

A STEP TOWARDS DECODING THE COMPLEX IFRS



A shift from country specific Generally Accepted Accounting Principles (GAAP) to International Financial Reporting Standard (IFRS) is proving to be an inevitable move virtually for all organizations around the world. It is imperative to be prepared to contend the extensive impact of this regulatory change on business practices, accounting practices and organization as whole.

The paragraphs below gives a bird's eye view of the following:

- ⇒ ***What is IFRS?***
- ⇒ ***Indian Initiative***
- ⇒ ***Process of conversion***
- ⇒ ***Overview of key difference***
- ⇒ ***Challenges under IFRS***
- ⇒ ***Role of independent directors***



What are Accounting Standards?

Accounting standards are authoritative statement on how transactions should be recorded and disclosed in the financial statements. They ensure uniformity amongst the various entities to the readers of financial statements. The compliance to standards is mandatory to ensure that the accounts are true and fair. This uniformity is now proposed to be spread from local boundaries to across the world with the advent of single global accounting standard namely IFRS.

Introduction to IFRS

IFRSs are adopted by the International Accounting Standards Board (IASB), the independent standard-setting body of the International Accounting Standards Committee Foundation (IASC Foundation).

More than 100 countries now require or permit the use of IFRSs or are converging with the International Accounting Standards Board's (IASB) standards. EU recognized IFRS in 2005 and the SEC has in its announcement on November 2007 permitted IFRS without reconciliation with US GAAP for non US companies.

Many of the accounting standards forming part of the IFRS are known by the earlier name of International Accounting standards (IAS), which were issued between 1973 and 2001 by the board of International Accounting Standards Committee (IASC). In April 2001 IASB adopted all IAS and continued their development calling new standards as IFRS which consist of:

- IFRS Standards issued after 2001
- IAS standards issued before 2001
- Interpretations originated from International financial Reporting Interpretations Committee (IFRIC)
- Standing Committee Interpretations (SIC) issued before 2001

Indian initiative towards IFRS

Institute of Chartered Accountant of India (ICAI), the apex accounting body in India has issued a '**Concept paper on convergence with IFRS in India**' in October 2007. The document lays down the convergence strategy. All public interest entities would have to adopt IFRS from 1st April 2011.



Financial Statements under IFRS

Generally in India we have the following as financial statements:

- Balance Sheet
- Profit & Loss Account
- Cash Flow
- Significant Accounting Policies and Notes to Accounts

Under IFRS the financial statements would comprise of:

- Statement of Financial Position as at end of the period
- Statement of comprehensive income for the period
- Statement of Changes in Equity for the period
- Statement of Cash Flow for the period
- Notes, Comprising a summary of significant accounting policies and other explanatory information
- Statement of financial position as at the beginning of the earliest comparative period when an equity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statement.

The old format as per Schedule VI of the Indian Companies Act would not be relevant and the financial statements would have to reflect items as prescribed by the relevant IFRS.

Key differences between IFRS and Indian GAAP

The adoption of IFRS affects more than a company's accounting policies, processes, and people. Ultimately, most aspects of a company's business and operations are affected potentially.

IFRS is a principle based approach to standard setting. It is less reliant on bright lines and detailed rules as compared to the US GAAP.

At various places IFRS provides scope of judgment and requires information to be presented on the basis of substance rather than rule. **For example** redeemable preference shares may be treated as liability and convertible debentures as equity.

While applying IFRS, usage by an investor is kept in mind and requirement of the law and management takes back seat. **For example** in case of the business combination the acquirer under IFRS could be different than the legal acquirer (like in case of reverse merger for tax benefit or other purposes).

Financial statements under IFRS places more reliance on the management estimate **For example** in case of depreciation of assets which would under IFRS have to be based on estimated useful life as against the present Indian requirement to follow Schedule XIV of the Companies Act, 1956.

The Fair Value concept is embodied in many of the IFRS (like IAS 30 on financial Instruments, IAS 40 Investment Property, etc.). The concept of fair value poses several issues on valuation, valuation models and accuracy and reliability of the same for the purpose of accounting and presentation of financial statements.



Few other examples where there is departure from Indian Accounting Standards are:

- Major overhauling cost for fixed assets which can be capitalized under IFRS (provided it meets certain criteria) as against the present requirement to expense out the same.
- Inventory for service organization for work which is in progress (already covered by proposed Indian Accounting Standard)
- Prior period item to be given effect retrospectively in opening equity
- Proposed dividend is not required to be reflected in financial statements under IFRS
- Under IFRS, provision made for dismantling of asset or for site closure can be capitalized
- Under IFRS, EPS to be disclosed separately for continuing and discontinuing operations

Challenges under IFRS

- Joint ventures: Consolidation proportionate or otherwise may become an issue. Consolidation method may impact structure of new arrangements
- Debt / equity: Possible reclassification of preference shares as liabilities
- Subsidiaries and associates: Different rules may impact the current treatment
- Valuation: Greater use of fair value
- Detailed hedge documentation, and ongoing effectiveness testing is required to achieve hedge accounting under IFRS
- Embedded derivatives: Possible requirement to fair value components of other instruments, including long-term contracts
- Contracting: Different rules will present different opportunities, challenges, management and accounting issues
- Financial communications will have to address changes in presentation of financial information as well as fundamental change towards fair value accounting and its impacts on traditional ratios and performance indicators



- Systems and processes
 - Data requirements
 - Calculation methodologies
 - Integration
- Uncertainly about Income Tax Department response
- Requires multi-disciplinary participation
- Aiming at a moving target
 - Uncertain timetable for implementation
 - Uncertainty about final form of IFRS

Conversion / Convergence to IFRS

The conversion to IFRS will have to be managed like any other large scale project. Sufficient time must be incorporated into project plan, proper resources must be secured and all key players must be involved in critical decision making.

IFRS is more than an exercise for the accounting and finance department. Its impact is far reaching, affecting areas from internal control and sales to research and development.

Typically the following three phases will be involved in convergence/conversion to IFRS:

| Stages | Key focus Points |
|-----------------------------|---|
| Pre-Implementation phase | <ul style="list-style-type: none"> • Formulation to detailed plan • Identifying key areas of difference between existing accounting policies and requirements of the IFRS • Understanding the implications • Educating/training the accounting team |
| Transition phase | <ul style="list-style-type: none"> • Map the existing systems, process, controls with IFRS and identify the impacted areas • Make changes in the controls, process, business documentation/SOP |
| Post - Implementation phase | <ul style="list-style-type: none"> • Validation of changes made - this involves testing of high risk areas for accuracy of systems and procedure • Continuous monitoring of IFRS regulatory changes |



Impact & Considerations out of IFRS

- First time adoption could be a mammoth task and hence it is essential to ensure that proper care and diligence is exercised so that there are no spill-over impacts in subsequent periods. IFRS 1 deals exhaustively with the first time adoption.
- To ensure that the judgment, estimated and fair valuation concepts are not misused by the Management, lot of reliance would have to be placed on independent valuers.
- Proper planning is required for transition to IFRS and hence to ensure that the company must have a proper road map / strategy and resources to migrate to IFRS.
- Emphasis on transparent and exhaustive disclosure which would mean that the source of data, compilation process and methodology are more robust.
- To ensure that the commercial color of the transaction is correctly reflected in the accounting of the same. **For Example** SPV to park non performing assets may be required to be consolidated.
- More data analysis, narrative accounting and hence more qualitative accountants and more time will be required to review.
- The taxation team will have to work closely with the accounts teams to examine IFRS impact on the new financing structures implemented within the group. Further there is also uncertainty regarding the response to the Income Tax department regarding change to IFRS
- Under Income Tax based on view that the tax department may take, there could be cash flow related implication which would have to be understood / captured and addressed appropriately
- The CFO will need to focus on the underlying commercial nature of transactions and events. Other areas where more judgment is required include property, leases, revenue recognition, provisions and consolidation policy.
-
- Convergence to IFRS will have an impact on the processes which lead to recording of a specific transaction and necessitate re-engineering of those process and related internal controls.



IFRS would benefit all the users of financial statements. It would take accounting and financial reporting to a new level. However it would in the initial years put too much burden on the preparers and reviews of financial statements.

Lot of research and development is still under progress for various items like fair value, etc. and the evolved version would lead to better and more narrative financial statements. IFRS for SME are yet to be released; the same is expected to reduce the compliance requirement and the cost for 'private entities' / 'non-publically accountable entities'.

IFRS in India is an opportunity for Indian enterprises to be in line with the global companies and would in turn help raise finances globally. It would be a boon to the accounting fraternity as it would expose them to International arena and would help service the global accounting market

N A Shah Associates

65 – C, Mittal Towers
Nariman Point
Mumbai 400 021.

Tel : +91 22 4073 3000
Fax: +91 22 4073 3090
Email: ifrs@nashah.com

Disclaimer

This document has been prepared as a service to the clients. We recommend you seek professional advice before taking any action on the specific issues.