Common Errors found by FRRB in implementation of AS 13: *Accounting for Investments* and AS 26: *Intangible Assets*

Financial Statements are the paramount source in hands of the stakeholders to understand the financial well-being of an enterprise. The users are highly reliant on the information depicted in the financial statements and therefore the preparers ought to ensure that the information presented in the financial statement is correct, complete, relevant and in adherence to the regulatory requirements. Financial Reporting Review Board (hereinafter referred as FRRB or Board) reviews the General Purpose Financial Statements (GPFS) of enterprises with the view to identify the non-compliances with Accounting and Auditing Standards, CARO, Companies Act, and other statutory requirements applicable in preparation and presentation of the financial statements. The non-compliances observed by the Board are compiled from time to time and published under the name of "Study on Compliance with Financial Reporting Requirement", till date three volumes of the aforesaid publication has been released by the Board. In addition, the Board publishes articles in the 'Journal' of the Institute and also conduct webinar on the non-compliances with various reporting requirements to disseminate the awareness amongst the members as well as general masses. This article deals with the non-compliances, observed by the Board, with disclosure requirements prescribed under Accounting Standards – 13 and 26.

AS 13: Accounting for Investments

1. Incomplete/ Incorrect accounting policy

Case

Certain companies have disclosed accounting policies on investments as follows:

"Investments are stated at cost."

Principle:

It may be noted that paragraphs 31 and 32 of AS 13 provide as below:

"31. Investments classified as current investments should be carried in the financial statements at lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis."

"32. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline other than temporary, in the value of the investments, such reduction being determined and made for each investment individually."

Observation:

From the above, it was noted that the **method of valuation of investments depends upon the nature of the investment, i.e., whether it is current investments or long- term.** However, the company had given a blanket policy of carrying all investments at cost regardless of the nature of such investments.

It was viewed that valuing investments without considering the purpose and/or the period for which these are intended to be held for is against the requirements of AS 13.

2. Inclusion of interest cost in cost of investments

Case

The accounting policy on investment, *inter alia,* states that cost includes interest attributable to funds borrowed for acquisition of investments (equity instruments).

Principle

It may be noted that paragraphs 3.2 and 6 of AS 16, Borrowing Cost, notified under the Companies (Accounting Standard) Rules, 2006 provide as follows:

"3.2 A Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale."

"6. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset."

Observation

It was noted that cost of investments includes

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interest on funds borrowed for acquisition of investments. It may be noted that AS 16 prescribes that borrowing cost can be capitalised if it is directly attributable to acquisition of a qualifying asset. Further, qualifying asset has been defined as an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

It was viewed that equity instruments are available for their intended use or sale when acquired, and hence, they are not qualifying assets. Therefore, capitalisation of borrowing cost with the cost of investments is against the principles of AS 16.

3. Provision for diminution in value of Investments should be made as and when indication of decline arise

Case

From the Annual Report of a company, it has been noted that its investment in a wholly-owned subsidiary has been stated at nil value at the end of the year under review while in the previous year significant value has been stated for which no provision for diminution in value was created in the books. Further, investment in wholly owned subsidiary has been fully written off during the year and this writing down has been done as part of an internal restructuring. **It was further noted from the notes that over last few years, the performance of the subsidiary was affected due to the recession** which impacted the end customers resulting in falling revenues and operational losses. Subsequently, it has been decided to wind up this subsidiary in the year under review.

Principle

It may be noted that paragraph 17 of AS 13, Accounting for Investments, notified under the Companies (Accounting Standards) Rules, 2006 provide as follows:

"17. Long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long term investment, the carrying amount is reduced to recognise the decline. Indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. The type and extent of the investor's stake in the investee are also taken into account. Restrictions on distributions by the investee or on disposal by the investor may affect the value attributed to the investment."

Observation

It was viewed that an appropriate provision against the investments in the subsidiary should have been recognised in the years **when the indication of decline in value of investment other than temporary, had arisen instead of writing off the complete amount after the decision to wind up the subsidiary has been taken.**

Accordingly, it was viewed that the requirements of AS 13 have not been complied with.

AS 26: Intangible Assets

4. Recognising Deferred Revenue Expenditure in Balance Sheet and its amortisation

Case

From the accounting policy on 'Deferred Revenue Expenditure' given in the Annual Report of a company it was noted that expenditure incurred on factory license fees, trade mark fee, seed marketing expenses, public/capital issue expenses, preliminary expenses and rental paid for pre-commencement of retail stores, factories has been treated as deferred revenue expenditure which are being amortised over the life of the concerned items.

Principle

It may be noted that paragraphs 6.2 and 56 of AS 26, Intangible Assets provides as follows:

"6.2 An asset is a resource:

(a) controlled by an enterprise as a result of past events; and

(b) from which future economic benefits are expected to flow to the enterprise."

"56. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. For example, expenditure on research is always recognised as an expense when it is incurred (see paragraph 41). Examples of other expenditure that is recognised as an expense when it is incurred include:

(a) expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for

commencing new operations or launching new products or processes (pre-operating costs);"

Observation

It was viewed that the expenditure incurred on **rental paid for pre-commencement of retail stores, factories, seed marketing expenses, public/capital issue expenses, preliminary expenses cannot be considered to be a 'resource' being controlled by the enterprise and hence, such expenses do not meet the criteria of the term 'asset' and therefore, they cannot be treated as asset.**

Accordingly, any such expenditure incurred after 1-4-2006 i.e. after AS 26 become mandatory should be expensed as and when it is incurred.

With regard to factory license fees, trade mark fees, it was viewed that these expenditure gives rise to intangible assets. Accordingly, they should be disclosed under the head of 'intangible assets' rather than 'deferred revenue expenditure'.

With regard to software development expense and product development expense, it was viewed that if it meets the definition of asset as stated in paragraph 6.2 of AS 26, the same should also be recognised as an 'intangible asset', otherwise it should be expensed in the Statement of Profit and Loss in the year in which the expenditure is incurred.

5. Amortisation of Intangible Assets over the useful life of underlying Fixed Assets.

Case

It was noted from the accounting policy on Intangible Assets of a company that Technical know-how is amortised over the useful life of the underlying plant and amortisation is done on straight line basis.

Principle

It may be noted that paragraph 69 of AS 26, Intangible Assets, provides as follows:

"69. If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless:

(a) the legal rights are renewable; and

(b) renewal is virtually certain."

Observation

It was noted that Technical know-how is amortised over the useful life of the underlying plant and the useful life of technical know-how has not been considered for determination of its amortisation period, which is an important element to determine its amortisation policy as explained in paragraph 69 of AS 26. It was viewed that intangible assets should be amortised over its useful life or the life of underlying assets or over the period of 10 years, whichever is earlier. In case if it is more than 10 years, then the reason should be disclosed for determining the useful life higher than 10 years as per paragraph 94 of AS 26.

Hence, it was viewed that the stated policy adopted for the technical know-how is not in line with the requirements of AS 26.

6. "Cost of Right of Way" was considered perpetual in nature and therefore not amortised

Case

The accounting policy on Intangible Assets stated by a company is as follows:

"Cost of Right of Way for laying pipelines is capitalised as Intangible Asset and being perpetual in nature, is not amortised".

Principle

It may be noted that paragraphs 6.7, 63, 68 and 69 of AS 26, Intangible Assets provide as follows:

"6.7 Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life."

"63. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use".

"68. The useful life of an intangible asset may be very long but it is always finite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short."

"69. If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless:

a. *the legal rights are renewable; and*

b. *renewal is virtually certain."*

Observation

It was noted that the cost of right of way is capitalised as intangible item but is not being amortised considering it to be perpetual in nature. **It was viewed that as per AS 26, the useful life of the right of way may be very long but it is not infinite, accordingly, the depreciable amount should be allocated on a systematic basis over the best estimate of its useful life which can be determined based on technical, legal and economic factors.** Accordingly, it was viewed that non- amortisation of the cost of right of way is not in line with AS 26. This view is also supported by EAC opinion on Query No 3 of Volume 33 published in 'The Chartered Accountants', September 2013.

7. Determination of cost of Franchisee Rights for amortisation

Case

From the accounting policy relating to intangible assets of a company, it was noted that the Franchise Rights were disclosed to continue in perpetuity. However, the useful life was determined as 25 years based on the expected term that franchise would continue to contribute to the net cash inflows of the company.

Principle

It may be noted that paragraph 94 (a) of AS 26, Intangible Assets, provides as follows:

"94. The financial statements should also disclose:

(a) if an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset;"

Observation

The company has stated that the franchise rights will continue in perpetuity, however, it has estimated the useful life of the franchise rights as 25 years. It was, further, observed from the franchisee agreement that the period of the said agreement will continue in perpetuity. The terms of the purchase agreement also provide for additional consideration which will be payable after completion of 10 years i.e. 20XX onwards for an amount which will be equal to 20% of the franchisee income received in respect of those years.

It was viewed that if the enterprise was of the view that it would be able to exercise such rights for 25 years, and therefore, it has adopted an accounting policy of amortising such rights over a period of 25 years, **it should also estimate the amount of additional fees that would be payable by it for such rights and, accordingly, the total cost of such rights should be capitalised and amortised.**

However, in the given case, it was noted that it has **neither included the consideration payable over the period of 10 years in the cost of franchisee rights nor has it disclosed the amount of commitments payable against such franchisee rights for the additional 15 years.** Thus, the treatment of franchisee fees as adopted by the enterprise is not in line with the requirements of AS 26.

8. Non-amortisation of Intangible Assets

Case

It was noted from the Balance Sheet of a company that the Miscellaneous Expenditure (to the extent not written off or adjusted) as at 31st March, 20XX was the same as in the immediately preceding year.

Principle

Paragraph 99 of AS 26, Intangible Assets, which provides the Transitional Provisions.

Observation

The balances of the miscellaneous expenditure for the current and previous financial years, indicates that the said expenditure has not been amortised during the financial year under review. Further, it was noted that neither the amortisation policy nor the information regarding miscellaneous expenditure (viz. nature of such expense, year of incurrence) has been disclosed in the financial statements.

In the absence of such information, it could not be ascertained as to whether the said miscellaneous expenditure was incurred before 1.4.2004 or after 1.4.2004. It was viewed that in case, it was incurred before 1.4.2004, it should be amortised as per original accounting policy of the company, provided the total period of amortisation does not exceed ten years, otherwise it should have been expensed as and when incurred. However, non- amortisation of such expenses during the year indicates that the accounting treatment adopted by the company is not in line with the requirements of paragraph 99 of AS 26.■