# Filling the GAAP – India and IFRS

Global challenges to trade have been falling over the past decades and this has resulted in countries around the globe being linked by a thread of economic interdependence. Robust corporate governance, harmonised accounting standards and changing legal framework have been instrumental in lowering trade barriers and this has paved the way for emergence of a truly global business language, the International Financial Reporting Standards (IFRS). The International Accounting Standards Board (IASB) is responsible for the content and interpretation of IFRS and it is expected that by 2011 over 140 countries would adopt IFRS.

Since 2001, IASB's mandate has been to create a single set of high quality global financial reporting standards. The primary intention is to provide a consistent accounting solution for similar transactions across geographies.

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The Institute of Chartered Accountants of India (ICAI), National Committee of Accounting Standards and the Government of India have affirmed that India will transition to IFRS from 1 April 2011. In accordance with the ICAI convergence paper, entities which are either listed or in the process of listing, entities having turnover of over Rs. 100 crores or public debt of over Rs. 25 crores would be required to adopt IFRS by 1 April 2011.

These entities are defined as public interest entities (PIE). There is a debate that is happening on what would be definitions or the threshold of the companies which would be applying IFRS in the first wave from 1 April 2011 and hence this definition of PIE of ICAI may consequently change.

**IFRS and the Company**

A company needs to develop a quick and thorough understanding of IFRS and how it applies to its business. This not only includes the principles of accounting

but also the systems, processes and controls that support the corporate reporting structure. Unlike other standards, IFRS is written with a view that countries around the world will transition from their national standards to IFRS. IFRS 1, First time adoption deals with issues on transition on first time adoption of IFRS. There are four mandatory exceptions and fifteen optional exemptions available to an entity.

These are available only once in its lifetime and only on first time of adoption of IFRS. The key exemptions that normally would be relevant to India are on business combinations, fixed assets at fair value, cumulative translation adjustments for companies having overseas operations, share based payments and financial instruments.

Acquisition or business combinations under IFRS will necessarily be accounted for using purchase method. Purchase method not only requires all assets and liabilities be restated at fair value but also requires separate recognition of intangible assets like brands, customer contracts etc., embedded in the price paid. Goodwill is the residual remaining after the purchase price allocation.

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Under IFRS 1, a company has a one time optional exemption of not restating its business combinations prior to the date of transition to IFRS and continuing to carry the assets and liabilities of the acquired entity at its previous Indian GAAP values. Alternatively, the company also has the option to restate prior business combinations at fair value on the date of transition, except that if it chooses to restate a prior business combination at fair value all subsequent business combinations thereafter up to the date of transition would have to be accounted for at fair value.

Under Indian GAAP, an acquisition or merger is usually accounted at cost or by way of a scheme of amalgamation duly approved by a High Court. All business combinations after the date of transition will be accounted for under the purchase method.

In India, mergers or de-mergers are done through court administered schemes. Under such schemes, companies routinely use reserves in their balance sheet to write off debts and other charges, which normally should be routed through the income statement. The challenge that lies ahead is how do we amend our laws so that court approved schemes also follow the principles of IFRS and the accounting is uniform irrespective of whether the acquisition is effected through a court scheme or not.
A simple answer would be to have ICAI's designated panel to rule on IFRS and other GAAP compliance for each such scheme and report to the court. This is not an IFRS issue but a unique path some Indian companies use for dressing up their accounts.

Another optional exemption is on fixed assets, which could be stated at fair value on the date of transition or at a revalued amount carried out at an earlier date. This eliminates the need for tracking all the documents relating to fixed assets to determine the cost and its related depreciation using IFRS principles, for example indirect costs including foreign exchange fluctuations capitalized with assets under Indian GAAP, which under IFRS need to be expensed.

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Companies otherwise would have to re-compute the book values of fixed assets using costs as defined in IAS 16, 'Property, plant and equipment', which means applying IFRS principles for fixed assets retroactively. This is a huge exercise for old companies, especially public sector undertakings which have a large base of assets with long useful lives, where one needs to go back to the date of acquisition of those assets still existing in the carrying value.

A company needs to be prudent on its choice of these options as these have a long term effect on earnings. A restatement at fair value would enhance the base of fixed assets, however would increase the related depreciation. Acquisitions would create intangible assets like customer rights or contracts which could have

higher amortization charge due to shorter useful life. Both these would contribute to higher depreciation charge over a period.

Under IFRS, an arrangement, though not specifically governed by a leasing agreement, which conveys a right use to an asset in return for a payment or a series of payments under certain conditions may need to be treated as a lease. These are usually third party manufacturing contracts, outsourcing contracts and other contracts that could give rights to use a capacity of manufacturing.

Fundamentally, if specified assets used in manufacturing are under the control or right to control of the customer, then such clauses may convey a financial lease and accounted for as an asset of the customer, without legally owning the asset. In such a case the impact on earnings and the effect on tax, especially Minimum Alternate Tax (MAT) paid on book profits, could be significant in many industries.

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Consolidation under IFRS is based on control and consolidated financial statements are fundamental to IFRS reporting as against treating each entity within a reportable group as a separate legal entity. The new IFRS principles of consolidation based on control could throw surprises for a number of groups, as more entities could potentially be included within the definition of group.

Convertible preference shares or bonds or debentures may be considered as compound financial instruments and may need to be split into debt and equity components. Complications may arise if the instrument also has a derivative instrument like options embedded in them. Separation of these embedded features may cause complications in accounting.

The subtleties of IFRS's significant other differences and depth in the details including disclosures are where we will have significant challenge to overcome.

**What does compliance with IFRS actually mean?**

Compliance with IFRS means that the financial statements contain an explicit and unreserved statement that they have complied with IFRS. IASB does not consider statements like "conformity with IFRS in all respects except for certain standards" as compliance. This would open up a whole new issue as how would companies and their auditors deal with non-compliance with IFRS.

IFRS requires that material errors are adjusted by restating the financial statements of the year to which those errors pertain, unlike Indian GAAP, wherein past errors are disclosed as adjustments in the current year's financial statements. Companies Act will need to be amended if we would need to comply with this IFRS standard. Restatements of previously issued financial statements will become a reality in India, a change corporate India will certainly not be looking forward to.

IFRS is more complex than it appears and a cohesive approach of ICAI, SEBI, Income Tax, RBI and other regulators and bodies of users like the industry associations need to deliberate and chart the route to IFRS transition in 2011. It is the collective will of the stakeholders that will help overcome the challenges and help India transition to IFRS.

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