Implementation challenges – Accounting Standards (Selected)

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Contents

- Accounting Standard (“AS”) 13 – Accounting for Investments
- AS 16 – Accounting for Amalgamations
- AS 21 – Consolidated Financial Statements
- AS 23 – Accounting for Investments in Associates in Consolidated Financial Statements
- AS 27 – Financial Reporting of Interests in Joint Ventures

AS 13 – ACCOUNTING FOR INVESTMENTS

AS 13 – brief Overview

- Deals with accounting of investments. Defines investments as assets held by an enterprise for earning dividend/interest income and also for earning rentals or capital appreciation.
- Defines the term “investment property” – as investment in land or building that are not intended to be occupied for use by, or in the operations of, the investment enterprise.
- Classifies investments as current and long term.
- Requires current investments to be valued at lower of cost or market value.
- Requires long term investments to be valued at cost less any diminution in value, other than temporary.

AS 13 challenges – Current v/s non-current

- Specially relevant in case of securities which are homogeneous and yet could be classified differently
- Challenges as to classification in investments between current and non current
- Should be done at the time of acquisition of investments
- Relevant as classification may impact taxability of investments – capital gain v/s normal business profits
- Mainly results in auditing challenges to determine classification of investments at inception
- In a well structured enterprise, entity's processes itself would provide a guide to classification
- Processes may be understood and controls over those processes may be tested.
- Greater judgment involved in smaller entities and owner managed entities with less structured processes

AS 13 challenges – Investment property

- Investment property defined as an investment in land and building not intended to be occupied for use by, or in the operations of, the investment enterprise
- Accounting of property held for lease rentals (especially if earning rentals is the main business activity of the enterprise). Fixed asset or investment property?
- Revised Schedule VI specifically contains a category of "investment property" within non current investments. No definition of investment property.
- Problem may be compounded if an enterprise owns a building partly occupied by itself, partly leased and partly operated as a hotel – real estate enterprises. Split between fixed assets and investment property?
- Further if this is self constructed, how to do the split during the construction phase?
- General practice is to classify all property as fixed assets

AS 13 challenges – Investment property

- Revised definition of investment property in IND-AS is more consistent with IFRS and may remove some confusion

  Investment property is property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

  (a) use in the production or supply of goods or services or for administrative purposes; or

  (b) sale in the ordinary course of business.

- More simplified definition would avoid confusion

AS 14 – ACCOUNTING FOR AMALGAMATIONS

AS 14 – brief Overview

- Deals with accounting for amalgamations
- Classifies amalgamations between those accounted for under the pooling of interests method and purchase method
- Under the pooling method all assets, liabilities and reserves of transferror company are recorded at their carrying values in the transferee company
- Under the purchase method the assets and liabilities of the transferror company are incorporated at "their carrying amounts" or the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation (Para 36).
- Para 12 (non mandatory para) also states "identifiable assets and liabilities in purchase method accounting may include assets and liabilities not recorded in the financial statements of the transferror Company
- Excess/shortfall of consideration over the value net assets is accounted for as goodwill/capital reserve.
- Goodwill is required to be amortized

AS 14 challenges – Purchase method

- Purchase method allows either cost method or fair value method of accounting for assets and liabilities of vendor company
- Under fair value method however, states that "purchase consideration must be allocated to individual assets and liabilities on their fair value". Would this mean there would be no goodwill
- A similar transaction between two entities one following cost method and one following the fair value method would result in goodwill/no goodwill
- Often, additional premium is paid for brand values, confirmed customer contracts (eg IT industry) which may not be recognised assets in the books of the vendor entity. Amounts may also be paid for controlling stake, greater than 75% stake, etc., which are in the nature of goodwill.
- Under cost method this would result in huge goodwill (as there is no provision to recognise identifiable assets in para 36. Under purchase method there may be no goodwill.
- Would a more fair view be to recognise assets which meet recognition criteria (eg long term customer contracts) at their fair value and put only balance as goodwill?

AS 14 challenges – Purchase method

- Generally practice is to use cost method in accounting for amalgamations

AS 14 challenges – No business combination standard

- AS 14 applies only in case of an amalgation
- There is no standard which exists when an entity acquires another entity by obtaining a majority stake in the other entity but the legal form of the other entity continues, eg acquisition of a subsidiary
- These matters are covered in the standard on business combinations which exists in IND AS and in the IFRS regime
- The business combination standard addresses most of the matters also raised in the earlier slide

AS 14 challenges – Some other matters

- Most amalgamations are required to be approved via court schemes.
- There is a time lag between the formation of the scheme and the court approval thereof which could take a lot of time. Changes in the composition of assets and liabilities between these dates may have to be addressed. Eg loan to be transferred under amalgamation which is converted to equity shares

AS 21– CONSOLIDATED FINANCIAL STATEMENTS

AS 21– brief Overview

- Standard lays down principles and procedures for preparation of consolidated financial statements
- Defines control as ownership of more than one half of the voting power of an enterprise or control over the composition of the Board of Directors of a Company
- Permits consolidation of one subsidiary by two parent companies (Explanation to para 10)
- States that financial statements of the parent and its subsidiaries should be combined on a line by line basis, by adding together assets, liabilities, income and expenses
- Intra group balances are required to be eliminated
- Date of financial statements of parent and subsidiary may vary by a period of not more than six months, but adjustments are required to be made for the intervening period in consolidated financial statements
- Consolidation procedures require adjustments to be made to ensure uniformity of accounting policies for the group.

AS 21– brief comparison with AS 23 & 27

- In summary in respect of the discussion on AS 21, 23 and 27 the following key points may be relevant
- The impact on consolidated net worth and net profit under all the 2 standards is the same, only the manner of arriving at is different.
- Under consolidation, all assets, liabilities, income & expenses are included in parent and minority interest is deducted therefrom
- Under associate accounting only parent's share is included in the financials but this is included only in a single line item – investments
- Under joint venture account parent's share of assets, liabilities, income & expenses are included in each line item in the financial statements

AS 21challenges – Different accounting periods

- AS 21 – like in the international standards permits parent and subsidiary to use different year ends for consolidating their financial statements with material adjustments to be made for the differences in the intervening period.
- How does this apply in practice?
- For example is the parent's year end is March 31, 2103 and the subsidiary's December 2012 financial statements are being used the following situations may arise
  - The closing balances between parent and subsidiary may be different. How to eliminate inter company balances.
  - Some material inter company transactions may have occurred in the Januar y-March period which exist only in the financials of the parent (given it uses March finacials). How to eliminate those transactions
  - How to eliminate during the year intercompany transactions during the year as only a 9 month period is common?
- In practice overseas, where such standards have been in existence for much longer different periods are not generally used

AS 21challenges – treatment of goodwill/capital reserve

- AS 21 absent a business combination standard re summarises the situation when goodwill and capital reserve arises
- It is however, silent on whether goodwill is to be amortized or not. Varying practices exist in this situation
- Inconsistent with AS 14 which requires goodwill on amalgamation to be amortized. A similar transaction in substance could give different results based on its transaction structure (acquisition of business v/s acquisition of subsidiary)
- Whether goodwill arising from one subsidiary and capital reserve arising from other should be netted off.
- Companies follow different practicies

AS 21challenges – Definition of control (Cos Act 2013)

- The AS 21 definition of control relats to control of voting power and control of composition of board.
- Under the Companies Act, 2013 however, subsidiary company is defined to mean a company in which the holding company "controls more than one half of the total share capital . . ."
- What happens in case of non voting shares held in a company normally considered to be a subsidiary. See example below:

Particulars	Equity sh (voting)	Pref sh (non voting)	Total
Total share capital of B Limited (numbers)	1,000,000	600,000	1,600,000
Shares owned by A Limited	550,000	100,000	650,000
% of ownership and control	55%	16.67%	40.625%

- How to comply with Act and standard if one entity is a subsidiary under one and not another?
- No transition rules are available as to how to de subsidiarise an existing subsidiary in such situations

AS 21challenges – Depreciation policies (Cos Act 2013)

- The Companies Act, 2013 categories companies in 3 categories – listed, unlisted and those regulated by other Acts (eg banking, insurance, etc).
- Prescribed class of companies are allowed to follow depreciation useful lives different from those specified under the new act, ie these could be higher or lower with suitable explanations
- Other companies (excluding regulated companies , however, are required to mandatorily follow the rates specified in the Act
- Implications for prescribed companies having companies requiring to follow depreciation as per the new act would require multiple depreciation calculations – for parent consolidation, for separate subsidiary financial statements to be filed with RoC
- What happens if these other companies are foreign subsidiaries or are joint ventures or associates over which the reporting entity has limited control?

AS 21challenges – Consolidation requirements (Cos Act 2013)

- The Companies Act, 2013, Section 129(3) states that when a company has subsidiaries it shall also prepare consolidated financial statements to the same level of detail as standalone financial statements
- Private companies would now require to prepare consolidated financial statements
- Interim holding companies would also require to prepare financial statements.

AS 21challenges – Specialised situations

- Business purchase and sale agreements today may take complex forms which may require significant judgment giving rise to implementation challenges
- For example a 50:50 joint venture company executing a single project, where after a couple of years in the construction phase, one partner entered into an agreement that the foreign JV partner under which
  - The foreign JV partner would continue to be a shareholder but would act in a manner to support the other partner's execution of the project. The foreign partner would vote in board and AGM matters in a manner consistent with the Indian party's interests
  - The Indian partner would be liable for all losses which occur in the "joint venture" entity from the date of the arrangement.
- Post certain approvals, the foreign party's stake would be purchased by the Indian party
- The entity is a single project entity and given it was in construction phase would not declare dividends.
- Does this effectively mean that notwithstanding the shareholding held by the foreign party control has passed to the Indian party and it should consolidate the entity now?

AS 21challenges – Specialised situations

- Inter company transactions and balances between parent and subsidiary are eliminated
- No clear guidance if the transaction is between, two subsidiaries of the parent. Would the income and expense be grossed up or netted of especially considering the requirement that the consolidation is line by line?

AS 23 & 27 – ASSOCIATES AND JOINT VENTURES

AS 23 & 27 – brief Overview

- The standards are similar to the standard on consolidation except for the manner of arriving at consolidated net profit/net worth which is briefly re summarised here
- The impact on consolidated net worth and net profit under all the 2 standards is the same, only the manner of arriving at is different.
- Under consolidation, all assets, liabilities, income & expenses are included in parent and minority interest is deducted therefrom
- Under associate accounting only parent's share is included in the financials but this is included only in a single line item – investments
- Under joint venture account parent's share of assets, liabilities, income & expenses are included in each line item in the financial statements

AS 23 & 27 challenges – Different reporting periods

- In addition to the accounting challenges which exist of having different reporting periods as indicated under the discussion in AS 21, the following matters may also pose challenges
- An investor in an associate or a joint venture may have only limited "influence/control" in its investee entities
- Challenges may emerge in case of different period ends to ensure that the financial statement uses for consolidation are prepared and/or if prepared are done with the same robustness as required
- Implications in case the amounts of these entities in the consolidated financial statements are material – how to audit?

AS 23 & 27 challenges – Materiality

- Accounting standards require financial statement to provide a true and fair in all material respects.
- Consider a situation of a profit making parent and a loss making joint venture. The loss is material to the consolidated financial statements (eg parent's share of loss is 30-40% of parent's standalone profit)?
- How is materiality to be calculated?
- Auditing deem 5% of profit before tax as a numerical threshold of materiality. Would a re audit be required of the parent for consolidation?
- Would this situation be partly addressed with the Companies Act, 2013 which enables a parent auditor to access information relating to the subsidiary relevant to consolidation.
- This may be relevant in a parent subsidiary situation but may pose lesser challenges given parent's ability to control subsidiary

AS 23 & 27 challenges – Consolidation (Cos Act 2013)

- Section 129(3) of the Companies Act, 2013 requires prescribed companies having subsidiaries to prepare consolidated financial statements
- Further explanation to provision 2 of this section states that "for the purpose of this section subsidiary shall include associate company and joint venture"
- The draft rules under the new act states that consolidation if required is to be done as per the accounting standards
- The applicability criteria 23 and 27 state that these standards apply only if AS 21 is applicable. Further, AS 21 is applicable only when a parent has subsidiaries. Hence, entities with associates and/or joint ventures but no subsidiaries were not preparing consolidated financial statements.
- Implications of the inclusion of associate/joint venture in the Companies Act, 2013 definition?
- Conflict with AS 21 as the applicability criteria differ?

AS 23 & 27 challenges – Definition of associate

Highlights

- "Associate" definition in the Companies Bill 2012:

  "*Associate company*, in relation to another company, means a company in which the other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company."

  "*Significant influence* means **control of at least 20%** of total share capital, or **of business decisions** under an agreement."

- "Associate" definition in notified AS 23:

  "An *associate* is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor."

  "*Significant influence* is the power to participate in the financial/ operating policy decisions of the investee **but not control over those policies**."

AS 23 & 27 challenges – Definition of associate

Key challenges

- Control of business decisions is an indicator of control not significant influence
- In accordance with AS 23, Ind-AS and IFRS;
  - A company may demonstrate that 20% share ownership does not constitute nsignificant influence
  - Significant influence can be evidenced by other ways as well even if company does not hold 20% shares in other company.
- No such provision under the Bill.

Thank you