MIND THE GAAP - INDIA & IFRS

International Financial Reporting Standards and the legal framework

The SEC on 27th August 2008 issued a roadmap of transition to International Financial Reporting Standards (IFRS) by US domestic companies from 2014. The issues relating to the roadmap will soon be set to debate and public comments. US companies, about 110 in number could go in for an early adoption from 2009 and that could set a trend of US domestic companies going in for IFRS as their primary financial statements before the 2014 date.

USA as a country has made undoubtly the highest investment in the developed world, in research and practices of accounting. US GAAP is over 120,000 pages of written literature which shows the width and depth of US accounting principles. This move of USA to endorse and participate in creation of a truly global GAAP-IFRS, puts aside their pride in their national GAAP - US GAAP and is a significant move towards emergence of IFRS as a global accounting language.

THOUGHT ARBITRAGE
Bridging the thought divide

India will be adopting IFRS from 2011 which means our National GAAP will be the same as that practiced in over 100 countries today.

Indian GAAP has conceptual differences with IFRS and our legal and regulatory frameworks needs to be amended for us to adopt IFRS as written

by the International Accounting Standards Board(IASB), the standard setting body of IFRS. IASB requires compliance to IFRS needs to be explicit and in an unreserved manner. The bridge between Indian GAAP and IFRS needs legal sanctions through the parliament for amendments to Companies Act, changes in evaluation criteria for loan loss provisions etc. by RBI, changes in some of our accounting norms by IRDA to comply with IFRS, tax laws especially for taxes payable on book profits like MAT and interim reporting requirements of SEBI need to converge with IFRS requirements. Apart from these, there are a number of other changes to be made in regulations for IFRS transition.

Form and substance

THOUGHT ARBITRAGE
Bridging the thought divide

Companies Act of 1956 (Act or Companies Act) defines the format of financial statements in Schedule VI to the Act and the auditors need to make an explicit statement in their report that the balance sheet and profit and loss account are drawn in the manner as required by the Companies Act. IFRS allows the discretion to the management in selection of currency for presentation of financial statements. The format in the schedule XVI of the Act prescribes Indian Rupees as the presentation currency. Hence, the form as defined by the Act plays a vital role in India for compliance with GAAP.

Entities under IFRS usually present their assets and liabilities classified as current and non-current , which is indicative of the relative permanence of items. Some companies opt for liquidity as the basis of preparation, which they

feel provides more relevant and reliable information of their state of affairs. IFRS prescribes a minimum number of items to be shown but management use their judgment on how these are to be presented. The Act treats Indian companies as separate legal entities, while IFRS promotes a group concept, where individual legal entities lose their individual relevance to the overall economic entity, the group, except for legal or tax compliance. The Act does not specifically deal with consolidated accounts or their auditors' reports. Hence the form applicable to the group can be different from the format specified by the Act for individual companies.

Our tax laws asses individual entities as separate units for tax and does not asses the group as a single taxable entity. Hence the role of consolidated accounts has no relevance for tax purposes. In many countries like the USA, the group could be the primary unit for tax assessment in one legal jurisdiction and the consolidated accounts become relevant, though tax laws might be different.

THOUGHT ARBITRAGE
Bridging the thought divide

Fixed assets

There is a significant distinction between the Act and IFRS for fixed assets, the description of assets itself. The Act defines the class of assets and their classification whereas IFRS promotes a concept of components of fixed assets based on their usefulness as the basis of classification. This means that various significant components embedded in an asset having different useful lives will be depreciated separately. It would be appropriate to

depreciate the engines and airframe of an aircraft using different lives. Another key difference with the Indian GAAP and the Act is on the definition of cost. Under IFRS, the fair estimate of the retirement obligation of an asset is discounted to a fair value and recognized as a liability. The associated costs are capitalized with the fixed assets. In India , future costs are not allowed to be discounted and capitalised and they are recognized as a liability when they become an obligation of past event.

Companies Act prohibits depreciation on revaluation of fixed assets to be reflected in the profit and loss account as such depreciation is netted off against the reserve specifically created on revaluation in the balance sheet. IFRS is based on fair value concepts and where a company revalues its fixed assets to reflect its current value, the depreciation of the revalued assets are routed through the income statement and effects the earning per share.

THOUGHT ARBITRAGE
Bridging the thought divide

Similarly, foreign exchange fluctuations for period before December 2007 on foreign currency loans for fixed assets are required to be capitalized as fixed assets but under IFRS needs to be expensed unless they qualify as interest expense for an asset under construction. But many large Indian companies still make the distinction between requirements under the Companies Act and those of the accounting standards and not take such a charge to the income statement. We saw this in the June quarter results of a

number of Indian companies where by foreign exchange fluctuations on loans for fixed assets were capitalised but not expensed.

Capital and Reserves

If we look at the capital side of the balance sheet, Companies Act requires capital instruments to be separately disclosed as equity and preference shares and there are separate provisions that govern issue of these instruments. Similarly, convertible debentures or bonds whether they are in Indian or foreign currency have specific rules relating to their issue and disclosure in the accounts. There are also foreign exchange regulations which would also come into play relating to these bonds. IFRS treats debentures, bonds or preference shares that are convertible into equity shares as compound instruments, that need to be segregated into a debt and an equity portion based on their relative fair values.

THOUGHT ARBITRAGE
Bridging the thought divide

Similarly, a redeemable preference share for cash will normally be a debt. Such re-classification of preference shares to debt or equity or creating equity instruments from bonds or debentures will need sanction of the Companies Act, which lays down rules on how such instruments are to be issued and shown in the accounts. Mere segregation by using IFRS principles will not comply with the Act nor will it retain the legal rights and obligations that are

associated with these instruments. This leaves a gap between our current laws and IFRS which needs to be looked at.

Indian companies have been using their share capital effectively either by using them as acquisition currency through multiple listings or enhanced liquidity by stock flotation and lately through share buy back as a protection from predators or reducing the equity base for improving earnings per share etc.

IFRS treats repurchase or buying back of an entity's own shares as a deduction from equity capital at cost. Any profit or loss on subsequent issue of these shares is reflected as a change in equity. Under Indian GAAP, a share buy back which is allowed under limited conditions need to be cancelled on acquisition.

THOUGHT ARBITRAGE
Bridging the thought divide

Any reissue will be treated as a fresh issue resulting in significant time and costs for the issuer. IFRS allows companies to have the flexibility to use re-purchased stocks as a treasury instrument, hence it is called treasury stocks, to be used as and when such entities need to raise cash. Our regulators need to evaluate whether our Acts need to be amended for our companies to have access to these alternatives for their business needs.

Reserves Profit in a balance sheet are a result of past profits following Indian GAAP and are available to shareholders either as regular dividend or on dissolution. Upon transition to IFRS, an entity will have an increase or deduction of reserve just by application of new GAAP. A shareholder could have more

distributable reserves or conversely if the reserves get wiped out, it could leave him poorer due to such a change.

It would be the cornerstone of decisions, how change in GAAP will affect the wealth or earnings of the shareholders.

IFRS and Initial Public Offerings

Some other areas of attention would be the rules relating to initial public offerings (IPO). Under the current laws, five years of audited financial accounts under Indian GAAP form the base financial information for an IPO. When we transition to IFRS in 2011, we are not sure whether all the five years of accounts for a company needs to be under IFRS or law will allow a part thereof - say three years. The efforts a company needs to make if they are to re-cast their accounts to IFRS for past five years will be significant. How the Act and SEBI will define this requirement will be important for companies looking for an IPO in the next few years.

THOUGHT ARBITRAGE
Bridging the thought divide

Ceilings under Companies Act

The Companies Act regulates the functioning of companies by provision of various ceilings which are calculated by reference to financial information. Inter corporate loans and investments, managerial remuneration in absence of adequate profits are regulated by reference to capital. Payment of managerial remuneration, payment of dividends is calculated with reference to profits. The change in GAAP would affect the amount by reference to which provisions of the

Act are applied. Preference capital is treated as part of share capital under Companies Act but the same is generally classified as debt under IFRS. These provisions will need to be relooked to achieve harmonised application of both IFRS and Companies Act.

Correction of past errors

Correction of errors under IFRS can be made in the years they pertain to, even if they are audited and adopted by the shareholders. Currently, past errors in India are shown as adjustment relating to previous years in the current year as no changes can be made to the accounts as adopted by shareholders. Furthermore, no specific disclosure relating to the error is required to be made. If we go the route of IFRS, restatement of material errors will be a feature that Indian companies and their auditors will need to be aware of. Whether this triggers a number of law suits in the future against the company and their auditors, only time will tell.

THOUGHT ARBITRAGE
Bridging the thought divide

These are some of the indicative areas where amendment to law needs to be made if we were to converge with IFRS. We have a choice of having specific differences in India between the accounting principles followed here and those under pure IFRS. These divergences are euphemistically referred as 'IFRS Lite' and are not considered by SEC and IASB as explicit compliance of IFRS. IFRS promotes the principle that the same economic transaction happening in New

York, New Delhi or Sao Paulo will have the same accounting result. The question is, how different India wants to be in this regard.

Kaushik Dutta, Director and Founding Member of Thought Arbitrage Research Institute. He is a Chartered Accountant and author of the book 'Corporate Governance: Myth to Reality'.