INVESTMENTS

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< EXECUTIVE SUMMARY >

◆ International Accounting Standards Committee (IASC) has recognized the growing need to recognize certain financial assets and liabilities (such as derivatives), which were hitherto not recognized in the financial statements. further it also felt that wide range of alternative methods of measurement such as cost, cost or market value or fair value, were available under the then existing IAS 25. Accounting for Investments and these options need to be harmonized to afford comparability of financial statements across the border.

Members and users of accountancy profession were also concerned about the limitation of lower of cost or market value basis. Even though this concept ensures fundamental principle of prudency but it fails to recognize the tangible and apparent improvement or account of economic events.

In an attempt to iron out the concerns of accounting profession, IASC promulgated IAS 39-Financial Instruments-Recognition and Measurement.

Author has analysed IAS 39 as well as Indian Accounting Standards to instigate a healthy debate on this topic. a comparative position in reference to FAS 115 issued by FASB of USA is also discussed in this article.

Changing business trends, perceptions and the expectations of investors had in recent past made the recognition, measurement and disclosure of investments in debt and equity securities in the financial statements a widely debated topic in the accounting profession. Under the International Accounting Standards ("IAS") measurement and recognition was dealt by IAS 25 Accounting for Investments till 31 December 2000. With effect from 1 January 2001 this was replaced (to the extent it relates to investments in equity and debt securities) by IAS 39 Financial Instruments: Recognition and Measurement. The promulgation of IAS 39 has almost taken 12 years of endless debate and discussion among the standard setters and the interested parties.

In comparison the recognition and measurement of investments in India is dealt by Accounting Standard ("AS") 13 Accounting for Investments and Guidance note on Accounting for Investments in the financial statements of Mutual Funds. AS 13 is in operation from 1995 and the Guidance note was issued in 2000.

In this article analysis of these standards and Guidance note is made, to the extent it relates to investments in equity and debt securities, to assess if these practices prescribed in India per the above authoritative

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documents are in line with global practices or the changing trends in the profession of audit and accountancy in India and elsewhere. The purpose is to relook at these documents and identify areas of improvement to initiate a healthy debate among the profession. I am pushed to review these sets of documents due to my basic Indian professional qualification and experience in the application of the International Accounting Standards.

The observations made may not be comprehensive and may not be relevant in certain circumstances. But the attempt is to trigger a healthy debate, which may be useful to the standard setters in India and the accounting profession.

BACKGROUND OF IAS 39

Before going further into the debate it may be useful to the readers if a brief background is provided with the evolution and promulgation of IAS 39. The International Accounting Standards Committee (IASC) in formulating the guiding principles, which gave rise to IAS 39, had recognised the growing need to recognise certain financial assets and liabilities (such as derivatives), which were hitherto not recognised in the financial statements. Further it was also felt that wide range of alternative methods of measurement such as cost, cost or market value or fair value, available under the existing international standards (IAS 25 before its replacement) needs to be harmonised to afford comparability of financial statements across the border. The growing concerns among the accounting profession of the limitation of the concept of lower of cost or market value basis has also received due weightage. The concept of lower of cost or market value in the valuation of investments ensures the fundamental principle of prudency. But fails to recognise the tangible and apparent improvement on account of economic events. These views received a fair degree of acceptance from the standard setters. Thus the exposure drafts and the discussion papers proceeded on the assumption of measuring all the financial assets and liabilities at fair value. However, it did receive certain resistance to the application of fair value measurement to all the assets and liabilities and to all the industries. As an interim measure it was decided by the IASC to issue an interim Accounting Standard which would setforth fair value measurement as principle basis of measurement except under certain circumstances. IASC decided to work with all the member national standard setters to seek to minimise and harmomise the differences.

IAS 39 is the result of such measure and would be replaced in course of time by a comprehensive standard after ironing all the differences among the member nations. However, the direction is clear - extensive use of fair value to measure the financial assets and liabilities.

CLASSIFICATION

For the first time the IAS 39 recommended a classification based on the nature and intent for which the instrument is held. The sub classification based on the period or term of the instrument as current or non-current follows thereafter. The identification of financial assets and liabilities into broad groups is essential since the method or the principles of measurement or valuation depend on such classification. The definition of financial instrument under IAS 39 is broad enough and encompasses investments in equity and debt instruments, which are the subject matter of this discussion. Financial assets are categorised as held for trading, investments held to maturity, loans and receivables originated by the enterprise and available for sale.

Held for trading investments include investments which are acquired for generating a profit from short-term fluctuations of price. Investments held for trading are by their nature current assets. Held to maturity investments represents investments that an enterprise has the intent and ability to hold to maturity. These are classified as current and non-current based on the period of their maturity as current and non-current.

Loans and receivables originated by the enterprise are financial assets that are created by the enterprise by providing money, goods or services directly to a debtor. They are principally current but under certain circumstances can also be classified as non-current based on the terms of their settlement.

Any other financial instrument, which does not fall under any of the classifications referred above, is called available for sale investments. These are classified as current and non-current based on their intention to sell.

MEASUREMENT

All the financial assets are initially recognised at cost including transaction cost, which is fair value of the instrument as on the date of the purchase or acquisition. Subsequent measurement is as follows

Classification	MEASUREMENT
Trading investments	All the trading investments are measured at fair value at the balance sheet date, which generally is market rate for a quoted investments. The resultant fair value gains/ losses are taken to the income statement.
Held to maturity	At amortised cost
Loans and receivables originated by the enterprise	At amortised cost
Available for sale	Option (a): At fair value - with the resultant gain/ loss being reflected in income statement. Option (b): At fair value with fair value gain/loss being reflected in the equity till the investment is either impaired or disposed off when the accumulated fair differences are transferred to income statement.

Amortised cost: Generally refers to the discount or premium on the purchase of a debt instrument, which is written off over the remaining period of instrument. The amortised cost in the case of a debenture with a face value of Rs 100 bought for Rs 90 is as follows

Original cost Rs 90. Repayment at the end of debt period Rs 100. Term of the instrument say 5 years

Amortised cost at the end of the first year	
Original cost	Rs 90
Add: Discount	2
(Credited to income)	
Year-end value of the instrument	Rs 92.

The treatment of gains or losses on available for sale investments as one option allows them to be reflected in the income statement. The second provides a more interesting reading. The gains or losses can be continued to be included in the equity (say a fair value reserve) till such time they are either sold or impaired. This method of measuring the investments was done with the intention of conforming to both the principles such as prudency- by taking the losses as soon as an investments is impaired and measuring the investments at fair value.

APPLICABLE US STANDARD

Federal Accounting Standards Board FAS 115 of USA deals with-investments in debt and equity securities. The investments in debt and equity instruments are classified in the identical manner as described above in relation to IAS 39 except to the extent that originated loans and receivable are dealt separately in a separate standard. The measurement of the investments as per this standard is as follows

CLASSIFI-CATION	MEASUREMENT
Trading investments	All the trading investments are measured at fair value at the balance sheet date, which generally is market rate for a quoted investments. The resultant fair value gains/losses are taken to the earnings.
Held to maturity	At amortised cost
Available for sale	At fair value. Unrealised gains and losses excluded from earnings and shown as a separate component of equity.

The difference as compared to IAS 39 as can be observed from the above is that IAS 39 gives a one time option to the enterprise in respect of available for sale investments to choose to reflect the fair value gains or losses in the income statement or, as part of equity till

such time they are sold or impaired. However, under FAS 1 15 there is no such option as all the gains or losses have to be reflected in the equity. This flows from the principle of not to include in the earnings the profits/gains or loss or diminution which are unrealised and whose realisation in the short term are unlikely to happen. However, it also fails to lay principles for recognition of a genuine impairment or diminution in the value of available for sale investments.

With the above international practices in the background I will now examine the accounting standard 13 and the Guidance note referred above.

It may be inappropriate to compare AS 13 recognition and measurement principles against the International and US standards in view of the fact that the later incorporated the latest changes in the perceptions of thinking in recent years. However, it be appropriate time to the profession in India to focus at the background which has given rise to these changes to the International and US standards. It may be ideal at this juncture to also take stock of the relevance of the concept of lower of cost or market value in measuring the current investments and at cost the long-term investments. Further, it is also time to reconsideration the basis of classification as current and non- current without giving adequate weightage to the industry considerations and intention and purpose of such investments. A healthy debate in India among all the interested parties with the background of the circumstances, which contributed to the changes in the international standards coupled with Indian perception of the required modification, may bring in a matured Indian Accounting Standard on financial instruments. Relevance of fair value measurement may have to be incorporated into the Indian standards with great care after taking into consideration of the views of various interested parties and specific industry considerations. By the time IASC is ready to issue a comprehensive standard in place of IAS 39, Indian standard setters and the apex body should be ready with their understanding of the relevance of the concept of fair value in the measurement of investments and their proposed treatment and presentation in the financial statements.

The Guidance Note on investments referred above was more recent and does take into consideration certain developments, which resulted in the changes to international standards. However, the Guidance Note was formulated more in lines with Securities and Exchange Board of India (Mutual Funds) Regulation, 1996. The investments held by these Mutual Funds, do not require any classification either as current or long term or trading or available for sale. The investments held by Mutual Funds are based on their strategic investment decisions and are expected to meet the objective of the fund either to provide constant rate of return on the investment or give long term appreciation. Total funds of the Mutual Funds are invested in different debt and equity securities to meet this objective. Since the SEBI Regulation or the Guidance Note does not require classification of investments the subsequent measurement principles laid out do not take these into consideration. The principles of measurement prescribed to the Funds, which takes into consideration the nature and intent of the investments may result in a better representative value of the Net Asset Value of the units of the Fund.

Both AS 13 and the Guidance Note fail to lay down the principles of measurement in respect of unquoted investments or investments for which fair value or market value is not readily available. It is common practice in Indian business to invest in start projects or in closely held companies in respect of which, in the absence of active trading, market values can not be ascertained. To deal with such circumstances alternative methods of measurement such as discounted cash flows, earning capitalisation, etc may have to be prescribed by the standards.

CONCLUSION

From the above discussion it can be seen that the current Indian Accounting Standard 13 on Investments needs a new look from the developments that are taking place elsewhere in the accounting and audit profession and, the growing pressure on more transparency and investor consciousness. The attempt is not indicate the differences and recommend for a standard on the lines as indicated in International Accounting Standard. But to a broad frame work for the discussion to follow in the Indian context. ■

Patience is not passive; on the contrary, it is active; it is concentrated strength.

-Edward G. Bulwer-Lytton