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REVIEW OF PRACTICAL IMPLEMENTATION ISSUES OF INTERNATIONAL FINANCIAL REPORTING STANDARDS*

Case study of India

Executive Summary

In concluding its 22nd session, the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) agreed to conduct further reviews of the practical implementation challenges of International Financial Reporting Standards (IFRS) as well as ways to meet these challenges. It was also agreed that the further review could be conducted by preparing country case studies with a view to developing guidance on good practices in IFRS implementation. Accordingly, five country case studies covering Brazil, Germany, India, Jamaica and Kenya were prepared.

This report presents the findings of the case study on India. The Institute of Chartered Accountants of India (ICAI) is the accounting standards-setting body in India. The ICIA has been setting accounting standards based on IFRS. This case study presents the regulatory framework, enforcement of accounting standards, challenges faced in the process of converging to IFRS, capacity-building issues and lessons learned in the process.

The main objective of this case study is to draw lessons learned from the experience of India in converging with IFRS and to discuss the findings with member States, with a view to facilitating sharing of experience among countries that are either implementing IFRS or that intend to so in the coming years.

* This document was submitted on the above-mentioned date as a result of processing delays.

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I. Introduction*

1. India has in recent years experienced strong economic growth, rising foreign exchange reserves, falling inflation, global recognition of its technological competence, and the interest shown by many developed countries to invest in the engineers and scientists produced in the country including setting up of new Research and Development centers. Above all, as the largest democracy in the world, India has a reputation for providing leadership for one billion people in a country with different cultures, languages and religions. India's technological competence and value systems are highly respected. Foreign institutional investors find investing in India attractive. Indians are also investing in companies abroad and are opening new business ventures. The Government of India is also committed to economic development by ensuring a growth rate of 7 to 8 per cent annually, enhancing the welfare of farmers and workers and unleashing the creativity of the entrepreneurs, business persons, scientists, engineers and other productive forces of the society. Today, India is one of the fastest growing economies in the world with a compounded average growth rate of 5.7 per cent over the past two decades. The Government of India has plans to transform India into a developed nation by 2020.

2. In India, accounting standards are issued by the Institute of Chartered Accountants of India based on IFRSs. Departures from the IFRS are made keeping in view the prevailing legal position and customs and usages in the country. Accordingly, this case study of India is prepared to highlight the practical challenges involved in adapting International Financial Reporting Standards in India. This case study also throws light on the existing regulatory framework in the country and the enforcement of the standards in the country.

Accounting Standards-setting in India: A Historical Perspective

3. India's accounting profession is among the earliest to develop after the introduced of the Indian Companies Act in the mid-1800s, giving the accounting profession its start. Since then, considerable efforts have been made to align India's accounting and auditing standards and practices with internationally accepted standards. Indian accounting and auditing standards are developed on the basis of international standards; and the country has many accountants and auditors who are highly skilled and capable of providing international-standard services.

4. The Institute of Chartered Accountants of India (ICAI) set up the Accounting Standards Board (ASB) in 1977 to prepare accounting standards. In 1982, ICAI set up the Auditing and Assurance Standards Board (initially known as the Auditing Practice Committee) to prepare auditing standards. ICAI became one of the associate members of the International Accounting Standards Committee (IASC) in June 1973. The ICAI also became a member of the International Federation of Accountants (IFAC) since its inception in October 1977. While formulating accounting standards in India, the ASB considers International Financial Reporting Standards (IFRS) and tries to integrate them,

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to the extent possible, in the light of the laws, customs, practices and business environment prevailing in India.

5. The Accounting Standards Board has worked relentlessly to introduce an overall qualitative improvement in the financial reporting in the country by formulating accounting standards to be followed in the preparation and presentation of financial statements. So far, the Board has issued 29 Accounting Standards. Besides this, it has also issued various accounting standards interpretations and announcements, so as to ensure uniform application of accounting standards and to provide guidance on the issues concerning the implementation of accounting standards which may be of general relevance. Appendix A contains a Comparative Statement of International Accounting Standards/International Financial Reporting Standards and Indian Accounting Standards.

6. As accounting standards in India are formulated on the basis of IFRS (issued by IASB), ICAI interacts with the IASB at various levels, namely:

- Sending comments on the various draft IFRSs issued by IASB;
- Active participation in the meetings of the global standard-setters with IASB;
- Active participation in the meetings of the regional standard-setters with IASB;
- Contribution in the discussions on various ongoing projects of the IASB, e.g. on the IASB management commentary project;
- ICAI is approaching IASB to take up projects to be carried on by India, e.g. IFRS for regulated enterprises.

II. Regulatory Framework and Enforcement of Accounting Standards

7. In the following paragraphs the regulatory framework of financial reporting and enforcement of accounting standards will be discussed.

(A) Legal Recognition of Accounting Standards issued by ICAI under the Companies Act (1956)

8. The Companies Act (1956) provides the basic requirements relating to financial reporting of all companies incorporated in India. The Act requires the preparation, presentation, publication, and disclosure of financial statements, as well as an audit of all companies by a member-in-practice certified by the Institute of Chartered Accountants of India (ICAI). Under the Act, the Central Government has the power, by notification in the Official Gazette, to constitute the National Advisory Committee on Accounting Standards (NACAS), to advise the Central Government on the formulation and laying down of accounting standards for adoption by companies or class of companies. For this purpose, the Act requires that NACAS has to consider accounting standards issued by the ICAI when recommending accounting standards to the Government. While, as stated earlier, the ICAI bases its accounting standards on the corresponding IASs/IFRSs, NACAS also specifically considers the deviations – and reasons, if any – from the corresponding

IAS/IFRS while reviewing ICAI accounting standards. In case the NACAS is not satisfied about any deviation, it requests ICAI to amend the standard to comply with IFRS. ICAI generally deviates from the corresponding IAS/IFRS because of the following factors:

- Legal and regulatory environment prevailing in the country;
- Alternatives permitted in IFRSs would lead to incomparable financial information;
- Economic environment within the country;
- Level of preparedness of industry.

9. NACAS has recommended that all 29 accounting standards issued by ICAI, with the exception of AS 8, '*Accounting for Research and Development,*' which has already been withdrawn pursuant to AS 26, '*Intangible Assets,*' becoming mandatory, to the Government, for notification under the Companies Act (1956). These include the revised AS 15, *Employee Benefits*, recently issued by ICAI in line with IAS 19, *Employee Benefits*. These are expected to be notified by the Government shortly. Until then, the Companies Act (1956) specifically provides that ICAI accounting standards need to be adhered to by companies.

(B) Legal recognition of accounting standards by other regulators

Reserve Bank of India

10. The Reserve Bank of India (RBI) was established to regulate the issue of banknotes and keeping reserves to secure monetary stability in India, as well as to generally operate the currency and credit system of the country to its advantage. **The Banking Regulation Act (1949)** empowers the RBI to regulate financial reporting of the financial sector, including banks and financial institutions**.** One of the Schedules to the Banking Regulation Act prescribes formats for general purpose financial statements (e.g. balance sheet, and profit and loss accounts) and other disclosure requirements. Banks are also required to comply with requirements of the Companies Act (1956), provided they are consistent with the Banking Regulation Act. The RBI has issued circulars requiring banks to comply with the accounting standards issued by ICAI.

Securities and Exchange Board of India

11. The Securities and Exchange Board of India (SEBI) Act protects investors and regulates the securities market. Listed companies in India are required to comply with the requirements prescribed by the SEBI in its Act of 1992 and the Securities Contracts (Regulation) Act of 1956, which provides for the regulation of securities transactions. To protect investor interests, SEBI has issued a listing agreement which specifies disclosures applicable to listed companies in addition to other applicable auditing and accounting requirements. In particular, it requires compliance with the accounting standards issued by ICAI.

The Insurance Regulatory and Development Authority (IRDA)

12. The Insurance Regulatory and Development Authority (IRDA) regulates the financial reporting practices of insurance companies under the Insurance Regulatory and Development Authority Act (1999). This Authority has been constituted to regulate, promote and ensure orderly growth of the insurance business and reinsurance business. Insurance companies and their auditors are required to comply with the requirements of the IRDA regulations of 2002 titled "*Preparation of Financial Statements and Auditor's Report of the Insurance Companies*", in preparing and presenting their financial statements and the format and content of the audit report. IRDA regulations require compliance with the accounting standards issued by ICAI.

The Institute of Chartered Accountants of India as a regulator

13. The ICAI requires its members to ensure compliance with all the accounting standards it issues while discharging their attest function. Further, the ICAI members are required to follow a detailed **Code of Ethics,** as prescribed under the Chartered Accountants Act, (1949). The ICAI Council is also entrusted with the disciplinary powers that are exercized through its Disciplinary Committee. Recently, extensive changes have been made in the Act though the Chartered Accountants (Amendment) Act, 2006, which has made the disciplinary mechanism of the ICAI more stringent.

14. The ICAI, with a view to further improving and strengthening financial reporting practices in India, has also constituted the **Financial Reporting Review Board (FRRB).** The FRRB reviews general purpose financial statements of certain selected enterprises with a view to check compliance, *inter alia*, with the accounting standards. In cases, where non-compliance is observed, an appropriate action is taken by the ICAI and/or it is referred to an appropriate authority for the action. This step definitely helps in improving the quality of financial reporting in the country.

15. ICAI's introduced a **peer review of audit firms** by establishing an 11-member Peer Review Board in March 2002. The Peer Review Board provides guidance to enhance the quality of services provided by ICAI members. In the first phase, peer review focuses on the review of firms that audit major enterprises at least once in a three-year period. The peer review does not lead to any disciplinary or regulatory mechanism. Peer review certification is either given or not given based on the findings of the review. Peer reviewers are practitioners with at least 15 years of audit experience.

16. The Chartered Accountants (Amendment) Act (2006) created a Quality Review Board (QRB) in place of the Peer Review Board; this board can make recommendations to the ICAI Council on the formulation of standards regarding the quality of services provided by the members. Further, the proposed QRB would also review the quality of services provided by the members of the ICAI, including audit services, and guide the members of the ICAI on how to improve the quality of services and adherence to the various statutory and other regulatory requirements.

Challenges involved in adoption of IFRSs and implementation issues

(A) Convergence with IFRSs in India

17. A financial reporting system supported by strong governance, high quality standards and a sound regulatory framework is key to economic development. Indeed, high quality standards of financial reporting, auditing and ethics form the foundations of the trust that investors place in financial information and therefore play an integral role in contributing to a country's economic growth and financial stability. As the forces of globalization prompt more and more countries to open their doors to foreign investment and as businesses expand across borders, both the public and private sectors are increasingly recognizing the benefits of having a commonly understood financial reporting framework, supported by strong globally accepted standards. The benefits of a global financial reporting framework are numerous and include:

- Greater comparability of financial information for investors;
- Greater willingness on the part of investors to invest across borders;
- Lower cost of capital;
- More efficient allocation of resources; and
- Higher economic growth.

18. However, before these benefits can be fully realized, there must be greater convergence to a single set of globally accepted high quality standards. International convergence is a goal that is embraced in the mission of the International Federation of Accountants (IFAC) and shared by IFAC members, international standard-setters and many national standard-setters.

19. As a member body of IFAC, India has recognized in its preface to the Statements of Accounting Standards that "ICAI, being a full-fledged member of the International Federation of Accountants (IFAC), is expected, *inter alia*, to actively promote the International Accounting Standards Board's (IASB) pronouncements in the country with a view to facilitate global harmonisation of accounting standards. Accordingly, while formulating the Accounting Standards, the ASB will give due consideration to International Accounting Standards (IASs) issued by the International Accounting Standards Committee (predecessor body to IASB) or International Financial Reporting Standards (IFRSs) issued by the IASB, as the case may be, and try to integrate them, to the extent possible, in the light of the conditions and practices prevailing in India".

20. Accordingly, the accounting standards issued by ICAI are by and large in conformity with the IFRSs. Indeed, with respect to certain recently issued/revised Indian Accounting Standards, there are no differences between the Indian Accounting Standards and the IFRSs. For example, Accounting Standard (AS) 7, *Construction Contracts*, and AS 28, *Impairment of Assets*, are identical with the corresponding IFRSs. However, in exceptional cases, when a departure from IFRS is warranted in light of Indian conditions, the major areas of differences between the two are pointed out in the appendix to the accounting standard.

21. ICAI endeavours to bridge the gap between Indian accounting standards and International Financial Reporting Standards by issuing new accounting standards and ensuring that existing Indian accounting standards reflect any changes in international thinking on various accounting issues. In this regard, it should be noted that ICAI is making a conscious effort to bring the Indian accounting standards into line with International Financial Reporting Standards by revising existing accounting standards. ICAI has so far issued 29 Indian accounting standards corresponding to IFRSs.

22. In view of the above, Indian accounting standards (ASs) are largely in step with the IFRSs. This is also recognised by the following extracts of article in an Indian financial daily (Hindu Business Line) on 5 November 2005:

> "Indian Companies can now get listed on London Stock Exchange (LSE) by reporting their financial results based on Indian Accounting Standards. Until now, these companies had to report their financial data in accordance with the International Financial Reporting Standards (IFRSs)."

This is an indication of the growing convergence of Indian accounting standards to IFRS.

(B) Challenges and Issues involved in convergence with IFRSs in India

Legal and regulatory considerations

23. In some cases, the legal and regulatory accounting requirements in India differ from the IFRSs; in such cases, strict adherence to IFRSs in India would result in various legal problems. The following examples illustrate this point:

IAS 1 – Presentation of Financial Statements

24. In India, laws governing companies (e.g. the Companies Act of 1956), banking enterprises (e.g. the Banking Regulation Act of 1949) and insurance enterprises (Formats of financial statements for insurance companies as prescribed by IRDA regulations in the document "*Preparation of Financial Statements and Auditor's Report of the Insurance Companies*" (2002), prescribes detailed formats for financial statements to be followed by respective enterprises. At this stage lawmakers/ regulators may not be willing to accept IAS 1 in its present form and change the existing law. Therefore, full adoption of IAS 1 may not be possible at this stage. However, it is proposed that the corresponding accounting standard being developed by ICAI, would have an Appendix containing suggested detailed formats of financial statements which, while complying with IAS 1, would also contain other disclosures prescribed in the formats laid down by various legislations to address the concerns of the legislature.

IAS 21 – The Effects of Changes in Foreign Exchange Rates

25. If IAS 21 is adopted in India it would result in violation of Schedule VI to the Companies Act of 1956. Schedule VI requires foreign currency fluctuations in respect of foreign currency loans raised to acquiring foreign assets to be reflected in the cost of the fixed assets, whereas IAS 21 requires the same to be charged to the profit and loss account. The corresponding Indian accounting standard prescribes the accounting treatment contained in IAS 21. However, through a separate Announcement issued by the ICAI, it is recognized that law will prevail.

IAS 34 – Interim Financial Reporting

26. The disclosures requirements of IAS 34 are not in accordance with the formats of unaudited quarterly/ half-yearly results prescribed in the listing agreement issued by the Securities and Exchange Board of India. The corresponding Indian standard prescribes disclosure as per IAS 34, but also recognizes that the law will prevail insofar as presentation and disclosure requirements are concerned.

Alternative Treatments

27. The IFRS allow alternative treatments a number of cases. The implications of adopting IFRS as they are would be that it would lead to presentation of incomparable financial information by various enterprises. The following examples illustrate this aspect:

IAS 23 – Borrowing Costs

28. IAS 23, *Borrowing Costs*, prescribes expensing of the borrowing costs as the benchmark treatment. However, it also allows capitalization of borrowing costs as an allowed alternative. If this standard is followed as it is, some enterprises would then charge borrowing costs to the profit and loss account, while others will capitalize these costs as part of the cost of the assets acquired/constructed using the borrowings. However, in India, the corresponding AS 16 does not allow any alternative and borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset are to be capitalized. However, IASB has issued an exposure draft of proposed amendments to IAS 23 in May 2006, in which it has decided to eliminate the option of immediate recognition of the borrowings costs as an expense and to allow only capitalization of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of the assets. Thus, once this exposure draft is finalized, no difference would remain between AS 16 and IAS 23.

IAS 19 – Employee Benefits

29. IAS 19 allows the following options with regard to the treatment of actuarial gains and losses:
    - Immediate recognition in the profit and loss account in the year in which such gains and losses occur; or

- adjust against the retained earnings, whereby the current year's profit and loss account is not affected at all; or
- recognize a part of the actuarial gains and losses in the profit and loss account which exceeds the specified percentage (known as the 'corridor approach').

30. The corresponding Indian AS 15, *Employee Benefits*, however, requires only the first alternative, i.e. immediate recognition in the profit and loss account.

31. The above examples are only some of the examples that could be presented. To facilitate comparability, it is imperative that there should be no options in the accounting standards, otherwise the investors and other users of financial statements cannot take decisions based on comparable information. Indian accounting standards do not ordinarily permit any option, but prescribe one of the most appropriate options permitted by the corresponding IAS/IFRS.

32. IASB recently issued the '*Statement of Best Practice: Working Relationships between the IASB and other Accounting Standard-Setters'*, which states that removing optional treatments does not mean any non-compliance with IFRSs.

Economic Environment

33. The economic environment and trade customs and practices prevailing in India, may in a few cases not be conducive for adoption of an approach prescribed in an IFRS. For example, in a country whose markets do not have adequate depth and breadth for reliable determination of fair values, it may not be advisable to follow a fair value-based approach prescribed in certain IFRSs. Certain IASs/IFRSs assume an economic environment with mature markets. For example, *IAS 41*, *Agriculture*, is based on the fair value approach presuming that fair values are available for various biological assets such as plants, crops and living animals. The standard is relevant only if the fair values are reliable, this may not be true in India as, in some instances, the market data may not be reliable in view of markets not being mature enough.

34. Conceptually, ICAI is in agreement with the fair value approach followed in various IFRSs. However, there is always the risk of misuse of this approach as happened in the case of Enron. ICAI has so far been cautious in adopting the fair value approach in its accounting standards, although certain accounting standards recognize this approach, (for example, *AS 28*, *Impairment of Assets*), and ICAI has decided to follow this approach in its proposed Accounting Standard on *Financial Instruments: Recognition and Measurement* corresponding to IAS 39.

Level of Preparedness

35. In a few cases, the adoption of IFRSs may cause hardship to the industry. To avoid the hardship, some companies have gone to the court to challenge the standard, for example:

- When ICAI issued AS 19 on *Leases*, which is based on the corresponding IAS, leasing companies are of the view that it may cause hardship to them. To avoid this, the Association of Leasing Companies approached the Court to context the standard.
- When ICAI issued AS 22 on *Accounting for Taxes on Income* to introduce the international concept of deferred taxes in India for the first time, a number of companies challenged AS 22 in courts as they were concerned about the effect AS 22 may have on their bottom lines.

36. In view of the above, to avoid hardship in some genuine cases, the ICAI has deviated from corresponding IFRS for a limited period till the preparedness is achieved.

37. Besides the above technical differences, there are a few conceptual differences between Indian accounting standards and the IFRSs. For example, IAS 37 deals with ‘constructive obligation’ in the context of creation of a provision. The effect of recognizing provision on the basis of constructive obligation is that, in some cases, provision will be required to be recognized at an early stage. For instance, in case of a restructuring, a constructive obligation arises when an enterprise has a detailed formal plan for the restructuring and the enterprise has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it. It is felt that merely on the basis of a detailed formal plan and announcement thereof, it would not be appropriate to recognize a provision since a liability cannot be considered to be crystallized at this stage. Furthermore, the judgment whether the management has raised valid expectations in those affected may be a matter of considerable argument. In view of this, the corresponding Indian accounting standard, i.e. AS 29, does not specifically deal with ‘constructive obligation’. AS 29, however, requires a provision to be created in respect of obligations arising from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. In such cases, general criteria for recognition of provision are required to be applied. The treatment prescribed in AS 29 is also in consonance with the legal requirements in India.

Frequency, Volume and Complexity of Changes to the International Financial Reporting Standards

38. It has clearly been a very challenging time for preparers, auditors and users of financial statements, following the publication of new and revised IFRSs. The following evidences the frequency, volume and complexity of the changes to the international standards:

- The IASB’s Improvements Project resulted in 13 standards being amended, as well as consequential amendments to many others. In India, a project to examine of IAS revisions, pursuant to IASB’s improvement project, has been launched to determine whether corresponding Indian accounting standards need revision.

- Repeated changes of the same standards, including changes reversing IASB's previous stands and changes for the purpose of international convergence.

- Complex changes on accounting standards, such as those on Financial Instruments, Impairment of Assets and Employee Benefits require upgrading of skills of those professionals who implement them, in order to keep up with the changes.

Challenges for small and medium-sized entities and accounting firms

39. In emerging economies like India, a significant part of the economic activities is carried on by small- and medium-sized entities (SMEs). Such entities face problems in implementing the accounting standards because of:

    - Scarcity of resources and expertise with the SMEs; and the
    - Cost of compliance is not commensurate with the expected benefits.

40. In order to address the issues of applicability of accounting standards to SMEs, ICAI has provided certain exemptions/ relaxations to such companies. For the purpose of applicability of Accounting Standards, enterprises are classified into three categories: Level I, Level II and Level III. Level I enterprises are large and publicly accountable entities. Level II enterprises are medium-sized enterprises; and Level III are small enterprises. Level II and Level III enterprises are considered as SMEs**.** Level I enterprises are required to comply fully with all the accounting standards issued by the ICAI. The relaxations/exemptions are provided to Level II and Level III enterprises from accounting standards. Level II and Level III enterprises are fully exempted from certain accounting standards which primarily lay down disclosure requirements such as AS 3, *Cash Flow Statements*, AS 17, *Segment Reporting*, AS 18, *Related Party Disclosures* and AS 24, *Discontinuing Operations*. In respect of certain other accounting standards, which also lay down disclosure requirements, Level II and Level III enterprises are exempted from some of its disclosure requirements such as AS 19, *Leases*, AS 20, *Earnings Per Share* and AS 29, *Provisions, Contingent Liabilities and Contingent Assets*. Generally, the ICAI does not favour exemptions to be given in respect of recognition and measurement requirements. However, considering rigorous measurement requirements in AS 15 (revised 2005), *Employee Benefits* and AS 28, *Impairment of Assets,* simplified measurement approaches have been allowed to the SMEs.

III. Capacity-Building

41. The pace at which accounting standards have recently been issued and mandated in India is posing various accounting problems and has serious business consequences. Building the capacity of the preparers and the auditors is therefore a stiff challenge to the accounting profession. To enhance capacity-building and to ensure effective implementation of accounting standards, the Institute of Chartered Accountants has acted proactively by taking the following steps:

(a) Issuing accounting standards interpretations on matters related to accounting standards. With a view to resolve various intricate interpretational issues arising in the implementation of new accounting standards that have already been issued, the ICAI has issued thirty accounting standards interpretations.

(b) Issuance of background materials on accounting standards: To facilitate discussion at seminars, workshops, etc., ICAI has issued background material on newly-issued accounting standards. The background material deals, *inter alia*, with the key requirements of the accounting standards with examples and Frequently Asked Questions (FAQs), which accountants and auditors may encounter in the application of accounting standards.

(c) Issuance of guidance notes on accounting matters: ICAI has issued various Guidance Notes in order to provide immediate guidance on accounting issues arising due to issuance of new accounting standards and to provide immediate guidance on new accounting issues arising due to changes in legal or economic environment and/or other developments,. These guidance notes form an important part of the generally accepted accounting principles in India and need to be referred to on a regular basis by people involved in the preparation and presentation of financial statements, as well as by people involved in auditing these statements.

(d) Organizing seminars and workshops: ICAI has always been striving for excellence in terms of standards of professional services rendered by its members. To enable members to maintain high standards of professional services, ICAI is providing inputs to members by way of seminars, workshops and lectures.

(e) Responding to various queries raised by members: While performing their attest function members of the institute are often posed with certain tricky situations, particularly as they apply accounting standards to the specific situations of an enterprise, where an authentic view is required. For the purpose of assisting its members, the Institute's Council formed the Expert Advisory Committee to answer queries from the members of the Institute. The Committee deals with the queries on accounting and/or auditing principles and related matters.

Auditing issues involved in implementation of accounting standards

42. Independent auditors play a vital role in enhancing the reliability of financial information produced by companies, not-for-profit organizations, government agencies and other entities by providing assurance on the reliability of the financial statements. As mentioned above, the ICAI members are required to ensure compliance with the ICAI accounting Standards issued by the ICAI while performing their attest function under certain legislations such as the Companies Act (1956), as well as by the ICAI itself.

43. The ICAI has established an Auditing and Assurance Standards Board (AASB) that formulates standards that are broadly in line with International Auditing Standards issued by the IAASB. In general the AAS text is based on the text of the equivalent ISA. Certain

modifications are introduced into the AAS in order to adapt them to local circumstances when considered necessary.

Examples of audit issues arising as a consequence of adaption of an IAS/IFRS

44. Some of the major issues that may have an impact upon the work of auditors in India in implementation of Indian accounting standards that have been formulated on the basis of the corresponding IAS/IFRS are as below:

45. **IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors:** IAS 8 provides that financial statements do not comply with the IFRS if they contain immaterial errors that were deliberately included to achieve a particular presentation of an entity's financial position, financial performance or cash flows. The ASB of ICAI has also prepared the preliminary draft of the revised AS 5, corresponding to IAS 8. In the draft, the ASB has decided that since the above accounting treatment is conceptually correct, it should be adopted in AS 5 also. However, the ASB also feels that this requirement would be too onerous on the auditors since it would be difficult for the auditor to determine as to whether the errors had been intentionally made or not and that he may ignore such errors on the grounds of materiality. The ASB has, therefore, decided that once the standard is finalized, it may request the AASB of ICAI to look into the matter and provide necessary guidance.

46. **IAS 19 - Employee Benefits:** IAS 19 also deals with measurement of defined benefit plans which is complex as compared to measurement of defined contribution plans since actuarial assumptions are required to measure the obligation and the expense and there is a possibility of actuarial gains and losses. The ICAI has recently issued the revised AS 15, *Employee Benefits*, on the lines of IAS 19, including recognizing the role of a professional actuary. An auditing issue may arise about the extent of reliance that an auditor may place on the actuary's report, particularly in view of extensive disclosure requirements prescribed in the standard.

47. To effectively address the problem, ICAI has requested the Actuarial Society of India (ASI) to revise its guidance note on the subject, so that the actuary's report contains the relevant information as envisaged in the accounting standard, in order to guide actuaries, as has been done in certain other countries such as the United Kingdom. In any case, the responsibility of the auditor will continue to be determined under Auditing and Assurance Standard (AAS) 9, *Using the Work of an Expert*, which provides guidance on auditor's responsibility in relation to, and the procedures the auditor should consider in, using the work of an expert, such as an actuary, as audit evidence.

48. IAS 27 - Consolidated and Separate Financial Statements: In accordance with IAS 27, a parent enterprise shall present consolidated financial statements in which it consolidates its investments in subsidiaries. Along the lines of IAS 27, IAS 21, *Consolidated Financial Statements* provides that a parent which presents consolidated financial statements should consolidate all domestic as well as foreign subsidiaries.

49. It is possible that the auditor of the parent enterprise is not the auditor of its subsidiary enterprises. Furthermore, the auditor of the consolidated financial statements may not necessarily be the auditor of the separate financial statements of the parent company, or one or more of the components included in the consolidated financial statements.

However, a law or regulation governing the enterprise may require the consolidated financial statements to be audited by the statutory auditor of the enterprise. In such cases, the auditor will face the issues of reliability on the work performed by the other auditors. In India, the listing agreement requires financial statements to be audited apart from the audit of separate financial statements under the Companies Act (1956). ICAI recently issued a *Guidance Note on Audit of Consolidated Financial Statements,* which provides detailed guidance on the specific issues and audit procedures to be applied in an audit of consolidated financial statements.

50. ***Fair Value Issues:*** Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. As mentioned in section 4 (*Challenges involved in adoption of IFRSs and implementation issues*), the economic environment in India may not be conducive for adoption of the fair value approach prescribed in various IFRSs. ICAI agrees on a conceptual level with this approach – it has used it in AS 28, *Impairment of Assets,* and has also decided to follow it in its proposed AS on *Financial Instruments: Recognition and Measurement,* corresponding to IAS 39 – but an auditor might face difficulties in satisfying himself that the fair values computed are reliable.

51. Although, the International Federation of Accountants (IFAC) has recently issued a new International Standard on Auditing (ISA) '*Auditing Fair Value Measurements and Disclosures*' to address the increasing number of complex accounting pronouncements containing measurement and disclosure provisions based on fair value, it still remains to be seen whether this ISA, in the Indian context, adequately addresses the auditing issues needs to be examined.

IV. Lessons learned

52. Convergence of accounting standards in all countries, including India, is duly recognized as the future of global accounting standards. In the past, different views of the role of financial reporting made it difficult to encourage convergence of accounting standards, but there now appears to be a growing international consensus that financial reporting should provide high quality financial information that is comparable, consistent and transparent, in order to serve the needs of investors. Convergence is possible in two ways, i.e. either by adopting or adapting a standard. As discussed in earlier sections, IAS and IFRS in India are being adapted while keeping in view the legal and other conditions prevailing in India. The major lessons learned during such adaption are:

53. ***1. Implementation of certain requirements of IFRSs should be a gradual process:*** India has learned that adapting IFRSs is not just an accounting exercise. It is a transition that requires that everyone concerned has to learn a new language and new way of working. While formulating accounting standards on the basis of IFRSs, one should consider the fact that, in certain cases, it may cause undue hardship to the industry, at least to begin with. In other words, Indian industry may not be prepared to apply the provisions of the standards immediately and some transitionary measures are needed to be introduced for them. For example, in the following cases, India has decided to implement Accounting Standards prepared on the basis of IFRSs gradually:

(i) AS 10 (revised) - Tangible Fixed Assets: This Standard is being revised on the basis of IAS 16. IAS 16 follows the components approach in accounting for property, plant and equipment. Under this approach, each part of a tangible fixed asset with a cost that is significant in relation to its total cost is depreciated separately. AS 10 (revised) also recognizes the components approach. However, it does not at present require full adoption of the said approach on the lines of IAS 16. Doing so may require an enterprise to segregate one asset into several parts, which may not be practicable in certain circumstances, at least to begin with. It is therefore proposed that the components approach may be followed as an option until the industry is ready. ICAI also proposes to discuss the matter with IASB to explore the possibility of providing guidance on the extent an asset can be divided into different components.

(ii) AS 15 - Employee Benefits (revised 2005): In respect of termination benefits, the revised AS 15 (2005), considering that industry in India is currently passing through a restructuring phase, specifically contains a transitional provision stating that where an enterprise incurs expenditure on termination benefits on or before 31^{s} March 2009, it may choose to follow the accounting policy of deferring such expenditure over its pay-back period. However, the expenditure so deferred cannot be carried forward to accounting periods commencing on or after 1 April 2010. IAS 19 does not provide such a transitional provision. In India, these are given keeping in view the interests of the industry at large.

(iii) AS 22 - Accounting for Taxes on Income: ICAI issued AS 22 in 2001 to introduce the international concept of deferred taxes in India for the first time. A number of companies challenged AS 22 in the courts primarily because it affects their bottom line and the retained earnings particularly in the year in which the standard is introduced. It is an important lesson as it is a new concept which has been met with widespread acceptance as companies are prepared to go to the courts to obtain relief; such standards should be therefore introduced gradually so that their impact may be softened. The legal cases pertaining to AS 22 are still pending in the court.

2. Lessons learned in addressing differences in the accounting treatment prescribed in IFRSs and law: As a standard-setter, ICAI has learned a lesson that where the conceptually superior accounting treatments prescribed in various IFRS are in conflict with the corresponding legal requirements, there are various ways to deal with it, including the following:

(i) Change the accounting requirements as per the law: This approach has generally been followed in some of the earlier ICAI accounting standards. The disadvantage of this approach is that the correct accounting treatment does not even get recognised in the Country. Furthermore, if this approach is followed it becomes difficult to persuade legal authorities to change the law subsequently on the basis of the conceptually superior accounting treatment prescribed in an IFRS. In view of this, this approach has not normally been followed in recent accounting standards and is followed sparingly when the legal position is so well entrenched that giving a different accounting treatment in a standard is considered totally unacceptable. Increasingly, the approach proposed in the paragraph (ii) below is currently being adopted.

(ii) Where the accounting treatment is conceptually superior in an IFRS compared to the treatment prescribed in a law, the standard lays down the approach recommended by the IFRS, while recognizing that until a change is made in the relevant legal requirements, the law will prevail. The advantage of this approach is that while the correct accounting treatment gets recognized in an accounting standard in the country, it also gets recognized that a change in law is imperative. For example, in the recently issued exposure draft of the proposed Accounting Standard on *Financial Instruments: Presentation*, while the exposure draft recognizes that certain financial instruments such as preference shares should be classified as equities or liabilities depending upon their substance, it is also recognized that until Schedule VI to the Companies Act (1956), which lays down the presentation and disclosure requirements for the companies, and accordingly requires that the preference shares to be classified as equity, will have to be followed by the companies until Schedule VI is amended.

3. Guidance needs to be provided in various cases for effective implementation of Accounting Standards: Adequate guidance needs to be provided for effective implementation of the accounting standards. In some cases, where accounting standards require management of the enterprises concerned to use judgement in making accounting estimates etc.; however, various issues arise in the actual implementation. To address those issues, ICAI has issued Accounting Standards Interpretations (ASIs), guidance notes and other explanatory material. For example, AS 16, *Borrowing Costs*, corresponding to IAS 23, defines the term ‘qualifying asset’ as “an asset that necessarily takes a substantial period of time to get ready for its intended use or sale”. The issue as to what constitutes ‘substantial period of time’ has been addressed by issuance of ASI 1, *Substantial Period of Time*.

Further, ICAI has also undertaken various projects for providing guidance on accounting matters arising from issuance of a new accounting standard, e.g., it has recently undertaken the project for preparation of a Guide on the manner of estimating future cash flows and discount rates in the context of AS 28, *Impairment of Assets*.

4. Capacity-Building required before issuance of some of the newer accounting standards or revision of accounting standards corresponding to IFRS:
Nowadays, with the issuance of newer accounting standards or revision of existing ones on the basis of IFRSs, various new concepts are being introduced in India for which the preparers as well as the auditors need to be adequately trained by organizing workshops, conducting seminars, etc. It is being increasingly realized that the preparers and auditors should be given training even before final issuance of a new standard, i.e. at the exposure draft stage itself, so that when the standard is finally issued, they are ready to effectively implement the standard.

V. Conclusion

54. Irrespective of various challenges, adoption of IFRSs in India has significantly changed the contents of corporate financial statements as a result of:
    - more refined measurements of performance and state of affairs, and
    - enhanced disclosures leading to greater transparency.

55. With the rapid liberalization process experienced in India over the past decade, there is now a huge presence of multinational enterprises in the country. Furthermore, Indian companies are also investing in foreign markets. This has generated an interest in Indian GAAPs by all concerned. In this context, the role of Indian accounting standards, which

are becoming closer to IFRSs, have assumed a great significance from the point of view of global financial reporting.

56. Indian companies using the Indian accounting standards are experiencing fewer difficulties accessing international financial markets, as Indian accounting standards are becoming closer to the IFRSs. Indian standards are expected to converge even further in the future, especially after the challenges mentioned in study are addressed over the next few years.

Appendix A: Comparative Statement of International Accounting Standards/ International Financial Reporting Standards and Indian Accounting Standards

(As on June 8, 2006)

I. Indian Accounting Standards already issued by the Institute of Chartered Accountants of India (ICAI) corresponding to the International Accounting Standards/ International Financial Reporting Standards

S. No	International Accounting Standards (IASs) / International Financial Reporting Standards (IFRSs)[1]		Indian Accounting Standards (ASs)	
	No.	Title of the Standard	AS No.	Title of the Standard
1.	IAS 1	Presentation of Financial Statements	AS 1	Disclosure of Accounting Policies[2]
2.	IAS 2	Inventories	AS 2	Valuation of Inventories
3.		Corresponding IAS has been withdrawn since the matter is now covered by IAS 16 and IAS 38	AS 6	Depreciation Accounting[3]
4.	IAS 7	Cash Flow Statements	AS 3	Cash Flow Statements
5.	IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors	AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies[2]
6.	IAS 10	Events After the Balance Sheet Date	AS 4	Contingencies and Events Occurring after the Balance Sheet Date[2]
7.	IAS 11	Construction Contracts	AS 7	Construction Contracts
8.	IAS 12	Income Taxes	AS 22	Accounting for Taxes on Income
9.	IAS 14	Segment Reporting	AS 17	Segment Reporting

[1] It may be noted that International Accounting Standards nos. 3, 4, 5, 6, 9, 13, 15, 22, 25, 30 and 35 have already been withdrawn by the International Accounting Standards Board (IASB).
[2] Under revision.
[3] It may be noted that AS 10, Accounting for Fixed Assets, is presently under revision to bring it in line with the corresponding IAS 16. After the issuance of the revised AS 10, AS 6 is proposed to be withdrawn.

10.	IAS 16	Property, Plant and Equipment	AS 10	Accounting for Fixed Assets[2]
11.	IAS 17	Leases	AS 19	Leases
12.	IAS 18	Revenue	AS 9	Revenue Recognition[2]
13.	IAS 19	Employee Benefits	AS 15	Employee Benefits
14.	IAS 20	Accounting for Government Grants and Disclosure of Government Assistance	AS 12	Accounting for Government Grants[2]
15.	IAS 21	The Effects of Changes in Foreign Exchange Rates	AS 11	The Effects of Changes in Foreign Exchange Rates
16.	IAS 23	Borrowing Costs	AS 16	Borrowing Costs
17.	IAS 24	Related Party Disclosures	AS 18	Related Party Disclosures
18.	IAS 27	Consolidated and Separate Financial Statements	AS 21	Consolidated Financial Statements
19.	IAS 28	Investments in Associates	AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
20.	IAS 31	Interests in Joint Ventures	AS 27	Financial Reporting of Interests in Joint Ventures
21.	IAS 33	Earnings Per Share	AS 20	Earnings Per Share
22.	IAS 34	Interim Financial Reporting	AS 25	Interim Financial Reporting
23.	IAS 36	Impairment of Assets	AS 28	Impairment of Assets
24.	IAS 37	Provisions, Contingent Liabilities and Contingent Assets	AS 29	Provisions, Contingent Liabilities and Contingent Assets

25.	IAS 38	Intangible Assets	AS 26	Intangible Assets
26.		Corresponding IAS has been withdrawn since the matter is now covered by IAS 32, 39, 40 and IFRS 7	AS 13	Accounting for Investments[4]
27.	IAS 40	Investment Property	-	Dealt with by Accounting Standard 13[5]
28.	IFRS 3	Business Combinations	AS 14	Accounting for Amalgamations[6]
29.	IFRS 5	Non-current Assets Held for Sale and Discontinued Operations	AS 24	Discontinuing Operations.[7] Further, AS 10 deals with accounting for fixed assets retired from active use.

II. International Accounting Standards/ International Financial Reporting Standards not considered relevant for issuance of Accounting Standards by the ICAI for the reasons indicated.

S. No.	**International Accounting Standards/ International Financial Reporting Standard**		
	No.	**Title of the Standard**	**Reasons**
1.	IAS 29	Financial Reporting in Hyper-inflationary Economies	The Institute notes that the hyper-inflationary conditions do not prevail in India. Accordingly, the subject is not considered relevant in the Indian context.
2.	IFRS1	First-time Adoption of International Financial Reporting Standards	In India, Indian ASs are being adopted since last many years and IFRSs are not being adopted for the first time. Therefore, the IFRS 1 is not relevant to India at present.

[4] Indian Accounting Standard on *Financial Instruments: Recognition and Measurement* is presently under preparation. After the issuance of this Indian AS, AS 13 is proposed to be withdrawn.
[5] Indian Accounting Standard corresponding to IAS 40 is also under preparation.
[6] Under revision.
[7] IASB recently issued IFRS 5 and withdrew IAS 35, Discontinuing Operations, on which AS 24 is based. An Indian Accounting Standard corresponding to IFRS 5 is under preparation. After the issuance of this Indian AS, AS 24 is proposed to be withdrawn.

III. Accounting Standards presently under preparation corresponding to the International Accounting Standards/ International Financial Reporting Standards

S. No	International Accounting Standards/ International Financial Reporting Standards		
	No.	Title of the Standard	Status
1.	IAS 26	Accounting and Reporting by Retirement Benefit Plans	Under Preparation.
2.	IAS 32	Financial Instruments: Presentation	Under Preparation. Exposure Draft issued.
3.	IAS 39	Financial Instruments: Recognition and Measurement	Under Preparation.
4.	IAS 41	Agriculture	Under preparation.
5.	IFRS 2	Share-based Payment	Under preparation. At present, Employee-share based Payments, are covered by a Guidance Note issued by the ICAI, which is based on IFRS 2. Further, some other pronouncements deal with other share-based payments, e.g., AS 10, Accounting for Fixed Assets.
6.	IFRS 4	Insurance Contracts	Under preparation.
7.	IFRS 7	Financial Instruments: Disclosures	Under preparation.

IV. Guidance Notes issued by the Institute of Chartered Accountants of India (ICAI) corresponding to the International Accounting Standards/ International Financial Reporting Standards

S. No	International Accounting Standards/ International Financial Reporting Standards (IFRSs)		Title of the Guidance Note
	No.	Title of the Standard	
1.	IFRS 6	Exploration for and Evaluation of Mineral Resources	Guidance Note on Accounting for Oil and Gas Producing Activities

Reconciliation of the International Accounting Standards/ International Financial Reporting Standards with the Indian Accounting Standards (As on June 8, 2006)

A) International Accounting Standards/ International Financial Reporting Standards issued by the International Accounting Standards Board

Number of International Accounting Standards (IASs) issued by the International Accounting Standards Board	41
Number of International Financial Reporting Standards issued by the IASB	7
Less: Number of IASs since withdrawn	(11)
Add: IAS 4 has been withdrawn, but, included here for reconciliation purposes because corresponding Accounting Standard of the ICAI (i.e. AS 6) is still in force	1
	38

B) Accounting Standards (ASs) and other documents issued by the Institute of Chartered Accountants of India

1.	Number of Indian Accounting Standards issued (excluding AS 8 which is withdrawn pursuant to AS 26 becoming mandatory)	28
2.	IAS/IFRS not relevant in the Indian context	2
3.	Guidance Note issued by the ICAI[8]	1
4.	Number of Accounting Standards under preparation	7
		38

[8] Corresponding to IFRS 6 (effective 2006), Exploration for and Evaluation of Mineral Resources, Guidance Note of the ICAI titled 'Accounting for Oil and Gas Producing Activities', has been issued.