Bala R

With Ind AS accounting standards, India moves towards the fair value regime

A global set of accounting standards was pioneered by the International Accounting Standards Committee, which was set up in 1973. The standards were called IAS Standards. Its successor the International Accounting Standards Board (IASB) developed the International Financial Reporting Standards, the IFRS, used by publicly accountable companies. About 87% of jurisdictions in the world require the use of IFRS standards. The IASB was established in 2001 and has stakeholders from around the world.

IFRS seeks to bring transparency by enhancing the international comparability and quality of financial information, enabling investors and other market participants to make informed economic decisions.

The Financial Accounting Standards Board (FASB) in the United States was established in 1973 to formulate financial accounting and reporting standards for public and private companies and not-for-profit organizations.

While the IFRS is currently not applicable in the United States, the FASB of the US is working with the IASB on a convergence project with IFRS. Considerable progress has been achieved in this direction.

INDIAN ACCOUNTING STANDARDS (Ind AS)

For the Indian jurisdiction, the Ministry of Company Affairs has notified the Indian Accounting Standards (Ind AS) with the date of transition as 1st April, 2015.

In Phase I, Ind As is applicable from 1 April 2016 to listed and unlisted companies whose net worth is greater or equal to Rs 500 crores. In Phase 2, it is applicable from 1 April 2017 to all listed companies; applicable to unlisted companies whose net worth is equal to or greater than Rs 250

crores. Ind AS applicability has been deferred for insurance companies, banking companies and nonbanking finance companies.

The Indian Accounting Standards are based on the IFRS, but with certain differences. India has chosen the path of convergence with IFRS rather than outright adoption.

STATEMENT OF PROFIT AND LOSS

A significant change in Ind AS as compared to the previous GAAP is the presentation of the Statement of Profit and Loss. Profit and loss and Other Comprehensive Income are presented in separate sections within a single statement of profit and loss.

OCI conceptually aims to capture those components of profits that are outside a company's core operations or volatile in nature. OCI is therefore excluded from calculation of Earnings Per Share, a key measure from a shareholder perspective.

INVENTORIES

Inventories are initially recognised at the lower of cost and net realisable value (NRV).

Ind AS requires the cost for items that are not interchangeable or that have been segregated for specific contracts to be determined on an individual-item basis. The cost of other inventory items used is assigned by using either the first-in, first-out (FIFO) or weighted average cost formula. Last-in, first-out (LIFO) is not permitted.

The FASB permits LIFO method on the US, but the Internal Revenue Services, the equivalent of the Indian Income Tax Department, requires that companies using LIFO inventory costing for tax purposes also use it for financial reporting.

Indian companies have generally adopted the weighted average or FIFO method.

PROPERTY, PLANT AND EQUIPMENT

PPE is measured initially at cost. Subsequently, they are carried at historical cost less accumulated depreciation and any accumulated impairment losses (the
cost model), or at a revalued amount less any accumulated depreciation and subsequent accumulated impairment losses (the revaluation model).

The depreciable amount of PPE (the gross carrying value less the estimated residual value) is depreciated on a systematic basis over its useful life. The straight line method is commonly used in the Ind AS financial statements of Indian corporates, though instances of written down value method of depreciation has also been observed.

There is no significant impact on financial statements on account of the new Ind AS standards as compared to the previous Indian GAAP for non-financial assets like PPE and inventory**.**

FINANCIAL INSTRUMENTS

Financial instruments include a wide range of assets and liabilities, such as trade debtors, trade creditors, loans, finance lease receivables and derivatives. The erstwhile IAS 39, the current IFRS 9 and Ind AS 109 deal with financial instruments.

Classification, recognition and measurement principles for financial instruments is one of the most significant changes in Ind AS as compared to the previous Indian GAAP.

Financial assets and financial liabilities are initially measured at fair value, which is usually the transaction price. Subsequently, financial instruments are measured according to the category in which they are classified.

DEBT INSTRUMENTS

A financial asset that meets the following two conditions is measured at **amortised cost:**

• Business model test: the objective of the Company's business model is to hold the financial asset to collect the contractual cash flows.
• Cash flow characteristic test: the contractual term of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding.
Instruments with contractual cash flows that are SPPI on the principal amount outstanding are consistent with a basic lending arrangement.

A financial asset that meets the following two conditions is measured at **fair value through other comprehensive income (FVOCI):**
• Business model test: the financial asset is held within a business model whose objective is achieved by both collecting cash flows and selling financial assets.
• Cash flow characteristic test: the contractual term of the financial asset gives rise on specified dates to cash flows that are SPPI on the principal amount outstanding.
Movements in the carrying amount are recorded through OCI, except for the
recognition of impairment gains or losses, interest revenue as well as foreign exchange gains and losses which are recognised in profit and loss.

All other financial assets are measured at fair value through **profit or loss (FVTPL).** Financial assets included within the FVPL category need to be measured at fair value with all changes recorded through profit or loss.

Analyzing the financial statements of large Indian corporates reveals that debt mutual funds are the favoured choice of investment. The debt fund industry with a size of around USD 170 billion owes its corpus largely to corporate treasuries. Investments in debt based mutual funds are usually measured at fair value through profit and loss as there is no contractual commitment by asset management companies to pay a fixed return, though some such investments have been measured at fair value through OCI.

Equity instruments

Investments in equity instruments are always measured at fair value. Equity instruments that are held for trading are classified as FVPL. For other equities, management has the ability to make an irrevocable election on initial recognition, on an instrument-by-instrument basis, to present changes in fair value in OCI rather than profit or loss.

Derivatives

Derivatives are measured at fair value. All fair value gains and losses are recognised in profit or loss except where the derivatives qualify as hedging instruments in cash flow hedges or net investment hedges.

Impairment

Ind AS specifies a three-stage model based on expected credit losses for impairment depending on changes in credit quality since initial recognition.

IMPACT ON SHIFT FROM PREVIOUS GAAP TO IND AS

The bulk of assets and liabilities are carried at amortized cost in the Ind As statements for FY 2016-17. This does not have a significant impact compared to the erstwhile gap. The major exceptions are financial assets comprising of debt mutual funds, certificates of deposit and bonds/debentures which are classified as FVTPL or FVOCI.

Disclosures of reconciliations from Indian GAAP to Ind AS are required. Analysis of the financial statements of some of the largest listed companies in terms of market capitalization, reveals some interesting trends based on these disclosures.

The profit after tax/total comprehensive income for an automobile major increased by 17% primarily because of debt mutual funds measured at fair value as per Ind AS, against cost or lower of cost and market value, in the previous GAAP statement for FY 2015-16. In the case of a refining/petrochemical conglomerate there was a 7% increase in net profit as per Ind AS. In the case of two of the largest information technology companies, there was a negligible change in total comprehensive income as per Ind AS compared to previous GAAP. For a large FMCG company, there was a 6% drop in total comprehensive income and for another it was negligible.

With the comparative statements showing a small difference in many cases and positive variation in some cases which goes against conservatism, and a muted change on an average, one wonders if the gargantuan exercise of adopting the new standards helped the consumers of the financial statements in any significant way. Perhaps, in volatile years, the statements will reveal the stark distinctions between profit and loss and OCI. But it would be difficult to assess, how the figures would have compared with the financial statements under the previous Indian GAAP. With Ind AS not aligned 100% with IFRS, international comparability too is not feasible.

NEW ACCOUNTING RULE IN THE US

The entities under US jurisdiction have some interesting times ahead of them. A new accounting standard applicable from January 2018, requires unrealized gains and losses in marketable and non-marketable equity securities, to be included in net income. Warren Buffet, the Chairman of Berkshire Hathaway in his annual letter to shareholders laments that this will produce some “truly wild and capricious swings” in the company’s bottom line. Realized gains were required to be reported in net income before the new rule, and even that was considered to distort the income statement. The impact extends beyond investment companies. Google too has issued a statement that the new rule will increase volatility in Other Income and Expense in the Income Statement.

As the accounting world moves towards a “truly” fair value world, financial statements may make less sense to shareholders, creditors and other stakeholders, in the traditional way. Perhaps, financial statements should henceforth be viewed through the prism of change in net asset value based on fair value, rather than the current focus on profit and loss/net income.