

# IFRS vs. Companies Act 2013 – An Analysis



*Indian regulatory environment follows a multipronged approach. Laws are multitude in number and often pose challenges to the lawmakers to bring the desired synchronisation among them in order to avoid debates and disputes. We are aware that the five-decade old Companies Act 1956 went through a drastic overhauling in the year 2013 and the new avatar is Companies Act 2013. Being the parent law for all companies registered in India, the Companies Act 2013 (like its predecessor) also contains certain provisions which carry linkages to the Indian GAAP (both existing and the future Ind AS) in aspects such as Depreciation, Dividend, etc. The forthcoming developments in the accounting system in India have indicated that a slew of amendments in either IFRS or the Companies Act will get necessitated. This article is intended to throw comparisons between certain key provisions of the Companies Act that is currently in force and the upcoming Ind ASs.*

## Depreciation

The Companies Act tabulates the rate of depreciation under Schedule II for each category of asset. It may be recollected that Para 23 of the Accounting Standard-6 on Depreciation reads that “*The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life.*” Thus the standard requires us to review the useful life of major depreciable assets and revise the depreciation charge accordingly. Nothing has been



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mentioned about review of the residual values until now.

Section 198 of the Companies Act talks about computation of net profits for the purpose of managerial remuneration. As per the same, depreciation for arriving at the net profits of the company should be as per the mandate of Section 123. Section 123 requires that for the purpose of clause (a) of sub-Section (1), depreciation shall be provided in accordance with Schedule II. Schedule II- Part C (unlike the predecessor law) specifies the useful life for the various categories of assets. But the interesting part is that the Schedule restricts the residual value of an asset to be not more than 5% of the original cost of asset.

In the above backdrop, if we take a look at Ind AS-16 on Property, Plant and Equipment, Para 51 of the standard requires that *“The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with Ind AS 8 Accounting Policies, Changes in Accounting Estimates and Errors”*. The one additional requirement that Ind AS-16 has brought about is the review of residual value of an asset in addition to the useful life with a mention of the periodicity *i.e.*, every financial year end. While the Companies Act has frozen the upper range of residual value, Ind AS-16 requires the review of residual value which would mean revision of an estimate either upward or downward. The ideal understanding under these circumstances could be that for the purpose of compliance with Ind AS 16, companies need to ensure that they revisit the residual value but not estimate at more than 5% as required by the Companies Act.

However, unlike the previous law, the new Act recognises the importance of depreciating certain parts of an asset separately when their cost is significant in relation to the total cost of the asset. This is very much in line with Ind AS-16 requirements regarding component-wise depreciation.

## Dividend Recognition

Accounting for Dividend income is regulated by Ind AS-18 on Revenue Recognition. The sole determinant of recognition of any dividend income is the shareholder's entitlement to receive the dividend. The entitlement is known once the same is declared

**There lies a very popular controversy as regards the nature of a Preference share capital. As far as Section 43 of the Companies Act, it is very clearly defined that Preference share capital forms part of the Share capital (i.e., equity). Since IFRS (Para 18 of Ind AS 32) dwells on the doctrine of 'Substance over form', it has more appropriately classified the Preference share capital as a Financial liability due to the reason that it may provide for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount.**

by the Board of Directors. However, Section 126 of the Companies Act deals with a peculiar situation wherein the instrument of transfer of shares has been lodged, but such a transfer is not being registered by the Company. In such cases, the Company is *inter alia* required to transfer the dividend in relation to such shares to the special account referred to in Section 124 unless the company is authorised by the registered holder of such share in writing to pay such dividend to the transferee specified in such instrument of transfer. Normally, a company will refuse to register the share transfer when, 1) Instrument of transfer is not proper or not been duly stamped/properly executed by transferor and transferee, 2) The name, address and occupation of transferee has not been delivered to the company or 3) Share certificate or letter of allotment has not been delivered along with instrument of transfer.

From the above, it is quite clear that the person who has already lodged the share transfer instrument without proper formalities will not be entitled to receive this dividend when the same is required to be transferred to a special account of the Central Government. This is despite his name not being struck off the shareholder register since the company has not registered the transfer as reckoned in Section 126. Similarly, the transferee will not get the entitlement automatically, since as per Section 125, he will have to apply to the authority constituted by Central Government, who after getting satisfied either through a certificate from the Company or otherwise, passes an order for payment of Dividend to the applicant. Thus, dividend entitlement then becomes a long drawn process until getting established. It would be

wonderful if IFRS can go a step ahead to clarify the point of dividend entitlement for revenue recognition under such situations, to give more refinement and completeness when compared to earlier standards.

### Preference Share Capital and Preference Dividend

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Along the expected lines, Para 35 of Ind AS 32 also requires all such dividends that are related to instruments classified as financial liability to be recognised only as Interest in Books of accounts. Both Dividend and Interest are completely different in terms of their nature. While interest is compensatory and depends on time value; dividend is by way of share of profit. Whether Corporate law would be ready to accept a different nature for Preference dividend in line with IFRS and exempt it from the provisions of Section 123 to Section 125 of the Act; is an interesting question. For, *e.g.*, Section 123 talks about paying dividend out of profits (be it current year or previous year) and after providing for requisite dividend. Will preference dividend be exempted from such requirements and treated as a charge against profits for the purpose of the Companies Act?

**As per Ind AS-1 on presentation of financial statements, one of the components of the financials is a Statement of Changes in Equity. The Statement of Changes in Equity is required to be presented as part of the Balance sheet. Since Schedule III of the Act is currently mandating the Balance sheet format, it may bring in the completeness by also specifying a format for incorporating the Changes in Equity. Of course, this is suggestive.**

### Law or Accounting Standards: Which of the two is Supreme?

Schedule III of the Act mandates the new presentation format for Balance sheet and Profit and Loss account. As intended by the law makers, the Schedule was made a subordinate to the Accounting standards by a mention in the 'General Instructions'. Thus the disclosure requirements in the schedule are only in addition to and not a substitute for those in the Accounting standards. However the Companies Accounting standard Rules 2006 still carries a paragraph as below,

*"Accounting Standards, which are prescribed, are intended to be in conformity with the provisions of applicable laws. However, if due to subsequent amendments in the law, a particular accounting standard is found to be not in conformity with such law, the provisions of the said law will prevail and the financial statements shall be prepared in conformity with such law."*

*(It may be noted that the Ministry of Corporate Affairs through a General circular No.15/2013 has clarified that until the accounting standards are notified under Section 133 of the Companies Act, the accounting standards covered by the Companies Act 1956 (Companies Accounting Standard Rules 2006) will apply.)*

It is therefore apparent that we have one more probable amendment in the offing with the advent of IFRS.

### Presentation of Financials

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- As per sub-Section (3) of the section, a company having one or more subsidiaries is required to prepare consolidated financial statements. But the aggravation here is that, while Section 129 of the Companies Act 2013 explains a 'subsidiary' to be including associates and Joint ventures as well, IFRS would not agree to an entity other than one which is controlled. It categorises those that are significantly influenced as associate and

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those that are jointly controlled as joint ventures and these are not to be consolidated. For reader's information; even proportionate consolidation method has been done away with for Joint ventures and only equity method of accounting is permitted. The same applies for interest in associates as well. It may be relevant to note that there are countries whose law governing corporate allows equity method of accounting (e.g., Australia). Perhaps our Companies Act can also emulate such stuffs.

- The ICAI proposes to issue amendments to Ind AS 110, Ind AS 112 and Ind AS 27 introducing investment entities which are again a result of developments carried out by IASB (International Accounting Standard Board) recently. It is directed at exempting investment entities from consolidation in respect of subsidiaries which are not providing investment services to the parent. These interests in subsidiaries are to be accounted at fair value through Profit or loss account. But there is a rigid mandate in Section 129(3) of the Companies Act that wherein companies across the board having one or more subsidiaries, is required to prepare and lay down consolidated financial statements in addition to the separate financial statements of the entity. Simply put, the concept of investment entity exemptions has not been envisaged in our corporate law. Let us keep our fingers crossed that such anomalies are removed by necessary clarifications from the Ministry of Corporate Affairs.

## Definition of Control

It is essential to understand the approaches of these laws in calibrating the control of an entity. The definition in the Companies law focuses on right to appoint majority of the directors or to control the management or policy decisions exercisable by a

person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner. To confirm this further, the definition of a 'subsidiary company' itself talks about a company in which the holding company controls the composition of Board and controls more than 50% of the share capital either directly or indirectly. Here, the focus seems to be more on legal form. As the Ind AS in pipeline currently stands, it does not pose problems since both are on the same page in many regards. But differences arise when the exposure draft on Ind AS 110 (the equivalent of IFRS 10 which is already applicable from accounting periods starting on or after 1<sup>st</sup> January 2013) will materialise, since then the focus shifts to a 'de facto' control system. 'Control', then assumes a different shape altogether as power over the investee, to control the returns, exposure to variability in returns, etc. Definitely, the gap needs to be addressed.

## Deviation from Accounting Standards

In the current scenario, Section 129 (5) of the Companies Act deals with deviation from Accounting Standards in the presentation of financial statements. The text belonging to the Section is reproduced below,

*"Without prejudice to sub section (1), where the profit and loss account and the balance-sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance-sheet, the following, namely:—*

- (a) the deviation from the accounting standards;*
- (b) the reasons for such deviation; and*
- (c) the financial effect, if any, arising due to such deviation."*

Plain reading of the above provision gives an impression that the Section focuses more on the disclosure requirements when there is a non compliance with accounting standard. Readers would agree that disclosure requirement can be treated as secondary, since the primary focus should be on ensuring compliance with AS. It does not indicate as to when such non compliance with accounting standards is permitted. The existing GAAP does not deal with this non compliance either. However the issue has been settled only by our Honourable Supreme Court in *JK Industries vs. Union of India*, [2008] case as follows:

*“..Implementation of the Accounting Standards and their compliance are made compulsory and mandatory by the aforesaid sections 211 (3A), (3B) and (3C)... Before introduction of Sub-sections (3A), (3B) and (3C) in Section 211 (w.e.f. 31.10.98), these Standards were not mandatory. Therefore, the companies were then free to prepare their annual financial statements, as per the specific requirements of Section 211 read with Schedule VI. However, with the insertion of Sub-sections (3A), (3B) and (3C) in Section 211 the P&L a/c and the balance-sheet have to comply with the Accounting Standards ... non-compliance with these Standards would lead to violation of Section 211 inasmuch as the annual accounts may then not be regarded as showing a "true and fair view”*

Though the case was contemporary to the erstwhile regime, the intentions will remain the same.

On the other hand, Ind AS-1 poses a very stringent requirement in Para 16 of the standard by requiring that an entity whose financial statements comply with Ind ASs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with Ind ASs **unless they comply with all the requirements of Ind ASs**. However the standard permits such departure only under *extremely rare circumstances* when management concludes that compliance with a requirement in an Ind AS would be so misleading that it would conflict with the objective of financial statements set out in the Framework which is to present a true and fair view of the financial state of affairs. Under such circumstances, disclosure is required along the same lines in Section 129 (5) of the Companies Act, but as regards disclosing the

financial effect, the difference is that the **effect is needed to be disclosed for each period presented in the financial statements** and not just in aggregate as one might probably conclude going by the wordings in the Companies Act 2013. Financial effect is to be computed as the difference between the measurement of an item when the relevant Ind AS is complied and the measurement when Ind AS is not complied.

Ind AS seems to tackle the situation well by ensuring that even SMEs which are unincorporated also comply with the discipline in wholesome when they are in fact required to.

### Restatement of Previous Financial Statements

Appreciably, the new Companies law tries to get closer to addressing a painful area which is the revision/reopening of accounts. According to Section 131 of the Act, “if it appears to the directors of a company that (a) the financial statement of the company; or (b) the report of the Board, do not comply with the provisions of Section 129 or Section 134 they may prepare revised financial statement or a revised report in respect of any of the three preceding financial years after obtaining approval of the Tribunal on an application made by the company in such form and manner as may be prescribed and a copy of the order passed by the Tribunal shall be filed with the Registrar...”. Thus if the Company decides to revise the accounts it can do so for any previous year which falls only within the immediately preceding three financial years. This aligns very well with the requirements of Para 42 of Ind AS 8 that calls for retrospective restatement of financials of preceding periods on discovery of an error.

### Conclusion

The Companies Act 2013 has advanced miles ahead from the previous incarnation in narrowing the gaps that existed with the Indian Accounting Standards. There were conspicuous differences in many areas such as Presentation of Consolidated Financial statements, Allowance of depreciation based on production unit method under Companies Act, Payment of Interest on Capital etc. These have anyway been efficiently addressed. However, there is still a need to bridge a lot by means of amendments and clarificatory circulars before companies can actually start implementing the new accounting standards. ■

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