# CONTEMPORARY ISSUES IN PUBLIC ACCOUNTABILITY AND AUDIT

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# IFRS and IND –Accounting Standards

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Along with globalization, the process of convergence of accounting standards all over the world is gaining increasing momentum. The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have been working closely on converging International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Standards in the United States (US-GAAP). Globally comparable, financial reporting standards enhances credibility of financial reporting to global investors, facilitates greater cross-border investment, efficient capital allocation, and comparability across political boundaries. This will also help companies to lower cost of capital, integrate IT systems, easier consolidation and maintenance of one set of books, and mobilizing capital from global markets.

IFRS, the most widely used global financial reporting standards, adopted over 110 countries, are issued by IASB, an independent accounting standard setter based in London, UK. The International Financial Reporting Interpretations Committee (IFRIC) reviews widespread accounting issues and provides authoritative interpretations. IFRS, being primarily principle based rather than rule based, are far less voluminous compared to US-GAAP. IFRS, as we understand, encompass conceptual framework, 8 IFRS, 29 International Accounting Standards (IAS), 17 IFRIC Interpretations and 11 Standing Interpretations Committee (SIC) Interpretations.

Realizing the significance of adoption of the IFRS, the Ministry of Corporate Affairs (MCA) notified 35 Indian Accounting Standards converged with International Financial reporting Standards, naming them as Ind-AS on 25th February 2011. Although the government is yet to determine the implementation date and there are deviations from IFRS, it is a major step towards convergence of Indian GAAP with IFRS.

Reasons for departures from IFRS include need to maintain consistency with the specific legal and regulatory requirements in the country, economic environment, level of preparedness and certain conceptual differences. Ind-AS are therefore formulated by creating Carving outs in IFRS, where they are not in conformity with IFRS. This article briefly captures areas of divergence between Ind-AS notified by the MCA and IFRS issued by IASB.

**Reasons for departures from IFRS**

As the legal and regulatory framework in India is different, Ind-AS diverge from IFRS to avert possible legal complexities that may arise. For example, as per the Companies Act, 1956, AS-21, Consolidated Financial Statements define 'control' as ownership of more than one-half of the voting power of an enterprise or control over the composition of the governing body of an enterprise. This definition of 'control' is based on the definitions of 'holding company' and subsidiary company' in the act. However, IAS 27, Consolidated and Separate Financial Statements, defines 'control' as 'the power to govern the financial and operating policies of an enterprise so as to obtain benefits from the activities'. Similarly, Accounting Standard (AS) 25, Interim Financial Reporting, does not require disclosure and presentation of interim financial statements because, in India, at present, Clause 41 of the Listing Agreement prescribes a quarterly / half- yearly financial results and also requires various disclosures to be made therein. IAS 34, Interim Financial Reporting, prescribes minimum disclosure and presentation requirements for interim financial statements.

A practice has been started to include accounting treatments in accordance with IFRS even though they are not in alignment with the legal requirements with an understanding that until the law is amended, the relevant legal requirements would prevail. For instance, the Exposure Draft of the proposed Accounting Standard (AS) 31, Financial Instruments: Presentation, proposes the same presentation requirements as those prescribed in ISAS 32, recognizing that until the relevant laws are amended, the latter would prevail.

**(a) Economic environment**

While various IFRSs have been based on the fair value approach, there has been reluctance in India to adopt this approach in view of the fact that various markets in the country are not equipped to provide reliable fair values on measurement of various assets and liabilities. For example, AS-13, Accounting for Investments, requires current investments to be valued at the lower of cost and fair value, whereas the corresponding IAS 39, Financial Instruments: Recognition and Measurement, requires measurement of similar investments at their fair value. With changing economic environment in the country, measurement of financial assets of trading nature can be shown at fair value corresponding to IAS 39.

**(b) Level of Preparedness**

Ind-AS deviate from IFRSs because adoption of IFRSs verbatim may cause hardship to the industry and therefore modifications are made in Accounting Standards until the industry is prepared for the IFRS. For example, AS-15, Employee Benefits, permits deferment of expenditure incurred on account of termination of services arising in a voluntary retirement scheme for a transitional period, since the Indian industry was undergoing a structural change at the time when the standard was introduced, whereas the corresponding IAS 19, Employee Benefits, does not allow the deferment of such expenditure even as a transitional measure.

**(c) Conceptual differences**

There are a few conceptual differences between the Ind-AS and the IFRSs. For example, IAS 37 deals with 'constructive obligation' in the context of creation of a provision, the effect of recognizing provision on the basis of constructive obligation is that , in some cases, provision will be required to be recognized at an early stage. For instance, in case of a restructuring, a constructible obligation arises when an enterprise has a detailed formal plan for the restructuring and the enterprise has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it. It is felt that merely on the basis of a detailed formal plan and announcement thereof, it would not be appropriate to recognize a provision since a liability cannot be considered to be crystallized at this stage. Further, the judgment whether the management has raised valid expectations in those affected may be a matter of considerable argument. Taking this aspect in to consideration, the corresponding Indian accounting standard, AS 29, does not specifically deal with 'constructive obligation', though it requires a provision to be created in respect of obligations arising from normal business practice. In such cases, general criteria for recognition of provision are required to be applied.

**First time adoption**

Convergence involves careful consideration of exemptions available for a first time adopter as well as proper understanding of the few areas where the Ind-AS diverge from IFRS. Some of the key areas of differences between Ind-AS and IFRS are summarized below:

- The areas where Ind-AS provides additional exemptions and reliefs,
- The areas where Ind-AS removes options or choices available in IFRS, and
- The areas where Ind-AS provides additional guidance.

IFRS 1 deals with the accounting by first time adopters of IFRS. One of the objectives was to enable the users of the financial statements understand the transition from previous GAAP to IFRS. As such, a first time adopter of IFRS needs to present an *o*pening IFRS statement of financial position at the date of transition to IFRS. This is the starting point for its accounting as per IFRS.

IFRS 1 defines the date of transition as the beginning of the earliest comparative period presented on the basis of IFRS. However, as per Ind-AS 101, the date of transition is taken to be the beginning of the current period.

An entity's first IFRS financials should have at least one year of comparative financial statements presented on the basis of IFRS, including the opening statement of financial position. Further, detailed disclosures on the first-time adoption of IFRS include reconciliations of equity and profit or loss from previous GAAP to IFRS.

However, Ind-AS 101 does not require one year of comparative financial statements on the basis of Ind-AS. It allows an option to present comparative financial statements in accordance with Ind-AS on a memorandum basis. Accordingly, the reconciliations would be provided by entities depending on which option is taken up by the entity adopting Ind-AS.

IFRS 1 defines previous GAAP as the basis of accounting that a first -time adopter used immediately before adopting IFRS. This implies previous GAAP is any GAAP other than IFRS. A first-time adopter could have prepared more than one set of financial statements of the same type for the same period, e.g., two sets of consolidated financial statements for the same annual period using different bases of accounting. In this case, an entity needs to assess which basis of accounting meets the definition of previous GAAP.

Ind-AS 101, however, defines previous GAAP as the basis of accounting that a first time adopter used immediately before adopting Ind-AS for complying with the reporting requirements in India.

Thus, if a company in India, hitherto, in addition to its Indian GAAP financial statements was also preparing US GAAP financial statements for purposes of filing with the SEC, its previous GAAP would be Indian GAAP and not US GAAP.

**Business combination and accounting for associates**

IFRS 3 deals with accounting for business combinations. As per IFRS 3 an acquirer of a business combination recognizes the assets acquired and liabilities assumed at their acquisition date fair value. Any difference between the consideration paid and fair value of the assets acquired and liabilities assumed is treated as goodwill or gain on bargain purchase.

IFRS 3 requires a gain on bargain purchase to be recognised in profit or loss account. Before recognizing a gain on a bargain purchase, the acquirer must reassess whether it has correctly identified all of the assets acquired and the liabilities assumed and review the procedures used to measure the amounts of (a) the identifiable assets acquired and liabilities assumed (b) the non-controlling interest in the acquiree, if any (c) for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree and (d) the consideration transferred.

However, as per Ind-AS 103, such a gain on bargain purchase is required to be recognized in other comprehensive income and accumulated in equity as capital reserve. Before recognizing a gain on a bargain purchase, the acquirer must determine whether there exists clear evidence of the underlying reasons for classifying the business combination as a bargain purchase. If such evidence exists, the acquirer must reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognize any additional assets or liabilities that are identified in that review. It should also review the procedures used to measure the amounts of (a) the identifiable assets acquired and liabilities assumed (b) the non-controlling interest in the acquiree, if any (c) for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree and (d) the consideration transferred.

If there does not exist clear evidence of the underlying reasons for classifying the business combination as a bargain purchase the excess, if any, must be recognized directly in equity as capital reserve. Similarly on acquisition of associates, Ind-AS 28 specifies that if there is excess of the investor's share of the associate's identifiable assets and liabilities over the cost of investment then it must be recognized in equity as capital reserve while under IFRS such excess is recognized in profit and loss account.

**Revenue recognition for real estate developers**

Another significant difference is that real estate developers would be allowed to recognise revenue on the basis of percentage of completion method under Ind-AS. The scope of Ind-AS 11, *Construction Contracts*, has been widened to include the accounting for construction contracts in the financial statements of the real estate developers. Under IFRS, such contracts are dealt with as per IFRIC 15 on *Agreement for Construction of Real Estate*, which specifies that such contracts are to be treated as sale of goods and the revenue should be recognised only when the significant risks and rewards of ownership have been transferred and the company has retained neither continuing managerial involvement nor effective control i.e., on possession of the real estate to the buyer or when all of the revenue recognition criteria of IAS 18, *Revenue* are satisfied continuously as construction progresses (continuous transfer approach) on transfer.

**Measurement of financial liabilities**

IAS 39, *Financial Instruments*: *Recognition and Measurement*, which deals with the accounting for financial instruments prescribes that any change to the fair value of financial assets or liabilities which are classified in the category 'at fair value through profit or loss' need to be recognised in profit or loss account. Such a change in fair value can be due to any factor including due to change in credit rating of the entity itself.

If the credit rating of an entity worsens, it will be required to borrow money at a higher rate of interest. Thus, for any borrowing which it has designated 'at fair value through profit or loss', the fair value of such a borrowing will fall down and resultant gain will be recognised in profit or loss account.

In the example above, the entity is allowed under IFRS to book a gain in its financial statement in spite of the fact that its credit rating is worsening. Thus, Ind-AS 39, includes a proviso that explains that in determining the fair value of the financial liabilities which upon initial recognition are designated at fair value through profit or loss, any change in fair value consequent to changes in the entity's own credit risk should be ignored.

Another major area of difference is the exception that Ind-AS provides to the definition of financial liability.

Ind-AS 32,*Financial Instruments: Presentation*, considers the equity conversion option embedded in a convertible bond denominated in foreign currency e.g., foreign currency convertible bond to acquire a fixed number of entity's own equity instruments is considered an equity instrument if the exercise price is fixed in any currency. While such conversion option under IFRS would be accounted as financial liability.

**Related party disclosures**

In the Ind-AS 24, *Related Party Disclosures*, disclosures which conflict with confidentiality requirements of statute/regulations are not required to be made since as per Ind-AS, these accounting standards cannot override legal/regulatory requirements. Such exception is not available under IFRS.

**Standards to be notified later on**

No corresponding standard has been released by the MCA to prescribe accounting treatment and disclosure related to agricultural activities.

The final Ind-AS defer the application of guidance on accounting for embedded leases and service concession arrangements. While guidance on accounting for such arrangements has been included as part of the Ind AS, the effective date for the application of these principles is not the transition date, and will be notified separately.

Similarly, the Ind AS that governs accounting for exploration and evaluation of mineral resources will be applied from a date to be notified later.

With a view to avoid inconsistencies and also to avoid abuse/distortions in financial reporting it will be necessary for regulators / standard setters to prescribe rules or provide guidance.

**Challenges to the auditing profession**

On adoption of IFRS, audit documentation will undergo a sea change and audit programs will have to be redrawn to cope with IFRS environment. Changes brought about by the move to IFRS results in a major change in the actual presentation of financial statement. Items may have to be measured differently in the financial statements of individual subsidiaries as also in the consolidated financial statements. Voluminous disclosures necessitate data capture of a larger magnitude and larger time for the audit process. Changes in accounting policies demand information systems to throw up information differently and with far greater depth and magnitude.

The other foremost audit consideration would be meeting the challenges of fraud. A transition phase represents a significant opportunity to earnings manipulation and the desire of the management to report unrealistic earnings. This may warrant audit to pay closer attention to (a) restatement of opening balances; (b) the fact that more choices would be available under IFRS and (c) use of fair values to a greater measure.

Amongst the many difficulties an auditor is likely to face are the pressures of early deadlines, the changes to the accounting environment, the absence of data for the comparative period which will limit the effectiveness of analytical review.

With the transition to IFRS also comes the challenge to the ability of the auditor in making judgments on areas which will have a high degree of subjectivity. The challenge to sit in judgment over the results of work done by outside specialists all of which will make for new vistas in the professional times for an auditor.

Some of the key areas like; Property Plant and Equipment, Financial Instruments, Revenue Recognition, Asset impairment, Hedge accounting, Consolidation of special purpose entities, Related party transactions which call for immediate attention in the transformation.

## Conclusion

In order to decide the date of implementation of Ind-AS, the government of India needs to make necessary amendments in the existing regulations. The new tax code and proposed changes in the draft Companies Amendment Bill including revised Schedule VI and Schedule XIV are expected to be approved by the Parliament for enactment in due course. Once these and other requisite regulatory changes are made, IFRS congruent Ind-AS will also be implemented in phases notifying the dates of implementation for different categories of corporates, as a momentous step towards improving the quality financial reporting along with creating conducive environment for good corporate governance.