

## An Analytical Study on Indian Accounting Standard -14

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### ABSTRACT

Accounting is the art of recording transactions in the best possible manner, so as to enable the reader to arrive at judgments/come to conclusions, and in this regard it is utmost necessary that there are set guidelines. These guidelines are generally called accounting policies. Objective of Accounting Standards is to standardize the diverse accounting policies and practices with a view to eliminate to the extent possible the non-comparability of financial statements and the reliability to the financial statements. In the current study a comparison has been made between the accounting standards related to merger and acquisition accounting in India, USA, UK and International Accounting Standards Board. Further, strengths and weaknesses of the Indian Accounting Standard related to mergers and acquisitions (AS-14) have been analyzed and suggestions have been given for the betterment of AS-14.

**Keywords:** Accounting Standards, AS-14, ASB, ICAI, IFRS

### Introduction

In order to make accounting information more valuable for the users who rely on them for their decision-making purposes, there has to be consistency in the way in which items are treated in the financial statements. Without this agreement it would be impossible to utilize them effectively for comparing the business performance. The limited liability companies have a statutory obligation to comply with these rules and it is the job of the qualified auditor to check its compliance. The Partnership firms and sole traders are also often bound by these rules because of professional or trade association standards or because of the conditions attached to loans. These rules are governed by two aspects of accounting:

1. The accounting treatments permissible for any individual, event or transaction. For example the rules state that stock must be valued at "the lower of cost and net realizable value". This means that valuation of stock at selling price is not normally allowed.
2. Disclosure requirements that tell us permissible layouts [called formats] for the balance sheet and profit and loss account items.

These rules are called Accounting Standards. In order to satisfy the statutory auditors, that the balance sheet and profit and loss account provide a "true and fair view" of actual transactions, the internal audit /control department is required to function effectively in the business. The scope of internal auditing within an organization is broad and may involve topics such as the efficacy of operations, the reliability of financial reporting, deterring and investigating fraud, safeguarding assets, and compliance with laws and regulations laid as per the Accounting Standards. Internal auditing frequently involves measuring compliance with the entity's policies and procedures. However, internal auditors are not responsible for the execution of company activities; they advise management and the Board of Directors (or similar oversight body) regarding how to better execute their responsibilities. As a result of their broad scope of involvement, internal auditors may have a variety of higher educational and professional backgrounds.

The current study is about the study of accounting standards. A comparison has been made between four accounting standards related to merger and acquisition accounting in India, USA, UK and International Accounting Standard Board.

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### Objectives of the Study

The following are the main objectives of the study:

1. To find out the main differences between the accounting standard related to mergers and acquisitions in India, USA, UK and International Accounting Standards Board.
2. To suggest ways for the betterment of AS-14.

### Research Methodology

For the purpose of study secondary data has been used. And the information about the Accounting standards issued by USA, UK, International Standards Board and ICAI were collected. Further news (The Economic Times) paper and journals issued by various accounting agencies have been used. But before comparing them a brief introduction of all the four accounting boards has been given below.

#### Indian Accounting Standards

In India, Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) issues the Accounting Standards. The ASB was constituted on 21<sup>st</sup> April 1977 by ICAI. The main function of the ASB is to formulate Accounting Standards so that such standards may be established by the ICAI in India. Till date the ASB of ICAI has issued 32 standards in line with the International Accounting Standards. The accounting standard governing the rule for mergers and acquisitions is AS-14, which is also known as Accounting for Amalgamations.

#### International Financial Reporting Standards (IFRS)

IFRS is the new form of International Accounting Standards and are issued by the International Accounting Standards Board (IASB). The IASB was formed in 2001 and adopted all the existing International Accounting Standards (numbered 1 to 41) issued by its predecessor body, the International Accounting Standards Committee (IASC), and decided that the current International Accounting Standards as well as all future accounting standards issued by it will be called IFRS. IFRS acts as a medium for the global accounting community to interact in a common accounting language. The accounting standard governing the rule for mergers

and acquisitions is IFRS-3, which is known as Accounting for Business Combinations.

#### UK Accounting Standards

The organization governing the formation of Accounting Standards in UK is Accounting Standards Board. This Board is similar to the Indian Accounting Standards Board. It is responsible for formulating the accounting standards in UK and making necessary amendments from as and when required. The accounting standard governing the mergers and acquisitions in UK is known as Financial Reporting Standard (FRS) No. 6 for Mergers and Acquisitions.

#### Accounting Standards in USA

In US, Financial Accounting Standards Board (FASB) sets the accounting standards. The accounting standard for mergers and acquisitions is called SFAS No.141. SFAS is the abbreviation for Statement of Financial Accounting Standards. SFAS 141 governs the rules for business combinations. In Table 1, the comparison between the four accounting standards is being made and discussed below.

Differences between Indian Accounting standards (I-GAAP), US-GAAP, UK-GAAP and IFRS.

1. The above comparison shows that only I-GAAP recognizes pooling of interests method. The other three methods strictly prohibit the use of this method and recommend only purchase accounting.
2. AS 14 requires that if the amount of the consideration is lower than the value of the net assets of the transferor company, in purchase accounting, the difference should be treated as capital reserve by the transferee company. It may be noted that capital reserve, by its very nature, is not recognized as an income at any point of time. It is not amortized also. However, the other three methods recommend it to be written off immediately or within a specified period.
3. AS 14 provides that amortization period of goodwill arising on amalgamation should not normally exceed 5 years. The period of amortization is not normally increased unless there is a very justified reason to do so. However

Table 1. Comparison of Indian Accounting Standards with IFRS, UK and USA related to mergers and acquisitions

S.No.	Subject	Indian Accounting Standard	UK GAAP*	IFRS	US GAAP*
1	Purchase method- <i>Fair values on acquisition</i>	The assets and liabilities may be incorporated at their existing carrying amounts, or the consideration is allocated to individual assets and liabilities on the basis of their fair values. No separate acquisition provisions are allowed.	The assets, liabilities and the contingent liabilities of the acquired entity are valued. Restructuring provisions are recognized when the acquiree has, at the acquisition date, an existing liability for restructuring in accordance with IAS 37. Recognizing liabilities for further losses or other costs, expected to be incurred as a result of the business combinations, are prohibited.	The assets, liabilities and the contingent liabilities of the acquired entity are valued. Restructuring provisions are recognized when the acquiree has, at the acquisition date, an existing liability for restructuring in accordance with IAS 37. Recognizing liabilities for further losses or other costs, expected to be incurred as a result of the business combinations, are prohibited.	Similar to IFRS. But there are specific rules for acquired-in-process research and development (generally expenses) and contingent liabilities. Restructuring provisions are allowed if management at the date of the acquisition begins to assess and formulate to exit an activity or terminate or relocate employees of the acquired entity.
2	Purchase method- <i>Subsequent adjustment to fair values</i>	Many business combinations recognize that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation for consideration. In all other cases the adjustment is recognized as soon as the amount is determinable in the income statement.	Fair values can be revised against the goodwill up to the end of the year after the acquisition if additional evidence of value becomes available. Subsequent adjustments are also recorded in the income statements.	Fair values can be revised against the goodwill up to the end of the year after the acquisition if additional evidence of value becomes available. Subsequent adjustments are also recorded in the income statements.	Similar to IFRS. However, allocation is up to one year following the date of acquisition. Once the fair value allocation is finalized, no further changes are permitted except for the resolution of known pre-acquisition contingencies. Adjustments made during the allocation period relating to data for which management was waiting to complete the allocation are recorded against goodwill.
3	Purchase method-	Goodwill is capitalized or amortised to income over	FRS 10 gives choice for positive goodwill between	Goodwill is capitalized but not amortised. Goodwill	Similar to IFRS; however impairment

Table 1 Contd...

S.No.	Subject	Indian Accounting Standard	UK GAAP*	IFRS	US GAAP*
	Goodwill	useful life, normally not exceeding ten years.	systematic amortisation and carrying at unchanged amount subject to annual impairment review (FRS10.15, 17).	should be tested for impairment annually at the cash generating unit level.	measurement model is different.
4	Purchase method- Negative goodwill	It is treated as a capital reserve, which is not amortized.	Negative goodwill must be recognized in the profit and loss account over a specified period (FRS10.48).	IFRS does not use 'negative goodwill'. It is termed as 'excess of acquirer's interest in the net fair values of acquirer's identifiable assets. First re-assess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination. Any excess remaining after the re-assessment is recognized in income statement immediately.	Reassess whether all acquired assets and assumed liabilities have been identified and properly valued. If negative goodwill remains, acquired assets (with certain exceptions) are proportionately reduced. If all eligible assets are reduced to zero and an amount of negative goodwill still remains, the remaining unallocated goodwill must be recognized immediately as an extraordinary loss.
5	Uniting/Pooling of interests method	It is restricted to the amalgamation in the nature of 'merger' only. It is allowed only when certain conditions are met.	This method is prohibited.	This method is prohibited.	This method is prohibited.

(Source: Accounting Standards issued by the accounting bodies)

\*GAAP = Generally Accepted Accounting Principles)

the other three methods require that goodwill arising out of amalgamation should be tested for impairment annually.

- AS-14, SFAS-141 and FRS-6 all require that amalgamations in the nature of purchase should be accounted for, as under the purchase method. However, there are differences in the application of the method. As per AS-14, in preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. On the other hand, the Benchmark Treatment under SFAS-141 and FRS-6 is to measure identifiable assets and liabilities at their fair values only.

#### Strength of AS-14 over IFRS -3, SFAS-141 and FRS-6

The biggest strength of AS-14 lies in the fact that in case of purchase accounting it allows the transferee company to incorporate the assets and liabilities of the transferor company at their existing carrying amounts or, allocate the consideration to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. Unlike SFAS-141 or FRS-6 or IFRS it does not enforce fair valuation of all assets and liabilities. There is no doubt about the fact that fair value accounting makes the financial statements transparent and facilitates better decision making, whereas in historical cost accounting the financial assets are stated at outdated values (at cost) and hence are not relevant or reliable. The fact that the market value of publicly traded firms on the New York Stock Exchange was five times their historical asset values in the year 2000 served to highlight this deficiency (Federal Reserve Chairman Alan Greenspan, as quoted in *Cracking the Value Code: How Successful Businesses Are Creating Wealth in the New Economy* (Richard E.S. Bolton, Barry D. Libert, and Steve M. Samek; HarperCollins, 2000). In normal times, fair value accounting would not have been a subject of great debate. However, in boom or bust times, experts argue that, if fair value

accounting results in notional gains and losses, since the eventual settlement price of the financial assets/liabilities could be substantially different. The current economic slowdown in the US economy and other European countries is believed to have been aggregated due to the application of fair value accounting. It is now being found that this method of accounting played a consequential role in bank failures in US in the year 2008. In all 19 banks failed in US in 2008. The economies of US and Europe are much dependent on banks. It has been proved that the failure of banks can bring trouble for whole economy. Hence, US-GAAP, UK-GAAP and IFRS are all under review for promoting fair value accounting. Although in India the situation is different. In India, economy is not that much dependent on banks as it is in US, however the situation in West shows what Fair value accounting can do in adverse cases. Recession has not hit India as much as in western countries because even if the stock markets have crashed, the balance sheets of companies have not been affected, because all assets were not valued on fair value.

#### Weaknesses of AS-14 as compared to IFRS-3, SFAS-141 and FRS-6

- India uses both pooling of interests method and the purchase accounting method for mergers and acquisitions. However the pooling of interest method does not show a true picture of the accounting statements. This can be proved as follows-

When the pooling of interest method is used, the balance sheets of the two businesses are combined and no goodwill is created. When the purchase method is used, the acquiring company will put the premium they paid for the other company on their balance sheet under the "Goodwill" category. AS-14 requires the goodwill to be amortized over a period of 5 years. Let us take an example of two companies

Particulars	Company A	Company B
Earnings	Rs. 1,00,000	Rs. 20,000
Book Value per share	Rs. 50	Rs. 10
Number of shares	50,000	10,000
Market Value per share	Rs. 100	Rs. 20

Suppose company A decided to buy all of company B's stock using the purchase method. Company B has a book value of Rs. 10 per share, and a market value of Rs.20 per share. If company B were to pay the current market price, it would spend a total of Rs. 2, 00,000 (20 X 10,000). To keep this example simple we assume that the shareholders of company B approved the merger for cash. Hence, company A would gain control over company B by paying the shareholders of company B Rs. 20 for each share they owned. Since the book value of company B is only 1,00,000 (10 X 10,000) and company A paid Rs.2,00,000, company A paid a premium of Rs.1,00,000. This is going to be shown as goodwill in their balance sheet . It is required to be amortized against earnings for upto 5 years. This means that each year, 1/5 of the goodwill amount must be subtracted from company A's earnings so that by the end of 5<sup>th</sup> year, there is no goodwill left on the balance sheet. Now that company A and company B are one company, their earnings will be combined. Assuming that next year's results were identical, the company would earn Rs.1,20,000, or Rs 2 per share (1,20,000/60,000). Now goodwill has to be amortized, meaning 1/5 the amount must be deducted from the earnings. Company A must deduct Rs. 20,000 (1,00,000/5) from the earnings as a charge against goodwill. Now company B can only report earnings of Rs.1,00,000 or Rs. 1.67 per share (compared to the Rs. 2 they would have been able to report before the goodwill charge). Here, goodwill reduced the earnings by Rs. 0.33 per share.

If the pooling of interest method had been used, no goodwill would have been created, and company A would have reported EPS (earnings per share) of Rs. 2. This means that depending on the type of method the same transaction can have an impact on the EPS.

Hence from the above analysis it is quite clear that pooling of interest method does not give a true picture of the position of the company.

2. India is expected to adopt IFRS completely by April 2011 Hence the same principles of fair value accounting shall be implemented in India also. Looking at the repercussions of fair value accounting which played some role in the global

economic crisis, its implementation in India shall be a difficult task for the government.

#### Suggestions for improvement of AS-14

1. Looking into the fact that pooling of interests method inflates earnings per share, it is suggested that AS-14 should also abolish this method and only purchase accounting method should be used.
2. India should adopt IFRS; however certain precautions should be used while implementing fair value accounting.
  - a) Fair value model should be applied only to those assets and liabilities that have real and determinable market value. Fair valuation of all intangible assets like prospective customers, computer software under development etc. shall make financial statements a lot more predictive. A list of assets and liabilities that shall be fair valued and those which shall be measured at historical cost should be made. Every entity should use the same method for fair valuation of a particular asset. This shall avoid any contradiction.
  - b) Companies should explain their reasoning behind the inputs they do use. If they have not plugged in the best observable data to come up with their assessments, they should show why their measurement choice was more appropriate.
  - c) To provide financial statement users with additional fair value information, a separate disclosure containing each entity's fiscal year-end balance sheet with all financial assets/liabilities at fair value and each entity's fiscal year-end income statement reporting the effects of all fair value changes in earnings should be made.
  - d) Unrealized losses on financial instruments measured at fair value should be recorded and shown under a separate head. This shall help investors understand existing economic conditions in a better way.
  - e) Since investors in India are not used to

understanding financial statements prepared completely on the basis of fair valuation hence in the beginning period for 2-3 years when IFRS is adopted, companies can make accounts in two separate sets; one on the basis of assets and liabilities measured on historical cost and the other on the basis of fair valuation. This shall help the investors understand the difference in the two valuation techniques better manner.

### Conclusion

The above study is a brief summary of comparison of the accounting standards in India, US, UK and as issued by the International Accounting Standards Committee. The study concludes on the note that India should abolish pooling of interests method. It also suggests certain precautions that should be taken by ICAI Institute of Chartered Accountants of India before switching over to IFRS in April 2011. The Fair value accounting is of great utility and worth, provided it is applied cautiously.

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