the management of an entity shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so.

Further, Ind AS 1, to assess whether the going concern assumption is appropriate, management should consider all available information about the future, which is at least, but is not limited to, 12 months from the end of the reporting period. Some of the factors which an entity may consider in assessing the ability of the entity to continue as going concern could be:

- Impact of current geo-political events and conditions on an entity's operations and potential impact on forecasts of future cash flows, such as, supply chain disruption, commodity prices, etc.
- Increase in interest rates and rate revision by RBI, etc.
- Whether the entity is operating in a sector which in highly impacted
- Whether the entity has sufficient liquidity to continue to meet its obligations as they fall due.
- Whether the entity has sufficient borrowing facilities to meet its short-term needs
- If required, has the entity initiated necessary actions to enable the entity to generate sufficient cash flow or access to borrowing facilities/liquidity to meet its obligations when they fall due.
- Whether the entity has plans and ability to restructure their debt obligations if required to ensure short term solvency
- Assessing financial health of key suppliers and customers.

4.5 Scope and Limitations

The purpose of this Research Publication ('Publication') is to provide a brief overview of Accounting Implication of Inflation, Foreign Exchange Variation and current Geo-Political environment. The Publication is prepared for general use and our views as stated above would be required to be revalidated vis-à-vis the facts of each case. It may be noted that nothing contained in the Publication should be regarded as our opinion and facts of each case will need to be analyzed to ascertain applicability or otherwise of the said notification and appropriate professional advice should be sought for applicability of legal provisions based on specific facts. We are not responsible for any liability arising from any statements or errors contained in this Paper.

RSM India

Mumbai

8th Floor, Bakhtawar
229, Nariman Point
Mumbai - 400 021

3rd Floor, A Wing,
Technopolis Knowledge Park
Mahakali Caves Road, Andheri (E)
Mumbai - 400 093

201, Shree Padmini
Rajashree Sahu Marg
Teli Galli Junction
Andheri (E), Mumbai 400 069

New Delhi - NCR
2nd Floor, Tower – B
B-37, Sector – 1, Noida
New Delhi - NCR – 201 301

Chennai
Apex Towers, 2nd Floor, No.54
II Main Road, R. A. Puram
Chennai - 600 028

1A, Chamiers Apartments
62/121, Chamiers Road
R. A. Puram, Chennai - 600 028

Kolkata
A-6, 12th Floor Chatterjee International Centre33A, Jawaharlal Nehru Road Kolkata - 700 071

Bengaluru
3rd Floor,
Jubilee Building, 45, Museum Road, Bengaluru - 560 025

Surat
DTA-2, G-02 to G-05 Plot
Gujarat Hira Bourse
Ichhapore-2
Surat - 394 510

T-720, Belgium Tower
Opp. Linear Bus Stop
Ring Road, Surat - 395 002

B/604-605, Tirupati Plaza
Athwa Gate, Nanpura
Surat - 395 001

Vijayanagar
A2/UT-F, Power Valley
JSW Steel Township,
Toranagullu
Bellary, Karnataka
583123

Hyderabad
301, Block-1, Whitehouse,
Greenlands Road,
Kundanbagh, Begumpet,
Hyderabad, 500016.

Ahmedabad
B/708, Mondeal Heights
Near Novotel Hotel
Opp. Karnavati Club,
S.G.Highway
Ahmedabad - 380 015

Pune
102, 1st Floor
Shree Residency
Baner Balewadi Road
Balewadi, Pune - 411 045

Gandhidham
206, Sunshine Arcade II
Plot No. 37, Sector 8
Near D-Mart
Gandhidham - 370 201

Jaipur
346, 3rd Floor
Ganpati Plaza, M.I. Road
Jaipur - 302 001

For further information please contact:

RSM Astute Consulting Pvt. Ltd.

8th Floor, Bakhtawar, 229, Nariman Point, Mumbai - 400021.

T: (91-22) 6108 5555/ 6121 4444
F: (91-22) 6108 5556/ 2287 5771

E: emails@rsmindia.in

W: www.rsmindia.in

Offices: Mumbai, New Delhi - NCR, Chennai, Kolkata, Bengaluru, Surat, Hyderabad, Ahmedabad, Pune, Gandhidham, Vijayanagar and Jaipur.

facebook.com/RSMinIndia

twitter.com/RSM_India

linkedin.com/company/rsm-india

Youtube.com/c/RSMIndia

August 2022