CONNECT THE GAAP

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Connect the GAAP: Upgraded accounting standards

The unending quest of laying down financial reporting standards which strive to provide reliable and relevant information to the readers of financial statements is what makes 'Financial reporting' a vital discipline. Financial reporting standards, which is considered the base of accounting and serves as a common language for communicating the financial results and financial position of business houses, need to be in sync with the global economic environment. Over a period of time, business transactions have changed in structure and form with the emergence of various fiancnial instruments. In this light, it is inapppropriate for entities to leave their accounting policies unchanged when more relevant and reliable alternatives exist.

The previous issue highlighted the intention of the Institute of Chartered Accountants (ICAI) and the Ministry of Corporate Affairs (MCA) to have a a two-tier system of accounting standards. We now discuss the upgraded Accounting Standards (upgraded AS) which are in the Exposure Draft stage. The upgraded AS are intended to be made applicable to companies not required to adopt Indian Accounting Standards (Ind AS) as well as to all other forms of business organisations.

In this issue, we discuss:

a) Overview of upgraded AS
b) The gaps that are being bridged - Key highlights of the Exposure Drafts of upgraded AS
   - Events after the Reporting Date (upgraded AS 10)
   - Accounting Policies, Changes in Accounting Estimates and Errors (upgraded AS 8)
   - Inventories (upgraded AS 2)
   - Government Grants (upgraded AS 20)
   - Statement of Cash Flows (upgraded AS 7)
c) Macro-level comparison with Ind AS

Overview of upgraded AS

Subject Matter	Existing AS	Upgraded AS	Ind AS
Inventories	AS 2	AS 2	Ind AS 2
Accounting Policies, Changes in Accounting Estimates and Errors	AS 1 and AS 5	AS 8	Ind AS 8
Events after reporting date	AS 4	AS 10	Ind AS 10
Government Grants	AS 12	AS 20	Ind AS 20
Statement of Cash Flows	AS 3	AS 7	Ind AS 7

The gaps that are being bridged - Key highlights of the Exposure Drafts of upgraded AS

Events after the Reporting Period (upgraded AS 10)

Entities will now be required to disclose the date of approval of financial statements. This will help users appreciate the fact that financial statements do not reflect events after that date.

Generally speaking, non-adjusting events do not affect the recognition of amounts and disclosures made. However, disclosures in the financial statements are required in case of material non-adjusting events. For example, announcing a plan to discontinue an operation or changes in tax rates enacted or announced after the balance sheet date, which have a material impact on the deferred tax asset/liability will have to be disclosed. In the current Indian Generally Accepted Accounting Principles (GAAP), such a disclosure is only required in the Board's report.

The principles for classifying events occurring after the balance sheet date into either an 'adjusting event' or a 'non-adjusting event' remain the same. Provisions that deem final dividends proposed after the balance sheet date as an adjusting event no longer exist. Accordingly, these dividends will not be recognised as a liability on the balance sheet date. However, disclosures will be required of the same.

A discovery of frauds or errors (which show that financial statements are incorrect) after the balance sheet date will be treated as an adjusting event.

If a material breach of a long term debt covenant before the balance sheet date, resulting in loan becoming payable on demand, is subsequently ratified by the lender then such ratification will be treated as an adjusting event. This will save the entity from the consequences of a loan being classified under current liabilities.

Evidence provided by court cases settled after the balance sheet date will now have to be specifically considered in determining the recognition and measurement of provisions as on the balance sheet date.

If events occurring after the balance sheet date indicate that the going concern assumption is no longer appropriate, the entity should not prepare its financial statements on a going concern basis.

Accounting Policies, Changes in Accounting Estimates and Errors (upgraded AS 8)

Accounting policies and changes thereto

Upgraded AS 8 clearly states that relevance and reliability of information should be the key factors in the selection and application of accounting policies for economic decision makers.

While adhering to the above principles and application of accounting policies for transactions not specifically dealt with by AS, recourse should/may be made to the following literature in the following order:

Must consider	May consider
• Requirements in AS dealing with similar and related issues • Framework to the AS	• Ind AS • Most recent pronouncements of ICAI • Most recent pronouncements of IASB • Most recent pronouncements of other standard setting bodies (with similar framework) • Other accounting literature and accepted industry practices*

*to the extent they do not conflict with principles in upgraded AS and Framework

Thus, where accounting standards and pronouncements by the ICAI are silent on the accounting treatment, references may have to be made to the recent pronouncements of International Accounting Standards Board (IASB), which may include references to International Financial Reporting Standards (IFRS) for SMEs. This may entail onerous efforts by smaller entities.

Accounting policies need not be applied to immaterial items. However, it is inappropriate to attempt such a non-application with the intention to achieve a particular presentation of financial position or performance or cash flows.

Changes in accounting policies due to the initial application of a new standard/statute shall be dealt with in accordance with the transitional provisions provided in the respective standard. In cases where transitional provisions are not provided, the change shall be accounted for by making 'retrospective computation' which entails calculating the impact as if the policy had always been applied.

Similarly, any other voluntary changes in accounting policies shall also be accounted for by making retrospective computation. AS 5 is silent on the same. AS 6: Depreciation requires similar treatment for changes in the method of depreciation. In cases where retrospective computation is considered 'impracticable', the policies are to be applied prospectively from the start of earliest period practicable by providing adequate disclosures.

Prior period items/errors

Under the current AS, only items of **income and expense** arising in the current period due to errors/omissions in the previous period are considered prior period items. However, according to the upgraded AS, all omissions/misstatements in the entity's previous financial statements are prior period errors. Accordingly, even erroneous classification of balance sheet items will be considered prior period items. Such errors which have an effect on the presentation or disclosure will be disclosed in the notes to financial statements.

Errors in the financial statement of earlier periods are to be corrected in the first set of financial statements approved for issue after their discovery.

Correction of errors is to be made by retrospective computation. If that is considered impracticable, the effect of correction of error is to be computed prospectively from the start of earliest period practicable by providing adequate disclosures.

Inventories (upgraded AS 2)

Service providers will now be required to recognise inventory in respect of services for which revenue is not yet recognised. The costs to be recognised as inventories in such cases would primarily include salaries and other directly attributable costs of labour and other personnel (including supervisory personnel) directly engaged in providing the service and would also include attributable overheads. Labour and other costs relating to sales and general administrative personnel are not to be included in inventory.

There is now an explicit requirement to use the same cost formula for inventories with similar nature and use. Different cost formulae (First in, first out (FIFO) or weighted average) may be used for inventories with different nature or use. However, a different nature may not be justified by a mere difference in geographical locations.

The inventory of materials and supplies should be written down to the net realisable value only if both of the following conditions are satisfied:

- There is a decline in the price of materials; and
- Cost of finished products (in which these materials will be used) exceeds the net realisable value.

Upgraded AS 2 excludes only measurement of inventories held by producers of agricultural and forest products, agricultural produce after harvest and mineral and mineral products from its scope. However, it does cover recognition and disclosure aspects of these inventories in its scope.

Government Grants (upgraded AS 20)

The fundamental principle stating that government grants (other than grants in the nature of promoter's contribution) should be recognised in the profit and loss statement on a systematic and rational basis over the periods necessary to match them with the related costs remains the same under the upgraded AS 20.

Taking this principle further, upgraded AS 20 acknowledges that for grants with multiple conditions attached, it may be appropriate to allocate one part of a grant on one basis and another part on another basis.

Government grants which are compensatory in nature and those with no future related costs are to be recorded in the statement of profit and loss in the period in which the grant becomes receivable.

The accounting treatment and presentation of grants related to depreciable assets remain the same. The entity may either set up a deferred income account or reduce the grant from the gross block. Both the treatments will eventually lead to recognising the grant in the statement of profit and loss in the proportion of the depreciation charged.

Regardless of the approach used for presentation, the two aspects (purchase of depreciable asset and receipt of grants) need to be presented separately in the statement of cash flows.

A government grant that becomes repayable is to be accounted for as a change in the accounting estimate.

Statement of Cash Flows (upgraded AS 7)

Bank overdrafts which are repayable on demand and which form an integral part of an entity's cash management shall be considered as part of cash and cash equivalents. Generally, in these cases, bank balance often fluctuates from being positive to overdrawn. Under the existing Indian GAAP, bank overdrafts never form a part of cash and cash equivalents (except in certain cases of book overdrafts).

For consolidated financial statements, the upgraded standard specifically requires adjustment to profit or loss for undistributed profits of associates. The current Indian GAAP doesn't specifically state the same.

The Indian GAAP specifically requires cash flows from extraordinary activities to be separately categorised as operating, investing and financing activities. The upgraded standard does not contain such requirements.

Upgraded AS 7 acknowledges that acquisition of fixed assets by way of finance leases are non-cash transactions and, at the same time, it also mandates that payments made by the lessee, which has the effect of reducing the outstanding liability (related to finance lease), should be disclosed under cash flows from financing activities. This is a welcome change compared to AS 3 which was silent on the matter.

A macro-level comparison with Ind AS

Having said that the rules of financial reporting should be standardised for various entities, it is also essential to understand that certain differences may continue to exist considering the size of the organisations. Certain requirements in Ind AS may prove to be too cumbersome for smaller entities and may increase the cost of compliance without proportionately increasing the benefits from such additional reporting. These differences between the Exposure Drafts of upgraded AS vis-à-vis their Ind AS counterparts are summarised below.

	Ind AS	Upgraded AS
Inventories	**Inventory with commodity brokers**	
	Measured at fair value less cost to sell. It is pertinent to note that the terms 'fair value' and 'net realisable value' are not synonymous.	Measured using the same principles as are used for other inventories i.e. the lower of cost and net realisable value. The corresponding disclosure requirements are also done away with.
	Inventories acquired on deferred payment terms	
	Interest component is to be separated from the cost of purchase.	Companies are not required to separate the interest component from the cost of purchase.
Statement of Cash Flows	**Segment-wise cash flows**	
	Cash flows arising from the operating, investing and financing activities of each reportable segment are to be disclosed.	Such requirement does not exist in upgraded AS.
	Assets acquired or held for rental purposes and/or sale	
	Payments and receipts relating to these activities are to be classified as cash flows from operating activities to give importance to substance over form.	This requirement has been done away with.

	Ind AS	Upgraded AS
Government Grants	**Non-monetary grants**	
	Measured at fair value	Measured at nominal value
	Presentation of grants related to assets	
	By setting up the grant as deferred income.	Either by setting up the grant as deferred income or deducting the grant from the gross value of the fixed asset.
	Government assistance and forgivable loans	
	Deals with concepts such as government assistance and forgivable loans from government	Such concept does not exist in upgraded AS.
	Grants in the nature of the promoter's contribution	
	The concept no longer exists in Ind AS	Such concept (existing in AS 12) is retained.

Accounting Policies, Changes in Accounting Estimates and Errors	Ind AS	Upgraded AS
Hierarchy of guidance literature	The entity may first consider the most recent pronouncements of the IASB.	The entity may first consider guidance given in Ind AS. In its absence, it has to first consider the recent pronouncements of ICAI before considering the pronouncements of the IASB.
Retrospective application vs Retrospective computation	It requires retrospective application, retrospective restatement of changes in accounting policies, estimates and errors. Accordingly, the impact of changes in accounting policies or prior period errors are to be given in the opening retained earnings of the earliest period presented or in the comparative period.	Only retrospective computations are required with effect being given in the current period (i.e. without restating comparative periods/opening retained earnings).
Changes in accounting policy	Such changes are not permitted on the grounds of change being required by statute.	Accounting policies can be changed pursuant to the requirements of a statute.

Events after the reporting period	Ind AS	Upgraded AS
Supervisory board	The concept of a supervisory board is included in Ind AS.	The concept of a supervisory board does not exist in upgraded AS.
Power to amend financial statements	In cases where the entity's owners or others have the power to amend the financial statements, such fact needs to be disclosed in the financial statements.	Such requirement does not exist in upgraded AS.
Distribution of non-cash assets to owners	Ind AS has an appendix A which details how to account in cases of distribution of non-cash assets to owners.	Such an appendix doesn't exist in upgraded AS.

In retrospect

Conventional accounting practices focused more on historical cost measurement of tangible assets. With the changes in the economic environment, companies are spending heavily on building brand values, employee trainings and managing customer relations while shareholders are in quest of information beyond numbers on tangible assets. The upgraded AS can be seen as a step to cater to these additional informational needs.

In time, these exposure drafts will be turned into mandatory AS to be complied with in the preparation and presentation of financial statements. When compared with their predecessors, these standards are forward looking as they further narrow down the gap between local and international standards. The implementation of these standards may bring certain challenges in the initial stage, which is generally the case with all the changes in external environment. However, these standards can be instrumental in improving India's presence on the global economic front.

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