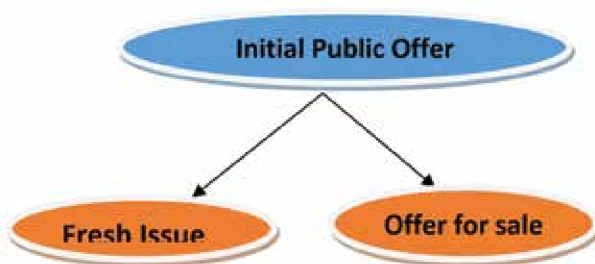
Initial Public Offer— Certain Accounting And Auditing Matters

In current times of increasing business and economic challenges, the growth of any company is dependent upon its ability to innovate, provide competitive products and services to capture the market and more importantly its ability to expand into new markets. Going for an Initial Public Offer ('IPO') is an indication that the company has progressed to a significant level in its relative industry and market. A company decides to issue securities for different reasons; the main reason being that of raising capital to fund organic growth or an acquisition or meet financial requirements for starting a venture or repaying debts or expansion and diversification. Read on to know more…



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What is an IPO

Initial Public Offer as defined in "Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009" means, "An offer of specified securities by an unlisted issuer to the public for subscription and includes an offer for sale of specified securities to the public by any existing holders of such securities in an unlisted issuer". A company can raise money by issuing either debt or equity stocks to the public.

Indian Economy and IPO

The Indian economy has been capricious in the last couple of decades. From a closed economy of the 1980s, the 1990s and early 2000s saw liberalisation which spurred the growth in the economy and in 2015, with "Make in India" as a pinnacle concept of the current Central Government, the economy

is set for an unprecedented further growth. History has shown us that the growth in the economy has been duly supplemented with significant increase in the capital markets activities, especially with a lot of companies going for an IPO.

"Going Public" represents a big challenge in a company's life cycle. A successful IPO can be the foundation which enables a company to reach its full potential. However, an IPO is a convoluted and a protracted process. Companies mounting the IPO process have to comply with many accounting and disclosure requirements that do not apply to unlisted companies. Embarking on an IPO and completing it successfully calls for strategic planning, advanced preparatory efforts and robust project management coupled with clear understanding and addressing of the potential challenges.

The process of an IPO- An Overview

IPO Process gets initiated

Lead manager appointed.
Registrar to the Issue appointed
Draft Offer Prospectus is prepared and filed with SEBI
IPO road shows are conducted

Prospectus reviewed

SEBI review's draft Offer Prospectus and reverts back for clarifications and changes.
Post approval, the draft Offer Prospectus becomes Offer Prospectus

Filing and Approval of Offer Prospectus

Lead Manager submits the Offer Prospectus to Stock Exchanges and Registrar of the Issue and gets it approved.
Issuer Company and lead manager decide the issue date and issue price band.
Red Herring Prospectus is finalised.
Red Herring Prospectus and IPO application forms are printed and distributed to investors.

Bidding process

Public Issue opens for investors bidding.
Investors fill the application forms and place orders.
Public Issue closes for investors bidding

Price fixing

Lead manager evaluates the final issue price and updates the 'Red Herring Prospectus' with the final issue price

Stock Listing

Registrar receives all application forms and cheques and finalizes the pattern of allotment of shares.
Transfer shares in the demat account of investors.
Refund the remaining money.
Once all allocated shares are transferred in investor's accounts, Lead Manager with the help of Stock Exchange decides the issue listing date.

IPO Regulations in India

Companies planning to issue securities in India have to comply with provisions of following relevant acts:-

a. Securities Contracts (Regulation) Act, 1956;
b. Securities Contracts (Regulation) Rules, 1957;
c. Companies Act, 2013;
d. The Companies (Prospectus and Allotment of Securities) Rules, 2014;
e. Securities and Exchange Board of India Act, 1992; and
f. Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.

Securities Exchange Board of India (SEBI), the capital market regulator has issued "Securities Exchange Board of India (Issue of capital and disclosure requirements) Regulations 2009" (hereinafter referred to as "ICDR regulations") laying down regulations governing an IPO. Moreover, the Institute of Chartered of Accountants of India has issued a Guidance Note on Reports in Company Prospectus (herein after referred to as the "guidance note") which provides guidance relating to the reports required to be issued by Chartered Accountants in prospectus/statement in *lieu* of prospectus issued by the companies for the offerings made in India.

Regulations regarding financial information of the issuer company

ICDR regulations requires the company to include the following in offer document:

- Restated Statement of Profit and Loss and Restated Statements of Assets and Liabilities for each of the five financial years immediately preceding the issue of the prospectus after making certain adjustments; and
- A statement of account for that part of the said period up to a date not earlier than six months from the date of issue of the prospectus indicating the restated profit or loss for that period and the

restated assets and liabilities position as at the end of that period.

The requirement is to give figures of restated profits and losses for the five financial years preceding the issue of the prospectus or statement in lieu of prospectus. If the company has been carrying on business for less than five financial years, the figures are to be given for the actual period. Where the five financial years immediately preceding the issue of the prospectus, covers a period less than five years, i.e., 60 months (this can happen if the company has changed its accounting period), the offer prospectus should cover as many financial years as may be necessary, so that the aggregate period covered is not less than five years (60 months).

Audited Statement of Profit and Loss and Audited Statements of Assets and Liabilities

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Adjustments as stated in ICDR regulations.

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Restated Statement of Profit and Loss and Restated Statements of Assets and Liabilities

ICDR regulations and the guidance note discuss adjustments to be incorporated while preparing Restated Financial Statements, wherever quantification is possible. Certain key adjustments are as follows:

- Adjustments/rectification for all incorrect accounting practices or failures to make provisions or other adjustments which resulted in audit qualifications.
- Material amounts relating to adjustments for previous years shall be identified and adjusted in arriving at the profits of the years to which they relate irrespective of the year in which the event triggering the profit or loss occurred.
- Where there has been a change in accounting policy, the profits or losses of the earlier years (required to be shown in the offer document) and of the year in which the change in the accounting policy has taken place shall be recomputed to reflect what the profits or losses of those years would have been if a uniform accounting policy was followed in each of these years. It should be noted that, if for any of these years, the change is not quantifiable, the same needs to be brought out in the report of the auditor/accountant. It is likely that the companies would have changed accounting policies to comply with several of the Accounting Standards that have become mandatory in the recent past. The Standards become applicable from a particular date specified in the Standard and some Standards have transitional provisions as well. In this regard, the date when the Standard became mandatory should be ignored and the same should be applied as if the Standard was mandatory throughout the period covered by the auditor/accountant. However, in case of practical problems in adoption of a Standard in earlier years for making the adjustment, the fact should be adequately brought out in the auditor's/accountant's report as an emphasis of matter paragraph or a qualification, as may be necessary, depending upon the facts and circumstances of each case.
- If an incorrect accounting policy is followed, the re-computation of the financial statements shall be in accordance with correct accounting policies.

Adjustments to financial information of the issuer company

Identification, measurement and dislosure of adjustments to the financial information is exigent and time consuming. While, the ICDR regulations and the guidance note, lays down various adjustments, there are certain practical issues, which we would to discuss in this article. Let us, examine certain adjustments:

I. How to adjust changes in useful lives of fixed assets, while preparing Restated Financial Statements

It is clear from the ICDR regulations and guidance note that audit qualifications, changes in accounting policies and items identified as prior period items should be adjusted. The question is whether revisions in accounting estimates also need to be adjusted and if so, in which circumstances?

Appendix 6 of the guidance note which gives an Illustrative Format of Restated Financial Statements includes following examples of adjustments arising out of (a) write back of certain provisions for doubtful debts (b)

income-tax refunds/provisions and (c) unspent liabilities written back.

As per ICDR regulations, material amounts relating to adjustments for previous years should be adjusted in arriving at the profits/losses for the years to which they relate irrespective of the year in which event triggering the profit or loss has occurred. In other words, where there are material facts which would have been taken into consideration while preparing the accounts for the respective years, had those facts been known at that time, the same should be considered in the year to which it relates. The auditor should, therefore, review the relevant information in respect of earlier years, such as, settlement of significant litigations items already reported as prior period adjustments, extraordinary items identified, *etc*. and adjusted in the respective years.

The issue devolves upon the interpretation of the above mentioned paragraph, which deals with adjustments to previous year's profits/losses for "material amounts relating to adjustments for previous years". Do these adjustments cover accounting estimates?

There are strong arguments that the adjustment for accounting estimates should be of an amount which has been debited or credited to the Statement of Profit and Loss of any of the periods covered in the offer document. If an amount has not been debited/credited and does not represent an error/omission or is not due to change in accounting policy, it does not seem that it should be adjusted. In other words, if an accounting estimate made in the last period, does not have an impact on the earlier years, it should not be adjusted. To do so will lead to certain unintended consequences as illustrated below in the context of change in estimated useful life of fixed assets.

Suppose the useful life of a substantial class of fixed assets is changed with effect from 1 April 2014 resulting in depreciation being charged over a significantly longer period (say 10 years as against 5 years earlier). This will have an accounting consequence, which we can examine by way of an example:

A company purchased an asset on 1st April 2010 for ₹500 to be depreciated on SLM basis over 5 years. The written down value ('WDV') as on 1st April 2014 will be ₹100, which will be written off in financial statements of years 2014-15 onwards over the residual life as per the newly estimated life of 10 years– ith the depreciation charge being lower than earlier. The interim period's financial statements of 2014-15 included in the offer document would also have lower depreciation than earlier. If the depreciation charge is also revised for all the five years as per the new accounting estimate, the WDV as on 1st April 2014 would be higher (₹300) as per the offer document. Apart from that the net worth in the offer document as at period end would be based on WDV of 300 were as actually only ₹100 would be as per financial statements. Further the Earning per Share ('EPS') in the offer document for each past year would be shown at a higher figure.

A change in the estimate of useful lives of fixed assets is a change in an accounting estimate. The first point to be considered is that unlike paragraphs 20-24 of Accounting Standard 5 which deal with the general accounting treatment of change in an accounting estimates, affecting only the current and future periods, paragraph 7 of Schedule II to the Companies Act, 2013, itself provides the accounting treatment of the change in estimate of useful life. Accordingly one of the following 3 positions may arise:

A. <u>Where the revised useful life is longer:</u>

   As per Schedule II to the Companies Act, 2013, there will be no effect on Statement of Profit and Loss or Balance Sheet as on 1st April 2014, since the WDV (minus residual value) as per the old lives will be depreciated over the remaining new useful life. However, the last period's (interim period of 2014-15, as included in the offer document) depreciation charge will be lower as compared to earlier years. In such a situation, if an adjustment is made and the impact is large, the net result will be:

   (a) The WDV on 1st April 2014 will be lower in the annual financial statements than that as per the offer document (₹100 against ₹300, as explained in the above paragraph).

   (b) The net profit, and therefore, EPS would be much higher as per the offer document.

(c) The net worth will be much higher as per the offer document.

(d) The future annual financial statements would show a total depreciation of ₹100 (minus residual value) resulting in actual future EPS being higher. (The difference of ₹200 would never get written off.)

B. Where the new useful life is significantly shorter but still some period is left as on the date of change:

There will be no effect on Statement of Profit and Loss or Balance Sheet, but if the adjustment is made, in the restated financial statements, the WDV as per offer document will be much lower (having an impact, opposite to that in (A) above).

C. Where useful life is over as per revised estimate

In such a case, there will be a debit of the WDV in the Statement of Profit and Loss or to opening reserves as per financial statements. Since the debit has already been made (and it is not for future financial statements) it would be rational to make the adjustments to previous years.

The guidance note also states that *"in making the adjustments, regards should be had to 'materiality' of the amounts involved in respect of various items of adjustment. The term 'materiality' is defined in Accounting Standard(AS)1 on 'Disclosure of Accounting Policies,' issued by the I nstitutes of Chartered Accountants of India, as below:*

"Financial statements should disclose all 'material' items, i.e., items the knowledge of which might influence the decisions of the user of financial statements."

Accordingly, adjustment of immaterial items is not warranted.

Conclusion

Accordingly, it could be interpreted that, adjustment for change in accounting estimates should be made only with regard to such items which have already been debited/ credited in the Statement of Profit and Loss prior to the last date upto which restated accounts are presented in the offer document.

II. How to adjust write-off of Minimum Alternate Tax Credit, which was set up in previous years, while preparing Restated Financial Statements

Background: In the previous years, the company had set up minimum alternate tax ('MAT') credit as there was convincing evidence that the company would be able to realise the asset during the specified period for which the asset can be carried forward. However, during the current year, management based on their re–estimation of the convincing evidence required to set up MAT credit, decided to write off MAT credit, which was set up in previous years.

The question arises, whether write-off of MAT credit, which was set up in previous years, qualifies for "adjustments" in the offer document?

The Guidance Note on 'Accounting for Credit available in respect of Minimum Alternate Tax' states as below:

11 *"The concept of probability as contemplated in paragraph 84 of the Framework relates to both items of assets and liabilities and, therefore, the degree of uncertainty for recognition of assets and liabilities may vary keeping in view the consideration of 'prudence'. Accordingly, while for recognition of a liability the degree of uncertainty to be considered 'probable' can be 'more likely than not' (as in paragraph 22 of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets') for recognition of an asset, in appropriate conditions, the degree may have to be higher than that. Thus, for the purpose of consideration of the probability of expected future economic benefits in respect of MAT credit, the fact that a company is paying MAT and not the normal income tax, provides a prima facie evidence that normal income tax liability may not arise within the specified period to avail MAT credit. In view of this, MAT credit should be recognised as an asset only when and to the extent there is convincing evidence that the company will pay normal income tax during the specified period. Such evidence may exist, for example, where a company has, in the current year, a deferred tax liability because its*

depreciation for the income-tax purposes is higher than the depreciation for accounting purposes, but from the next year onwards, the depreciation for accounting purposes would be higher than the depreciation for income-tax purposes, thereby resulting in the reversal of the deferred tax liability to an extent that the company becomes liable to pay normal income tax.

12. Where MAT credit is recognised as an asset in accordance with paragraph 11 above, the same should be reviewed at each balance sheet date. A company should write down the carrying amount of the MAT credit asset to the extent there is no longer a convincing evidence to the effect that the company will pay normal income tax during the specified period."

Assuming that, the company had, in the case of recognition of MAT as an asset, evaluated the criterion of "convincing evidence" appropriately, we believe that the adjustment should be made in the earlier years (since the write off is already a part of the accounting estimate used in the annual financial statements), while preparing Restated Financial Statements.

III. Effect of merger from the appointed date in the Offer Document

Background: The company filed a merger scheme in January 2014 with 1st April 2013 as the appointed date. The scheme was approved by the High Court on 10 January 2015.

The question that arises is whether the impact of merger needs to be provided as on 1st April 2013 in the Restated Financial Statements?

In this regard it is noted that as per ICDR regulations, material amounts relating to adjustments for previous years should be adjusted in arriving at the profits/losses for the years to which they relate irrespective of the year in which event triggering the profit or loss has occurred. The matter devolves on the interpretation of the words "material amounts relating to adjustments for previous years". The Guidance note interprets this as below:

"In other words, where there are material facts which would have been taken into consideration while preparing the accounts for the respective year, had those facts been known at that time, the same should be considered in the year to which it relates. The auditor should, therefore, review the relevant information in respect of earlier years, such as, settlement of significant litigations items identified and adjusted in the respective years etc".

In the given case, the merger scheme was filed in January 2014 with 1st April 2013 as the appointed date. Had the court approval been received in the financial year ended 31st March 2014 thereby settling the merger petition, the amalgamation would have been considered in the year ended 31st March 2014 itself. Though the court approval of the order was passed in January 2015, it should be adjusted retrospectively to the year to which it relates in the Restated Financial Statements.

IV. Presentation of interim financial statements and disclosure of comparative numbers in the Restated Financial Statements

Background: The financial year end of the company is 31st March. The company has historically not prepared any interim financial statements. The company expects to file Draft Red Herring Prospectus ('DRHP') for issue of equity shares by 31st March 2015.

As required by ICDR regulations, the company should include a statement of account for that part of the said period up to a date not earlier than six months from the date of issue of the prospectus indicating the profit or loss for that period and the assets and liabilities position as at the end of that period.

Accordingly, the restated financial information for the five years and an interim period (say 1st April 2014 to 30th September 2014, also referred to as the "stub period") would be included in the offer document to be submitted by the company. The aforesaid financial statements for the broken period ('stub period') should be prepared on the basis of recognition and measurement principles laid down in Accounting Standard 25 as per requirements of guidance note. As far as disclosures in the aforesaid financial statements are concerned, they may be as comprehensive as required for the composite financial information required to be disclosed in the offer document as per ICDR regulations. It is recognised that these disclosures are somewhat different than both the Accounting Standard 25 disclosures as well as disclosures in a general purpose financial statement. Further, the aforesaid regulations do not require comparatives for inclusion in the financial statements for the stub period.

Accordingly, it is imperative for the company to disclose in the 'Basis of preparation of financial statements' that the company has complied with the measurement and recognition requirements of Accounting Standard 25. However, the disclosure requirements of Accounting Standard 25 including the requirement of comparative figures have not been followed and the disclosures are such so as to comply with the requirements of ICDR regulations.

The following statement could be included in the Audit Report on the interim financial statements: Considering the fact that these interim financial statements are special purpose financial statements, in accordance with the requirements of guidance note and Standards on Auditing 800, the auditor should draw reference to the disclosure paragraph relating to 'Basis of Preparation' included by management in the interim financial statements and include an emphasis of paragraph in the audit report of interim financial statements stating that the interim financial statements follow the measurement and recognition criteria as laid down in Accounting Standards 25 but they do not contain all the disclosures required by Accounting Standards issued under the Companies (Accounting Standards) Rules, 2006 which continue to apply under Section 133 of the Companies Act 2013. Moreover, the auditor should also ensure that the purpose of preparation of financial statements should be clearly brought out in the 'Restriction on use' paragraph.

Conclusion

The journey to a successful IPO is a marathon. Companies generally hastily move towards an IPO believing that by sheer willpower they can speed up the process. But the IPO process is a measured program that makes incremental advances over a period of time to safely and successfully achieve the goal. The preparation for an IPO, including identification, measuremnt and disclosure of adjustments is often complex for any company to undertake on its own without adequate knowledge and experience. ■