

Chapter 4

Accounting and Measurement Standards

4.1 Introduction

Companies prepare financial reports that are directed toward their primary users, who are not limited to domestic stakeholders but include international stakeholders. These stakeholders face a major obstacle in the form of different accounting principles followed in the financial reporting across countries.²³¹ Accounting principles also referred to as Generally Accepted Accounting Principles (GAAP) include a set of convention, rules and procedures necessary to define an accepted accounting practices of a firm. These principles encompass a set of guidelines general applications and also detailed procedures and practices. Divergence in use of reporting and accounting standards may affect the reader's confidence in the reported figures. Differences in accounting measurement along with the economic, cultural and institutional factors impacts the development of the capital markets. The changing economic trend of the world has brought the capital markets closer which in turn has necessitated the preparation of comparable high quality financial statements. Bringing Indian accounting standards on par with international standards and pronouncing standards that are clear and free from ambiguity will help the investors and other decision makers. Accounting diversity can be classified into differences in reporting requirements and differences in accounting standards. Differences in reporting requirements were discussed in Chapter 3. Differences in accounting standards are discussed in this chapter.

The fundamental question that arises on standardisation is can we have a uniform accounting standards cut across all barriers? Standardisation of accounting principles would mean that all countries or companies in a country follow the same method of accounting for various transactions (see figure 4.1) In

²³¹R. Ball, S.P. Kothari and A. Robin, "The Effect of International Institutional Factors on Properties of Accounting Earnings", 29(1) *Journal of Accounting and Economics* 1-51 (2000) and B. Basu, L. Hwang and C.L. Jan "International Variation in Accounting Measurement Rules and Analysts Earnings Forecast Errors", 25 (9) *Journal of Business Finance and Accounting* 1207-1247 (1998) For example the US GAAP may be more rigid and allow less alternatives. The definitions may be different.

a way this is the extreme opposite of the total diversity where there is no uniformity in accounting. A standard will normally advocate the use of only one method in order to create uniformity.

Tay and Parker define standardisation as: "a process or a movement towards uniformity..... it includes the clustering associated with harmony and reduction in the number of available methods."²³² Standardisation occurs when a standard reduces the number of acceptable methods from which companies may choose or altogether eliminate alternatives in standards. While standardisation is the ultimate goal, it may not be possible for countries to have the same accounting alternatives for various reasons. Therefore, accounting organisations all over talk about harmonisation.

Harmonisation and standardisation although used interchangeably are different concepts. Harmonisation can be referred as coordination, and tuning of two or more objects.²³³ In accounting terms the process of 'harmonisation' as against 'standardisation' refers to the process of reducing the differences in accounting practices among the countries. Quoting Radebaugh and Gray²³⁴, "Harmonisation implies a more flexible approach compared to standardisation which suggests a more strict approach resulting ultimately in a state of uniformity". Harmonisation can also be defined as a "process of increasing the compatibility of accounting practices by setting limits on how much they can vary."²³⁵ It would mean moving away from diverse practices and bringing together different accounting systems²³⁶ as depicted in Figure 4.1

Standardisation occurs at the macro level where countries issue accounting standards which reduces the alternative accounting methods. In a way standardisation may directly or indirectly influence and ultimately lead to harmonisation. Harmonisation means rules, which do not exclude themselves, and can continue to exist next to each other. That means harmonisation does

²³² J.S. Tay and R. H. Parker "Measuring International Harmonisation and Standardisation" , 26(1) *Abacus*. (1990) at 73

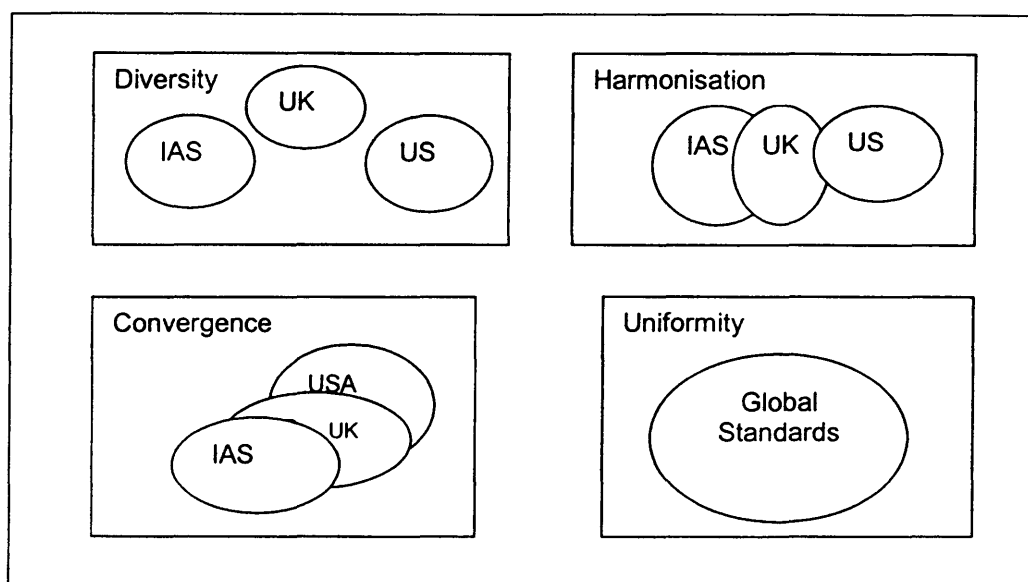
²³³ G.L. van der Tas, "Measuring Harmonisation of Financial Reporting Practice", 70(18) *Accounting and Business Research* (1988) at 157

²³⁴ L.H. Radebaugh and S.J. Gray, "Pressures for International Accounting Harmonisation and Disclosure", *International Accounting and Multinational Enterprises* (L.H. Radebaugh, S.J. Gray and J.S. Arpan. eds., New York: Wiley, 1993)

²³⁵ F.D.S. Choi, C.A. Frost and G.K. Meek, *International Accounting* (New Jersey: Prentice Hall 2002) at 291

not focus on the elimination of differences, but on the reduction of contradicting rules. Recent developments in harmonisation are the talk of convergence of accounting standards. In October 2002, the FASB and the IASB announced the issuance of a memorandum of understanding ("Norwalk Agreement"), marking a significant step toward formalising their commitment to the convergence of the US GAAP and IAS.

Figure 4.1: Diversity, Harmonisation Convergence and Uniformity



This resulted in the attempt to have a short-term convergence of a few accounting standards.²³⁷ The objective of the short-term convergence project is to remove a variety of individual differences between the US GAAP and IAS that are not within the scope of other major projects. This convergence is limited to differences that can be removed, in short period of time by selecting between existing IAS and US GAAP. FASB and IASB intend to address the differences within their scope and either amend the relevant US GAAP literature or reduce or eliminate the differences or communicate to each other the rationale for electing not to change the respective standards.

In this chapter, the Indian accounting standards are compared with the International Accounting standards and the US GAAP and the difference

²³⁶ Roberts et al., *International Financial Accounting* (London: Financial Times, 1998) at 116

²³⁷ http://www.fasb.org/project/short-term_intl_convergence.shtml#iasb_short-term (Sep 05, 03)

identified. This is followed by a review of prior studies in harmonisation and a discussion of the result of degree of harmonisation of accounting standards between the UK, USA, Germany and IAS.

4.2 Comparative Study of the Accounting Standards

Accounting standards or Generally Accepted Accounting Principles are concerned with the measurement of economic activity, the time when they are recognised and the disclosure of information in the financial statements. Accounting standards are authoritative statements of how particular types of transaction and other events should be reflected in the financial statements. Accordingly, compliance with accounting standards will normally be necessary for the fair presentation of the financial statements.

The importance of high quality accounting standards cannot be over emphasised. Standards that give options and are not rigorous may give rise to variety of fraudulent practices in the preparation of the financial statements. These practices include the 'big bath' restructuring charges, creative acquisition accounting, 'cookie jar reserves', material misapplications of accounting principles and the premature recognition of revenue.²³⁸

Big bath charges refer to the write off of huge restructuring and other expenses and one-time losses as the investors will focus only on the future incomes. Acquisition accounting refers to the purchase price allocation procedures, where a large amount of the acquisition price is allocated to in process research expenses and is written off as a one time charge so that future earnings are not affected. Sometimes, large liabilities for future operating expenses are created to protect future earnings. Companies use cookie jar reserves when they make unrealistic assumptions to estimate liabilities for such items as sales returns, loan losses or warranty costs. In doing this, they create reserves in good times and reach for it when needed in the bad times.

²³⁸ These practices are described by A. Levitt former Chairman of the SEC. A. Levitt, "The Number Game", remarks at New York University Centre for Law and Business, September 28, 1998 at www.sec.gov/news/speeches/spch220.txt (Dec 12, 01)

Companies may use the 'materiality concept' to record errors and may justify it on the basis that the effect on the profit is too small to matter. Materiality requires consideration of all relevant factors that could impact an investor's decision rather than justifying based on some percentage. Companies may also recognise revenue before a sale is complete, before the product is delivered to a customer, or at a time when the customer still has options to terminate, avoid or delay the sale. If all the above techniques are not prevented by the accounting standards or by the auditors the financial statement numbers will no longer be relevant and reliable to the stakeholders.

Accounting standards consist of conventions, rules and procedures at a particular point of time. Over a period of time when they are mandated they become accounting standards. The Accounting Standards Board issues the accounting standards in India. ICAI also issues 'Guidance Notes' and 'Statements' on a number of matters. 'Statements' relating to accounting matters are complied with in the presentation of financial statements and are mandatory like the accounting standards. 'Guidance Notes' are primarily designed to provide guidance to members on matters, which may arise in the course of their professional work. Guidance Notes are recommendatory in nature. ICAI also issues General Clarifications on accounting standards and Accounting Standards Interpretations.

The power to establish the accounting standards rests with Securities Exchange Commission in the US and the setting of standards is primarily undertaken by the FASB. SEC also allows the accounting professionals to issue pronouncements and self regulate. US GAAP has to be referred from different sources and are not available from a single document and there is a hierarchy for using these principles. Sources of US GAAP and its hierarchy are:

Category A: These are mandatory and any violation will result in the audit qualification, consisting of; Statement of Financial Accounting Standards (SFAS) and their interpretations issued by the FASB. Accounting Principles Board (APB) Opinions and Accounting Research Bulletin (ARB) issued by the AICPA.

Category B: Consists of FASB technical bulletins and AICPA issued Industry Audit and Accounting Guides²³⁹ and Statement of Position issued by AICPA.

²³⁹ This has to be cleared by FASB

Category C: Consists of Accounting Standards Committee's Practice Bulletins, Abstracts and Consensus Positions issued by Emerging Issues Task Force (EITF).

Category D: The next level consists of Accounting Interpretations by AICPA, Implementation guides in the form of question and answers published by FASB staff, and also the prevalent industry practices.²⁴⁰

Standards issued by the International Accounting Standards Board are designated as 'International Financial Reporting Standard' (IFRS), while the statements of International Accounting Standards issued by the Board of the International Accounting Standards Committee (1973-2001) continue to be designated 'International Accounting Standard'. The Preface to International Financial Reporting Standards issued in 2002 makes it clear that IFRS include IAS. The Interpretations of International Accounting Standards issued by the International Financial Reporting Interpretations Committee (IFRIC) (formerly, the 'Standing Interpretations Committee' (SIC)), do not have the same status as IAS, but, in accordance with IAS 1, *Presentation of Financial Statements*, paragraph 11, financial statements should not be described as complying with International Accounting Standards unless they comply with all the requirements of each applicable Standard and each applicable interpretation of the Standing Interpretations Committee.

In the next section measurement and accounting standards are compared with IAS and US GAAP. The Accounting standards are broadly categorised into those relating to assets and others. Disclosure requirement under AS is summarised in Appendix 4.

4.2.1 Comparison of Standards Relating to Assets

Assets are defined as "resources controlled by the enterprise as a result of past event from which the future economic benefits are expected to flow."²⁴¹ An essential characteristic of an asset is that, future economic benefit must contribute to the cash flow of a company directly or indirectly. Assets are broadly classified into fixed Assets or property, plant and equipment, current assets and other assets. Assets are normally recorded at cost.

²⁴⁰ P Delaney, R. Nach, B.J.Eapstein and S.W.Budak, *GAAP 2004* 3 (New Jersey, John Wiley and Sons, 2003)

²⁴¹ ICAI, *Compendium of Accounting Standards 20* (New Delhi: ICAI, 2002)

In the US, the fair value concept is used extensively in measurement. Fair value provides important information about the financial assets and liabilities as compared to values based only on their historical cost (original price paid or received). Since fair value reflects current market conditions, it provides comparability of the value of assets bought at different times. In addition, financial disclosures that use fair value provide investors with insight into prevailing market values, further helping to ensure the usefulness of financial reports. AS has used fair value concept in a limited way only. The use of fair value in measurement is discussed later in the chapter.

The relevant accounting standards dealing with assets are Valuation of Inventories - AS 2, Accounting for Fixed Assets - AS 10, Depreciation - AS 6 (as it relates to assets) Intangible Assets - AS 26 and Impairment of Assets - AS 28 and Accounting for Investments - AS 13.

1. Inventories: AS 2

Inventories are assets used in the process of production or form the end products for sale in the ordinary course of the business. They have been broadly classified as finished goods, work in progress and materials and supplies that are to be consumed in production process or in of rendering services. Accounting of inventory is important for the manufacturing industries. The intricacy involved in the accounting for inventory is due to high volume of transactions and the method involved in maintaining accurate records. Inventory valuation will substantially affect the profit and loss as well as the balance sheet of a firm. An important objective of accounting for inventory is the matching of costs against the revenue to arrive at the correct profit. The accounting standard deals with the determination of the inventory cost and the method of valuation of the closing inventory.

Inventories are usually valued at cost and consist of all costs incurred to bring it to the present location and condition. The cost components included in the finished goods are i) cost of purchase ii) cost of conversion and iii) other costs. Cost of purchase includes purchase price plus duties and taxes, freight inwards and other expenditure directly attributable. Trade discounts etc are deducted from cost. The cost of conversion includes costs directly related to production, such as direct labour and systematic allocation of fixed and variable

production overheads incurred in conversion to finished goods also called as absorption costing for valuing inventory. Fixed cost is allocated on normal capacity and variable cost on actual use of facilities.

Interest and other borrowing costs are not considered as relating to 'bringing inventory to current location and condition' and hence not included in the ordinary course. Certain costs like abnormal amounts of wasted material, labour or other production costs, storage costs, administrative overheads that do not contribute to bringing inventories to present location and condition and selling and distribution costs are usually treated as expenses and are not treated as part of the inventory cost.

Different cost formulas are used for valuation of the year-end inventory. The use of different cost formula will have a major impact on the profitability of the company. AS 2 recognises: Specific identification of individual costs, the first-in first-out (FIFO) method and the weighted average cost method. Standard cost or retail method can be used for measurement, for convenience, if the result approximates actual cost. The standard cost considers normal levels of consumption and capacity utilisation. They are regularly reviewed and revised. Retail method is also allowed for inventories that have similar margins and in retail trade business. Inventories are valued at cost or market value whichever is lower. Recognising inventory at market rates subject to certain conditions is also permitted for specific industries such as mineral ores and agriculture and similar others. Similar provisions are also found in the US GAAP and IAS. Because of the important nature of the item the auditors have to report, whether physical verification of inventory has been conducted at reasonable intervals by the management; and whether the procedures of physical verification of inventory followed are reasonable and any inadequacies in such procedures.²⁴² The auditor is also required to state if the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and have been properly dealt with in the books of account.

Comparison with IAS and US GAAP

The benchmark treatment for cost flow formula is the same as in AS. The allowed alternative treatment in IAS is the last in, first out (LIFO) cost formula,

which is not permitted under the AS. LIFO method had been eliminated from the allowed alternative in the AS. LIFO method implies that goods purchased last will be used first. This method is a better measure for gross profit, but over a period of time the year ending balances will be distorted. Since it is not a benchmark treatment, IAS specifies that, when LIFO method is used, additional disclosures giving the i) net realisable value and ii) FIFO, and iii) weighted average cost.

The LIFO method though allowed is not a preferred treatment under the US GAAP. It is allowed method for valuation under the Internal Revenue Code (Section 472) for tax purposes. Companies following LIFO method in the tax must also follow the same method in external financial statements. A change to the LIFO method is treated as a change in the accounting policy and is done retrospectively.

Under AS and IAS inventory is carried at the lower of cost and net realisable value (NRV) while in the US GAAP it is carried at the lower of cost and market value. The market value is computed as the lower of 'Replacement cost' and 'Net Realisable Value' reduced by the normal profit margin. This appears to be a more rigorous measure of inventory valuation. The adjustments of lower of cost or market value is done on an item by item basis as against allowed grouping of similar items in the IAS. IAS permits write back of inventory written off earlier, if certain conditions are met, which is not permitted in US GAAP. AS is silent on this issue.

Disclosures

AS requires the accounting policies adopted in measuring inventories, including the cost formula used; and the total carrying amount of inventories and its classification appropriate to the enterprise to be disclosed

Similar disclosure is required under US GAAP and IAS. Additionally, US GAAP requires that if there is an unusual write off of inventory they must be disclosed separately in the profit and loss account. Carrying amount of inventory at net realisable value and any amount of reversal of write down needs to be disclosed. IAS also requires the disclosures of inventory carried at net realisable value and the disclosure of any reversal of write offs of inventory made earlier

²⁴² These requirements are as per the Companies (Auditor's Report) Order, 2003

along with the reasons. This should also be mandated in India as write offs are not visible in the profit and loss account.

Critical issues in inventory accounting

The application and monitoring of the accounting standards is an area of concern for the auditors. In a 1999 study, the Committee of Sponsoring Organisations of the Treadway Commission found misstated asset valuations accounted for nearly half the cases of fraudulent financial statements. Inventory overstatements made up the majority of asset valuation frauds.²⁴³

The accounting standards on inventory is not clear in some places and there may be potential areas of conflicts that may result in overvaluation or under valuation of the inventory that may affect the earnings of the firm. Specifically, the cost of conversion related to overheads, the normal capacity of production and the use of standard cost are a few areas that need elaboration or it may lead to inconsistent application of the standards. Influencing the profit through inventory manipulation adopted through the above ambiguity has to be strictly monitored by both the external auditors and the audit committee.

Corporate Practices

Escorts Ltd: The company has shown inventory write-off of Rs. 5.77 crores during the year 2002. Of this Rs. 1.12 crores is charged to the profit and loss account. The balance amount of Rs. 4.23 crores is adjusted against the Contingency reserve and from the provision created in the earlier years. Contingency reserves are usually an appropriation of profits and this does not impact the profit and loss account. (Annual Report 2002, page 32).

2. Fixed Assets –AS 10

Fixed assets are assets held with the intention of being used for the purpose of producing or providing goods or services and not held for sale in normal course of business (Para 6.1 of AS 10). IAS 16 defines 'fixed assets', as assets used in a productive capacity that have physical substance, are relatively long lived and provide future benefits that are readily measurable. This definition

²⁴³ J. T. Wells, " Ghost Goods: How to Spot Phantom Inventory " 6 Journal of Accountancy (2001) www.aicpa.org/pubs/jofa/ (Dec 15, 2002)

is more elaborate and captures the recognition criteria in great depth with respect to the flow of economic benefits of the future. Fixed assets comprise a major portion of the total assets of an enterprise and therefore are important in the presentation of the financial statement. Fixed assets provide economic benefits to a company for long periods in future. The determination of whether expenditure is an asset or an expense can have a material effect on the firm's profitability.

The three important issues in accounting for fixed asset are:

- The amount at which the assets are recorded (Recognition and measurement issue)
- The rate at which they are allocated to future periods (Depreciation)
- Recording of subsequent disposal of assets (Impairment)

Recognition and Measurement

Fixed assets are recognised at cost. Initial cost comprises of all those costs related to bringing the asset to its working condition for its intended use. The word 'working condition' is a subjective term and difficult to interpret. This cost includes: purchase price and taxes, installation and set-up costs and other directly attributable costs. Trade discount/outdates are deducted from the price. Fixed assets are recognised at the fair market value when they are exchanged for another asset. Acquisition through donation is taken at the nominal value. The indirect costs like administration and general overhead expenses, which are specifically attributable to the construction process of the fixed assets and commissioning expenses are also added to the cost. Borrowing costs are also included in the cost of the asset. Expenses cannot be capitalised after an asset is commissioned. In India under the Income Tax Act, (Sec 43 A) and also the Companies Act (Schedule VI) provides that exchange differences related to a borrowing for fixed asset can be capitalised even after the asset is commissioned. This is in variance with the accounting standard AS 11, which prohibits such a treatment.

New companies and new projects of companies incur two types of expenses before the production commences: Preliminary expenses and expenditure during the construction period. Preliminary expenses include expenses of incorporation, legal fees and other similar expenses incurred at the

beginning of the company. The other start up costs relates directly to the project or can be an indirect expense. Direct expenses relating to the project are capitalised to the respective assets under construction using a suitable method. Indirect expenses not related to the project are not capitalised but in some circumstances they may be capitalised as part of the fixed assets. Indirect expenses are usually capitalised only till the date of commercial production. If this is prolonged, then all the expenses can be treated as deferred revenue to be written off over 3-5 years. Preliminary expenses are also capitalised and shown under the head miscellaneous expenditure and written of over a period although the period of write off is not specified in the Companies Act.²⁴⁴

Self constructed assets for internal use is also dealt with in the AS. In such cases, direct costs are capitalised and related overheads are also allowed for capitalisation. Internal profits cannot be added to the cost of the asset. A degree of judgement is involved in the identification of indirect cost overheads.

Expenses incurred subsequently by a company are capitalised only if it increases the future benefits beyond previously assessed standards of performance.

Fixed assets are generally valued at cost. However, revaluation of fixed asset is permitted in both the accounting standard and the Companies Act. Revaluation is done for the entire class of assets. Increase in net book value arising on revaluation of fixed assets should be credited directly to owners' interests under head of revaluation reserve. Losses on revaluation should be charged to Profit and Loss account. A potential area of concern relates to the accounting for revaluation of assets. Assets are revalued and the revaluation is credited to the reserves (as prescribed in the Companies Act). Depreciation is charged to the profit and loss account on the revalued amount. However, companies may offset the higher depreciation with a transfer of equal amount of reserves to the profit and loss account. In effect, the revaluation does not affect the profit and loss account account. The profit and loss account may however be affected when the inventory cost will include the revised higher depreciation.

Comparison with IAS and US GAAP

²⁴⁴ There is no accounting standards, but the ICAI has issued a Guidance note titled 'Expenditure During Construction Period'.

The measurement provisions are in line with the IAS 16. Some additional requirements are given in Para 16 to 22 of the IAS, which are not found in the AS. For example, when the payment terms are extended beyond normal credit terms, then the defined or the charged interest payment included in the liability must be removed. A corresponding reduction in the cost of the asset is also made. Preliminary expenses are written off to the profit and loss account under IAS.

IAS allows for revaluation of assets. Subsequent to the initial recognition the IAS provides that the assets should be carried at the cost less accumulated depreciation and any impairment losses. IAS also specifies how the revalued amount should be presented. The US GAAP does not allow for revaluation of the fixed assets being more stringent in its requirement (APB 6, Para 17). Allowing revaluation of assets is a contradiction to the historical cost concept and this practices must not be permitted, as assets and capital are over stated.

Major overhaul cost are required to be treated as separate components and are to be depreciated over the period between the overhauls as in SIC 23, of the IAS. US GAAP allows capitalisation of subsequent expenses only if the value has materially increased or the useful life has been extended. They are not treated as separate components like IAS.

US GAAP considers development stage enterprises in SFAS 7 where costs relating to the establishing of new companies are dealt with. For a development stage company, start up activities is expensed as incurred (SOP 98). These relates to introducing an new product or services, opening an new facility, initiating a new process in the existing facility or starting a new operation and costs incurred for the formation of the accompany. US GAAP also requires certain disclosures at the start-up stage like the activities at the development stage.

Disclosures

Detailed disclosures of fixed assets showing additions, disposals opening and closing balances of various types of assets are as prescribed in Schedule VI of the Companies Act. Material items retired from active use and those held for disposal should be show separately. Expenditure incurred on account of fixed assets in the course of construction or acquisition are also to be disclosed.

Disclosures on account of revaluation is elaborate and require details such as the method adopted for computing the valued amounts and the appraisal and external valuation made. When fixed assets are revalued, the Act requires the fact of revaluation to be stated in 5 subsequent financial statements. In practice not many companies are giving sufficient details.

IAS and US GAAP have similar disclosures. IAS 16 mandates disclosures relating to exchange differences arising on translation of financial statements of a foreign entity included in the reconciliation. In the case of revaluation, the carrying amount of the asset under the benchmark treatment i.e. at cost has also to be given. Voluntary disclosures are recommended under IAS for the carrying amount of 'Temporarily Idle Property Plant and Equipment', the gross carrying amount of any fully depreciated fixed assets still in use and those held for sale. Additional disclosures under US GAAP relate to, Assets held for sale and idle assets. If assets are reclassified from 'held for sale' to 'held and used' the facts and circumstances leading to this decision has to be disclosed.

3. Depreciation - AS 6

The underlying accounting concept for depreciation is the matching principle, where the cost of fixed assets is allocated to periods that benefit the use of the assets. Depreciation is defined in Para 3.1 of the accounting standard as a measure of wearing out consumption or other loss of value arising from use, effluxion of time or obsolescence through technology and market change.

IAS defines depreciation as the systematic allocation of the depreciable value over the useful life of the asset. Thus recognising the fact that depreciation, is needed to arrive at the correct profitability of the firm.

The standard does not prescribe any method but only mentions that the depreciable amount should be charged on some basis to each accounting period during useful life of asset and that most commonly used methods are the straight line and the reducing balance method. The Companies Act prescribes rates of depreciation in Schedule XIV for both the written down value method and straight-line method. These are minimum depreciation rates. Companies can charge a higher depreciation in their books of accounts if justified.

Change in the method of depreciation is allowed if the adoption of the new method results in a better presentation of the financial statements. Depreciation is recalculated using the new method; from the date on which the asset is first put to use (retrospectively) and the difference is adjusted in the profit and loss account of the current year.

Comparison with IAS and US GAAP

IAS 16 recognises three depreciation methods of straight line, reducing balance and sum-of-the-year-digits method. The method to be selected is based on the expected pattern of economic benefits, maintenance costs and similar factors that will affect the life of the asset. IAS requires the review of the depreciation method applied periodically and requires a change in the method if there is a significant change in the pattern of benefits received. Such changes are accounted as changes in the accounting estimates and are affected in the current period and future periods only. In US GAAP, change in the method of depreciation is permitted and is treated as a change in the accounting policy and would require retrospective application with a cumulative-effect adjustment recorded in the period of change. A change in the useful life or the salvage value is accounted as a change in the accounting estimates and is accounted prospectively.

Disclosures

The depreciation methods used, the useful lives or the depreciation rates used if different from the Companies Act, total depreciation allocated for the period and the gross amount of depreciable assets and the related accumulated depreciation are disclosed. Effect of revaluation on the depreciation must be disclosed separately in the year of revaluation. US GAAP and IAS require the method of computation of depreciation to be disclosed.

Corporate Practices

Pfizer Ltd.

The company has decided to change the method of depreciation for furniture and fixtures in the leasehold premises over the remaining lease period. Consequential additional depreciation of Rs. 24.68 lakhs is charged to the profit and loss account. (page 59, Annual report, 2002)

Reliance Industries Ltd

The company has changed the method of depreciation for certain assets from the straight-line method to written down value method. AS states that depreciation is recalculated under the new method from the date it is put to use. 'In case the change in the method, results in a deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss account'. The company has changed the method of depreciation of certain assets as on 1-4-2001 and has arrived at an additional depreciation of Rs. 450.16 crores relating to the previous year (pages 77 and 94 of the annual report, 2002). The said depreciation is charged to the profit and loss account, however an equivalent amount is setoff from the general reserves and credited to the profit and loss account resulting in no impact on the profit and loss account.

AS does not specify any system for computation of depreciation for assets acquired during the year as in the Income Tax Act.²⁴⁵ Hence companies have used a variety of methods for calculation of depreciation; record full years depreciation in the year of acquisition, record depreciation based on the half year use, record depreciation based on the number of days used or from the month it is put to use.

4. Intangible Assets - AS 26

Intangible assets are assets that have no tangible existence like technical know-how, trademarks, goodwill and patents. These assets can be defined as identifiable non-monetary asset, without physical substance held for use in the production or supply of goods or services, for rental to others, or for administration purposes (paragraph 6 of AS 26). AS on intangible assets is also applicable to research and development expenses, training, and advertising expenses.

An intangible asset is recognised only if the future economic benefits will flow to the enterprises and are controlled by an enterprise as result of a past event. An intangible asset should be initially measured at cost and only if costs

²⁴⁵ The Income tax Act allows for depreciation based on purchase before 180 days or later and consequently depreciation is allowed for half year or for the full year.

can be measured reliably. Internally generated goodwill, brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets.

For research and development expenses, AS 26 has superseded the earlier standard AS 8. AS 26 provides that research costs must be expensed immediately. Development costs (from the development phase of the internal project) can be recognised as intangible asset only when there is technical feasibility and intention of completing the intangible asset. A firm must also have adequate resources to complete and use or sell the asset. Additionally, a firm must also demonstrate how the asset will generate future economic benefits by use or by sale.

Measurement

An intangible asset should be carried at its cost less accumulated amortisation. Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life. Depreciable amount is the cost of the intangible asset as reduced by estimated net realisable value at the end of its useful life. The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. There is a presumption that the useful life of the intangible asset will not exceed ten years. Self generated goodwill, brands etc are not recognised in the accounts. Goodwill arising out of business combinations is not dealt in the AS but has to be derived from AS 14.

An intangible asset should be eliminated from balance sheet when no future economic benefits are expected from its use and subsequent disposal. Gains or losses arising from retirement of intangible asset should be recognised in the profit and loss account.

Comparison with IAS and US GAAP

AS 26 is comprehensive and is substantially in line with the IAS-38. Some differences are observed. IAS defines 'cost' as the amount of cash and cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or production. AS does not define the word cost.

IAS requires the recognising of interest component in the transaction, if the payment for intangible asset is extended beyond the normal credit period. AS does not consider segregating of interest components from the cost of the asset. Intangible assets acquired through government grants free of cost are accounted at nominal value in AS against nominal or fair value in IAS.

The benchmark treatment of IAS is to recognise the intangible asset at cost less amount amortised as depreciation. Allowed alternative treatment is to revalue the asset based on fair value and account for any subsequent amortisation and impairment losses. IAS 38 permits revaluation of Intangible assets if fair value can be determined with reference to an active market. AS is silent on revaluation, hence it is not clear if the intangible assets can be revalued. The amortisation period generally cannot exceed 20 years in IAS. In the case of research and development, AS and IAS allow capitalisation of development expenses subject to certain conditions as discussed earlier

Intangible assets acquired individually or as a group of assets (under SFAS 142) are recognised at fair value. They are further classified into those having finite life and indefinite life. Intangibles having finite life is amortised over the useful life of the asset. This is based on the pattern of use or consumption of economic benefits. In the absence of a pattern, it is written off using the straight-line method. Intangible asset with indefinite useful life is not amortised until its useful life is no longer indefinite. The remaining useful life is reviewed each year. These are not amortised, but are regularly tested for impairment. US GAAP prohibits revaluation of intangible assets.

The costs related to internally generated intangibles with indeterminate lives are addressed in APB Opinion No.17. Research and development costs are addressed in FASB Statement No. 2, 'Accounting for Research and Development Costs'. Under both the standards, research and development costs are to be expensed because of the inherent uncertainty of future economic benefits related to internally generated intangibles. Internally generated intangibles, which are not specifically identifiable, have indeterminate lives or are inherent in a continuing business, are charged off as expenses (SFAS 142, Para 10). From the AS it is not clear whether the research expenses also include

capital expenses or only the revenue expenses although the companies capitalise the asset costs and expense the revenue expenses.

While computer software, patents, copyrights, all represent intangibles that could qualify for asset recognition under similar concepts, it is better to have separate accounting standards for computer software. At present, the issues related to software are included in the appendix of AS 26, which may not be sufficient and needs the formulation of new standards. The software developments are dealt with as separate standards in the US GAAP.

Disclosure

Intangible assets are important and the disclosure of information is useful in understanding the financial statements better. AS requires information on internally generated intangible assets and others to be disclosed separately. The useful lives, the amortisation method used and a reconciliation of the carrying amount and the amount at the beginning of the period through internal development or through amalgamations needs disclosure. Retirements, impairments and reversal of impairment have to be show separately Amortisation during the period, accumulated amortisation with the accumulated impairment loss has to be shown separately. Any changes in the carrying amount during the period must also be given.

Under SFAS 142 the disclosure requirements are similar and companies have to report the following for amortised intangibles (i) the gross carrying amount and the accumulated amortisation in total (ii) the amount of amortisation expenses for the period iii) Estimated aggregate amortisation expenses for each of the five succeeding fiscal years. If intangibles are not amortised then the total carrying amount of each class of intangible asset has to be disclosed. If intangible assets are impaired then the circumstances that led to the impairment must also be disclosed.

Corporate Practices

Asian Paints Ltd.

The Company's accounting policy: Capital Expenditure on research and development is shown separately under the respective fixed assets, while revenue expenses are charged to the profit and loss account. Know how

developed related to manufacturing process is expensed in the year in which it is incurred. (Annual report, 2002)

Bajaj Auto Ltd

The expenses made to acquire technical know-how is amortised over a period of six years

Hindustan Lever Ltd.

Trademarks are amortised over a period of four years. Other intangible assets are written off in the year in which it is incurred (Annual report 2002)

5. Impairment of Assets – AS 28

The principle behind the standard is that asset should not be valued over its fair market price or value in use. Fixed assets and other intangible assets include many costs, which include overheads, and other expenses which may vitiate the true value of the asset. Thus, assets should not be carried in books at more than the recoverable amount. These assets include, land, buildings, plant, machinery, intangible assets, investments in subsidiaries, associates and joint ventures. AS does not include impairment of investment property.

Recognition of an Impairment Loss

Assets are said to be impaired when the carrying amount of an asset in the books is higher than its recoverable amount. The recoverable amount is higher of the assets net selling price or its value in use. Assets have to be evaluated every year for impairment.

Comparison with IAS and US GAAP

The AS 28 is substantially same as IAS 36. US GAAP addresses the impairment of long-lived assets in SFAS 121, which was superseded by SFAS 144. The scope of IAS and US GAAP are the same as in AS with the exception of the investment property which are not dealt with in AS 28.

Measurement differences are found between AS and US GAAP. The impairment is triggered off, if the carrying amount of an asset exceeds the expected future cash flows to be derived from an asset. While the US GAAP uses undiscounted cash method both IAS and AS use the discounted cash method at the time of recognition itself. US GAAP uses a dual step process of

recognition and measurement to prevent the premature loss recognition by management. Subsequent to recognition, measurement of impairment uses the discounted rates. Differences are also found in the recognition of reversal of impairment losses. In AS under certain circumstances, the reversal of impairment losses in subsequent reporting periods is permitted. While the US GAAP requires an entity to report subsequent revisions in estimates of fair value less cost to sell for assets 'held for disposal'. It prohibits the reversal of impairment losses for assets 'held and used'.

AS and IAS require to measure an impaired asset at the higher of net selling price and value in use, whereas FAS 121 measures an impaired asset at its fair value (or fair value less cost to sell) of the asset. The fair value of an asset is the amount obtainable for which an asset can be exchanged between knowledgeable willing parties in an arms length transaction

Disclosures

Companies need to disclose information relating to an asset or group of assets that is reviewed for impairment even if an impairment loss is not recognised. The amount of impairment losses recognised in the profit and loss account and reversal needs to be disclosed. The amount of impairment loss recognised directly against revaluation surplus during the period and reversals are to be given. The events and circumstances that led to the impairment, the method of determining the fair value and the business segment affected if applicable. IAS and US GAAP has similar disclosure requirements as in AS. Managers will have considerable discretion in deciding whether to hasten or defer the recognition of an impairment loss or to reverse the impairment during a period, which will be a potential technique to smooth reported earnings by adjusting estimates of cash flows. Continuous assessment of assets for impairment will impose more costs and effort for the companies. Although this standard is very relevant to attain a true and fair view of the financial statements there are a number of implementations and interpretational issues that might arise, which has to be clarified by the ASBI. The AS 28 is effective from the accounting year beginning from April 01, 04 onwards.

6. Accounting for Investments – AS 13

Firms make investments for different reasons. These investments may be investment in shares or other securities or investments in subsidiaries, or investment in property. These investments may be passive investments or others.

Investments are defined in the AS 13, Para 3 as assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are not investments. The cost of the investment includes all acquisition charges such as brokerage and fees. Interest, dividends and rentals receivables in connection with an investment are taken as income except in certain special circumstances at the time of purchase.

Investments are classified into current and long term. The current investments are valued at the lower of cost and market/fair value and any reduction in the value is taken to the profit and loss statement. Long-term investments are usually carried at cost. When there is a permanent decline in value of the long-term investments, then the carrying amount is reduced to that value. The loss on diminution in value is charged to the profit and loss account. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist. The treatment under US GAAP for such securities seems to be more reliable and is discussed later in the section. Investment in property is treated as long-term investments.

Certain aspects of investments require judgements by the management. Classification of investments into current and long term is an area where the intention of management is relevant. This has implications on the profitability as current investments have to be valued at cost or fair value whichever is lower, while long-term investments are valued at cost unless there is a permanent devaluation in the value. When there is a "permanent devaluation" in value of investments then they have to be written down. The judgements made by management in applying this accounting policy have significant effect on the amounts recognised in the financial statements. When long-term investments are reclassified as current then the lower of cost or the carrying amount is applied to the investments.

Comparison with IAS and US GAAP

Investments are dealt in AS 39 Financial instruments and IAS40 Investment property. IAS 39 defines financial assets as an asset that is: a cash, contractual right to receive cash or other financial asset or exchange a financial instrument with / from another enterprise or an equity instrument of another enterprise. The financial assets are categorised into those a) held for trading, b) held to maturity investments, c) loans and receivables originated by the enterprises and d) those that are available for sale. Trading investments are akin to current investments and are held for generating profits from short-term fluctuations. Held to maturity implies that the firm has positive intent and ability to hold it to maturity. IAS 39 also specifies conditions that are indicative of the intent to hold to maturity. Loans and receivables originated by the enterprise are financial assets classified separately and held for sale and are not trading or held to maturity instruments. Available for sale are financial assets that are not categorised into the above three. Financial asset are recognised initially at its cost, which is the fair value of the consideration given. Subsequent measurements of 'held to maturity investments', 'loans and receivables originated by the enterprises' and not 'held for trading' and financial assets, which do not have a quoted market price, are measured at amortised cost using effective interest rate method. Those that do not have a fixed maturity should be measured at cost.

Under SFAS 115, passive investments or marketable securities are to be classified as those i) held to maturity i.e. debt securities which the entity has intent and capability of holding till maturity ii) Held for trading (Trading securities are held for selling in the near future usually for the purpose of short term buying and selling) iii) Available for sale (securities that are not trading securities or held for maturity). Those available for sale are either current or non-current depending on the intent of the management. SFAS 115 also specifies factors that help identifying the intent of the management for classifying as 'held to maturity'.

The investments are taken at the fair value also called as 'mark to market' accounting for those available for sale and held for trading. Amortised values are taken for held to maturity, loans and receivables. Change in the

value of trading securities will be taken to the profit and loss statement. While unrealised gains and losses of those 'available for sale' are taken to the equity under other comprehensive income statement. Realised gains and losses and non-temporary unrealised losses are taken to the income statement. If subsequently, the fair value of the available for sale goes up then they should be included in the other comprehensive income. Debt securities have a further classification of held to maturity. If the debt securities are held for their full term these are valued at amortised costs. If the fair value of an available for sale or held to maturity security is less than the carrying amount (other than temporary decline) then the carrying amount should be reduced to the fair value.

When marketable securities are re classified from one group to another, then they have to accounted as follows:

- i) transfer from trading securities to other categories, no adjustments as they are already at the market value and the unrealised holding gains or losses are already taken into account.
- ii) if transferred to trading category then the unrealised gain or loss are recognised in the earnings immediately.
- iii) in the case of debt securities classified as held-to-maturity and are transferred to available-for-sale then the unrealised gain or losses on the date of transfer are recorded in the comprehensive income.
- iv) when available-for-sale are transferred to held to maturity the unrealised gain continue to be reported in the comprehensive income and amortised over the remaining life of the security

Transfers from held-to-maturity into trading account would be rare as there is a strict requirement for classifying into those categories.

Similar provisions are not available in the AS leaving greater discretion to management to transfer the classification to suit their purposes. Financial instruments (measurement and disclosure) are dealt in greater detail in US GAAP and IAS.

Disclosures

Schedule VI requires the nature of investment, mode of valuation to be given. Investments are classified into Government or Trust securities, shares, debentures or bonds including those in subsidiary companies, investment in

partnership firms, immovable properties (investments), and balance of unutilised money raised from issues. Investments are further classified into quoted and unquoted. The market values of the securities have also to be given.

Investments are also classified as: "long term investments" and "current investments". AS requires the accounting policies for carrying amount of investments, the amounts included in profit and loss statement for interest, dividends (showing separately dividends from subsidiary companies), and income from long term and current investments separately. Profits and losses on disposal of current investments and changes in carrying amount of such investments also need to be disclosed.

IAS requires disclosures when investments are not valued at fair values. The disclosures include the description of the financial asset and their carrying amount and an explanation why they cannot be measured reliably. For each category of investments that are re-categorised, additional information giving the reason for reclassification must be given. The amount recognised during the current period or that removed from equity and reported in net profit or loss for the period, of those transferred from available for sale securities needs disclosures. Disclosures about pledged assets are also required.

For securities classified as held to maturity US GAAP requires, the aggregate fair value, gross unrecognised holding gains and losses, the net carrying amount and the gross unrealised gains and losses in accumulated other comprehensive income. For all debt securities separate information for each classification (available-for sale and held- to- maturity) giving information about the contractual maturities grouped as i) one year ii) one year through five years, iii) five years through ten years and iv) after 10 years needs to be given. Securities having different maturity dates should be shown separately. Proceeds from sales, method of accounting, unrealised gains, realised gains included in income and any reclassification must be shown separately. For the different categories of securities the aggregate fair value, the total gains/losses in accumulated other comprehensive income should be given.

Corporate practices

Many companies have clearly not stated the current and non current classification and one has to infer some times that there are no current investments. Shifting of current investments to long-term investments is also a method to avoid providing for diminution in value of investments. Some companies adjust the diminution in the value of long-term investments directly to the reserves and avoiding the impact on the profit and loss account. A stringent enforcement of investment standards are needed as many companies attempt accounting misdemeanours of such nature.

Pentamedia Graphics Ltd

The company has made provisions for diminution in the value of investments to the tune of Rs.33,82,584 This diminution is adjusted through the reserves. The capital reserves have an opening balance 1030,026, which is adjusted against this diminution. Additionally Rs.42, 50,000 is transferred from the profit and loss appropriation account and this amount along with an opening balance of Rs.1,50,000 are adjusted against "diminution in value of investments and assets". (Annual report 2002, page 30).

India Cements have also adjusted in similar way.

NIIT Ltd, have made provision for the diminution in the value of investments through the profit and loss account (page A11, 2002).

Differences in accounting practices indicate that the accounting standards have alternate interpretations possible and the standards are not strictly enforced. It is also recommended to include the unrealised losses on the long-term securities to be accounted for as in IAS. AS deals with investments only in a limited way. Complex financial instruments like interest rate swaps, treasury bonds and options etc have not been dealt with. The Institute has issued guidance note on financial instruments covering Equity index futures, investments by mutual funds, Equity index and stock options. Other financial instruments like derivatives and hedges are complex and may not warrant immediate pronouncements. IAS is also in the process of revising this standard. Most of the accounting for financial instruments is based on fair value accounting (as historical cost may not provide for relevant information), which is still not the basis of accounting in India. Financial instruments give greater opportunity for companies to enter into off balance sheet transactions and hence there is a need for revising the standards.

4.2.2 Comparison of other standards

Other standards compared in this section are Construction Contracts - AS 7, Revenue Recognition - AS 9. Other standards included in the comparison are Accounting for changes in foreign exchange rates - AS 11, Government Grants - AS 12, Accounting for Amalgamations - AS 14, Accounting for retirement benefits in the financial statements of the employers - AS 15, Borrowings Cost - AS 16, Leases - AS 19, Accounting for Taxes on Income - AS 22, Provisions, Contingent Liabilities and Contingent Assets - AS 29. Accounting standard on Research and development (AS 8) is now included as part of the intangible assets.

1. Construction Contracts - AS 7

A construction contract is a contract negotiated for the construction of an asset or a combination of assets. Usually they are long term in nature and the execution of such contracts will fall in different accounting periods, hence the determining the profit for each period will be fundamental accounting issue. The construction contracts can be accounted for using percentage of completion method or the completed contract method. Under the percentage of completion method profits are recognised in stages as the work progress using certain criteria. In the completed contract method revenue and profits are recognised only when the contract is completed or substantially completed. The accounting principle for both the methods of accounting are different. The construction contracts can take form of cost plus contract or a fixed price contract.

The revised accounting standards provides that contract cost and revenue are recognised in the profit & loss account based on the stage of completion of the contract activity at the reporting date, only if the outcome of the construction contract can be estimated reliably. An expected loss on the construction contract should be recognised as an expense immediately when it is known regardless of whether the activity has commenced or not. When the outcome of a construction contract cannot be estimated reliably, contract costs should be recognised as an expense in the period in which they are incurred and revenue should be recognised only to the extent of contract costs incurred when recovery is probable.

Stages of completion are determined by proportion of cost or by survey of work performed or through completion of the physical proportion of the contract work i.e. they can be termed as input measures or output measures. The AS before revision had a specified an indicative limit of 20-25%. Costs that relate to the activities of the contractor generally, or that relate to contract activity but can not be related to specific contracts such as general administration and selling costs, research and development costs are charged off to profit and loss account the year of incurrence and are not carried forward. The revised AS is not applicable to builders and developers, hence, the ICAI has to issue specific standards or guidelines for them.

Comparison with IAS and US GAAP

AS 7 was revised in 2002, where the completed contract method was eliminated as an alternative method and has now fallen in line with the IAS 11. The revision of the accounting standards has removed all fundamental differences from the IAS. Most of the provisions of the AS are verbatim of those given in the IAS.

US GAAP allows the completed contract method, when the estimated cost to complete or the stage of completion is not determinable. The two methods are not alternative methods and are used when certain conditions are not fulfilled for the percentage completion method. SOP81 is elaborate and considers issues such as Joint ventures and shared contract, accounting for contract options under construction contracts. A change in the method of accounting in the US is a special change in principle, which requires retroactive treatment and restatement of previous financial statements and additional disclosures.

Disclosures

AS requires disclosures on the method used in recognising the revenue and the method used in determining the stage of completion. Aggregate cost incurred, profits recognised till the reporting date, the amount of advance received and the retention amount for contracts that are in progress also. Contingencies that arise out of the contract must be disclosed. IAS and US GAAP have similar disclosures.

2. Revenue Recognition - AS 9

Revenues is defined in AS 9 as 'gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends.' Revenue from sale of goods or service transactions should be recognised when requirements as to performance are met, if at that time it is not unreasonable to expect ultimate collection.

In the case of sale of goods, performance is complete when the following conditions are fulfilled: i) the seller of goods has transferred to the buyer the property in the goods for a price ii) all significant risks and rewards of ownership have been transferred to the buyer iii) the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and iv) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods. In services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates revenue to the work accomplished.

Comparison with IAS and US GAAP

An important difference in the definition of revenue in IAS is revenue must result in the increase of equity, other than those relating to the contributions from the equity participants. This definition clearly excludes items that do not add to equity like the collection of sales tax and excise duties, which a company collects from the customers and pays to the government. The IAS specifically prohibits amounts collected on behalf of third party to be shown as revenue.

US GAAP and IAS require measurement of revenues at fair value of consideration received or receivable, which is not there in the AS. When the consideration receivable is deferred, the fair value of the consideration may be less than the nominal amount of cash received. For instance, interest free credit may be given to the buyer. In such cases the difference between the fair value and the consideration is recognised as interest. IAS allows for discounting to present values where inflows are deferred. IAS prohibits recognition of revenue as a result of swap transaction to fulfil demand on timely basis.

US GAAP deals with the realisation concept of revenue where the revenue is considered only when a transaction is converted into cash or cash equivalent or the likelihood of its receipt is reasonably certain. SAB 101 interprets and presents four criteria for revenue recognition. These are: i) persuasive evidence that an arrangement exists; ii) delivery has occurred or service has been rendered, iii) seller's prices are fixed or determinable and iv) collectibility is assured. US GAAP is more stringent than AS.²⁴⁶ GAAP has many specific industry standards that deal with revenue recognition of industries like software services, freight services, power sales contracts, real estates and others. Other specific pronouncements are Revenue recognition when right of return exists (SFAS 48), Accounting for separately priced extended warranty and product maintenance contracts (FTB 90), Reporting revenue gross as a principal versus net as an agent (EITF 99).

Disclosures

Disclosure requirement under AS 9 is minimal and mainly requires disclosures as discussed under AS 1 and circumstance if revenue recognition is postponed. Disclosures under US GAAP and IAS are also minimal. IAS requires disclosures of revenue recognition accounting policies, amount of each significant category of revenue recognised and the amount of revenue from exchanges of goods or services.

Corporate practices

Many companies are including inter divisional transfers as sales in their profit and loss account. Inter divisional transfers refers to the sale made to another division within the same company. If the definition of IAS is applied then this does not result in an increase in the equity and hence will not be included in the revenue. Similarly companies are including excise duty as part of the revenue, which in effect is only a collection and remittance to the government. These two items should not form part of the revenue. Recent clarification by ICAI requires companies to show separately the excise duty but inter divisional transfers are still part of the revenue. Many companies still include excise duty in sales although some of them have disclosed it the way as suggested in AS

²⁴⁶Comparing WIPRO Ltd, Indian GAAP and US GAAP reconciliation, in WIPRO Annual Report.

clarification. Some companies that include excise duty and interdivisional transfers are given in Table 4.1

Revenue recognition is a very important area involving judgements that have to be carefully monitored by the auditors. The substance of the transaction is more important than the form of the transaction. For example, transaction that is consignment arrangements are included as sales before they are actually sold to a third party. Real sale does not occur, when conditions have to be fulfilled or there are other terms that remain unperformed. In the absence of net income, market capitalisation is based on revenues as an indicator of future earnings potential, hence, companies resort to earnings management through the revenue.²⁴⁷

Aggressive recognition policies and practices have given rise to instances of financial reporting frauds in the recent years by many US companies who have restated their earnings of prior years. This area provides a challenge to the standard setters all over the world.

3. Foreign Currency translation - AS 11

A company may have activities involving foreign exchange transactions with parties in other countries. They may have transactions in foreign currencies or have foreign operations. In order to include foreign currency transactions and foreign operations in the financial statements of an enterprise, transactions must be stated in the enterprises reporting currency and the financial statements of foreign operations must be translated into the company's reporting currency. The principal issues in accounting for foreign currency transactions and foreign operations, relate to the exchange rate to be used and the method of recognition in the financial statements and the effects of changes in exchange rates. Exchange difference will arise when transactions are settled at exchange rates, which are different from those used when the transactions were previously recorded. They will also arise from unsettled transactions at the balance sheet

²⁴⁷SEC Chairman, A. Levitt gives several earnings management scenes followed by companies in his speech reported in A. Levitt, "Earnings Management and the Abuse of Materiality", 9(1) *Journal of Finance and Accounting* (2000) at 41

date if the closing rates are different from those previously used. This may result in exchange losses or gains, which may be unrealised or realised.

The financial statements of a foreign operation can be translated using i) temporal method, ii) current and non-current method, iii) monetary method and the iv) current rate method. Each method is briefly described.

Both the temporal and the monetary method are based on the concept that the group companies operate as a single entity and each transaction is recorded by the parent company. The temporal method translates all the assets recorded at the historical rates to be translated at the historical rates. The assets recorded at current rates like cash, receivables, payables, revenue and expenses are translated at the closing rates. Translation difference does not arise because of economic events but because of the method of translation.

Under the monetary method, monetary items are recorded at the current rates and non-monetary items are measured at the historical rates. Share capital is translated at the historical rates, and the revenues and expenses are translated at the rate on the date of transaction. Under this method it may be difficult to classify items as monetary or non-monetary. This method was followed in the US, SFAS 8 until it was superseded by SFAS 52.

Under the current and non-current method, current assets and liabilities are translated at the current rate and non current assets and liabilities are translated at the historical rates. In this approach inventory will be translated at the current rate while the long-term debt will be translated at the historical rate. The logic behind this method is, how soon the assets/liabilities are likely to be realised in cash to/from the parent. However, this may be misleading to the users of information as the long-term debt are translated at the historical costs although payments have to be made at the current rates. This method requires proper classification of the balance sheet items into current and non-current.

Under the current rate method also called as closing rate method, all the assets and liabilities are translated at the current rate. The shareholders equity is translated using the historical rates. The basis of this method is the 'net investment' concept where the foreign entity is viewed as a separate entity than that of the holding company. Standard setters in US have preferred this method,

as the information provided in this method retains the relationship and results created in the environment in which the entity operates.

AS 11 provides that a foreign currency transaction should be recorded, on initial recognition at the exchange rate on the date of the transaction. Although the spot rates are current rates, AS allows the use of average rates for convenience. For unsettled transactions, at each balance sheet date, foreign currency monetary items should be reported using the closing rates. Non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction. Non-monetary items, which are carried at, fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined. Exchange differences arising from foreign currency transactions either settlement or restating monetary items on the balance sheet date should be recognised as income or expense in the period in which they arise.

Provision of the Companies Act, 1956 and the Income Tax Act and AS 11 (before its revision) treated the foreign exchange difference in the same way. Section 43 A of the Income tax Act states that, "where an assessee has acquired any asset from a country outside India for the purpose of the business or profession and in consequence of a change in the rate of exchange at any time after the acquisition of such asset, there is an increase or reduction in the liability of the assessee as expressed in India currency for making payment towards the whole or part of the cost of the asset or for repayment of the whole money borrowed in any foreign currency. The amount by which the liability is so increased or reduced during the previous year when payment is made shall be added to or deducted from the actual cost of the asset."

The Companies Act, in Schedule VI, Form of Balance sheet, provides that, 'when the original cost aforesaid and additions and deductions thereto relates to any fixed asset which has been acquired from a country outside India and in consequence of a change in the rate of exchange at any time after the acquisition of such asset, there has been an increase or reduction in the liability of the company as expressed in Indian currency, for making payments "borrowed money" such amount shall be taken to the cost of fixed asset'. The

provisions were introduced at the time of devaluation of the Indian rupee. The revised As 11 is in conflict with the Companies Act.²⁴⁸

Foreign operations are separated into a) integral foreign operation and b) foreign entities. Integral operations are those that operate as an extension of the company's business. Foreign entities function independently accumulates cash, incurs expenses, and arranges borrowings in its own currency. Integral operations use the temporal method and the exchange gains and losses are taken to the profit and loss account.

The financial statements of a non-integral foreign operation are restated in the reporting currency and exchange differences are accounted by using the following procedures: all assets and liabilities are translated at the closing rate; all incomes and expenses are translated at exchange rates at the dates of the transactions. All resulting exchange differences as well as the exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment i.e. Share in the net assets of that operation should be accumulated in a foreign currency translation reserve until the disposal of the net investment. On disposal, the cumulative amount of the exchange differences, which have been deferred, and which relate to that operation should be recognised as income or expense in the same period in which the gain or loss on disposal is recognised.

When a forward exchange contract is entered into as a hedge, the premium or discount arising at the inception of the contract should be amortised as expense or income over the life of the contract. Exchange differences on such a contract should be recognised in the profit and loss a/c in the reporting period in which the exchange rates change.

In some cases, the classification of a foreign operation as either a non-integral foreign operation or an integral foreign operation of the reporting enterprise may not be clear, and judgement is necessary to determine the appropriate classification.

Comparison of IAS and US GAAP

²⁴⁸ The ICAI has given an announcement in that the rule of the Companies Act will prevail over the Accounting standard till such time the government changes the law. ICAI 52(5) *The Chartered Accountant* (2003) at 497

The revised AS is substantially the same as IAS except in the few items and the definition of two terms integral and non integral operations. The term integral operations is not defined in the IAS like in AS.

AS 11 deals with forward exchange contracts both intended for hedging and for trading or speculation. IAS 21 does not deal with hedge accounting for foreign currency items other than the classification of exchange differences arising on a foreign currency liability accounted for as a hedge of a net investment in a foreign entity. It also does not deal with forward exchange contracts for trading or speculation. These are considered in IAS 39. The IAS 21 along with SIC 11 gives an alternative treatment for when there is severe devaluation that cannot be hedged which is not relevant, and not included in AS.

IAS 21, requires, that exchange differences on transactions be recognised as income or as expenses in the period in which they arise. This is the benchmark treatment. An alternative treatment is to account for exchange differences that arise from a severe devaluation or depreciation of a currency be included in the carrying amount of an asset, if certain conditions are satisfied. This treatment is not adopted in AS. IAS also does not consider forward contracts in this accounting standard. Exchange losses and gains are taken to the income statement except if they arise out of extraordinary items. IAS requires the resulting exchange differences on translation of financial statements of a foreign entity as an item in equity (similar to the foreign currency translation reserve in AS) till the investments are disposed off.

Under US GAAP, the translation of foreign currency financial statements is based on the selection of functional currency. When the functional currency is the foreign currency the current rate method is used (i.e. foreign entity's local currency is the functional currency). When the functional currency is not maintained by the reporting entity than the monetary method is used (i.e. foreign entity's local currency is not the functional currency). The resultant exchange difference is taken to the comprehensive income statement. Derivative instruments and hedging transactions are pronounced in separate accounting standards in the US.

Disclosures

The following disclosures are required to be made:

- 1) the amount of exchange differences included in the net profit or loss for the period
- 2) net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.
- 3) When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed.
- 4) Change in the classification of a significant foreign operation, an enterprise should disclose: the nature of the change in classification; the reason for the change; the impact of the change in classification on shareholders' funds; and the impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.

IAS also requires similar disclosures. US GAAP requires additional analysis of changes included in the comprehensive income. Gains and losses on hedges of net investments in a foreign entity and amounts transferred to net income along with the tax treatment.

Conflicts in various laws must be resolved to avoid confusion to the preparers.

4. Government Grants AS 12

Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. Capital grants are usually in the form of capital to be added to the share capital, as they are not related to the earnings of the firm in any way.

Grants in the nature of income are recognised in the profit and loss statement on a systematic and rational basis over the periods necessary to match them with the related costs, where there is reasonable assurance that the enterprise will comply with the conditions attached to them.

Specific expenditure grants are taken into income in the period in which the enterprise qualifies to receive it. Grants in the nature of non-monetary assets, such as land or other resources, given at concessional rates are usually recorded at the acquisition cost.

Non-monetary assets given free of cost are recorded at a nominal value. Recording of grants at a nominal value may not be adequate disclosures as this lacks transparency. Some researchers also feel that this is not consistent with the principle of substance over form and may lead to inconsistent treatment of assets, which will affect the comparability of the firms. Allowed alternative is to record the full value of the assets and correspondingly record the grants as deferred income. As and when depreciation is charged the deferred income is also recognised. Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income from such assets. Grants given for acquiring specific fixed assets are shown as a deduction from the gross value of the asset concerned to arrive the book value.

Comparison with IAS and US GAAP

The recognition criteria of government grants are the same under IAS -20. Differences exist in the way of accounting government grants. Grants related to assets are recorded at the fair value which is the benchmark treatment instead of the nominal value like in AS. The allowed alternative is to record non-monetary assets at nominal value. US GAAP does not specifically cover the government grants. When assets are received free of cost they are recorded at fair market value.

Disclosures

Accounting policy adopted for government grants including the presentation methods must be given. Nature and extent of grants recognised in the financial statements including non-monetary assets at concessional rate or free of cost, should be disclosed. Under IAS, additional disclosure regarding unfulfilled conditions and other contingencies attaching to the government assistance should be disclosed.

5. Accounting for Amalgamations – AS 14

Economic reforms and liberalisation were the hallmark of the early 1990's. This liberalisation saw intense activity in mergers and acquisitions by many big companies. Before this amalgamations were not encouraged by law specially the MRTP Act, Section 108 of the Companies Act, and the Rule 40 A and 40 B of the Listing agreement. The new industrial policy and the omitting of certain

restrictive sections in the MRTP Act, 1969 encouraged the growth of industrial sector and saw a spate of mergers and amalgamations. The accounting standard on mergers did not keep pace with the subsequent economic development post liberalisation and the standards have remained almost the same.

Amalgamation or the term business combinations refers to one or more companies merging with another company. Amalgamation as defined in the AS 14 paragraph 3(a) "means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute that may be applicable to companies."

Section 391 to 395 of the Companies Act, contains provision relating to amalgamations and similar arrangements. The Companies Act 1956, does not define amalgamation but refers to compromise or arrangement between the company and its creditors and any of its members or any class of them by application to the court. If a majority representing three-fourths in values of the applicants agree to the proposal then the court shall sanction the proposal, which will be binding on the persons. The court has the power to supervise and give directions relating to its orders. Section 394 explains the essence of amalgamation as transfer of all properties, assets and liabilities from the amalgamating company to the amalgamated company. Section 394 (4) further explains the term property to include 'property, rights, powers of every description and liabilities include duties of all description.' The scheme of amalgamation is always under a scheme of arrangement sanctioned by the court. Outright purchase of transferor company by transferee company is also recognised as amalgamation under section 391 and 394 of the Companies Act, as laid in the case of S.P.S Pharma Ltd. v Tagore Pure Drugs Ltd.²⁴⁹ Amalgamation is also defined in section 2 (1B) of the Income Tax Act, 1961 as "the merger of two or more companies to form one or more companies in such a manner that, vesting of all properties of the amalgamating company, vesting of all the liabilities in the amalgamating company belong to the amalgamated company by virtue of their amalgamation. Shareholders of the amalgamating company holding not less than 75% of the shares of the transferor company

²⁴⁹ S.P.S Pharma Ltd. vs Tagore Pure Drugs Ltd in (1997) Comp Case 774 AP.

become equity shareholders of the transferee company. These, limited definition does not cover many other types of mergers that may be possible in business restructuring.

Business combination as defined in the International Accounting standard includes: i) Purchase by an enterprise the equity or the net asset of another enterprise ii) establishment of new enterprise to have control over the combining enterprise iii) business combination may result in a parent subsidiary iv) a legal merger as required under the law.

AS 14 recognises two types of amalgamation: amalgamation in the nature of merger and amalgamation in the nature of purchase. Amalgamation is considered in the nature of merger when i) all the assets and liabilities of the transferor company becomes the assets and liabilities of the transferee company after amalgamation. ii) Shareholders holding not less than 90 percent of the face value of the equity shares of the transferor company (other than held prior to amalgamation) become shareholders of the transferee company iii) considerations receivable by the equity shareholders of the transferor company are discharged through equity shares only.

The business of the transferor company is intended to be carried on by the transferee company and no changes are made to the value of the assets and liabilities are made. A scheme of amalgamation that does not satisfy any of the above condition is treated as amalgamations in the nature of purchase. AS 14 deals with only the above two forms of amalgamations.

Accounting methods

Two methods are used for accounting for amalgamations: Purchase Method and the Pooling of interest method.

The purchase method is used in accounting for amalgamations in the nature of purchase. The underlying concept of the purchase method is that one entity purchases the business of another. The acquiring company will record at cost the assets and liabilities of the acquired company or by allocating the consideration to the individual assets on the basis of their fair values on the date of the amalgamation. In the purchase method, the identity or the form of reserves of the transferor company does not come into the transferee company's books except where they are statutory reserves. Thus, post mergers the

reserves of the transferee company only remain. When the consideration is deducted from the net value of the assets, the result may be positive in which case goodwill is recorded or if negative, it is credited to capital reserve.

Pooling of interest method is followed in cases of amalgamations in the nature of mergers. The shareholders of the two companies are said to have combined their interest to form the pooled entity. All the assets, liabilities and reserves are recorded at the book value of the transferor company. All the reserves appearing in the financial statements of the transferee company appears in the same form post merger in the books of the transferor company. The balance in the profit and loss account can be aggregated with the profit and loss account balance or can be transferred to general reserves. Goodwill is amortised over a period of 5 years and the AS does not particularly mention any method for amortisation.

The two method of accounting suggested for business combinations are very different from each other. Pooling of interest method is very popular method for accounting for amalgamation and widely used all over the world. Companies often use the pooling method because it produces higher reported earnings and rates of return subsequent to the combination than the purchase method. For example US GAAP allows the reported income of the companies for the period prior to the combination to be added to the amalgamated company's result. Subsequent rate-of-return measures will be artificially inflated because the numerator (earnings) is higher and the denominator (investment) is lower. The earnings per share reported by the companies would be higher post merger. Under the pooling of interest method investors are provided with less information in the subsequent financial statement post merger. The pooling method does not provide information about individual assets and liabilities of the amalgamating company. It also does not provide them with the information they need to assess the subsequent performance of that investment and compare it with the performance of other companies as it ignores the values exchanged in a business combination transaction.

Under the purchase method of accounting the balance sheet reflects the transactions, as they are, which results in greater transparency. If the net assets were recorded at the book value instead of the actual rates at which they were

purchased, a hidden reserve would be created. For example, if company A acquired company B (whose net assets have a book value of Rs.10 million) for Rs.100 million, use of the pooling method would result in creating a hidden reserve of Rs.90 million. Assuming no other changes, if company A later sold company B for Rs.100 million, company A would report a Rs.90 million gain that it did not earn. Alternatively, if company A later sold company B for Rs.60 million, company A would report a Rs.50 million gain, even though economically it would have suffered a Rs.40 million loss.

The pooling method is based on the assumption that ownership interests are continued following the amalgamation. The holdings can and often do change following the amalgamations and owners may sell their interests in the amalgamated company for a variety of reasons. Pooling of interest method was originally conceived for a parent company subsidiary combination. The complicated business combinations of today may not be captured by the pooling of interest method. Any acquisitions whether they are of individual assets, groups of assets, or entire businesses should be recorded in a way, based on the value of what is given up in exchange for them, regardless of whether that is cash, other assets, debt, or equity shares. The pooling of interest method will not give a true picture of the financial statements.

Comparison with IAS and US GAAP

The International accounting standards deals with Business Combination in IAS 22. IAS recognises 'Acquisitions' and 'Uniting of Interest'. IAS recognises the purchase method of accounting for the "acquisitions" and the pooling of interest method for 'uniting of interests'. IAS specifies that the pooling of interest method can be used if the following criteria are satisfied:

- The shareholders of the combining enterprises must achieve a continuing mutual sharing of the risk and benefits attaching to the combined enterprise.
- The basis of the transaction must be principally an exchange of voting common shares of the enterprises involved and the voting rights and interest in the combined entity are relative to each other after the combination.
- The fair value of one enterprise is not different from the other enterprise.
- The whole, or effectively whole of the net assets and operations of the combining enterprises are combined into one entity

- The control of the enterprise after the combination will also determine whether true uniting of interest has occurred.

IAS considers better way of identifying the pooling of interest including the sharing of risk and return and control of the combined entity. If the above conditions are not satisfied, for example, if the arrangements provides a relative advantage to one group over the other group of share holders prior or after the combination then the purchase method must be followed.

IAS also identifies the circumstances of the 'acquisition of business', where one entity obtains power by obtaining more than one half of the voting rights of the other company. All acquisitions in such cases are accounted using the purchase method.

IAS under paragraph 39 gives the guidelines for determining the fair value of identifiable assets and liabilities like marketable securities, receivables, inventories, land and buildings, plant and machinery and other intangibles. IAS also gives an alternative to use discounting to arrive at the fair values of the assets. IAS, paragraph 28, 29 and 31 also recognises the identification of certain assets that may not be in the books earlier like that of the tax benefits or other intangible assets.

Any excess of consideration over the fair value of the assets is recognised as goodwill and amortised over its useful life. A rebuttal presumption is that the useful life normally will not exceed 20 years. Goodwill is also written off using the straight-line method. Only under any special circumstances this can be deviated. Factors to be considered in estimating the useful life of the goodwill are given in the IAS like, stability of the industry, effects of product obsolescence etc., and are not found in the AS.

Negative Goodwill is recognised in the IAS, when the fair value of the net assets exceeds the consideration. Such negative goodwill is i) recognised in the income statement on a systematic basis over the useful life of the identifiable asset, (to the extent of the fair value of the assets) ii) the negative goodwill in excess of the fair values acquired of a non-monetary asset is recognised immediately in the income statement. The same is accounted in capital reserve in AS 14, which seems to be more prudent form of approach. The accounting

treatment for reserves are sometimes specified in the court orders that sanction amalgamations, in which case the court orders have to be followed.

Special cases where there may be a guaranteed market price for the consideration are not given in the AS, as this is not a common practice here. AS 14 does not deal with the cost of acquiring the other company like the legal fees, appraisal fees and other expenses and the method of accounting for such expenses.²⁵⁰ Subsequent identification or changes in the value of identifiable assets and liabilities are also considered in the IAS.

IAS 22 requires the uniting of interests to be accounted for under the pooling of interest method. The financial statements of the combined enterprise along with the comparative period should be combined from the earliest period presented. Any difference between the amount recorded as share capital and any additional consideration and the amount recorded for the share capital acquired should be adjusted against equity.

Business Combinations are dealt in SFAS 141 and SFAS 142, which superseded APB16. US GAAP recognises different forms of business combination like entities merging to become subsidiaries, transfer of assets or transfer of equity interest to a new entity by one or more entities and exchange of one business for another business. Many of the provisions are similar to that of IAS however differences still exist in a few areas. US GAAP recognises only the purchase method and pooling of interest is prohibited.

All assets and liabilities are recorded at their fair value. US GAAP also provides guidelines for valuing various assets like marketable securities (at fair value), inventory (finished goods at estimated selling price less the sum of costs of disposal and reasonable profit allowance), plant and equipment (current replacement cost). Contingent assets and liabilities are not recognised as acquired assets and liabilities in a business combination in IAS however, US GAAP requires the allocation of a portion of the cost of the acquired company to these, subject to certain conditions. .

Goodwill is capitalised but not amortise in the US GAAP and they are subject to an annual impairment test. Negative goodwill is initially allocated on a

pro-rata basis against the carrying amounts of certain acquired non-financial assets, with any excess recognised as an extraordinary gain. Goodwill of the acquired company and deferred income taxes are not to be recorded as assets in the acquired company.

IAS 22 recognises restructuring liability as part of a purchased business combination in limited circumstances, while US GAAP it is not recognised. US GAAP also considers situations like contingent consideration that needs to be paid, pension plans and post retirement benefits of the acquired company. US GAAP requires a portion of the purchase price to be allocated to the research and development activities. Upon completion of the business combination cost assigned to assets used for research and development activities are to be charged to expense unless they have an alternative future use (SFAS 141, paragraph 42)

Disclosures

AS 14 requires the disclosure of:

- Name and nature of business of the amalgamating company and the effective date of amalgamation, the method of accounting and the particulars of the scheme sanctioned.
- Amalgamation is accounted under the pooling of interest method should disclose: description and the number of shares and percentage offered
- The amount of any difference between the consideration and the value of net identifiable assets acquired and how they are treated in the accounts
- If the shares are accounted by the purchase method then the consideration along with the description should be given. The amount of goodwill that arises and the treatment in the accounts.

IAS requires elaborate disclosures. In addition to the general information like in AS, information on goodwill and negative goodwill are required to be disclosed. A reconciliation of the carrying amount of goodwill showing: gross carrying amount and accumulated amortisation (including accumulated impairment losses) at the beginning of the period, additions, disposals, amortisation, impairment losses recognised during the period, impairment losses reversed during the period, other changes during the period (e.g. exchange

²⁵⁰ Although the Income Tax Act now requires these expenses to be amortised and written off

differences from the translation of financial statements of foreign entities), and the carrying amount and the accumulated impairment losses needs to be disclosed. Negative goodwill should be presented as a deduction from the assets, in the same balance sheet classification as goodwill

US GAAP also requires elaborate disclosures. Additional disclosures compared to AS are:

- Primary reasons for the acquisition and a description of the factors that contributed to the purchase price, which resulted in recognition of goodwill.
- Percentage of voting interest acquired and a description of the entity
- Period for which the results of operations are included in the combined entity's income statement.
- A condensed balance sheet giving the amounts assigned to each class of assets and liabilities. Any contingent payments that is required to be made.
- Material information on business combination must be disclosed if they are completed after the balance sheet date.
- Details of amortisation of intangible assets and others like goodwill.
- Results of the operations of the operations for the current period as if the combination had completed at the beginning of the period.
- A proforma giving revenue income before extraordinary items, net income and earnings per share information needs to be given.

Corporate practices

The Corporate practices on disclosures for business combination are given in Table 4.2 along with a disclosure by an US company

To sum up, AS deals only with simple amalgamations. IAS gives elaborate criteria for determining the method of accounting to be used, thus IAS leaves no room for interpretation of true 'pooling' of interest, which includes sharing of risk and the benefits of the combining group. In contrast, AS 14 does not spell out stringent requirements for the pooling of interest method. AS 14 specifies the using of the pooling method based on the criteria of "consideration" and it can only be used when the consideration is substantially in the form of shares. Even the US GAAP before the elimination prescribed 12 criteria to be

over a period of five years.

satisfied for accounting under the pooling method. The conditions reflect the true meaning of "uniting of Interest" unlike the AS. The AS is thus found deficient in many areas. Additional disclosures as in the US GAAP need to be mandated so that the disclosures are comprehensive in the annual report.

In business combinations, accounting standards should not themselves seek to encourage or discourage combinations. Instead, those standards should portray the results of the combinations fairly and neutrally so that investors and others can form judgments about the combinations and their subsequent performance. This in turn will help funds to be allocated efficiently in the capital markets. The standards should not favour certain companies competing in the markets for mergers and acquisitions. The pooling of interest method must be eliminated, however, there will be consequences in the Income Tax Act and the Companies Act that should be suitably amended. Disclosure requirement must also be suitable amended so that the annual report gives all the relevant information.

6. Accounting For Retirement Benefits in the Financial Statements of Employers AS-15

Retirement benefits form a substantial portion of an employees compensation plan. These benefits cover gratuity, leave salary, post retirement medical benefits and similar employee benefits. These benefits are given to the employee at or after the retirement. The question therefore is whether the current financial statements should account for the retirement benefits. Although they are future liabilities, they are paid for exchange of present services and have to be accounted from year to year and provisions have to be made in the accounts. The standard deals with how the retirement benefits are accounted in the financial statements of the employer.

Retirement benefits can be broadly categorised as 'contributory schemes' and 'benefit schemes'. The standard requires that the contribution payable by the employer for a year should be charged to the statement of profit and loss in that year. When payment for retirement benefits are made out of the own funds, or through a trust, then an appropriate charge to the statement of profit and loss for the year should be made through a provision for the accruing liability. The

accruing liability should be calculated according to actuarial valuation. If the schemes are funded through insurance schemes then an actuarial valuation should be got from the insurer and amount of contribution paid will be charged to the profit and loss account.

Comparison with IAS and US GAAP

The Indian GAAP considers accounting for employee benefits only. The accounting for the funds themselves is not considered like in IAS and US GAAP. IAS 19, employee benefits was substantially revised in 2000. The scope of IAS 19 is much more than AS 15. IAS considers all employee benefits. This includes equity compensation plans, equity benefit plans, and multi employer plans, state plans and insured plans. Equity compensation plan and equity benefit plans are dealt with in the Guidance notes and no standards are available in AS. IAS considers short-term compensated absences, which are accumulating, and non-accumulating type not found in AS. US GAAP and IAS have some differences in recognition and measurement of employee benefits.

IAS 19 does not make distinction between termination benefits and special termination benefits. Termination benefits are recognised when the employer is committed to pay. US GAAP recognises special (one-time) termination benefits when employees accept the offer and the amount can be reasonably estimated.

IAS 19 requires recognition of past service costs related to vested employees on a straight-line basis, while in US GAAP it is amortised over the remaining service period or life expectancy. There is no minimum liability recognition for benefits under defined benefit plan in IAS, while in US GAAP the un-funded accumulated benefit obligation is recognised as a minimum. Pension assets have limitations on the amount that can be recognised while in US GAAP there are no limitations on the amount that can be recognised. The attribution of benefits starts when the employee becomes entitled to benefits (conditional or unconditional) under US it starts when the plan grants credit. The rate used for discounting plan liabilities are the rate on high quality corporate bonds at balance sheet date in US it is the effective settlement rate / return on high-quality fixed-income. Plan assets are recognised at fair values in IAS while in the US it may be based on the market related values.

Disclosures

AS 15 requires disclosure of the method used for determining retirement benefit cost, the period or the date of actuarial valuation and the method followed for accrual if it is not based on actuarial valuation. IAS and US GAAP require additional disclosures with other aspects of the employee benefits.

Accounting standards must be formulated for other aspects like in IAS and US GAAP. IAS and US GAAP have undertaken certain items in the Employee benefits standards for short-term convergence. AS 15 is also being revised to include other aspects of employee benefits.

7. Borrowing Costs - AS 16

Borrowing costs as defined in paragraph 3 of the AS includes interest and other costs like commitment charges, discounts or premiums relating to borrowings, other costs incurred for arranging the funds, finance charges of an asset acquired under finance lease and may include exchange difference arising from foreign currency borrowings to the extent of interest costs in them.

Normally all borrowing costs are expensed, as they do not add to the utility of the assets. Borrowing costs can be capitalised when certain assets called as qualifying assets, take long period of time for making it ready. Capitalisation should commence only when the following condition are satisfied:

- i) expenditure for acquisition or construction of the qualifying asset is being incurred
- ii) borrowing costs are being incurred and
- iii) the activities needed to prepare the asset for its intended use are in progress.

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. If funds are borrowed but they cannot be identified to a specific asset then the borrowing costs is worked out using a capitalisation rate which is the weighted average of the borrowing cost. Any income earned on the temporary investment of those borrowings should be deducted. Borrowing cost must cease to be capitalised when the qualifying asset is substantially complete and ready for its intended use. If the construction is interrupted, then capitalisation of the borrowing costs should be suspended during those extended

periods. The borrowing cost capitalised during a period cannot exceed the total borrowing cost for the period.

Comparison with IAS and US GAAP

AS takes a broad view like the IAS 23 and includes costs other than interest costs also. The benchmark treatment in IAS is to expense the borrowing cost in the period incurred. The allowed alternative treatment is to capitalise the borrowing costs directly related to the acquisition or production of a qualifying asset. Interpretation SIC 2, requires consistency in the application of the borrowing cost to all qualifying asset or to none at all.

US GAAP requires interest to be capitalised when certain conditions are met (SFAS 34) and are similar to AS. In AS the borrowing costs include interest, certain additional costs, and exchange differences arising out borrowings in foreign currency, while, in US GAAP borrowing costs includes only interest. Income on temporary investment of funds borrowed for construction of an asset is reduced from the borrowing cost eligible for capitalisation while in US GAAP they are not reduced. SFAS 58 requires interest to be capitalised on an investment accounted under the equity method and are included in the carrying amount of investments.

Disclosure

AS 16 requires the disclosure of accounting policy and the amount of borrowing cost capitalised during the period. The IAS requires additional disclosure of the capitalisation rate used to determine the amount of borrowing cost eligible for capitalisation. US GAAP has similar disclosures

Corporate practices

Larsen and Toubro Ltd give the accounting policy for capitalising and expensing the borrowing costs. (page 60 Annual Report, 2002). The amount capitalised during the years is not available.

TELCO Ltd gives the amount of interest cost that is capitalised during the year. (page 25, Annual Report, 2002)

8. Leases - AS 19

A firm can acquire assets and finance it through loans or through internal financing. Some times it does not buy the assets but rents or leases the assets. Traditionally leasing meant hiring of equipment or other asset from the lessor who owns the assets and leases them for a periodic payment to the lessee. Leasing today forms an integral part of the economic activity of any business and is designed to satisfy economic needs of the customers.

In the recent years leasing has become a financing arrangement and has many advantages. Leasing assets avoids the burden and risk of owning property and is a source of financing the acquisition of property, plant, and equipment. When fixed assets are leased, it enables users to conserve working capital as compared to more traditional financing arrangements. Leasing also reduces the credit risk in the balance sheet by not having any loans to be disclosed. Leasing has tax benefits for both the lessor and the lessee. Until recently, companies were accounting for lease arrangements by charging the lease payments as expenses in the period. The financing entities accounted the same in their books as assets and recorded depreciation as expenses. Recording of lease transaction in this manner did not capture the essence of the transaction and became a main source of off balance sheet financing.

Off balance sheet financing implies that the lease obligations are referenced in the footnote section of the financials and not in the balance sheet as assets and liabilities. This reduces the level of debt in the books and improves key financial ratios, such as debt to equity. In addition, financial performance indicators such as return on assets are also improved making the financial position look better than what it is, which makes it easier for future financing. Lease accounting is one of the complex accounting procedures. It is stated that in US as "workable method of reporting leases in the financial statements of lessees has been the Holy Grail of accounting standard setters in this country for at least 40 years."²⁵¹

Lease transactions are broadly classified into finance lease and operating lease. Accounting for lease requires the substance of a transaction rather than

²⁵¹ D. W. Monson, "The Conceptual Framework and Accounting for Leases", 15 (3) *Accounting Horizons* (2001) at 275

its legal form. That is, in a lease transaction although the legal title has not passed, the lessee is the substantial beneficial owner of the asset and hence records it as an asset. The accounting treatment of the transaction depends on the nature of the arrangement.

As defined in the accounting standard a lease is 'an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time'. Leases are classified into finance lease and operating lease. Sale and lease back operations are also dealt with in the AS.

A finance lease is a lease that transfers substantially the risks and rewards incidental to ownership of an asset. In effect it is like a borrowing arrangement. The legal ownership of the asset does not pass to the lessee. The leased asset and the lease obligations are both recorded at the beginning itself by the lessee. The present value of the minimum lease payments is taken as the cost of asset as well as the liability. Subsequently, each lease payment is split between the principal and interest portions and recorded. The principal portion is to be deducted from the balance of the lease obligations. The interest portion is charged to the profit and loss account. The asset is also depreciated and charged to the profit and loss account over the lease term. The lessor records the finance lease as a receivable and no other assets are recorded. When the lease amount is received, they are split between the lease payments and interest portions.

Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

The sale and leaseback transaction has to be classified as a finance lease or as an operating lease at the inception itself. The method of accounting will depend on the classification. The profit/loss on account of this sale proceeds over the carrying amount is amortised over the lease period in a finance lease and is taken to the profit and loss account in an operating lease.

Comparison with IAS and US GAAP

The corresponding standard is IAS 17 and SFAS-13. Like all the recently published accounting standards, AS 19 are in conformity with IAS at most places. Differences are observed in the way some terms such as minimum lease payments, finance lease, useful life and residual value, un-guaranteed residual value and unearned finance income are defined. For instance, the useful life is 'either the period over which the leased asset is expected to be used by the lessee or the number of production or similar units expected to be obtained from the use of the asset' in AS, while in IAS, the useful life is defined as 'the estimated remaining period, from the beginning of the lease term, without limitation by the lease term over which the economic benefits in the asset are expected to be consumed by the enterprise'.

The recognition criteria in the AS (IAS) is that substantially all the risk and rewards are transferred to qualify as a finance lease although the word 'substantially all' is not defined. In a sale and lease back transaction recognition of sale proceeds in the income statement is amortised over the lease term in proportion to the depreciation of leased asset while in IAS it is amortised over the lease term. AS provides a number of examples to help in the proper classification of the lease

Although conceptually same there are procedural differences in recognition of lease transaction between IAS (also AS) and the US GAAP. US GAAP lease pronouncement is contained in a number of standards such as SFAS 13, 22,23,27, and 98. The SFAS 13 provides specific quantitative criteria that must be assessed to determine how a lease should be treated. Such specific number is believed to be helpful in the application of the standard and would provide a foundation on which accountants can assess the facts and circumstances and make decisions about accounting for lease transactions. The US GAAP provides 90% test (discounted present value of the minimum lease payments) or 75 % test (economic life test) for classification as a financial lease. US has given a thresh hold number against the principle based standards of IAS. A limitation of the rule-based accounting is that transactions can be created at 89% to avoid the finance lease test.

In computing the present value of minimum lease payments the rate used is the implicit rate in the lease, while US GAAP uses the incremental borrowing

rate. The sale and lease back transaction recognition of the profits are more detailed and has three methods of accounting viz. i) to defer ii) partly recognise or iii) fully recognise in the income statement, depending on the conditions satisfied. The US GAAP is more detailed and gives specific rules for different types of leases such as the sale or purchase of tax benefit through leases, real estate leases and other advanced transactions. All lease transactions are recognised based on substance over the form principle.

Disclosures

Disclosure requirement are the same under AS and IAS and are as follows: For a finance lease,

- i) assets acquired under finance lease as segregated from the assets owned; and for each class of assets, the net carrying amount at the balance sheet date;
- ii) a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for less than a year, later than one year and not later than five years; and later than five years;
- iii) Contingent rents recognised as expense in the statement of profit and loss for the period;
- iv) the total of future minimum sublease payments expected to be received under non-cancelable subleases
- v) General description of the lessee's significant leasing arrangements like the a) the basis on which contingent rent payments are determined b) the existence and terms of renewal or purchase options and escalation clauses c) restrictions imposed by lease arrangements. Similar requirement for the operating leases.

The lessor has to disclose corresponding disclosures for lease receivables (as above), along with the a) amount of unearned finance income b) the un-guaranteed residual values accruing to the benefit of the lessor and c) the accumulated provision for uncollectible minimum lease payments receivable d) contingent rents recognised in the statement of profit and loss for the period e) the accounting policy adopted in respect of initial direct costs.

US GAAP requires additional disclosures like, basis for determining the contingent rent payments, and restrictions imposed by the lease agreements, lease arrangements with related parties.

9. Accounting for Taxes on Income AS - 22

The amount of tax charged against the profit in any period is an important measure to calculate the earnings per share and the price earnings ratio. The profit after-tax is used for calculations and evaluation of performance of a company. The tax charged in the profit and loss account is not the same as the applying a tax rate to the accounting profits. The tax payable by a business is different due to differences in accounting and tax deductions.

The accounting standard on deferred tax is based on matching concept, where accruing taxes on income in the same period as the revenue and expenses to which they relate, instead of accounting for taxes based on tax payable for the year.

Factors that cause difference between 'taxable income', which is computed as per tax accounting and 'accounting income', which is computed under GAAP for any year are divided into two categories—'timing difference' and 'permanent difference'. Timing differences arise in one period and get reversed in one or more subsequent periods. Permanent differences arise in one period and do not reverse subsequently.

The tax expense for any period is tax payable under the tax law added or subtracted from it are the tax effect on timing difference (deferred tax). If the tax effect is a charge, a corresponding deferred tax liability arises. If the tax effect is a credit, a corresponding deferred tax asset arises. Deferred tax assets can be carried in the balance sheet only to the extent there is a reasonable certainty of realisation from future taxable income. Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period and disclosed under a separate heading in the balance sheet, separately from current assets and current liabilities. There are lot of practical difficulties in the implementation of deferred taxes, which has to be addressed by the standard setting body. Some of the issues relates to minimum alternate tax, companies showing losses continuously and the considerations of tax holidays for determining the effective tax rates. Interpretations have been issued to clarify some of the issues.

Comparison with IAS and US GAAP

Differences are observed between AS and IAS in the definition of various terms like accounting profits, taxable profits and other terms. The term temporary difference is used in the IAS, while AS refers to differences as timing differences. IAS also gives specific definition of the term deferred tax assets and deferred tax liabilities, AS defines only the term 'deferred tax'. AS is mainly driven by the timing differences based on the income statement approach, whereas the IAS is a balance sheet approach with temporary differences. Income statement approach is based on the differences between profit chargeable to tax and profit as per the profit and loss account. Deferred tax assets are accrued for nearly all-deductible temporary differences if it is probable a tax benefit will be realised for nearly all-taxable temporary differences. Tax losses and tax credits are accrued only if it is probable that they will be realised. Deferred tax on government grants are also not recognised.

IAS gives additional elaborations for certain topics. For instance paragraph 36 of the IAS specifies criteria for assessing the probability that the taxable profits will be available against the unused tax losses. IAS is also elaborate and considers provisions relating to consolidated statements, differences arising out of business combinations, goodwill and those related to the assets carried at fair value since the deferred taxes are based on the balance sheet approach.

SFAS 109 contains the standards on presentation of income tax. US GAAP uses the balance sheet approach to deferred tax. All differences arising between the a) amount of taxable income and pre-tax financial income and b) the tax basis of assets and liabilities and their reported amounts in the financial statements are collectively referred as temporary differences. Deferred tax assets are recognised to the extent it will result in deductible amounts in future years for carry forwards. US GAAP requires that deferred tax assets be recognised in full and then reduced by an valuation allowance if some portion of it will not be realised (it is more likely than not) as against recognition subject to availability of sufficient taxable income in the future. Specific procedures are provided to measure the deferred tax liabilities and assets using a rate convention and assess whether a valuation allowance should be established for deferred tax. It specifically prohibits recognition of temporary differences related

to foreign currency non-monetary assets when the reporting currency is the functional currency. US GAAP also addresses tax accounting for undistributed earnings of subsidiaries, investment in corporate joint ventures, Investment tax credits offsetting of securities against tax payables which are not relevant in the Indian context.

Disclosures

Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise although there is no specific head as 'Deferred tax'²⁵² A deferred tax asset as per the clarification issued, is required to present the amount of the deferred tax assets after the head 'Investments'. The 'deferred tax liability', is presented in the balance sheet of a company after the head 'Unsecured Loans'.

The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts. The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

IAS12 requires additional disclosures as they are based on the balance sheet approach. An explanation of the relationship between tax expense and the accounting profit: giving reconciliation between tax expenses and product of the accounting profit multiplied by the applicable tax rates. IAS also requires explanation of changes in the applicable rates and the amount and expiry date of any deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognised in the balance sheet and tax expenses relating to discontinued operations. US GAAP requires splitting of deferred tax into current and non-current portion, which is not required under both AS and IAS.

Corporate Practices

²⁵² The Accounting standards interpretations clarifies that Part I of Schedule VI to the Companies Act, 1956, does not contain a specific head for disclosure of deferred tax assets/liabilities. Section 211(1) of the Companies Act, 1956, provides that every balance sheet of a company shall be prepared in the form set out in Part I of Schedule VI, or as near thereto as circumstances admit. It is, therefore, clear that format of balance sheet as set out in Part I of Schedule VI to the Companies Act, 1956, has in-built flexibility to accommodate necessary modifications.

The year 2001-2002 was the first year for the standards and companies have disclosed deferred tax under different heads in the balance sheet.

Infosys Ltd. (page 60, 2002) reports deferred tax after Investments.

Tata tea Ltd. (page 38 and Schedule 14 and page 55, 2002) The deferred tax asset is reduced from the deferred tax liability and is presented as a net figure after net current asset as a negative figure. Also states “ Keeping in view the past trends as well as measures undertaken to improve business performance the management is confident that the deferred tax asset will be reversed in future, within a period not later than eight years.”

The accounting standard setters must clarify issues as and when certain changes occur in the Income tax Act, which may have an impact on the deferred tax computations.

10. Provisions, Contingent Liabilities and Contingent Assets –AS 29

Provisions and liabilities are an important requirement of the accrual basis of accounting. Appropriate recognition criteria and measurement basis are important for provisions and contingent liabilities and sufficient information must be disclosed to enable the users to understand their nature, timing and amount.

The key principle established by the standard is that a provision should be recognised only when there is a liability i.e. a present obligation resulting from past events. The standard thus aims to ensure that only genuine obligations are dealt with in the financial statements.

AS provides that a provision should be recognised only when a) an enterprise has a present obligation as a result of a past event b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and c) a reliable estimate can be made of the amount of the obligation. If those conditions are not met, a provision should not be recognised. The standard also goes to elaborate the meaning of present obligations, past events and probable outflow.

An enterprise should not recognise a contingent liability or a contingent assets. Contingency is defined in the AS, as “a condition or situation, the ultimate outcome of which, gain or loss, will be known/determined only on the occurrence or non-occurrence of one or more uncertain future events”.

Accounting treatment for contingent loss determined by expected outcome of contingency. Estimates of outcome and financial effect of contingencies are determined by the judgment of management of enterprise. If amount is not estimatable, then existence of the contingency and its nature is disclosed. If there is a potential to reduce/avoided then net amount is mentioned along with gross amount. The amount of guarantee obligations is also disclosed. Contingent gains are not normally recognised in the financial statements. The new standards effectively prohibit excess write offs and creation of provision where no obligations to a liability exists and the use of provisions to smoothen profits.

The listing agreement of the stock exchange has a clause in Item VI (i) on the contingent liabilities whereby, the companies have to provide a clear description in plain English of each material contingent liability and its risks, which shall be accompanied by the auditor's clearly worded comments on the management's view. This section shall be highlighted in the significant accounting policies and notes on accounts, as well as, in the auditor's report, where necessary.

Comparison with IAS and US GAAP

IAS 37 deals with provisions, contingent liabilities and assets, which updated the IAS 10. The AS 29 and IAS 37 are now substantially in conformity except for certain differences. Differences are observed in certain definitions like provision, obligating event, and legal obligation. For example provision is defined as 'a liability of uncertain timing or amount' in the IAS, while in AS it is defined as a 'liability that can be measured only by substantial degree of estimation'. AS-29 defines the terms 'present obligation' and 'possible obligations' and 'probable obligation' that are not found in the IAS. Constructive obligation and onerous contracts definition are not found in the AS 29 and are given in IAS.

IAS 37 requires discounting of provisions based on the time value of money concept. AS recognises only the cost basis for recognising liabilities and provisions. AS does not consider onerous contracts, and constructive obligations that are considered in IAS 37. AS does not distinguish between 'accruals' and 'provisions' as required under IAS 37 hence differences exists

wherever there are separate discussion for provisions or accrual. (as IAS requires discounting of provisions). IAS 37 also provides for certain statistical methods for measuring the provisions, which is left to the management discretions in the AS. IAS 37 requires disclosure of contingent assets though it is not recognised in the financial statements. AS 29 does not require the disclosures of the contingent assets.

US GAAP, ARB 43 describes different types of liabilities. SFAS 5 defines contingency at different levels as probable (likely to occur), reasonably possible (more than remote but less than likely) and remote (less chance of occurring). SFAS 5 requires that loss must be accrued only when the two conditions are satisfied i) the probable asset has been impaired or a liability has been incurred at the date of the financial statements and ii) the amount of loss can be reasonably estimated. If the loss is reasonably possible, then only disclosures are made regarding the nature of contingency and the nature of possible loss and that an estimate cannot be made. When the loss is remote the contingencies are neither recorded nor disclosed. USGAAP is more conservative and requires that losses or costs should not be charged to the appropriation of retained earnings and no appropriation should be transferred to income.

No explicit definition of provisions and restructurings is found in US GAAP. Provisions are measured based on the best estimate to settle the obligation, which is the expected value as against the low end of the range of possible amounts. If certain disclosures may prejudice seriously the position of the enterprise then the liability amounts and details may not be disclosed. But disclosure is required of the general nature of the dispute and the fact that and reason why, the information has not been disclosed. As against this in US full disclosure is required in all cases.

Disclosures

Disclosure is required for each class of provision giving i) the carrying amount at the beginning and at the end ii) additional provisions made during the period iii) unused amounts reversed during the period and iv) amounts charged during the period v) brief description of the nature of obligation vi) indication of uncertainties about the outflows and details of reimbursement are also required.

For contingent liabilities the description of the liability, the estimate of the financial effects and the indication of uncertainties and possibility of reimbursement needs to be disclosed.

IAS requires the above disclosures and additional disclosures relating to discounting and changes in the discount rates for each provision made.

Other standards

Other measurement standards under US GAAP are related to specific industry like Banking and Savings institution, Broadcasting Industry, Computer Software, Franchisee Accounting, Government Contracts, Insurance Industry Transactions, Mortgaging, Banking Activities, Motion Picture Industry, Oil And Gas Producing Activities, Employee Benefit Plans, Recording And Music Industry and Regulated Operations. In addition to these US GAAP also has pronouncements on financial instruments like derivatives and hedging. IAS 39 deals with financial instruments. IAS also deals with investment property, which is not a separate standard in the Indian Accounting Standards.

To sum up, the disclosure standards relating to measurement although substantially in line with IAS lacks clarity in terms of implementation issues. Some of the earlier standards have still not reached conformity with IAS like business combination. Accounting standards that are under preparation at the time of this study relates to financial instruments and agriculture and a revision to AS 15. Some financial instruments covered under the guidance notes relates to equity index futures, Investments by mutual funds, equity Index options and equity stock options. There are no specific industry related standards like the US. The US GAAP appears more stringent than the Indian GAAP. Results under US GAAP and Indian GAAP for a few companies are given in Table 4.3

4.3 Harmonisation of Accounting Standards with International Accounting standards

International harmonisation of accounting standards will help the capital market participants by reducing the cost of capital through the reduction of uncertainty relating to the interpretation and implementation of local standards. When companies have been listed in multiple jurisdictions the use of common

accounting standards will reduce administrative costs and time-consuming process of adjusting, reconciling and explaining differences in accounting. The comparability and transparency of financial reporting requirements and credibility of the reported information is increased through the use of common accounting standards.

Prior studies in the harmonisation of standards uses the Price Waterhouse surveys of accounting principles. These surveys gathered data from different countries on various accounting practices followed within the country. The practices were then classified into required, majority practices, predominant practices, minority practices, found not accepted, not permitted and no applications. Some of the studies using this data are discussed.

Nair and Frank²⁵³ used the three Price Waterhouse surveys to study the harmonisation between the countries. The sample consisted of 37 countries and 131 accounting practices. The practices were categorised into 5 criteria's. They hypothesised that the harmony would exist if all of the countries responses were aligned in the required or not permitted categories.²⁵⁴ The result indicated that no country met the criteria and hence harmony did not exist for the sample countries and practices. They also indicated that, their study supported the conclusion that there was a movement towards harmonisation, which coincided with the issuance of the International Accounting Standards.

A study by Mckinnin and Janell²⁵⁵ also used the Price Waterhouse survey of 1979 to investigate the harmonisation. They studied three accounting standards relating to depreciation, equity method of accounting for minority interest and foreign currency translation. The sample consisted of 64 countries. The study did not look for alternative practices but only concentrated on selected methods. For instance, the study included only the straight-line method and the accelerated method for depreciation and looked into whether depreciation expenses were required. This was a very narrow study, the results would be a clear harmonisation or diversity in the accounting practices. The study found that in respect of depreciation 59 countries had some form of charging depreciation

²⁵³ R.D. Nair and W. G. Frank, "The Harmonization of International Accounting Standards, 1973-1979", 17(1) *International Journal of Accounting* 61-77 (1981)

²⁵⁴ This definition of harmonisation implies that harmony can exist only in uniformity.

²⁵⁵ S. M. Mckinnon and P. Janell, "The International Accounting Standards Committee: A Performance Evaluation", 19(2) *International Journal of Accounting* 19-34 (1984)

to expenses. For the equity method of computing the minority interest, nearly forty three percent rarely used this method or did not permit at all. An important conclusion arrived was, at that point of time the International Accounting Standards were only a collection of all the accounting practices around the world.

Another study by Doupnik and Taylor²⁵⁶ compared the IAS and computed the level of compliance. The study used the PriceWaterhouse survey for both the years 1979 and 1983. The study computed the level of conformity (i.e. harmony). The sample consisted of 53 accounting practices from fifty countries of which there were 16 European countries. Scores were assigned to each of these between 4 and 0. If a country required all the practices the weighted average score for that country would equal to 4. If the weighted average score increased then there was an increase in the conformity. The scores were averaged based on groups in geographical areas of Africa, Asia, Europe, Latin America and North America. They found that Europe had the lowest overall score indicating that level of conformity was low and that Europe lagged behind the rest of the world based on the compliance with International Accounting Standards between 1979 and 1983. The study also showed that within the European countries twelve countries scores increased for both the years. Doupnik extended the study using factor analysis for 36 countries. In all, seventy accounting practices and six groups were considered for comparison. The study concluded that macro level harmonisation was achieved.²⁵⁷

Study by Salter et al surveyed the US, Canadian and Mexican accounting practices. They surveyed 100 accounting practices. Using ANOVA, Salter et al. determined that 34 accounting practices were different among the countries. The Canadian and the US accounting procedures differed on inventory and research and development practices. Mexico differed from both Canada and the US on 30 practices. This difference was explained by the use of inflation accounting as Mexico had high inflation rate. The study concluded that Mexico was not harmonised with that of US and Canada. Also concluding that some differences may be easily eliminated, others more deeply rooted in the cultural development

²⁵⁶ T. S. Doupnik and M. E. Taylor, "An Empirical Investigation of Observance of IASC standards in Western Europe", 25(1) *Management International Review* 47-67 (1985)

of Mexico's accounting systems might be more difficult to align. Most of the earlier studies were based on IAS before revision. After 1989 IASC issued many new accounting standards restricting the accounting choices available for companies. Subsequent study of 27 countries reporting practices with IASC, revealed that there was a move towards harmonisation, but still considerable differences existed amongst countries and the IAS.²⁵⁸

Methodology

For this study forty-two accounting practices were taken. These are given in Appendix 5, Panel A. The accounting rules of USA, UK, Germany, IAS and India were compared. Data for this purpose were taken from accounting standards of each country and also the TRANSAC.²⁵⁹ Each of the practices was first coded into three categories of 'Required or Allowed', 'Forbidden' and 'Allowed subject to conditions'. Pure disclosure standards are not considered for comparison. Next ordinal numbers of 1, 0, -1 were given to identify the levels of scores. The level of harmonisation occurs between countries if the acceptable alternatives are the same between the countries. If the alternatives are different then there is diversity in the accounting system which means that there are differences in definitions of a particular item or there are variety of accounting methods or are implemented differently.

Comparing the accounting regulations with IAS, it is found that the accounting standards in Germany are in variation with IAS to the extent of 38 % of the items. UK GAAP and IAS are also at a variance for 37 % of the items taken for comparison (however the differences reduced when the convergence project was considered). US GAAP varies considerably with IAS by about 49 % of the items, indicating many areas that are divergent with IAS. Of the four countries Indian AS has the variance of only 29 % with IAS, which is low as compared to other countries. This is mainly due to the recent accounting standards, which are in convergence with IAS. The result of the harmonisation confirms the earlier study which shows similar results for the AS and IAS

²⁵⁷ T.S. Douplik, "Evidence of International Harmonisation of Financial Reporting" 23(1) *International Journal of Accounting*, 47 –67 (1987)

²⁵⁸ S. B Salter and C.B. Roberts, "The IASC Comparability Project: A Cross National Comparison of Financial Reporting Practices and IASC Proposed Rules", 5(1) *Journal of International Auditing and Taxation* 89-112 (1996)

²⁵⁹ *Transactional Accounting*, (D. Ordelheide and KPMG eds., New York: Palgrave, 2001)

comparisons.²⁶⁰ US GAAP shows considerable variation with AS in at least 49 % of the items. A summary of major differences is given in Appendix 5, Panel B. Variation in accounting standards in different assets and liabilities are given at the end of this chapter in Table 4.4 and 4.5.

Recent initiatives between FASB and IASB expect to make significant progress toward international convergence in the next few years. However, because of the volume of differences and the complex nature of some issues, the FASB anticipates that many differences between IAS and US will persist well beyond 2005.²⁶¹ By 2005, all European Union listed public companies are required to prepare their consolidated financial statements using IASB Standards hence differences between IAS and countries like Germany and UK will cease to exist for consolidated financial statements.²⁶²

Two of the emerging issues that may cause difficulty in implementation of the International accounting standards are the use of fair value in accounting and the off balance sheet items that are discussed in the next section.

4.4 Emerging Issues in Accounting

Recent trends in financial accounting have raised two issues for standard setters and preparers of accounting reports; the use of fair value in accounting and reporting of off balance sheet items.

4.4.1 Use of fair value in accounting

US GAAP and IAS have increasingly used fair values in valuation of certain assets and liabilities. Investments, Financial instruments, stock options, business combinations are a few areas where the fair value has been used. Various accounting projects are underway that would require more assets and liabilities to be measured at fair value.

The various measurement attributes that can be used for measuring the assets and liabilities are, historical cost, current replacement cost, net realisable

²⁶⁰ D.L. Street, "GAAP 2001 – Benchmarking national accounting standards against IAS: summary of results", 11(1) *Journal of International Accounting Auditing and Taxation* (2002) at 80

²⁶¹ http://www.fasb.org/intl/convergence_iasb.shtml (Nov 03,03)

²⁶² <http://www.icaewco.uk> (Nov 03,03)

value and the discounted value.²⁶³ At the inception, most transactions are recorded at the historical costs. On the date of acquisition, the value of the assets acquired are the same as the current market value at which it was purchased, that is the historical cost is the same as the current value or the fair value. In such cases the current balance sheet figures gives the current value of the assets and liabilities and the information is reliable and relevant. As depreciation is provided each year, assets are measured at cost less depreciation in the subsequent balance sheet. Because of this the underlying value of the assets can change over a period of time, which will not be reflected in the balance sheet. The change in the values of the assets may arise due to change in business conditions, market fluctuations, inflation and such other factors. In such cases, the original acquisition price becomes less relevant measure of future economic benefits, and fair value becomes important which the investor is most interested.

There is no definition of the fair value in the concept statement, which was developed in 1984, although there is current market value, which is nearest to the fair value method. Fair value is defined in a few accounting standards in the US GAAP and can be summarised as follows: Fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties, other than in liquidation. The fair value of a liability is the amount at which that liability could be incurred or settled in a current transaction between willing parties, other than in liquidation. A prerequisite is that the price at which an asset or a liability could be exchanged must be between knowledgeable unrelated parties.

Fair value can be measured using the market-based approach, income approach or the cost based approach. In a market approach a quoted market price in an active market is the best evidence of fair value and should be used as the basis for the measurement. The prerequisites in a market approach are that information is timely and are based on actual or observable transaction and there are multiple sources that are independent in deciding the prices. Thus, in active market, prices should be readily and regularly be available. The income

²⁶³ Financial Accounting Standards Board, "Statement of Financial Accounting Concept No 5" *Original Pronouncement* (FASB: Connecticut, 1999)

approach includes techniques such as the present value techniques. Some times even a cost based approach is used when the other approaches are not possible.

US GAAP extensively uses the fair value in a number of standards. For example SFAS-115: Valuing equity investments, SFAS-123: Stock-option accounting, SFAS-133: Hedging derivatives, SFAS-141: Business combinations, SFAS-142; Purchased intangibles and SFAS-143: Asset retirement obligations

AS has also issued standards that require measurement using fair value. Fair value is defined in a number of AS, "as an amount for which the asset could be exchanged between willing parties (buyers and sellers) in an arms length transaction." Fair value has been used in AS-13 Accounting for investments, AS-14 Accounting for amalgamations, AS 19 Leases, AS 20 Earning per share and AS 28 Impairment of assets.

Though the trend is towards use of fair value as a measurement attribute, it is difficult to implement it in practice. The use of fair value conflicts with the historical cost stems from the primary qualitative characteristics of relevance and reliability. Fair-value advocates and emphasise relevance, while historical-cost places greater weight on reliability. This conflict has resulted in a great concern on the use of fair value in accounting.

The concern for use of fair value also arises from the subjectivity and the judgement that may be involved in determining the fair value of the assets, if there is no readily available market to sell or settle the transactions. Another argument against fair value measurement is that regularly measuring the effect of market movements on a company's assets and liabilities can introduce volatility into the financial statements. This volatility may be construed as companies resorting to earnings management.

While, standard setters have required measuring assets and liabilities at fair value, not providing detailed guidance for valuation and auditing for estimating those fair values may lead to complications. Inadequate definition and lack of specific guidance by the standard setters, may lead to arbitrary application of the fair values. The disclosure requirements would also be large,

as companies would have state all their assumptions. There may be many practical issues that would need to be resolved before fair value accounting is adopted.

4.4.2 Off-Balance Sheet Items

The last few years have seen a number of attempts by companies to remove assets and liabilities from balance sheets through transactions that may obscure the economic substance of the company's financial position. These are termed as off balance sheet items. Off balance sheet items also include creating of special entities, joint ventures, and subsidiaries of the holding companies, research and development arrangements and project financing arrangements. These areas of off balance sheet items have the potential to hide the company's assets and liabilities. Traditionally leasing constituted an off balance sheet financing.²⁶⁴

A company that owns an asset, and finances that asset with debt, reports an asset and a liability (the debt). However, a company that operates the same asset under a lease structured as a finance lease reported neither the asset nor the liability. This will not be a faithful representation of economic reality. To some extent, this has been resolved with the accounting standards on leases. A company that transfers assets (like loans or credit-card balances) through a securitisation transaction recognises the transaction as a sale and removes the amounts from its balance sheet. Some securitisation is appropriately accounted for as sales, but many continue to expose the transferor to many significant risks and rewards inherent in the transferred assets and should not be removed. This matter needs to be addressed in the accounting standards.

A company may transfers assets and liabilities to a subsidiary company must consolidate that subsidiary in the parent company's financial statements. However, in some cases, by using certain types of organisation forms, a company can escape consolidation. In such cases the real financial condition of the company is not known. Companies may enter into joint venture arrangements with other companies to share the costs and benefits associated with the specific projects. If the benefits of the joint ventures are uncertain,

²⁶⁴ The third one is more prevalent in the US, as seen in the Enron Case.

strong external audit and an equally strong enforcing authority must also support the accounting framework.

4.5 Chapter summary

Accounting and measurement standards are important for reporting the true financial position of the company. In this chapter the accounting standards were compared with International Accounting standards, which has gained importance in the last few years. Many countries have now harmonised their accounting standards or are in the process of harmonising them with the IAS. A comparison was also made to US GAAP.

The comparative study indicated many differences between IAS and the earlier pronounced standards. Accounting standards on Investments, Business combinations have many differences and needs considerable revision to fall in line with IAS. Disclosure requirements have to be enlarged for certain standards so that adequate information is given to the stakeholders. As observed in the comparative study, there are considerable differences between Indian AS and the US GAAP. Hence the role of the standard setting bodies will increase manifold not only to converge with the IFRS but also with US GAAP. US GAAP is more rule-based standards with more specific application guidance and extensive use of fair market value accounting. Many industry specific standards have also been pronounced. This implies that standards setters must be prepared for these changes and to issue necessary guidelines. The corporate practices indicate that companies adopt different ways to account and measure transaction. Hence there is a need for strong enforcement authority for enforcing the standards and also issue interpretations in cases there are any conflicts in the AS. It is also recommended that differences in the Companies Act and the Accounting Standard be resolved at the earliest.

Table 4.1: Companies Including Excise Duty and Inter Divisional Transfers

| Company | Gross Sales | Excise | Inter Divisional Transfer | Remarks |
|--------------------------------|-------------|--------|---------------------------|---|
| Larsen and Toubro Ltd. | 8358 | 440 | -- | Sales includes excise duty |
| Reliance Industries Ltd | 57119 | 3314 | 11715 | Sales includes Excise duty and Inter Divisional Transfers |
| Nirma Ltd | 2276 | | Amount not specified | Accounting policy states that Sale of industrial chemicals including, interdivisional sales was.... |
| Sterlite Optic Technology Ltd | 769.87 | | 62.6 | Sales including Inter divisional transfers |
| ACC Ltd | 3239.91 | 429.68 | -- | Excise duty not shown on the face of the Profit and Loss or schedule |
| Nicholas Piramal Ltd | 946.48 | 80.26 | | Sales including Excise duty |
| Raymond Ltd | 947.11 | 106.67 | | Sales include Manufactured goods and for self - consumption and internal arising. |
| The West coast Paper Mills Ltd | 476.63 | 54.25 | 73.09 | Sales figure also includes movement in stocks |
| Rs. Crores | | | | |

Table 4.2: Disclosures of Business Combinations

| |
|--|
| <p>Company: Pfizer Ltd (page 49) Some Extracts regarding the amalgamation in the annual report</p> <p>Amalgamation of Parke-Davis (India) Limited with the Company</p> <p>(a) In accordance with the Scheme of Amalgamation (the Scheme) of the erstwhile Parke-Davis (India) Limited has been approved by the members at a Court-convened meeting held on 21st August, 2002 and subsequently sanctioned by the Honourable High Court of Judicature at Bombay vide its order dated 7th February, 2003, the Undertaking of Parke-Davis being all its assets and properties, both movable and immovable, industrial and other licenses, trademarks, all other interests, rights and powers of every kind, etc., and all its debts, liabilities including contingent liabilities, duties and obligations, has been transferred to and vested in the Company retrospectively with effect from 1st December, 2001. The Scheme has according been given effect to in these accounts.</p> <p>(b) The operations of Parke-Davis include manufacturing and trading of pharmaceutical products.</p> <p>(c) The amalgamation has been accounted for under the "pooling of interests" Under (AS - 14) Accordingly, the assets, liabilities and reserves of Parke-Davis as at 1st December, 2001 have been taken over at their book values, after making necessary adjustments to bring about the uniformity in the accounting policies followed by the two companies as specified in the Scheme. Accordingly, Rs. 1223.51 lakhs (net of tax) has been deducted from the General Reserve taken over by the Company on account of such adjustments.</p> <p>(d) Pursuant to the Scheme, 53,57,244 Equity Shares of Rs. 10/- each of the Company are to be allotted to the shareholders of Parke-Davis in the ratio of 4 (four) fully paid-up Equity Shares of the Company for every 9 (nine) fully paid-up Equity Shares of Rs. 10/- each in Parke-Davis. Pending allotment, an amount of Rs. 535.73 lakhs has been shown under the Share Capital Suspense Account as at 30th November, 2002 (Schedule 1A).</p> <p>(e) In terms of the Scheme, the Equity Shares when issued and allotted by the Company shall rank for dividend, voting rights and in all other respects pari-passu with the existing Equity Shares of the Company. Accordingly, the appropriation for the proposed dividend includes dividend on 53,57,244 Equity Shares, which would be allotted to the shareholders of Parke-Davis [referred to in note(d) above].</p> <p>(f) The income accruing and expenses incurred by Parke-Davis during the period 1st December, 2001 to 30th November 2002 have also been incorporated in these accounts.</p> <p>Observations: Individual break-up of liabilities and reserves taken over are not given in the disclosures. Assets transferred are given in a separate column in the Fixed Assets schedule. Each item has to be taken from the respective schedules The income and expenses of Parke Davis is not available.</p> |
| <p>Company: Tata Tea Ltd (page 56)</p> <p>Bambino Investment and Trading Co Ltd. Has been amalgamated with TTL ,with effect from ...</p> <p>The amalgamation is in the nature of merger and is accounted for under the pooling of interest method, has resulted in the transfer of the following assets and liabilities and reserves to TTL.</p> <p>Observation: Details of Assets, Liabilities and reserves taken over and their amounts are given</p> |
| <p>ACQUISITIONS AND DIVESTITURES by Bristol Myers Squib Annual Report 2002</p> <p>DuPont Pharmaceuticals Acquisition</p> <p>On October 1, 2001, the Company acquired the DuPont Pharmaceuticals business (DuPont) from E. I. DuPont de Nemours and Company for \$7.8 billion in cash. The results of DuPont have been included in the consolidated financial statements from the date of acquisition. DuPont is primarily a domestic pharmaceutical</p> |

and imaging product business focused on research and development. This acquisition was financed with proceeds from the issuance of \$1.5 billion of commercial paper, the issuance of \$5.0 billion of medium-term notes and internal cash flows.

Following is a summary of the final allocation of the estimated fair values of the assets acquired and liabilities assumed (dollars in millions):

| | | |
|--|-------|-------|
| Current assets | \$ | 520 |
| Property, plant and equipment | | 321 |
| Intangible assets | | 1,976 |
| Acquired in-process research and development | 2,009 | |
| Goodwill | | 3,780 |
| Other assets | | 280 |
| Total assets acquired | | 8,886 |
| | | |
| Current liabilities | | 353 |
| Restructuring liabilities | | 575 |
| Acquisition liabilities | | 90 |
| Long term liabilities | | 123 |
| Total liabilities assumed | | 1,141 |
| | | |
| Purchase Price | \$ | 7,745 |

The total intangible assets of \$1,976 million are being amortized over their weighted-average useful lives and include core and developed technology of \$1,783 million (15 and 11 years weighted-average useful life, respectively) and patents of \$193 million (11 year weighted-average useful life). The goodwill of \$3,780 million was assigned to the Pharmaceuticals segment. Of that total amount, \$2,418 million is expected to be deductible for tax purposes over a 15 year period.

Observation: The report also discusses the accounting policies followed on amalgamations. Restructuring liabilities are also discussed. The unaudited pro forma financial information presents results as if the acquisition had occurred at the beginning of the respective periods (Mandatory Requirement)

Table 4.3: Profitability Under US GAAP and Indian AS for Select Companies

| Companies | Profit After Tax - AS | Profit as per US - GAAP | |
|--------------------|-----------------------|-------------------------|---|
| Wipro Ltd | 8854 million | 8300 million | Difference due to Revenue recognition standards, amortization of intangibles deferred stock Compensation expenses. |
| Reliance Ltd | 3678 crores | 3033 crores | The difference is primarily on account of prior year charge for change in method of depreciation and foreign exchange fluctuation |
| Infosys Ltd | 8059 million | 7858 million | Major difference is on account of amortisation of deferred stock compensation |
| Satyam Ltd | US \$ 94373 thousand | US \$25892 thousand | Differences due to stock compensation, accounting for subsidiaries and joint ventures |
| Zee Tele Films Ltd | 1,778.9 million | (1,911.6) million | Figures of US GAAP not audited and is provided by the company for information purposes at their website. |

Table 4.4: Differences in Accounting for Long lived Assets

| Scale | Intangible Assets | Tangible Assets | Leased Assets | Financial Assets |
|-------|-------------------|-----------------|---------------|------------------|
| 4 | | | | |
| 3 | # 0 | | \$ | |
| 2 | @ * | | | 0 \$ |
| 1 | | * @ 0 | * # 0 | # @ |
| 0 | | | @ | |
| -1 | | # | | * |
| -2 | | | | |
| -3 | \$ | \$ | | |
| | | | | |
| | | | | |

= Germany \$ = USA * = UK 0 = IAS @ =India

Table 4.5: Differences in Accounting for Liabilities and Others

| Scale | Inventory | Liability | Others |
|-------|-----------|-----------|--------|
| 4 | | | |
| 3 | | | \$ |
| 2 | \$ | | |
| 1 | # 0 | \$ | @ |
| 0 | @ * | | 0 |
| -1 | | 0 * | * |
| -2 | | @ # | # |
| -3 | | | |
| | | | |

= Germany \$ = USA * = UK 0 = IAS @ =India