ASSURANCE & ADVISORY
BUSINESS SERVICES

ERNST & YOUNG
Quality In Everything We Do

Thinking IFRS?

EY Guide on Transition to IFRS

Including a CD Containing Ernst & Young IFRS Publications and
Detailed Comparative Statement on Indian GAAP and IFRS

Thinking IFRS?

EY Guide on Transition to IFRS

Managing the Transition to IFRS

The requirement for public interest entities in India to comply with International Financial Reporting Standards (IFRS) from April 1, 2011 as announced by the Institute of Chartered Accountants of India is in line with the global momentum towards convergence and high quality financial reporting.

Significant benefits can be derived from converging to IFRS. These include enhanced comparability and reporting transparency. Migration to IFRS will lower the cost of raising capital, as it will eliminate multiple reporting and reduce the risk premium built in by investors who are not conversant with Indian GAAP, unlike IFRS.

Conversion to IFRS is more than a mere technical exercise. The consequences are far wider than financial reporting issues, and extend to various significant business and regulatory matters including compliance with debt covenants, structuring of ESOP schemes, training of employees, modification of IT systems and tax planning.

For the first IFRS-compliant financial statements it is a requirement that the comparatives should also comply with IFRS. The consequence of this is that impacted Indian entities will need to start preparing IFRS compliant accounts from the period commencing April 1, 2010 and preferably much earlier. Thus, a great deal of preparation will be necessary long before the adoption date. A carefully considered strategy with support from the leadership and strong teamwork will be necessary to successfully migrate to the new system. For many entities, financial statements and ratios may change dramatically. This will affect the perception of analysts, bankers and investors. A proper communication strategy could turn this event to your advantage.

The purpose of this booklet is to answer questions such as:

- How will IFRS impact the financial statements of businesses and what would be the conversion efforts?
- What challenges, other than converting the financial statements, will the entity face?
- What approach or strategy should be followed in transiting to IFRS?
- What are the high level differences between IFRS and Indian GAAP?

The next few years will be exciting, but challenging at the same time. We at Ernst & Young are committed to help you migrate to IFRS as smoothly as possible, and look forward to teaming with you on this landmark event both for Corporate India, and for your entity.

Dolphy D'Souza
Partner and National Leader, IFRS Services
Ernst & Young

Contents

Overview

of IFRS 

1. Overview of IFRS

1.1. What is IFRS?

IFRS has recently emerged as the numero-uno accounting framework, with widespread global acceptance. The IASB, a private sector body, develops and approves IFRS. The IASB replaced the IASC in 2001. IASC issued IAS from 1973 to 2000. Since then, IASB has replaced some IAS with new IFRS and has adopted or proposed new IFRS on topics for which there was no previous IAS. Through committees, both, the IASC and IASB have issued Interpretations of Standards.

The term IFRS has both, a narrow and a broad meaning. Narrowly, IFRS refers to the new numbered series of pronouncements that the IASB is issuing, as distinct from the IAS series issued by its predecessor. More broadly, IFRS refers to the entire body of IASB pronouncements, including standards and interpretations approved by the IASB, IASC, and SIC. Till date, IASB has issued 30 IAS and 8 IFRS. It has also issued 11 SICs and 13 IFRICs to provide guidance on some interpretation issues arising from IAS and IFRS (see Appendix for a detailed listing of IFRS issued till date). In this publication, the term 'IFRS' has been used in the broader context.

IFRS is principle based, drafted lucidly and easy to understand and apply. However, the application of IFRS requires an increased use of fair values for measurement of assets and liabilities. The focus in IFRS is more towards getting the balance sheet right and hence brings significant volatility in the income statement.

1.2. IFRS – A truly Global Accounting Standard

The year 2000 was significant for IAS, now known as IFRS. The International Organisation of Securities Commission formally accepted the IAS core standards as a basis for cross-border listing globally. In June 2000, the European Commission passed a requirement for all listed companies in the European Union to prepare their CFS using IFRS (for financial years beginning 2005). Since 2005, the acceptability of IFRS has increased tremendously.

There are now more than 100 countries across the world where IFRS is either required or permitted. This figure does not include countries such as India, which do not follow IFRS but their national GAAP is inspired by IFRS. The table below provides a snapshot of IFRS acceptability globally.

Domestic Listed Entities	Number of Countries
IFRS required for all domestic listed companies	77
IFRS permitted for domestic listed companies	24
IFRS required for some domestic listed companies	4
IFRS not permitted for domestic listed companies	32
Total	137

Considering that more than 100 out of 137 countries require or permit IFRS, this should not leave any doubt that IFRS is now numero-uno. This status has been unequivocally accepted by the SEC as well. The SEC has passed a ruling to allow the use of IFRS without reconciliation to US GAAP in the financial reports filed by foreign private issuers, thereby giving foreign private issuers a choice between IFRS and US GAAP. In addition, the SEC is also examining the possibility of treating US and foreign issuers at par by also providing US issuers the alternative to use IFRS. This is a milestone proposal that will bring almost the entire world on one single uniform accounting platform, i.e., IFRS.

1.3. IFRS and India

The issue of convergence with IFRS has gained significant momentum in India. At present, the ASB of the ICAI formulates Accounting Standards based on IFRS, however, these standards remain sensitive to local conditions, including the legal and economic environment. Accordingly, the Accounting Standards issued by the ICAI depart from the corresponding IFRS in order to ensure consistency with the legal, regulatory and economic environments of India.

At a meeting held in May 2006, the Council of ICAI expressed the view that full IFRS may be adopted at a future date, at least for listed and large entities. The ASB, at a meeting held in August 2006, considered the matter and supported the Council's view that there would be several advantages of converging with IFRS. Keeping in mind the extent of differences between IFRS and Indian Accounting Standards, as well as the fact that convergence with IFRS would be an important policy decision, the ASB decided to form an IFRS Task Force. The objectives of the Task Force were to explore: (i) the approach for achieving convergence with IFRS, and (ii) laying down a road map for achieving convergence with IFRS with a view to make India IFRS-compliant.

Based on the recommendation of the IFRS Task Force, the Council of ICAI, at its 269th meeting, decided to adopt a 'big bang' approach and fully converge with IFRS issued by IASB, from accounting periods commencing on or after 1 April 2011. IFRS will be adopted for listed and other public interest entities such as banks, insurance companies and large-sized organizations.

With an objective to ensure smooth transition to IFRS from 1 April 2011, ICAI will take up the matter of convergence with IFRS with NACAS. The NACAS was established by the Ministry of Corporate Affairs, Government of India, and various regulators including RBI, IRDA and SEBI. ICAI will formulate a work-plan to ensure that IFRS are effectively adopted from 1 April 2011. Further, ICAI will conduct IFRS training programmes for its members and others concerned to prepare them to implement IFRS. ICAI will also discuss with the IASB, those areas where changes in certain IFRS may be required, keeping in view the Indian conditions.

1.4. Benefits of adopting IFRS for Indian Companies

The decision by ICAI to converge with IFRS is a milestone decision and is likely to provide significant benefits to Indian corporates.

Improved Access to International Capital Markets

Many Indian entities are expanding or making significant acquisitions in the global arena—for which huge capital is required. Majority of stock exchanges require financial information prepared under IFRS. Migration to IFRS will enable Indian entities to have access to international capital markets, without the risk premium involved in Indian GAAP financial statements.

Lower Cost of Capital

Migration to IFRS will lower the cost of raising funds, as it will eliminate the need for preparing a dual set of financial statements. It will also reduce accountants' fees, abolish risk premium and will enable access to all major capital markets as IFRS is globally acceptable.

Enable Benchmarking with Global Peers and Improve Brand Value

Adoption of IFRS will enable companies to gain a broader and deeper understanding of the entity's relative standing by looking beyond country and regional milestones. Further, adoption of IFRS will facilitate companies to set targets and milestones based on global business environment, rather than merely local ones.

Escape Multiple Reporting

Convergence to IFRS, by all group entities, will enable company managements to get all components of the group on one financial reporting platform. This will eliminate the need for multiple reports and significant adjustment for preparing CFS or filing financial statements in different stock exchanges.

Reflects True Value of Acquisitions

In Indian GAAP, business combinations, with few exceptions, are recorded at carrying values and not at fair values of net assets taken over. Purchase consideration paid for intangible assets not recorded in the acquiree's books is usually not reflected separately in the financial statements; instead the amount gets added to goodwill. Hence, true value of the business combination is not communicated through financial statements. IFRS will overcome this flaw as it mandates accounting for net assets taken over in a business combination at fair value. It also requires recognition of intangible assets, even though they have not been recorded in the acquiree's financial statements.

New Opportunities

Benefits from the IFRS wave will not be restricted to Indian corporates. In fact, it will open up a host of opportunities in the services sector. With a wide pool of accounting professionals, India can emerge as an accounting services hub for the global community. As IFRS is fair value focused, it will provide significant opportunities to professionals, including, accountants, valuers and actuaries, which in-turn will boost the growth prospects for the BPO / KPO segment in India.

1.5. IFRS Challenges

Shortage of Resources

With the convergence to IFRS, implementation of SOX, strengthening of corporate governance norms, increasing financial regulations and global economic growth, accountants are most sought after globally. Accounting resources is a major challenge globally and will remain so in the short-term. India, with a population of more than 1 billion, has only approximately 145,000 Chartered Accountants, which is far below its requirement.

Training

If IFRS has to be uniformly understood and consistently applied, training needs of all stakeholders, comprising CFOs, auditors, audit committees, teachers, students, analysts, regulators, and tax authorities need to be addressed. It is imperative that IFRS is introduced as a full subject in universities and Chartered Accountancy syllabus.

Information Systems

Financial accounting and reporting systems must be able to produce robust and consistent data for reporting financial information. The systems must also be capable of capturing new information for required disclosures, such as segment information, fair values of financial instruments, and related party transactions. As financial accounting and reporting systems are modified and strengthened to deliver information in accordance with IFRS, entities need to enhance their IT security in order to minimize the risk of business interruption—particularly to address potential fraud, cyber terrorism, and data corruption.

Taxes

IFRS convergence will have a significant impact on financial statements and consequently tax liability. Tax authorities should ensure that there is clarity on the tax treatment of items arising out of convergence to IFRS. For example, will government authorities tax unrealised gains arising out of the accounting required by the standards on financial instruments? From an

entity's point of view, a thorough review of existing tax planning strategies is essential to test their alignment with changes created by IFRS. Tax and other regulatory issues as well as the risks involved will have to be considered by the entities.

Communication

IFRS may significantly change reported earnings and various performance indicators. Managing market expectations and educating analysts will therefore be critical. A company's management must understand the differences in the way the entity's performance will be viewed, both internally and in the market place, and agree on key messages to be delivered to investors and other stakeholders. Reported profits may be different from perceived commercial performance due to the increased use of fair values and the restriction on existing practices such as hedge accounting. Consequently, the indicators for assessing both, business and executive performance, will need to be revisited.

Management Compensation and Debt Covenants

The amount of compensation calculated and paid under performance-based executive and employee compensation plans may be materially different under IFRS, as the entity's financial results may be considerably different. Significant changes to the plan may be required to reward an activity that contributes to an entity's success within the new regime. Re-negotiating contracts that referenced reported accounting amounts, such as bank covenants, may be required on convergence to IFRS.

Distributable Profits

IFRS is fair value driven, which results very often in unrealised gains and losses. Whether this can be considered for the purpose of computing distributable profits will have to be debated, in order to ensure that distribution of unrealised profits will not eventually lead to reduction of share capital.


IFRS
BUSINESS
ISSUES
Tax Planning
Management
Reporting System
Investor
Relations
Employee and
Executive Compensation
Employee
Benefit Plans
Performance
Indicators
Corporate Finance
and Structured
Financial Products
Financial Accounting
and Reporting

Getting Ready for

Transition to IFRS

2. Getting Ready for Transition to IFRS

At the outset, it should be understood that changing from Indian GAAP to IFRS is not merely changing from one set of accounting policies to another. It is much more, since it not only has significant accounting consequences but also has far reaching business consequences. Hence, the process of conversion should be taken seriously and not done in a casual manner. Any mistake in the conversion could invite negative publicity and regulatory action.

2.1. Impact Assessment

This process entails a detail impact assessment between Indian GAAP and IFRS accounting policies and identifies areas of differences and challenges, which the management might face, such as:

» Business Combinations

» Financial Instruments (It should be noted that ICAI has recently approved AS 30 and AS 31 and has issued an exposure draft on proposed AS 32 which are based on IFRS)

» Group Accounts

» Fixed Assets and Investment Property

» Presentation of Financial Statements

» Share-based Payments

Impact assessment is an enabler to produce IFRS financial statements that compare to and eventually replace, an entity's current financial statements. However, it is equally important for the entity to see how IFRS information will affect the perception of its business performance.

2.2. Business Re-engineering

Converting is not just a technical exercise. It provides executives with opportunities to challenge the way in which their organisation is viewed and evaluated by investors, other key stake-holders, and competitors. Every important decision that an entity makes will be affected by IFRS, making it essential for the management to anticipate changes in the market perception.

2.3. IFRS Conversion Programme

The transition to IFRS is a complex and time-consuming process. Entities need to undertake a preliminary study before proceeding for IFRS conversion, which will give them an opportunity to challenge the way it is viewed and evaluated by the outside world.

Diagnostic and Design	Solution Development	Implementation and Maintenance
• Perform the accounting diagnostic	• Develop and document scenarios (estimated impacts, necessary changes in reporting)	• Restate opening balance sheet
• Identify industry issues and benchmarks	• Prepare accounting manual	• Restate balance sheet and profit and loss account for comparative information
• Assess business impact (eg, reporting, tax, investor relations, etc.)	• Determine IT critical changes required and launch development when appropriate	• Prepare full year IFRS Financial Statements
• Perform an IT diagnostic surrounding major accounting differences		• Follow IFRS updates (new interpretations and standards)
• Tailor the team with appropriate expertise		
• Prepare detailed timetable		

Entities should identify a dedicated team, which will work on the conversion exercise and ensure that the management is fully geared to meet reporting deadlines. Experience strongly suggests that major conversions to IFRS can take 18 months or more, and less complex conversions can take between 6 to 12 months. Ernst & Young understands the complexity of this transition and IFRS requirements. We can work with you to effectively convert your existing practices.

Step 1: Diagnostic and Design Process

The time and effort required to conduct a 'Diagnostic and Design' process will vary depending on the nature of an entity. Typically, entities such as banks or a company with several subsidiaries will require significant time and effort to undertake and implement this process, which entails the following:

» Assessment of existing practices: performing the accounting diagnostic and identifying industry issues and benchmarks

» Comparison of Indian GAAP with IFRS: assessing business impact and performing an IT diagnostic surrounding major accounting differences identified through comparison

» Gather IFRS practices followed: tailoring the team with appropriate expertise based on the current practices followed in IFRS and preparing a detailed timetable

Step 2: Solution Development Process

IFRS requires many changes in IT. The 'Solution Development' process identifies the required changes by developing and documenting scenarios, preparing accounting manuals in compliance with IFRS, and determining critical IT changes required.

Step 3: Implementation and Maintenance Process

Implementation of IFRS will require assistance from experts. This process also involves preparation of the first IFRS financial statements. Ernst & Young is equipped to support companies in the process of making the first financial statements in compliance with the IFRS requirements. The process involves restating the opening balance sheet, restating the financial statements for comparative period, and preparing IFRS financial statements for the first year. The maintenance process involves consistently following IFRS updates.

Impact of

Key Differences

3. Impact of Key Differences

3.1. Presentation of Financial Statements

Key Differences

» IAS 1 *Presentation of Financial Statements* is significantly different from the corresponding AS 1 *Disclosure of Accounting Policies.* While IAS 1 sets out overall requirements for the presentation of financial statements, guidelines for their structure, and minimum requirements for their content, Indian GAAP offers no standard outlining overall requirements for presentation of financial statements.

In India, for various entities, the statutes governing the respective entities lay down formats of financial statements. For example, in the case of companies, format and disclosure requirements are set out under Schedule VI to the Companies Act, 1956. For entities such as partnership firms, the statute governing those entities does not lay down any specific format of financial statements.

» IAS 1 recognises true and fair override. True and fair override is generally not permitted under Indian GAAP. Though Clause 49 of the Listing Agreement contains provisions relating to the true and fair override, no practical guidance is available.

» IAS 1 requires SOCIE or SORIE to be presented separately as a part of the financial statements. The concept of SOCIE or SORIE does not prevail under Indian GAAP, however, information relating to appropriation of profits, movement in capital and reserves, etc., is presented on the face of the profit and loss account and/or in the captions share capital and reserves and surplus in the balance sheet.

» IAS 1 requires disclosure of (i) critical judgments made by management in applying accounting policies (ii) key sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year, and (iii) information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital. There are no such disclosures required under Indian GAAP.

» IAS 1 prohibits any item to be presented as an extraordinary item, either on the face of the income statement or in the notes. As compared to this, AS 5 in Indian GAAP specifically requires disclosure of certain items as extraordinary items.

Impact on Financial Reporting

IAS 1 essentially sets out overall requirements for presentation of financial statements. In case of balance sheets, it requires a clean segregation of current and non-current items for assets and liabilities. In the profit and loss account, both, the functional format and the format based on nature of expenses are allowed. Therefore, IAS 1 significantly impacts the presentation of financial statements. These impacts are covered under the following broad parameters:

Enhanced Transparency and Accountability

- The disclosure of information required by IAS 1, with reference to critical judgments made by the management in applying accounting policies and key sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year in the financial statements, would not only bring greater transparency in the financial statements, however, it would also put an extra onus on entities to ensure that estimates and judgments made are justifiable, since they are publicly accountable for them.
- Application of IAS 1 would require entities to present total amount of recognised gain or loss for the period—comprising profit or loss for the period and amounts recognised directly in reserves—to be presented in SORIE or as a separate item in SOCIE. This amount is not available separately in Indian GAAP financial statements.

Better Presentation of Financial Position

- Under IAS 1 each entity should present its balance sheet using current and non-current assets and liabilities classifications on the face of the balance sheet, except when a presentation based on liquidity provides information that is reliable and more relevant. As per IAS 1, whichever method of presentation is adopted, for each asset and liability item that combines amounts expected to be recovered or settled both, before and after twelve months from the balance sheet date, an entity shall disclose two amounts separately. For various items, there is no similar requirement under Indian GAAP. For example, under Schedule VI, companies are not required to disclose the amount payable within one year with respect to secured loans.

Legal Implications

Unless Indian laws are amended to comply with IFRS, entities would not be able to make unreserved and explicit statement of compliance with IFRS, as required to be made under IAS 1 in case of compliance with IFRS.

Impact on Organisation and its Processes

Till now, we have discussed the impact of IFRS convergence on financial reporting. However, the impact on an organisation implementing IFRS may be very different, than what can be understood only by analysing the impact on financial reporting.

Although IAS 1 would not have any bottom line impact on entities, they would be required to review and modify, if necessary, their organisation and processes to ensure that information to comply with all disclosure requirements of IAS 1 is collected. It may be noted that because of the current/non-current classification, some of the gearing ratios may change or become more transparent.

Many entities, particularly those not subject to any externally imposed capital requirements, may not have well documented and formally established objectives, policies and processes for managing capital. To comply with IAS 1 requirement for making disclosures regarding capital, even such entities would need to formalise and document such objectives, policies, processes,

etc. This would involve personnel not only from the entity's accounts department, but also from other functions, such as finance and treasury. Similarly, disclosure of current and non-current portion of assets and liabilities in the balance sheet would also require the involvement of finance and treasury functions.

Though not prohibited, most entities do not use functional classification to present their expenses, as this would result in extra efforts, since Schedule VI requires information to be given as per the nature of expense. Apparently, only some software companies and a few other entities provide information according to the function of expense on the face of profit and loss account. They also present complete information as per nature of the expense in the notes to comply with the requirements of Schedule VI. If entities want to follow functional classification under IFRS, the successful establishment of such a mechanism would require changes in the accounting system and codification structure.

3.2. Business Combinations

Key Differences

» IFRS 3 *Business Combinations* applies to most business combinations, both amalgamation (where acquiree loses its existence) and acquisition (where acquiree continues its existence). Under Indian GAAP, there is no comprehensive standard dealing with all business combinations. AS 14 applies only to amalgamation, i.e., when acquiree loses its existence and AS 10 applies when a business is acquired on a lump-sum basis by another entity. AS-21, AS-23, and AS-27 apply to subsidiaries, associates and joint ventures respectively.

» IFRS 3 requires all business combinations (excludes common control transactions) within its scope to be accounted as per Purchase method and prohibits merger accounting. Indian GAAP permits both Purchase method and Pooling of Interest method. Pooling of Interest method is allowed only if the amalgamation satisfies certain specified conditions.

» IFRS 3 requires net assets taken over, including contingent liabilities, to be recorded at fair value unlike Indian GAAP, which requires recording of net assets, with a few exceptions, at carrying value. Contingent liabilities are not recorded as liabilities under Indian GAAP.

» IFRS 3 prohibits amortisation of goodwill arising on business combinations and requires it to be tested for impairment. Indian GAAP requires amortisation of goodwill in the case of amalgamations. With reference to goodwill arising on acquisition through equity, no guidance is provided in Indian GAAP.

» IFRS 3 requires negative goodwill to be credited to profit and loss account, whereas the same is credited to capital reserve under Indian GAAP.

» In IFRS 3 acquisition accounting is based on substance. Reverse acquisition is accounted assuming the legal acquirer is the acquiree. In Indian GAAP, acquisition accounting is based on form. Indian GAAP does not deal with reverse acquisition.

The changes brought in by IFRS 3 are going to affect all stages of the acquisition process—from planning to the presentation of post deal results. The implications primarily involve providing greater transparency and insight into what has been acquired and allowing the market to evaluate the management's explanations of the rationale behind a transaction. The key impact of IFRS 3 is summarised below:

Impact on Financial Reporting

True Value of Acquisition will be Reflected

Following an acquisition, financial statements will look very different. Assets and liabilities will be recognised at fair value. Contingent liabilities and intangible assets which are not recorded in the acquiree's balance sheet will be appearing in the acquirer's balance sheet. This change in recognition of net assets will significantly change the value of goodwill recorded in the books of accounts. Goodwill reflected in the books will project actual premium paid by an entity for the acquisition.

Greater Transparency

Significant new disclosures are required regarding the cost of the acquisition, the values of the main classes of assets and liabilities, and the justification for the amount allocated to goodwill. All stakeholders will be able to evaluate actual worth of an acquisition and its impact on the future cash flow of the entity.

Significant Impact on Post Acquisition Profits

In Indian GAAP, net assets taken over are normally recorded at book value and hence the charge to profit and loss account on account of amortisation and depreciation is based on carrying value. However, net assets taken over will be recorded at fair value under IFRS 3. This results in a charge to profit and loss account on account of amortisation and depreciation based on fair value, which is the true price paid by acquirer for those assets. Goodwill is not required to be amortised but is required to be tested for impairment under IFRS 3. Negative goodwill is required to be credited to profit and loss account under IFRS 3. These items increase volatility in the income statement.

Accounting for Business Combination vis-à-vis High Court Order

In India, 'law overrides Accounting Standards' is an accepted principle. Hence, accounting is done based on treatment prescribed by the High Court in its approval, even though it may not be in accordance with Accounting Standards. However, IFRS does not recognise the principle of legal override. Thus, once IFRS is adopted, accounting will need to be done based on principles prescribed in IFRS 3. To achieve this, entities will need to ensure that scheme filed with the High Court does not prescribe any treatment or the treatment is in accordance with IFRS.

Impact on Organisation and its Processes

Use of Experts

The acquisition process should become more rigorous—from planning to execution. More thorough evaluation of targets and structuring of deals will be required in order to withstand greater market scrutiny. Expert valuation assistance may be needed to establish values for items such as new intangible assets and contingent liabilities.

Purchase Price Allocation

Under Indian GAAP, no emphasis was given to purchase price allocation as net assets were generally recorded based on the carrying value in the acquiree's balance sheet. IFRS 3 places significant importance to the purchase price allocation process. All the identifiable assets of the acquired business must be recorded at their fair values. Many intangible assets that would previously have been subsumed within goodwill must be separately identified and valued. Explicit guidance is provided for the recognition of such intangible assets. Contingent liabilities are also required to be fair valued and recognised in the acquirer's balance sheet. The valuation of such assets and liabilities is a complex process and would require specialist skills.

Deal Structures may Change

In Indian GAAP, entities were inclined to give consideration in equity shares to satisfy conditions of merger accounting. The end of merger accounting for all acquisitions, under the scope of IFRS 3, removes this constraint on the structure of deal considerations. Presently, it is possible for entities to buy companies which do not violate merger conditions so that pooling method can be applied. Under IFRS 3 those opportunities will no more be available.

3.3. Group Accounts

Key Differences

» Under IFRS preparation of group accounts is mandatory subject to few exemptions, whereas preparation of CFS is required only for listed entities under Indian GAAP.

» Under IFRS the application of equity method or proportionate consolidation to associates/joint ventures is mandatory subject to a few exceptions, even if an entity does not have any subsidiary. Under Indian GAAP, application of equity method or proportionate consolidation is required only when the entity has subsidiaries and prepares CFS.

» Under IFRS consolidation is required for all subsidiaries, whereas there are two exemptions from consolidation provided under Indian GAAP.

» Control definition is different under IFRS and Indian GAAP.

» Both, IFRS and Indian GAAP require use of uniform accounting policies for preparation of CFS. However, Indian GAAP provides exemption on grounds of impracticality.

» IFRS allows a three-month time gap between financial statements of parent or investor and subsidiary, associate or jointly controlled entity. Indian GAAP allows a six-month time gap.

» IFRS requires consolidation of SPEs, whereas Indian GAAP does not provide any specific guidance on this subject.

Impact on Financial Reporting

Preparation of CFS

Indian GAAP does not require preparation of CFS for unlisted entities. If IFRS is adopted by such entities, they will have to prepare their group accounts. Even for listed entities, under

Indian GAAP, there is no guidance on consolidation of SPE and hence many are not being consolidated. Under IFRS, many SPE, which satisfy certain criteria need to be consolidated. Unlike Indian GAAP, consolidation of associates and joint venture will be required even if the entity does not have any subsidiary in the financial statements prepared under IFRS.

Adoption of IFRS does not always result in consolidation, but would result in de-consolidation of certain subsidiaries in some cases. Under Indian GAAP, two groups can consolidate the same entity, i.e., one group consolidates as it holds majority ownership stake, whereas other group consolidates as it controls the board of directors. Under IFRS, control can be held only by one entity and it is unlikely that two entities would consolidate the same company.

Uniform Accounting Policies

Indian GAAP provides an exemption from the use of uniform accounting policies for consolidation of subsidiaries, associates and joint ventures on the grounds of impracticality. IFRS does not provide such exemption and mandates use of uniform accounting policies for subsidiaries, associates and joint ventures. This is likely to pose significant challenges, especially in the case of associates where the entity does not have a control over the associate. All entities will have to gear their systems or develop systems like preparation of group accounting manuals to ensure compliance with this requirement. On adoption of IFRS, many group entities will have to change their accounting policies to bring them in line with the parent entity.

Financial Year-Ends of all Components in the Group

Indian GAAP allows a maximum time gap of six months between financial statements of parent and subsidiary. There is no time limit prescribed between financial statements of investor and associate. IFRS allows a maximum time gap of three months for subsidiaries, associates, and joint ventures. On adoption of IFRS, many entities may be compelled to change the year-ends of their group entities to comply with this requirement.

Impact on Organisation and its Processes

Use of Group Accounts by Various Stakeholders

Under Indian GAAP preparation of CFS is required only by listed entities. Once IFRS is adopted, preparation of CFS will be required for all entities. Benchmarking by analysts and other stakeholders will move from entity centric to group centric information. Management of the holding entity will be questioned not only for their own performance but also for the performance of all group entities. Consolidation of previously unconsolidated entities may adversely affect key ratios and performance indicators such as risk-based capital ratios of a financial institution.

Coordination with Management of Associates and Joint Ventures

Under IFRS there is no exemption from the requirement of uniform accounting policies. Also, time gap between financial statements of investor and of an associate can be maximum three months. Hence, an entity needs to initiate dialogue with the management of the associate and joint venture to obtain information of the requisite data as per the group accounting policies for the purpose of consolidation.

Updation of Group Structures

Adoption of IFRS will result in consolidation of certain entities including SPE and de-consolidation of certain entities. The adoption of IFRS will also require potential voting rights that are currently exercisable or convertible, including potential voting rights held by another entity, to be considered when assessing whether another entity is a subsidiary, associate or joint venture of the entity. This will require updation of the organisation structure maintained by the entity. Many unlisted entities, who are not required to prepare CFS, might not have prepared a comprehensive group structure. They will have to initiate this exercise for identifying all components in the group.

3.4. Financial Instruments

Key Differences

IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement*, and IFRS 7 *Financial Instruments: Disclosures* deal with presentation, recognition and measurement and disclosure aspects of financial instruments, in a comprehensive manner. In India, the Council of the ICAI has recently approved AS 30, *Financial Instruments: Recognition and Measurement*, AS 31, *Financial Instruments: Presentation*, and has issued an exposure draft on AS 32 *Financial Instruments: Disclosures,* which are based on IAS 39, IAS 32 and IFRS 7, respectively. However, the same has not yet been adopted under the Companies Accounting Standard Rules. Pending the application of these AS, the pronouncements which deal with certain types of financial instruments are AS 13, *Accounting for Investments*, *Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options*, *Guidance Note on Investments by Mutual Funds* and *Guidance Note on Accounting for Securitisation*.

» IAS 32 requires the issuer of a financial instrument to classify the instrument as a liability or equity on initial recognition, in accordance with its substance and the definitions of these terms. The application of this principle requires certain instruments which have the form of equity to be classified as liability. For example, under IAS 32, mandatorily redeemable preference shares on which fixed dividend is payable are treated as a liability. Under Indian GAAP, classification is normally based on form rather than substance.

» IAS 32 requires compound financial instruments, such as convertible bonds, to be split into liability and equity components and each component is recorded separately. Under Indian GAAP, no split accounting is done and financial instruments are classified as either liability or equity, depending on their primary nature. For example, a convertible debenture is treated as liability.

» Under IAS 39 all financial assets are classified into four categories, namely, FVPL, AFS, HTM, and L&R. Subsequent to initial recognition, FVPL assets are valued at fair value with gain or loss being recognised in profit or loss. AFS assets are valued at fair value with gain or loss being recognised in equity, which is recycled into profit or loss, either on impairment or on derecognition of those assets. HTM and L&R assets are valued at amortised cost using the effective interest rate. Under Indian GAAP, long term investments are recorded at cost less "other than temporary" diminution in value of investments. Current investments are recorded at lower of cost or market price. L&R are carried at actual cost and interest thereon is recognised at contractual rate, if any.

» IAS 39 defines derivative as financial instruments or other contracts having all three characteristics, namely (i) its value changes in response to the change in a specified interest rate, financial instrument price, etc., (ii) it requires no or smaller initial net investment, and (iii) it is settled at a future date. As per IAS 39, all derivatives, except those used for hedge purposes, are measured at fair value and any gains/losses are recognised in profit or loss. Under Indian GAAP, there is no specific standard dealing with derivatives; though, there are some pronouncements which deal with specific types of derivatives. Consequently under Indian GAAP many derivatives remain outside the balance sheet.

» IAS 39 deals with various aspects of hedge accounting in a comprehensive manner. It defines three types of hedging relationships comprising fair value hedge, cash flow hedge and hedge of net investments in a foreign operation. It also lays down conditions which need to be fulfilled to apply hedge accounting. In India, presently, only AS 11 deals with forward exchange contracts for hedging foreign currency exposures.

» IAS 39 requirements on derecognition of financial assets are different than those contained in the *Guidance Note on Accounting for Securitisation.* Further, under Indian GAAP there is no methodology for determining impairment of financial assets. IAS 39 includes detailed provisions for determining impairment.

» IFRS 7 requires entities to provide comprehensive disclosures in their financial statements that enable users to evaluate (a) significance of financial instruments for its financial position and performance and (b) the nature and extent of risks arising from financial instruments, and how the entity manages those risks. The disclosures required under IFRS 7 include quantitative as well as qualitative information. Under Indian GAAP, at present, there is no AS corresponding to IFRS 7 which requires such disclosures. However, ICAI has recently issued an exposure draft on AS 32 *Financial Instruments: Disclosures.* Also ICAI has issued an announcement on '*Disclosure regarding Derivative Instruments'* which requires certain minimum disclosures to be made concerning financial instruments.

Impact on Financial Reporting

Recognition and Measurement

As compared to Indian GAAP, IAS 39 requires balance sheet recognition for all financial instruments (including derivatives) and makes greater use of fair values. All financial assets and financial liabilities are initially recognised (in the balance sheet) at fair value. In case of FVPL assets, liabilities and derivatives, (other than those used for hedging) subsequent changes in fair value are recognised in profit or loss. The use of fair values sometimes causes volatility in the income statement or equity. To comply with the IAS 39 requirement to measure all derivatives at fair value, entities have to make use of valuation tools.

Impairment

IAS 39 requires a provision for impairment to be recognised as soon as there is a risk that the initial value of an asset may not be recovered. The measurement of impairment takes into account the time value of money. Thus, under IFRS, other things being equal, even a change in the timing of cash flows may cause impairment. Under the principles of IAS 39, change in timing of the cash flows may be treated as an impairment, even if the entity does not expect any default on restructured terms. IAS 39 prohibits reversal of impairment on AFS equity instruments and unquoted equity instruments carried at cost. Thus, under IFRS, an impairment of the above equity instruments would be final and the entity would never be allowed to reverse the same.

Debt

Debt and equity classifications are substantially changed as a result of several provisions in IAS 32 and 39. Some of the instruments, such as redeemable preference shares, are classified as equity, based on their form under Indian GAAP. Similarly, to convert to IFRS, the compound instruments which are classified as debt or equity depending on their primary nature need to be split into debt and equity and each portion treated separately.

Derecognition

Because of the very strict criteria for derecognising financial assets in IAS 39, some financial asset disposal transactions (particularly the sale of trade receivables) may be reclassified as guaranteed loans. This risk is greater since SPE involved in such transactions must generally be consolidated by the vendor entity in accordance with strict criteria as per SIC 12 of IFRS. The IFRS derecognition criteria are based on the substance of the transaction, and are generally more restrictive than the approach applied under the *Guidance Note on Accounting for Securitisation.*

Comprehensive Disclosures

IFRS 7 requires very comprehensive disclosures regarding financial instruments and financial risks to which an entity is exposed, as well as the policies for managing such risks. Comprehensive information on the fair value of financial instruments would enhance the transparency and accountability of financial statements.

Impact on Organisation and its Processes

The implementation of IAS 39 and IAS 32 will have a significant impact on all banks and on many industrial and commercial entities. In particular, entities with central treasury functions will have to review their operational processes and consider implications for their current hedge accounting policies. In addition to accountants, operational personnel from various departments must be involved in implementing IAS 32 and IAS 39, including the following:

- Treasury teams (front office, back office, and middle office)
- Sales representatives in charge of negotiating contracts

- Purchasing personnel
- Legal staff

For example, identifying derivatives would be an entity-wide process under IAS 39. Embedded derivatives are also considered as derivatives and must be recognised separately from their host contracts (debts or sales contracts). In addition, certain contracts, which were up till now not classified as derivatives, may be qualified as such and measured at fair value (with an impact on profit or loss).

Therefore, the first phase of IAS 39 implementation will include identification of derivatives, documentation of hedges, and requires the involvement of:

- The treasury department: for analysing all financial contracts, particularly debt contracts
- Sales representatives: for identifying any embedded derivatives in the form of indexation to a financial instrument price, interest rate or any other variable without a close link with the host contract
- Purchasing department personnel: for performing similar analyses on supply contracts, including any indexing provisions in commodity contracts
- Operational personnel: for documenting hedges

3.5. Income Taxes

Key Differences

- AS 22 *'Accounting for Taxes on Income'* is based on the income statement liability method, which focuses on timing differences, whereas IAS 12 *'Income Taxes'* is based on the balance sheet liability method which focuses on temporary differences.
- IAS 12 requires recognition of deferred taxes in case of business combination. Under IFRS, the cost of a business combination is allocated to the identifiable assets acquired and liabilities assumed by reference to their fair values. However, if no equivalent adjustment is allowed for tax purposes, it would give rise to a temporary difference. Under Indian GAAP, business combinations (other than amalgamation) will not give rise to a deferred tax adjustment.
- Where an entity has a history of tax losses, under IFRS the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available. Under Indian GAAP, if the entity has carried forward tax losses or unabsorbed depreciation, all deferred tax assets are recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised. IAS 12 does not lay down any requirement for consideration of virtual certainty in such cases.

Impact on Financial Reporting

Deferred Tax Accounting for the Group

Under IFRS temporary differences arise to the extent that the subsidiary, associate or joint venture has not distributed its profits to the parent or investor, which is normally the case. IAS 12 requires deferred tax to be recognised for this, except in specified circumstances. IAS 12 also requires deferred tax to be recognised on temporary differences that arise from the elimination of profits and losses resulting from intra-group transactions. As a result, deferred tax for the group under IFRS can be significantly different than under Indian GAAP depending on the undistributed profits of the subsidiaries, associates or joint ventures and the effect of elimination of profits and losses resulting from intra-group transactions. IFRS requires deferred tax on revaluation of assets. This, however, is not required under Indian GAAP.

Acquisitions

Deferred tax on acquired assets, liabilities, and contingent liabilities is itself considered an acquired asset or liability and is adjusted against goodwill under IFRS. When it gives rise to deferred tax liability, reversal of such liability in future years affects the tax expense or income of those years. Therefore, the effect of acquisition deferred taxes on future financial statements will differ significantly under IFRS and Indian GAAP. This factor will influence the acquisition transaction.

Entities in Tax Losses

Due to the strict principle under Indian GAAP of virtual certainty, in very rare cases can entities recognise deferred tax assets when they have carried forward losses and unabsorbed depreciation. The 'convincing evidence' principle under IFRS, which is lenient compared to Indian GAAP 'virtual certainty' principle, allows the entity to recognise tax income on carried forward tax losses and unabsorbed depreciation as well.

Impact on Organisation and its Processes

IAS 12 implementation requires accounting personnel to work effectively with the tax department to:

- Monitor and calculate tax bases of assets and liabilities
- Monitor tax losses and tax credits of all components in the group
- Assess recoverability of deferred tax assets
- Determine possible offsets between deferred tax assets and liabilities
- Monitor changes in tax rates and collect applicable tax rates to determine the amount of deferred tax in the event of asset disposal
- Understand implications of double tax treaty, where there are foreign operations
- Prepare more detailed disclosures—tax reconciliation

Tax teams should be involved, both at the group and subsidiary level. If no tax specialists are available at the subsidiary level, tools (e.g., accounting and tax manuals, including checklists that enable group entities to accurately determine tax bases) and appropriate training should be provided to ensure quality reporting. The group needs to do a thorough review of existing tax planning strategies to test alignment with any organisational changes created by IFRS conversion.

3.6. Employee Benefits and Share-based Payments

Key Differences

- IAS 19 provides options to recognise actuarial gains and losses immediately in the income statement or in SORIE or apply the corridor approach. Under the corridor approach, an entity recognises a portion of its actuarial gains and losses as income or expense if the net cumulative unrecognised actuarial gains and losses at the end of the previous reporting period exceeded the greater of: (a) 10% of the present value of the defined benefit obligation at that date (before deducting plan assets); and (b) 10% of the fair value of any plan assets at that date. Any actuarial gains and losses above the 10% corridor can be amortised over the remaining service period of employees or on an accelerated basis. Indian GAAP requires all actuarial gains and losses to be recognised immediately in the profit and loss account.
- Under IFRS, the liability for termination benefits has to be recognised based on constructive obligation, Indian GAAP requires it to be recognised based on legal obligation.
- In IFRS there is no concept of deferral for termination benefits. Under Indian GAAP, for VRS expenditure incurred on or before 31 March 2009, the entity may choose to follow the accounting policy of deferring such expenditure over its pay-back period. However, the expenditure so deferred cannot be carried forward to accounting periods commencing on or after 1 April 2010 (sunset date).
- Under IFRS, employee share-based payment should be accounted for using Fair Value Method, whereas Indian GAAP permits an option of using either Intrinsic Value or Fair Value Method.
- IFRS provides detailed guidance for accounting group and treasury share transactions, whereas no such guidance is provided in Indian GAAP.

Impact on Financial Reporting

Reduce Volatility in Income Statement on Account of Actuarial Differences

Actuarial gains and losses arise due to changes in actuarial assumptions, such as in respect to the discount rate, increase in salary, employee turnover, mortality rate, etc. Under the corridor approach of IFRS, it is permissible to defer the actuarial gains or losses under certain circumstances. This flexibility is not provided under Indian GAAP. This approach, purely from a fair value and asset or liability definition perspective, is superior to IFRS but puts Indian entities at a disadvantage as compared to their global counterparts. On adoption of IFRS, an entity can choose to reduce volatility in their income statement arising on account of actuarial differences.

Timing of Recognition of Termination Benefits

Under IFRS termination benefits are required to be provided for when the scheme is announced and the management is demonstrably committed. Under Indian GAAP, termination benefits are required to be provided for, based on legal liability (when employee signs up for the VRS) rather than constructive liability. This is a timing issue for creating a provision. Under IFRS, an entity cannot spread the impact of providing termination benefit to more than one accounting period as deferral is not permitted. Under Indian GAAP, the VRS expenditure prior to the sunset date could be deferred.

True Value of ESOP

Indian GAAP permits entities to account for ESOP either through Fair Value Method or Intrinsic Value Method though disclosure is required to be made of the impact on profit or loss of applying the Fair Value Method. It is observed that most Indian entities prefer to adopt the Intrinsic Value Method. The drawback of the Intrinsic Value Method is that it does not factor option and time value while determining compensation cost. In IFRS, the accounting for ESOP will have to be done as per Fair Value Method, which may result in increased charge for ESOP for many entities and will have a significant impact on key indicators like EPS.

Accounting for Share-based Payments to Non-employees

In recent times, it is observed that many entities are entering into partnership agreements with their vendors so as to provide them with opportunities of sharing profits of a particular venture by offering them share-based payments. This mode of payment is also considered as an incentive tool intended for vendors doing efficient and quality work. Under Indian GAAP, AS 10 requires a fixed asset acquired in exchange for shares to be recorded at its fair market value or the fair market value of the shares issued, whichever is more clearly evident. For other goods and services, there is no guidance for recognising the cost of providing such benefits to the vendors in lieu of goods or services received. Different accounting policies are being followed by Indian entities which ranges from no-charge to accounting as per principles of IFRS 2. On adoption of IFRS, an entity will have to account for such benefits as per Fair Value Method laid down in IFRS 2.

Accounting for Group ESOP Plans

In India, the practice is a subsidiary normally does not account for ESOP issued to its employees by its parent entity, contending that clear-cut guidance is not available and it does not have any settlement obligation. Under IFRS, such ESOP plans will have to be accounted as per principles laid down in IFRIC 11 *'IFRS 2 Group and Treasury Share transactions',* i.e., either as equity settled or as cash settled plan, depending on whether the parent or subsidiary is obligated to provide stock options to the employees. As per IFRIC 11, all entities whose employees are being provided ESOP benefits by its parent or other group entities will have to account for the charge in their income statement, which will reflect the true compensation cost of receiving employee benefits.

Impact on Organisation and its Processes

IAS 19 and IFRS 2 are likely to have a major impact on many organisations. Additional liabilities arising from adoption of IFRS 2 will negatively impact financial results and ratios. In some situations, the ability to pay dividends may be affected and there may also be implications from restrictive covenants in existing debt/equity agreements or lease contracts. As a result, many entities should carry out a comprehensive review of their rewards and recognition mechanisms in order to ensure that these continue to support business strategies in a cost effective manner. Not only cash cost, but accounting cost also needs to be considered, and the impact on key stakeholders (senior management, employees, potential recruits, trade unions, pension trustees, and rating agencies) needs to be understood. While IFRS 2 may have a negative effect, IAS 19 has the opposite effect, since actuarial losses are allowed to be deferred.

Senior management, finance, operational and human resource personnel will need to work closely with each other, their actuaries and their external advisors to ensure a full understanding of the accounting and business impact of alternative employee benefits and of emerging best practices in an IFRS environment.

3.7. Impairment of Assets

Key Differences

» Under Indian GAAP the recoverable amount needs to be estimated at least at the end of each financial year for intangible assets, which are not yet available for use, or intangible assets that are amortised over a period exceeding ten years from the date when the asset is available for use. Under IFRS, an annual impairment test is required for intangible assets with an indefinite useful life or an intangible asset not yet available for use. This test can be performed at any time during the year, provided it is performed at the same time every year.

» IFRS requires an annual impairment test for goodwill acquired in a business combination.

» Once an impairment loss is recognised for goodwill, it cannot be reversed subsequently under IFRS. In Indian GAAP the impairment loss on goodwill is reversed in a subsequent period when the impairment loss was caused by a specific external event of an exceptional nature, that is not expected to recur and subsequent external events have occurred that reverse the effect of that event.

Impact on Financial Reporting

Income Statement Volatility due to Impairment of Specified Intangible Assets and Goodwill

Indian GAAP does not allow intangible assets to be assigned an indefinite useful life. Therefore, all intangible assets are amortised over time. Since IFRS permits certain intangibles to be assigned an indefinite useful life with no amortisation, it creates volatility in the income statement when impairment is recognised for such intangible assets. Due to the requirement under IFRS on annual impairment testing of goodwill, impairment testing is unavoidable for CFS when such financial statements include goodwill, which is the case in most of the groups.

Goodwill once Impaired is Impaired Forever under IFRS

IAS 36 prohibits reversal of impairment loss on goodwill in subsequent periods. In Indian GAAP, entities have the possibility of reversing such loss of goodwill.

Impact on Organisation and its Processes

The identification of CGUs for impairment testing purposes requires the participation of operational staff in addition to accounting and finance staff. Personnel from strategy and planning, mergers and acquisitions, as well as management and operations are likely to play an important role in identifying CGUs, allocation and tracking of goodwill arising on acquisition to various CGUs and in preparing cash flow projections used for calculating recoverable amounts.

The future cash flows are estimated for the asset in its current condition under both the frameworks. Typically, an entity's budgets will include cash inflows and outflows related to restructuring planned in the coming years. Such cash flows need to be excluded for impairment testing. As a result, the entity will not be able to use its budgets straight away for impairment tests.

Future impairment on newly acquired businesses may invite negative publicity and class action from investors. The threat of impairment will also mean that a company will be extremely cautious in its merger and acquisition strategies. In many situations, the entity would probably refrain from those acquisitions where the threat perception of impairment is greater.

3.8. Fixed Assets, Intangibles, Investment Property and Leases

Key Differences

» IAS 16 *Property, Plant and Equipment* mandates component accounting, whereas AS 10 *Accounting for Fixed Assets* recommends, but does not force, component accounting.

» IFRS requires depreciation to be based on useful life. In Indian GAAP, depreciation is based on higher of useful life or Schedule XIV rates.

» Major repairs and overhaul expenditure are capitalised under IFRS as replacement, if they satisfy the recognition criteria, whereas in most cases Indian GAAP requires them to be charged off to the profit and loss account as incurred.

» IFRS requires estimates of useful lives and residual values to be reviewed at least at each financial year-end. In Indian GAAP, there is no need for an annual review of estimates of useful lives and residual values.

» Both IFRS and Indian GAAP permit the revaluation model for subsequent measurement. IFRS mandates revaluation to be done for entire class of property, plant and equipment and to be reviewed periodically. In Indian GAAP, revaluation is not required for all the assets of the given class, it is sufficient that the selection of the asset to be revalued is made on systematic basis, e.g., an entity may revalue a class of assets of one unit and ignore the same class of assets at other location. Also, there is no need to update revaluation regularly under Indian GAAP.

- Under IFRS depreciation on the revaluation portion cannot be recouped out of revaluation reserve and will have to be charged to the income statement over the useful life of the asset, whereas Indian GAAP permits depreciation on revaluation portion to be recouped out of revaluation reserve to the income statement.
- IFRS provides detailed rules for the classification of an asset as an investment property and allows subsequent measurement of investment property at cost or at fair value. Indian GAAP requires investment property to be recognised only at cost less diminution in value other than temporary.
- Under IFRS intangible assets can have indefinite useful life. Such assets are required to be tested for impairment only without any amortisation. Under Indian GAAP, there is no concept of indefinite useful life.
- Under IFRS the revaluation model is allowed for accounting of an intangible asset provided an active market exists, whereas Indian GAAP does not permit use of the revaluation model for intangible assets.
- IFRS requires land leases to be normally classified as an operating lease unless title passes to the lessee at the end of the lease term. Under Indian GAAP no Accounting Standard deals with land leases. As per a recent EAC opinion, long-term lease of lands should be treated as finance lease.
- IFRS requires an entity to determine whether an arrangement, comprising a transaction or a series of related transactions, that does not take the legal form of a lease but conveys a right to use an asset in return for a payment or series of payments, is a lease. As per IFRIC 4, such determination shall be based on the substance of the arrangement, e.g., power purchase agreements and outsourcing contracts may have the substance of lease. Indian GAAP does not provide any guidance for such arrangements.

Impact on Financial Reporting

Fixed Asset Management

Under IAS 16 a part of item of property, plant and equipment with a cost that is significant in relation to total cost of an item shall be separately depreciated. Hence, entities need to bifurcate the cost of an asset into significant parts if their useful life is different and depreciate them separately. This requirement will require entities to restructure their fixed asset register and recompute depreciation. Also, requirement of estimating residual value is likely to change depreciation of many assets as Indian entities normally presume 5% of value of assets as their residual value without actually making any estimate of the residual value.

Revaluation of Fixed Assets

Indian entities, which have done selective revaluation of fixed assets or intend to revalue the fixed assets, will have to determine whether they want to continue with the revaluation model or not. This decision is crucial for an entity, as to continue with the revaluation model, (i) they will have to adopt revaluation model for entire class of assets which cannot be restricted to some selective location, (ii) update such revaluation on regular basis, and (iii) take depreciation charge in the income statement based on revalued amounts.

Investment Property

In IFRS Indian entities will have an additional option of reflecting their investment property at fair value and recognising any resulting gain or loss in the profit or loss for the period. If an entity decides to adopt fair value model for its investment property, it is not required to charge any depreciation on it. Detailed guidance is provided in IAS 40 for classification of an asset as an investment property, which may result in some reclassifications into or out of the investment property category.

Intangible Assets

Unlike Indian GAAP, amortisation will not be required under IFRS for an intangible asset for which there is no foreseeable limit on the period over which the asset is expected to generate net cash inflow for the entity. However, annual impairment testing will be required for such an asset. This can create volatility in profit or loss. Also, the entity will be able to reflect intangible assets at their fair value, provided there is an active market for them. This will help the entity project the real value of their intangible assets in the balance sheet, to their stakeholders.

Service Contracts

Under IFRS, services contracts, such as power purchase contracts, waste management contracts, and outsourcing contracts may have to be accounted for as leases, if the use of the specific asset is essential to the operations and satisfies certain conditions. In such cases, lease is analysed in light of IAS 17 to determine its classification. Such contracts are presently not assessed for identifying lease under Indian GAAP, though there is no such restriction. This can have a substantial impact as the service provider might be required to derecognise the asset from its books if it satisfies finance lease classification.

Impact on Organisation and its Processes

Several provisions of IAS 16, IAS 40 and IAS 17 require entities to transfer responsibilities—previously assumed by the finance function—to operational personnel for the purpose of:

» Validating costs of parts of property, plant and equipment items (including determining cost of directly attributable costs)

» Defining the relevant components

» Identifying investment properties

» Validating depreciation periods and methods for items of property, plant, and equipment

» Regularly reviewing the depreciation periods and methods, residual values, and valuation of unused property, plant, and equipment

» Reviewing various arrangements to identify lease arrangement

The maintenance of a fixed asset register would be a cumbersome exercise since this will now have to be more granular to include components and major repairs that are capitalised. It would be difficult, if not impossible, to maintain them manually and hence appropriate ERP packages need to be implemented or the existing ones modified to capture such information.

One of the methods permitted for accounting of investment property is the fair valuation method. If such a method is followed by a company, then it needs to institute an appropriate mechanism of valuing such investment properties on a regular basis as also an internal control mechanism to ensure that such a valuation is robust and reliable.

The Purchase department needs to be trained in order to identify leases in a service contract. This would ensure that service contracts which are in substance leases are properly accounted for as leases in accordance with IFRIC 4.

3.9. Related Party Disclosures

Related party transactions cover transactions with certain defined parties, regardless of whether any price is charged or not. It is common for every entity to enter into transactions with related parties. Therefore, the differences between Indian GAAP and IFRS will impact many entities.

Key Differences

» AS 18 *Related Party Disclosures* defines related party as "parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions". While defining related party under IAS 24 *Related Party Disclosures*, the words used are "financial and operating decisions." Therefore, it appears that AS 18 definition is more stringent in this regard.

» AS 18 does not include post-employment benefit plans as related parties, whereas these are covered under IAS 24.

» IAS 24 includes close members of families of key management personnel as related parties. It also includes close members of the families of persons who exercise control or significant influence over related parties. AS 18 includes only relatives of key management personnel as related parties.

» AS 18 has defined relatives by specifying certain relationships in the definition. IAS 24 definition is broader and principle based, which defines close member of the family as those who may be expected to influence, or be influenced by, that individual in their dealings with the entity.

» IAS 24 includes executive as well as non-executive directors in the definition of key management personnel. However, AS 18 through ASI 21 excludes non-executive directors from the definition of key management personnel.

» Definition of control given in IAS 24 is principle based. It states that control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. It does not define ways in which the control can be demonstrated. AS 18 provides different ways of control as definition of control, such as ownership of voting power, control of composition of board of directors or substantial interest in voting power and the power to direct the financial and/or operating policies. Therefore, it is interpreted in a restrictive manner.

» While discussing the term 'significant influence', AS 18 states that holding 20% or more of

the voting power of the entity is presumed to result in significant influence. IAS 24 does not give any percentage to interpret significant influence and is based on the substance.

» Disclosures required in the two frameworks differ to a certain extent. IAS 24 requires that when neither the entity's parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so is required to be disclosed. IFRS also requires disclosure of terms and conditions of outstanding balances, including whether they are secured, and the nature of the consideration to be provided in settlement, details of any guarantees given or received. Indian GAAP mandates certain disclosures which are not required under IFRS, such as the name of the transacting related party and amount written back in the period in respect of debts due from or to related parties. Indian GAAP permits disclosure of volume of transactions and outstanding items to be given either in amounts or as an appropriate proportion. IFRS requires amounts to be disclosed for these items.

» AS 18 provides exemptions for transactions with the related parties where reporting of such disclosures would conflict with the reporting entity's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority. IAS 24 does not contain any such exemption.

» IAS 24 requires disclosure of the key management personnel's compensation in total and for certain specified categories, such as short-term employee benefits and post-employment benefits. AS 18 does not have such requirement.

Impact on Financial Reporting

Scope of Applicability of IAS 24

IAS 24 disclosures will apply to the following entities and transactions if the entities adopt IFRS:

» All Indian entities (including level II and III) will have to disclose related party transactions, transactions with post employment benefit plans like gratuity, provident fund plans, etc.

» Transactions among state controlled entities

» Transactions with non-executive directors

» IAS 24 does not grant exemptions of non-disclosure of related party transaction on the basis of conflict of duty of confidentiality. Thus, banking organisations will be required to disclose all related party transactions.

Identifying Related Parties

Related parties identified under Indian GAAP may not provide the correct list of related parties under IFRS and the entities would be required to reassess all related party relationships under IFRS, for the following:

» Parties exercising significant influence need to be reassessed to determine whether they influence both financial and operating decisions

» Post-employment benefit plans need to be added to related party list

» All relatives of key management personnel may not be close members of his family and therefore not a related party under IAS 24 and vice versa

» Non-executive directors need to be considered as related parties under IAS 24

If additional parties are covered in related parties, additional information for transactions with those parties needs to be compiled and disclosed.

Transactions with SPVs

Since the definition of 'control' in AS 18 is restricted to three conditions given therein, SPVs may not be caught in the net. IAS 24 definition is based on substance. Therefore, it is unlikely that transactions with SPVs will not get covered under IAS 24.

Impact on Organisation and its Processes

Under IFRS all small and medium-sized entities, including non-corporate entities, will be required to disclose related party relationships and transactions. Such entities will have to develop an internal reporting system to identify and record the related party transactions and educate their accounting staff. Since these entities normally have basic accounting software which may not capture the required data, they will need to strengthen their reporting processes and information technology systems.

3.10. Segment Reporting

The IASB has recently issued IFRS 8 *Operating Segments* which would supersede IAS 14. IFRS 8 would be applicable for accounting periods on or after 1 January 2009. Early application is permitted. The following discussion regarding segment reporting is based on IFRS 8.

Key Differences

» IFRS 8 adopts the management reporting approach to identifying operating segments. It is likely that in many cases, the structure of operating segments will be the same under IFRS 8 as under AS 17. This is because AS 17, like IFRS 8, considers reporting segments as the organisational units for which information is reported to key management personnel for the purpose of performance assessment and future resource allocation. When an entity's internal structure and management reporting system is not based either on product lines or on geography, AS 17 requires the entity to choose one as its primary segment reporting format. IFRS 8, however, does not impose this requirement to report segment information on a product or geographical basis and in some cases this may result in different segments being reported under IFRS 8 as compared with AS 17.

» An entity is first required to identify all operating segments that meet the definition in IFRS 8. Once all operating segments have been identified, the entity must determine which of these operating segments are reportable. If a segment is reportable, then it must be separately disclosed. This approach is the same as that required by AS 17, except that it does not require the entity to determine a 'primary' and 'secondary' basis of segment reporting.

» IFRS 8 requires that the amount of each segment item reported, is the measure reported to the CODM in internal management reports-even if this information is not prepared in accordance with the IFRS accounting policies of the entity. This may result in differences between the amounts reported in segment information and those reported in the entity's primary financial statements. In contrast, AS 17 requires the segment information to be prepared in conformity with the entity's accounting policies for preparing its financial statements.

» Unlike AS 17, IFRS 8 does not define terms such as 'segment revenue', 'segment profit or loss', 'segment assets', and 'segment liabilities'. As a result, diversity of reporting practices will increase.

» As IFRS 8 does not define segments as either business or geographical segments and does not require measurement of segment amounts based on an entity's IFRS accounting policies, an entity must disclose how it determined its reportable operating segments, and the basis on which the disclosed amounts have been measured. These disclosures include reconciliations of the total key segment amounts to the corresponding entity amounts reported in IFRS financial statements.

» A measure of profit or loss and assets for each segment must be disclosed. Additional line items, such as interest revenue and interest expense, are required to be disclosed if they are provided to the CODM (or included in the measure of segment profit or loss reviewed by the CODM). AS 17, in contrast, specifies the items that must be disclosed for each reportable segment.

» Under IFRS disclosures are required when an entity receives more than 10% of its revenue from a single customer. In such instances an entity must disclose this fact, the total amount of revenue earned from each such customer, and the name of the operating segment that reports the revenue. This is not required by AS 17.

Impact on Financial Reporting

Change in Segment Reporting Approach

On adoption of IFRS 8, the identification of an entity's segments will, in many cases, change from the position under AS 17. IFRS 8 requires operating segments to be identified on the basis of internal reports on components of the entity that are regularly reviewed by the CODM in order to allocate resources to the segment and to assess its performance. AS 17 requires an entity to identify two sets of segments, business and geographical, using a risk-and-reward-approach, with the entity's 'system of internal financial reporting to key management personnel' serving only as the starting point for the identification of such segments.

Goodwill Impairment

IAS 36 requires goodwill to be allocated to each CGU or to groups of CGUs. The relevant CGU or group of CGUs must represent the lowest level within the entity at which the goodwill is monitored for internal management purposes and may not be larger than an operating segment. If different segments are reported under IFRS 8 than were reported under AS 17, it follows that there will be differences between the CGUs that make up an IFRS 8 segment and those that made up an AS 17 segment. As a result, the CGUs supporting goodwill may no longer be in the same segment under IFRS 8 as under AS 17. It may, therefore, be necessary to reallocate goodwill associated with CGUs that are affected by the change from AS 17 to IFRS 8. It is possible that this reallocation of goodwill could 'expose' CGUs for which the carrying amount, including the allocated goodwill, exceeds the recoverable amount, thereby giving rise to an impairment loss.

Customer Concentration

On adoption of IFRS, entities will be required to furnish a disclosure of customer concentration, which will enable investors to assess risk faced by a company. The company will have to compile information of revenue generated by each customer to furnish disclosures required by IFRS 8.

Impact on Organisation and its Processes

Reconciliation of Management Information System with Financial Statement

IFRS 8 requires segment reporting to be made based on information furnished to the chief decision makers. If the policy followed for computing information for management information system does not match with the financial statements, an entity will need to furnish reconciliation. Hence, entities need to devise or upgrade systems to prepare reconciliation between the MIS and accounting system.

Identification of CODM

Reporting under IFRS 8 is based on information furnished to CODM. The term CODM defines a function rather than an individual with a specific title. The function of the CODM is to allocate resources and assess operating results of the segments of an entity. The CODM could be an individual, such as the chief executive officer, or the chief operating officer, or it could be a group of executives like the board of directors or a management committee. Entities should review their management structure to identify CODMs.

3.11. Revenue Recognition

Key Differences

» IAS 18 *Revenue,* unlike its Indian counterpart AS 9 *Revenue Recognition,* requires revenue to be measured at the fair value of the consideration received or receivable.

» For recognition of revenue from sale of goods, IAS 18 also prescribes the condition that the costs incurred or to be incurred in respect of the transaction can be measured reliably. This condition is not there in AS 9.

» For recognition of revenue from rendering of services, IAS 18 states that when the outcome of a transaction can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the balance sheet date. Under Indian GAAP, AS 9 provides an option to use either the proportionate completion method or the completed service contract method for recognising revenue from service transactions.

» IAS 18 requires interest to be recognised using the effective interest method as outlined in IAS 39 *Financial Instruments: Recognition and Measurement.* AS 9 requires interest to be recognised on a time proportion basis, taking into account the amount outstanding and the rate applicable.

Impact on Financial Reporting

Contracts with Multiple Elements or Barter—Fair Value Concept

AS 9 states that revenue is measured by the charge made to customers or clients for goods supplied and services rendered and by the charges and rewards arising from the use of resources by them. In the absence of a fair value concept, it sometimes becomes difficult to determine the revenue in a contract that contains multiple elements such as sale of goods and rendering of services. For example, in case of franchise fees IAS 18 states that for supply of equipment and other tangible assets, the amount based on fair value of the assets sold is recognised as revenue when the items are delivered or the title passes. Under Indian GAAP, an EAC opinion deals with accounting in the case of multiple element contracts. Unlike IFRS, Indian GAAP does not deal with barter sales.

Management's Judgement to Determine Revenue from Sale of Goods

IAS 18 prescribes five conditions, all of which should be fulfilled for recognising revenue. Apart from transfer of significant risks and rewards of ownership as required in Indian GAAP, IFRS also requires fulfilment of the conditions relating to seller not retaining continuing managerial involvement and effective control over the goods sold, reliability of measurement of the amount, probability that the economic benefits associated with the transaction will flow to the seller and reliable measurement of costs incurred in respect of the transaction. As a result the management has to use their own judgement to determine if, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue under IFRS.

Reduced Volatility of Revenue Recognition for Rendering of Services

Since IFRS requires recognition of revenue arising from rendering of services only on the basis of stage of completion, the entities who defer revenue based on the completed service contract method under Indian GAAP will have a significant impact on their income statement. The volatility of income statement of such entities will be smoothened by the application of IFRS and the profit or loss for the period will better represent the efforts put in by entities during the period.

Impact on Organisation and its Processes

Though the revenue recognition principles under Indian GAAP and IFRS may not be significantly different, yet one has to take a close look at practices that have emerged over time. These practices may not be in accordance with international norms. A case in point is the accounting for real estate sales. IASB believes that real estate sales by developers should be recognised based on product completion, whereas in India the percentage of completion method is followed. Such issues could have a significant impact on how an organisation sells or how the contracts and payments are structured.

Unlike Indian GAAP, IFRS provides detailed guidance on identification of the transaction. Under IFRS, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. Therefore, strategies developed by the marketing department which combine various components in a single transaction would need to consider its impact on revenue recognition.

Impact on

Key Industries

4. Impact on Key Industries

Here we take a look at the key impact of IFRS on some critical industries. It may happen that in some cases there may be no difference between IFRS and Indian GAAP. However, in practice the manner in which the standard is understood and implemented in India may be quite different as compared to the global practice. In this section we discuss not only GAAP differences by industry, but also certain areas where we believe that global practices may not be consistent. Analysis presented in this section does not consider the impact of AS 30 and AS 31 recently issued by the ICAI.

4.1. Telecom

Both Indian GAAP and IFRS do not provide any industry specific guidance. The Telecom Industry poses significant accounting challenges due to complexities in the schemes offered to customers, distribution arrangements, infrastructure sharing arrangements entered by telecom players, etc. This section identifies a few areas where accounting treatment under IFRS will be different from accounting done under Indian GAAP or industry practice in India and some other practical issues.

Key Impact Areas

Bundled Multiple Service Offerings

Telecom entities provide package offers comprising handset, prepaid minutes, messages, discounts, special offers and other incentives. The decision to account for a transaction in its entirety or individual components can have a significant impact on the results. For example, separating handset sales from connection revenues may result in increased revenues upfront for sale of handsets. Indian GAAP does not provide any specific guidance on revenue recognition in case of multiple element contracts and hence inconsistent practices are followed by various telecom entities. IAS 18 requires the recognition criteria to be applied separately to each transaction. However, in certain circumstances it is necessary to apply the recognition criteria to separately identifiable components of a single transaction in order to reflect the substance of the transaction. The recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.

The key issue which all telecom entities will have to face on adoption of IFRS is whether the components of a single transaction can be technically and commercially separated, and if yes, whether the fair values can be reliably determined to recognise revenue. As no specific guidance is available under IFRS, many entities could well use the hierarchy in IAS 8 to consider any relevant US GAAP requirement for determining fair value of separate components.

Accounting for Indefeasible Right to Use

In the Telecom Industry, entities often buy and sell capacity of each other's networks, often referred to as IRU. The main issue involved here is on revenue recognition—Can revenue be recognised upfront (as an asset sale) or should revenue be recognised over the IRU term as a provision of service. If it is considered that an IRU arrangement contains a lease then the appropriate arrangement under IFRS would be determined by IAS 17 *Leases*. IFRIC 4 provides more guidance on this subject. If IRU is not a lease, it will have to be ascertained whether the arrangement constitutes sale of goods or rendering of services. The accounting consequences for sale of goods and rendering of services would be significantly different.

Under Indian GAAP no guidance is available on identification of leases contained in arrangements or transactions which are not structured as lease. Thus, lease elements contained in IRU may not be captured by AS 19, which governs lease accounting in India. The accounting for IRU under Indian GAAP is significantly different from that required under IFRS.

Revenue from Interconnect and Content Revenue Agreements – Gross or Net

Both, fixed line and mobile operators, may enter into a number of interconnect agreements with other carriers. Industry practice under Indian GAAP and IFRS is to account revenue and costs from such transactions on gross basis as the carriers are exposed to gross risks of the transaction. Interconnect agreements usually allow carriers to settle the amount on a net basis which does not normally change the appropriateness of recognising transaction gross even if periodic cash settlements may be made on a net basis.

It is common for telecommunications operators to enter into arrangements with third party content providers to offer a range of services to their subscribers (e.g., ringtones, games and traffic updates), with charges based either on duration or on quantity. Often, the operator collects all of the content revenue from the subscriber and is required to remit the content revenue to the supplier net of a percentage retained as commission. If the operator is acting as the principal in the relationship with the subscriber, the revenue should be recognised on a gross basis, with the amount remitted to the supplier being accounted for as a cost of sale. However, if the operator is acting as an agent for the supplier in its relationship with the subscriber, only the net amount of commission retained should be recognised as revenue.

Close attention needs to be paid to the details of each such arrangement since that may have an impact on the accounting.

Asset Retirement Obligation

In the construction of networks, mobile and fixed line operators often build assets on leased land or premises where an obligation exists (e.g., under the lease agreement) to reinstate the land or premises at the end of the agreed term. Provision for such costs is required under IFRS where they are referred to as ARO. The obligation is accounted for by including the present value of the estimated cost of dismantling and removing the asset as part of the cost of the asset and setting up a provision for an equivalent amount. The discounting of provisions get unwound over the relevant period and is accounted for as interest expense. Under Indian GAAP, AS 29 requires a provision to be created at undiscounted amount of ARO at the time of setting up the assets.

The challenge in providing for ARO is that often it may not be evident from the contractual terms that an obligation exists. The contract may be unclear or silent on restoration requirements at the end of the contracted period. There might not be express legislation, which requires companies to carry out restoration work. In such cases entities need to make their 'best estimate'

based on past experience. Many times entities contend that restoration work as per legislation/contractual arrangement is not enforced and hence no cost is incurred by them. For instance, obligations with respect to cables laid in international waters on the seabed or on coastal 'landing stations' may be unclear and inconsistently enforced. Some consider that removing the original cables may cause more environmental damage than leaving them intact. The question then arises is should the obligation not be valued at all on the grounds that it may not crystallise?

Another complexity in ARO provision, under IFRS, is the assumption of tenor of lease. Many telecom companies enter into agreements to lease land or property to erect cell sites. These leases can vary in length and may contain an option to extend the lease. In these circumstances, issues arise in calculating the present value of ARO. Should the obligation be based on the original length of the lease or the extended period?

In practice an estimate needs to be made of what is perceived to be the most likely economic life of the asset taking into account all the above variables. For example, if there is no certainty of renewing the lease term of a particular site, dismantling and removal costs should be based on the assumption that removal will be required at the end of the initial lease term.

Fixed Assets

In 2005, when many global entities adopted IFRS, Ernst & Young conducted a global online study of major Telecom Industry players to find out how the new environment is affecting them and their management of fixed assets. Various entities from around the world participated in this study by providing their time and input. Ernst & Young developed and disseminated an online survey on changing reporting and regulatory requirements. The entities represented had more than $ 309 billion in combined annual revenues and more than $ 298 billion in combined total fixed assets. Until this study was made, there had been a limited analysis of this topic.

Typically, this industry faces poor ROI, which drives a rigorous investment approach. Investors focus more on the balance sheet, about 60% of which is made up of fixed assets. Therefore, losing market reputation and rating is unaffordable. Compliance with IFRS increases the complexity of verifying and accounting for fixed assets for most, though not all, telecom entities. National regulators also focus on these accounting practices. The study brought out the following points:

» Increasing customer demands for new communication products and services are pressuring telecom entities to update existing networks or deploy new ones

» Many telecom entities are yet to recognise the need to proactively manage potential changes to their fixed asset accounting practices and how this impacts their competitive position

» Matching operational realities to changing business and customer demands and complying with IFRS are critical to success in the telecommunications marketplace

» The financial health of the industry was stabilising, opening the path to renewed profitability and growth, however, the transition to IFRS may create earnings volatility

» The entities that succeed in a dynamic environment will be those that can adapt to IFRS quickly while proactively managing their asset bases

» The pressure to update or replace network assets increases the risk of traditional assets being impaired. In the study referred above, 62% respondents believed that their current IT systems, accounting processes and fixed asset designs were suitable for IFRS adoption.

In the case of Telecom entities, IFRS reporting requirements will have the greatest potential impact on the management of their fixed asset accounting—component accounting, estimation of useful life, residual value, impairment, etc.

Other Issues

Under both, IFRS and Indian GAAP, start up costs cannot be capitalised. Another interesting issue is the straight-lining of operating lease rentals. As per an EAC opinion straight-lining is required. However, this matter is not fully tested under IFRS. Accounting for various incentive schemes is another area where practices may not be consistent.

4.2. Mutual Funds

Key Impact Areas

Units of Mutual Fund

Mutual fund units are puttable financial instruments. Units of open-ended mutual fund can be put back at any time for cash equal to a proportionate share of the net asset value of an entity. Thus, as per IAS 32 principles, these units are a financial liability for the mutual fund. Under IAS 39, put option available to the holder is treated as embedded derivative.

To address the accounting for puttable instruments the IASB has issued an exposure draft on financial instruments puttable at fair value and obligations arising on liquidation. The draft proposes to amend IAS 32 to classify financial instruments puttable at fair value as equity, provided the specified criteria are met. Until the exposure draft is finalised and amendments are made to IAS 32, these instruments are disclosed as liability. This has a significant effect on the balance sheet of mutual funds as the funds would have net assets of nil when the units are classified as financial liability under IAS 32.

Under IAS 32 gains or losses relating to changes in the carrying amount of a financial liability are recognised as income or expense in the profit or loss even when they relate to puttable financial instruments. Therefore, under IFRS, mutual funds may not have any profit or loss as any surplus or deficit will represent changes in the carrying amount of a financial liability which is immediately charged or credited to the income statement.

In Indian GAAP the mutual fund balance sheet does not identify equity specifically since the concept of equity is not as precise in Indian GAAP as under IFRS. Industry practice is to disclose unit capital under the head 'Sources of funds'. Funds prepare revenue account disclosing surplus for the year and appropriations.

Under IFRS, though puttable instruments at fair value are not disclosed as equity, it does not mean that the funds do not have any equity. There may be other items that are required to be accounted for under equity. If the fund is carrying investments classified as AFS, the fair value changes in the investments will be recorded in equity.

Carrying Value of Investments

Under IFRS, entities have an option to designate financial assets and liabilities at fair value and account the changes in fair value in profit or loss when certain criteria are met. Mutual funds meet the criteria that a group of financial assets, financial liabilities or both are managed and its performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy and information about the group is provided internally on that basis to the entity's key management personnel. Accordingly, mutual funds may designate their financial assets at fair value through profit or loss.

Under Indian GAAP accounting policies of mutual funds are governed by SEBI regulations which require all investments to be carried at marked-to-market value in the balance sheet. *The Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds* issued by the ICAI, in the context of the regulations require that any diminution in value (unrealised loss) to be routed through Revenue Account and any increase in value of investment (unrealised gain) is recognised directly in reserves. The Guidance Note also requires any such appreciation recorded at the balance sheet date to be reversed on the next day.

In case of asset management companies, classification of investments as required by IAS 39 will result in investments being classified as any of the four categories of financial assets. These include FVPL, AFS, L&R, and HTM. The first two categories require carrying value to be determined based on fair value, whereas carrying value is based on amortised cost in the later two. Apart from AFS, all other categories have an impact on profit or loss for the period. Movements in fair values of AFS category are recognised in equity.

In India asset management companies carry investments at the cost or market value, whichever is lower when the investment is classified as a current investment. Long term investments are carried at cost less diminution in value, which is other than temporary.

4.3. Venture Capital Funds

Under Indian GAAP, there is no specific accounting standard dealing with accounting for VCF. AS 13, *Accounting for Investments*, specifically excludes VCF from its scope. *The Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996,* which apply only to listed ventures, also do not contain any specific requirement for accounting by VCF. Following are key areas where the accounting treatment under IFRS may be significantly different than accounting done under Indian GAAP or industry practice in India.

Key Impact Areas

Carrying Value of Investments

Under Indian GAAP, in the absence of any specific treatment laid down in the accounting standards, general industry practice is to measure investments in VCC at fair value. Unrealised gains and temporary losses arising on restatement of such investments are accounted in Unrealised Investment Reserve. Such gains and losses are recognised in the profit or loss on actual realisation. Losses other than temporary are recognised in the profit or loss immediately.

Under IFRS, classification of investments as required by IAS 39 will result in investments being classified as one of the four categories of financial assets, namely FVPL, AFS, L&R and HTM. Entities have an option to designate financial assets and liabilities at fair value and account the changes in fair value in profit or loss if certain criteria are met. VCF entities meet the criteria that a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel. Accordingly, VCF may designate their financial assets as FVPL. In case the VCF entity does not choose to classify its investment in a VCC as FVPL, these would be classified as AFS investments. Investments held by VCF entity for trading purposes will be classified as FVPL.

Consolidation of Subsidiaries

Under Indian GAAP, there is no requirement to prepare CFS for unlisted VCFs. Industry practice is generally not to prepare the CFS.

Under IFRS, preparation of CFS is generally required except in certain limited cases where specified criteria are met. IAS 27 *Consolidated and Separate Financial Statements* provides that a subsidiary is not excluded from consolidation simply because the investor is a venture capital organisation or a similar entity. It also provides that a subsidiary is not excluded from consolidation because its business activities are dissimilar from those of the other entities within the group. Thus, under IFRS, VCF entity which has any subsidiary would be required to prepare CFS and consolidate all its subsidiaries.

Investments in Associates and Interests in Joint Ventures

IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures* do not apply to investments / interests held by mutual funds, unit trusts and similar entities including investment-linked insurance funds that upon initial recognition are designated as FVPL or are classified as HFT and accounted for in accordance with IAS 39. When such investments are accounted for under IAS 39, IAS 32 and IFRS 7 are also applicable to them.

Under Indian GAAP, there is no such scope exclusion under AS 23 and AS 27. Thus, a VCF entity, which prepares CFS, would be required to account for its investments in associates and joint ventures in accordance with AS 23 and AS 27 respectively.

Embedded Derivative/ Equity Kicker

Instruments involving embedded derivatives, e.g., warrants with an option of conversion to shares, convertible debts / preference shares, zero coupon bonds, are common feature in case of VCF. Such instruments provide the holder an option of conversion into equity instruments at a future date and carry no interest or interest at a rate which is lower than the market rate. In absence of any specific requirements / guidance on the matter, under Indian GAAP, VCF are not accounting for such options separately. VCF recognise interest on the instruments at actual / stated rate, if any.

Under IFRS, conversion option in a host instrument normally meets the definition of an embedded derivative. IAS 39 requires embedded derivative to be separated from the host contract and treated separately if certain conditions are met and the combined instrument is not treated as FVPL. Implementation Guidance to IAS 39 also provides that VCF entities may be providing subordinated loans on a condition that if and when the borrower lists its shares on a stock exchange, it would be entitled to receive shares of the borrowing entity free of charge or at a very low price (an 'equity kicker') in addition to interest and repayment of principal. As a result of the equity kicker feature, the interest on the subordinated loan is lower than it would otherwise be. As per IAS 39, the equity kicker feature meets the definition of an embedded derivative even though it is contingent upon the future listing of the borrower. With regard to such embedded derivatives, if VCF does not treat the entire instrument (i.e., combined instrument including embedded derivative) as FVPL; it should separate embedded derivative from the host loan agreement and treat the two separately.

Units of Venture Capital Fund

VCF units are puttable financial instruments. Units of VCF can be put back at any time for cash equal to a proportionate share of the net asset value of an entity. Thus, as per IAS 32 principles, these units are financial liability for the VCF. To address the accounting for puttable instruments, the IASB has issued an exposure draft on financial instruments puttable at fair value and obligations arising on liquidation. The draft proposes to amend IAS 32 to classify financial instruments puttable at fair value as equity, provided the specified criteria are met. Until the exposure draft is finalised and amendments are made to IAS 32, these instruments are disclosed as liability. This has significant effect on balance sheet of VCF since the VCF would have net assets of nil when the units are classified as financial liability under IAS 32.

Under IAS 32, gains or losses relating to changes in the carrying amount of a financial liability are recognised as income or expense in the profit or loss even when they relate to puttable financial instruments. Therefore, under IFRS, VCF may not have any profit or loss, since any surplus or deficit represents the changes in the carrying amount of a financial liability which is immediately charged / credited to the income statement.

In Indian GAAP, VCF's balance sheet discloses total liabilities and total assets. Industry practice is to disclose unit capital under the head 'capital / equity'. Funds prepare revenue account disclosing surplus for the year, and appropriations.

Under IFRS though puttable instruments at fair value are not disclosed as equity, it does not mean that the funds do not have any equity. There may be other items that are required to be accounted for under equity. If the fund is carrying investments classified as AFS, the fair value changes in the investments will be recorded in equity.

4.4. Banking

The biggest impact of adopting IFRS in India would be on the banks. Banking is a highly regulated industry in India. Like other entities, banks are also required to comply with the accounting standards issued by the ICAI, to the extent applicable to the banking industry. In addition, the regulator, viz., RBI also prescribes certain mandatory accounting principles to be followed by banks (e.g., investments are accounted as per RBI guidelines instead of AS 13 *Accounting for Investments*). The aim of IFRS is to present fairly the position, performance and cash flows of an entity. The RBI, however, sets prudential norms on banks and so the requirements of the RBI are not fully in compliance with IFRS. Additionally, banks have other extensive regulation to deal with such as Basel II capital requirements.

Key Impact Areas

Income Recognition

In Indian GAAP, in accordance with the RBI regulations, interest income is recognised in the profit or loss on an accrual basis, except in the case of non-performing assets. Any associated fees, such as loan processing fees are recognised upfront when those are received. IAS 39 *Financial Instruments: Recognition and Measurement* requires that income on loans be recorded on an effective interest-rate basis. This spreads the interest and any associated fees, unless they can clearly be demonstrated to relate to the delivery of a separate service, over the life of the loans. Therefore, for example, when there is moratorium period, interest ballooning in the loan terms, interest will be measured differently under IFRS and Indian GAAP.

In case of HTM assets, IAS 39 requires carrying value to be measured after initial recognition at amortised cost. This results in premium / discount being recognised on effective interest rate basis. Under Indian GAAP, in accordance with the RBI regulations, for HTM assets acquired at discount and having coupon interest, banks recognise interest income based on the coupon without considering the amortisation of discount. It results in a gain being recognised at the time of maturity when the entire discount gets realised. However, for Zero coupon assets and treasury bills, discount is amortised to bring carying value of the discounted instrument to par value on maturity.

Identification of Impaired Loan

RBI has prescribed the guidelines for identification of impaired loans. An asset is a Non-Performing Asset ('NPA') in respect of which interest / instalment has remained unpaid for more than 90 days. Under IFRS, a financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Credit losses expected as a result of future events, are generally not recognised.

Impairment Provision

In India, the impaired assets (NPAs) are classified into three categories: sub-standard assets, doubtful assets and loss assets as per the time buckets prescribed by RBI. The impairment

provision is made on the basis of the above three categories prescribed by RBI at the prescribed minimum percentage of the asset value. Under IFRS, if there is objective evidence that an impairment loss on L&R or HTM investments carried at amortised cost has occurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. Under IFRS, the formula prescribed by the RBI will be considered as acceptable only if it can be demonstrated to produce an estimate sufficiently close to one determined under the methodology specified in IAS 39. In practice, there may be significant differences between IFRS loan loss provision and RBI loan loss provision.

When a provision is created for the portfolio of standard assets, the loss is computed based on RBI guidelines under Indian GAAP as a certain percentage of carrying values. However, under IFRS, these general provisions are not allowed but there is a requirement to hold a provision for any Incurred But Not Reported (IBNR) losses. An IBNR loss can occur when assessing assets collectively for impairment and it is known that a loss event would have occurred as at a reporting date, but this loss event has not manifested itself as objective evidence of impairment. This IBNR provision is computed on a similar basis as explained in the preceding paragraph, i.e. based on the present value of the estimated future cash flows rather than provision being made at a predetermined percentage.

Hedge Accounting

Accounting for hedges in the two frameworks is different. There are three types of hedges under IFRS, being cash flows hedges, fair value hedges and hedges of net investments in foreign operations. The treatment of the three approaches are different. For a fair value hedge, both the hedging instrument and the hedged item are accounted at fair value in the profit and loss, leaving only the net ineffectiveness that impacts profit or loss. For a cash flow or hedge of net investments in foreign operations, only the hedging instrument is held at fair value, with the effective portion being accounted for in equity and the ineffective portion being accounted for in the profit and loss. In Indian GAAP, it is accounted in the profit and loss.

Under IFRS, hedge accounting is allowed as an option to replicate the economic purpose of the hedging relationship. However, IAS 39 imposes a considerable documentary and procedural burden. Unless such documentation is maintained, banks cannot follow hedge accounting.

Under Indian GAAP, banks can classify the instruments for hedging the risk of hedged item so that hedge accounting can be applied on those instruments. Hedges are not required to be classified as fair value hedge, cash flow hedge or hedge of net investment in foreign operation. Hedging instruments are accounted for on approval basis and not marked to market unless the underlying is also marked to market. Banks are provided freedom to assess the effectiveness based on their internal policy, such as duration coverage, marked to market etc.

Embedded Derivatives

Identification of embedded derivatives is a very onerous area in the case of banks. Typical embedded derivatives that could be found in many banking arrangements are convertibility options, prepayment options, interest caps and floors, foreign exchange derivatives, etc. Indian GAAP does not provide any guidance on this. Under IFRS, an embedded derivative is separated from the host contract and accounted for as a derivative if the economic characteristics and the risk of the embedded derivative are not closely related to the economic characteristics and the host contract, a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative and the hybrid instument is not measured at fair value with changes in fair value recognised in profit or loss.

Accounting for Financial Assets

RBI guidelines require investments in AFS and HFT categories and derivatives to be marked to market; net depreciation is charged to the profit and loss account; net appreciation is not recognised except to the extent of depreciation already provided. This measurement can be made on a category basis. In case HFT investment is not sold in 90 days then the same is required to be transferred to AFS category.

Under IFRS, IAS 39 prescribes principles for accounting for financial assets. All financial assets other than those categorised as at FVPL are required to be initially recognised at fair value plus directly attributable transaction costs. FVPL assets (HFT assets fall in this category) are initially recognised at fair value. Subsequent measurement of the financial asset depends on the categorisation given. AFS and FVPL, including all derivatives, equity investments (except those covered by other standards such as associates and subsidiaries) and most listed debt instruments are carried at fair value in the balance sheet. Fair value movements of FVPL investments are charged / credited to the income statement. Fair value movements of AFS investments are booked in equity. These are computed on asset by asset basis.

Under Indian GAAP, investments that a bank intends (whether or not it has an ability) to hold till maturity are classified under HTM category. A bank can transfer securities between the AFS, HFT and HTM categories.

Classifying an investment as HTM is very restrictive under IFRS. A bank cannot classify any financial assets as HTM if it has, during the curent finance year or during the two preceding financial year, sold or reclassified more than an insignificant amount of HTM investments before maturity, expect in very limited circumstances. Consequently, the HTM category is used only sparingly.

Loan Commitments to provide Loan at a Below-market Interest Rate and Financial Guarantees

RBI has not prescribed any guidelines for accounting of loan commitments and loan commitments are not disclosed as off balance sheet items in the financial statements. Under IFRS, a commitment to provide a loan at a below-market interest rate is initially recognised at fair value, and subsequently measured at the higher of (a) the amount that would be recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and (b) the amount initially recognised less, cumulative amortisation recognised in accordance with IAS 18 *Revenue*, as appropriate.

IFRS would also result in a significant impact arising out of fair valuing financial guarantees. Financial guarantees provided will be accounted for at fair value at the time of initial recognition. The commission charged for issuing the guarantee will be the fair value in most cases. The financial guarantee will be subsequently measured at the higher of (a) the amount that would be recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and (b) the amount initially recognised less, cumulative amortisation recognised in accordance with IAS 18 *Revenue,* as appropriate. Under Indian GAAP, the commission received is accounted upfront, on time proportion basis or in some cases on receipt basis.

Priority Sector Loans and Restricted Assets

IFRS requires financial assets to be recognised initially at fair value. Fair value is "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction". Due to directed lending regulations, in many cases, banks are often compelled to give loans to priority sectors which are not at fair value. It is not clear whether fair value in regards to priority sector lending should be evaluated based on the overall market or specifically in regards to the priority sector lending market.

Other Contentious Issues

When banks adopted IFRS in Europe in 2005, they were particularly affected by IAS 32 and IAS 39. Many of the changes required by IAS 32 and IAS 39 entail developing processes to churn out vast amounts of data. IAS 32 requires recording derivative transactions gross and does not allow netting them off, even with the same counterparty trading under a master netting agreement, unless they are intended to be settled net. Another issue not specific to banks, but impacting on adoption of IFRS, is the classification between liabilities and equity of various sources of funds.

4.5. Technology

Due to the nature of technology entities, significant accounting challenges arise in the areas of software revenue recognition, accounting for intangible assets and ESOP. Also, the technology companies in India are more exposed than others to foreign currency variations as they generate significant revenues from export of services. In this section, we have discussed a few of the challenges that arise in these areas due to the conversion to IFRS.

Key Impact Areas

Multiple Element Contracts

There are a number of issues relating to the timing of revenue recognition in the software services industry. However, one of the more complex issues which the industry continues to grapple with is the accounting for multiple element contracts, such as when a composite contract is entered into for the sale of licenses, implementation fees and maintenance services at a lump-sum price. There is no specific guidance available in AS 9 on accounting for such contracts. Industry practice (other than companies that are globally listed and also draw their accounts under International GAAP) is to account for revenue for such contracts based on values specified in the contract. When values stated in the contract do not prima-facie appear to be fair, no adjustment is carried out. Moreover, multiple element contracts that provide for free "version upgrades" and other "free" add on software/hardware are generally treated as being "free" and are not fair valued to be accounted for separately over the period of the contract.

These issues have not been addressed in IFRS also. IAS 18 provides limited guidance with respect to multiple element contract; the recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed. Clearly, this is of little help in addressing the complex revenue recognition issues that characterise the multiple element contracts, such as how to allocate consideration among various components and determining fair value of each component. IAS 8 permits reference to the most recent pronouncement of other standard setting bodies that use a similar conceptual framework, to the extent it does not conflict with other standards, interpretations or the framework. US GAAP provides detailed guidance on multiple-element contracts which require appropriate adjustment to the contracted values if they reflect fair value of each component. In practice, many IFRS companies use US GAAP guidance to account for multiple-element contracts.

Share-based Payments

Following the global trend, the IT sector in India also makes extensive use of ESOP schemes towards attracting and retaining employees. Under Indian GAAP share-based payments are accounted as per the Guidelines issued by SEBI (for listed companies) and the *Guidance Note on Accounting for Employee Share-based Payments*, both of which permit the use of the Intrinsic Value Method as an alternate to the Fair Value Method. However, a majority of the entities in India presently follow the Intrinsic Value Method. On transition to IFRS, share-based payments would need to be accounted as per the Fair Value Method. This is likely to reduce profits of various technology entities that may be compelled to reconsider share-based payment schemes.

Many global entities across the world have set up subsidiaries in India. Normally, the global parent provides ESOP benefits to the employees of its Indian subsidiary. The Indian subsidiary generally does not account for any compensation cost in their Indian GAAP financial statements on account of ESOP granted by the parent entity as they do not have settlement obligation and clear guidance is not available in this context. This approach is not permissible in IFRS. IFRIC 11 requires the subsidiary to measure the services received from its employees in accordance with the requirements applicable to equity-settled share-based payment transactions with a corresponding increase recognised in equity as a contribution from the parent.

Another significant aspect in the case of technology entities is share-based payments made to non-employees. For example, shares granted to a customer for committing a certain volume of business or option granted to certain service providers for obtaining their services. Currently,

guidance is only available under Indian GAAP for accounting of share-based payments made to employees and for acquisition of fixed assets (covered under AS 10) and not for other goods and services thereby resulting in disparate practice followed by various technology entities. Whilst we believe that such arrangements under Indian GAAP need expensing, it is absolutely clear under IFRS that such share-based payments are required to be accounted for based on the Fair Value Method.

Outsourcing Contracts

Technology entities enter outsourcing arrangements for programming support, data storage, network support etc. Such arrangements are normally structured as service contracts and revenue is accounted as and when such services are rendered based on terms of the contract. Indian GAAP does not require evaluating such contracts to determine whether, in substance, these are leasing arrangements. However, under IFRS such transactions could fall within the scope of leases in terms of IFRIC 4 *Determining whether an Arrangement contains a Lease.* IFRIC 4 sets out the criteria for determining whether a transaction is in the nature of a lease or not. This determination is based on the substance of the arrangement and assesses whether the fulfilment of the arrangement is dependent on the use of a specific asset and if the arrangement conveys a right to use the asset. If such arrangement is identified as a leasing arrangement, revenue and asset under consideration will be accounted as per principles of IAS 17 *Leases*.

Hedge Accounting

Technology entities usually generate substantial amount of revenue and incur expenses in foreign currency Therefore they are exposed to significant foreign exchange fluctuation risk. To manage the exchange fluctuation risk, technology entities use various risk management products, such as forward exchange contracts, options and swaps. These products are used to hedge the exchange rate fluctuation on existing assets, liabilities, cash flows arising from future commitments or highly probable forecast transactions. Presently, Indian GAAP provides guidance for forward contracts only. Based on this guidance, entities treat forward exchange contracts for hedging purpose without having robust documentation. Other risk management products, such as options and swaps are normally accounted for when they get settled. Under IFRS all derivatives are required to be recognised in the financial statements at fair value. Hedge accounting is permitted only if entities have robust documentation and specified conditions are satisfied. Thus, entities will have to reconsider their hedging strategies and documentation protocols to ensure that they satisfy requirements of IAS 39. It should be noted that ICAI has recently approved AS 30 and AS 31 on Financial Instruments which are based on IAS 32 and IAS 39 and contain the same hedging requirements. Under IFRS the more exotic a hedge instrument, it is less likely that hedge accounting would be permitted. For example, a foreign exchange forward contract with barriers or knock-in-knock-out features is unlikely in many situations to qualify for accounting purposes as a hedging instrument.

Accounting for Intangibles

Although there are not many "product" development companies in India, companies that do develop software products either for sale or for their own use often run into the same difficulties as other companies investing in research and development activities in that they are required to write off a significant part of the cost of developing the software as and when the cost is incurred. Moreover, IAS 38 has the concept of indefinite useful life for such assets which is absent under Indian GAAP.

4.6. Extractive

Extraction of natural resources are high risk activities as significant investments are made, which may or may not result in the production of commercially viable reserves. Accounting for these activities is complex. Under IFRS except for accounting treatment of exploration and evaluation expenditure, there is no guidance for extractive industry. Most of the accounting treatment followed in Indian GAAP is based on principles laid down in the *Guidance Note on Oil and Gas Producing Activities*. We believe convergence to IFRS will have an impact on the areas mentioned below.

Key Impact Areas

Accrual for Abandonment Costs

Most extractive entities have an obligation for abandonment costs relating to their production assets. In accordance with agreements and legislation, the well head, production assets, pipelines and other installations may have to be dismantled. The obligation to decommission the asset normally arises the moment an asset is constructed. Both IFRS and Indian GAAP require provision to be created for abandonment costs net of salvage value. With respect to oil and gas exploration activities, certain entities assume that in case of onshore activities salvage value would be equal to the cost of dismantling the facilities and carrying out the clean-up and reclamation activities. Consequently, dismantling costs are typically ignored in such cases. In those instances, particularly offshore activities where dismantling costs are significantly greater than the salvage value, a provision is often recognised for full eventual liability at initial stages at the time of installation of the concerned asset. Provision for such abandonment costs are made at current prices. No guidance is available under Indian GAAP for subsequent changes in estimation of abandonment cost leading to varied practices followed by various extractive entities in India.

Under IFRS the provision for abandonment cost needs to be discounted to its present value at the time of initial recognition. The unwinding of discount is recognised as interest expense over the life of the asset. IFRIC 1 deals with changes in measurement of abandonment costs arising from changes in the estimated timing, or amount of liability, or a change in the discount rate. As per the interpretation, the treatment depends upon whether the entity has followed the Cost Model or Revaluation Model for the asset. In case, the entity has followed the Cost Model, the amount is adjusted to the carrying amount of the asset. If the Revaluation Model is followed, changes in the liability alter the revaluation surplus or deficit previously recognised on that asset.

Method of Accounting

There is no specific accounting guidance under IFRS for expenditure incurred for prospecting, acquisition, exploration and development of natural resources, other than IFRS 6 *Exploration for and Evaluation of Mineral Resources,* which provides some guidance on expenditure incurred on exploration and evaluation of mineral resources. In Indian GAAP, the Successful Efforts Method and the Full Cost Method are two widely used methods for accounting for expenditure on exploration activities. Under the Full Cost Method, all costs incurred in searching for, acquiring and developing the reserves in a large geographic cost centre are capitalised. Cost centres are typically grouped on a country-by-country basis. Although sometimes countries may be grouped together if the fields have similar or linked economic or geological characteristics. Full Cost Method permits capitalisation of cost even for unsuccessful wells. This is not consistent with the definition of an asset given in the IFRS framework. Till the time further guidance is provided on extraction activities, Indian entities would continue using the Full Cost Method. The probability that IASB may prohibit use of this method in future, however, is more due to inconsistency with the framework.

Exploration and Evaluation Assets

The *Guidance Note on Oil and Gas Producing Activities* issued by ICAI permits capitalisation of (i) costs of drilling and equipping exploratory and appraisal wells and (ii) costs of drilling exploratory-type stratigraphic test wells under the successful efforts method. It does not permit capitalisation of geological and geophysical costs, costs of carrying and retaining undeveloped properties, such as delay rental, ad valorem taxes on properties, legal costs for title defence, maintenance of land and lease records, and annual licence fees for the Petroleum Exploration License. Under the Full Cost Method all exploration costs are treated as capital work-in-progress. Capitalisation of exploration cost may differ under IFRS, as IFRS 6 permits capitalisation of geological and geophysical costs, provided the entity classifies them as exploration and evaluation assets and applies the policy consistently.

Impairment

Indian GAAP does not provide any specific indicators for assessing the impairment of exploration and evaluation assets. General indicators specified in AS 28 are used for assessment of impairment for exploration and evaluation assets.

IFRS 6 requires exploration and evaluation assets to be assessed for impairment when facts and circumstances suggest that the carrying amount of an exploration and evaluation asset may exceed its recoverable amount. It specifies explicit indicators for impairment testing of exploration and evaluation assets. The following facts and circumstances are specified, which indicate that an entity should test exploration and evaluation assets for impairment:

» The period for which the entity has the right to explore in the specific area has expired during the accounting period or will expire in the near future and is not expected to be renewed

» Substantive expenditure on further exploration for and evaluation of mineral resources in the specific area is neither budgeted nor planned

» Exploration for and evaluation of mineral resources in the specific area have not led to the discovery of commercially viable quantities of mineral resources and the entity has decided to discontinue such activities in the specific area

» Sufficient data exists to indicate that although a development in the specific area is likely to proceed, the carrying amount of the exploration and evaluation asset is unlikely to be recovered in full from successful development or by sale

If the above indicators suggest impairment, measurement is done as per principles specified in IAS 36 *Impairment of Assets*.

The determination of CGUs also poses a great challenge for extractive companies because of the nature of their activities. For example, an individual asset such as an oil well, will not be considered a CGU if it is dependent on other assets to generate cash inflows. Some oil and gas companies identify CGUs on a field-by-field basis. A field approach to CGUs is often taken because all assets within the field usually share common production facilities integral to the operations and cannot be separated, sold or transferred for alternative use. However, several oil or gas fields may use common production and transportation facilities and thus may constitute one CGU. The determination of a CGU may also be impacted by laws and regulations. Allocation of more than one field in one CGU, if applicable should be done cautiously.

Accounting for Support Equipment and Facilities

Support equipment and facilities are defined as equipment and facilities of the nature of service units, camp facilities, godowns (for stores and spares), workshops (for equipment repairs), transport services (trucks and helicopters), catering facilities and drilling and seismic equipment.

As per industry policy, all support assets pertaining to the oil and gas block are capitalized as part of the exploration or development / producing assets and these are then depleted alongwith the development / producing asset block over the useful life of the field in the IFRS financial statements of the oil and gas companies. Under Indian GAAP, the cost of acquiring or constructing support equipment and facilities used in exploration and production activities is normally capitalised in accordance with AS 10 *Accounting for Fixed Assets*. Depreciation on such equipment and facilities is arrived at in accordance with AS 6 *Depreciation Accounting*, and accounted for as exploration cost, development cost or production cost, as may be appropriate.

4.7. Pharmaceuticals

Key Impact Areas

Collaborative Arrangements

Pharmaceutical entities often enter into collaborative Research and Development (R&D) arrangements with counterparts that include multiple elements, such as, intellectual property license, R&D services, manufacturing services and commercialisation activities. The products

and services delivered under these arrangements are unique. Therefore, it raises issues of accounting for such transactions. Under IFRS it is necessary to apply the revenue recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. Even then, it poses peculiar problems in some circumstances since the term ‘component’ is not defined. In such cases, the vendor has various performance obligations imposed by an arrangement. Indian GAAP does not provide any guidance on applying revenue recognition criteria to each component.

Acquisitions

Acquiring new businesses for new brands is a common practice in the Pharmaceutical Industry. Indian GAAP does not have fair value accounting for business combinations and hence, the true worth of intangible assets acquired may not be captured in most cases. In IFRS 3 the only method allowed for accounting for business combinations is the purchase method where accounting is done based on the fair values of the identifiable assets, liabilities and contingent liabilities. Significant differences in accounting for business combination result in considerable differences in financial results in the year of the acquisition as well as in the years subsequent to such an acquisition.

Intangible Assets

In the Pharmaceutical Industry, companies face challenges in accounting for development expenditure. The issue becomes complex in this industry because some of the development expenditure is incurred internally, whereas part of it is incurred in external development. The industry capitalises internal development expenditure incurred after the final scientific approval is obtained. IAS 38 provides criteria that must be met for capitalisation of development expenditure. To determine when to start capitalising internal development expenditure poses the following challenges:

» *Technical feasibility:* For capitalising development expenditure on a new molecule, technical feasibility of completing it, needs to be proved

» *Intention of completion and ability to use / sell:* Intention to complete and ability to market needs to be demonstrated prior to capitalization.

» *Ability to use or sell:* Pharmaceutical companies will have to obtain letters of intentions from other companies who will purchase the new compound once developed

» *Generation of probable future economic benefits:* Pharmaceutical companies will continue with development expenditure only when the new molecule has a proven market

» *Availability of resources:* This will have to be assessed for each company separately. Within each company, each development project needs to be assessed to test whether this criteria is satisfied when expenditure is capitalised

» *Measuring the expenditure:* Accounting systems need to be developed to capture this data correctly

For example, Pythopharm Plc., in its 2006 annual report, states as follows:

> "All on-going research expenditure is currently expensed in the period in which it is incurred. Due to the regulatory and other uncertainties inherent in the development of the Group's products, the criteria for development costs to be recognised as an asset, as prescribed by IAS 38 'Intangible assets', are not met until the product has been submitted for regulatory approval and it is probable that future economic benefit will flow to the Group. The Group does not currently have any such internal development costs that qualify for capitalisation as intangible assets."

Whilst there is no difference between Indian GAAP and IFRS on the issue of capitalisation, it may be noted that any capitalisation of R&D cost in IFRS financial statements will be subject to a higher level of scrutiny-nationally and globally.

Indian Pharmaceutical companies are largely in the generics market where the capital cost is not as high as in the development of a new molecule. However, even in the generics space the costs incurred in developing a test batch, carrying out bio-equivalence test and the filing fee to be paid are significant expenditures that are subject to the same rigorous tests under AS 26 and IAS 38.

Amortisation of Intangible Assets

Under Indian GAAP intangible assets are amortised over their estimated useful lives and there is a rebuttable presumption that the useful life cannot exceed 10 years. Only in cases where there is persuasive evidence that the useful life of intangible asset is a specific period longer than 10 years, the presumption of 10 years is not used. IFRS does not prescribe any such presumption. The entity is required to determine whether the intangible asset has finite or indefinite useful life. In case of finite life intangible assets, the amortisation is charged over the estimated useful life of the asset. Therefore, even in the absence of persuasive evidence an entity can estimate useful life as more than 10 years under IFRS.

4.8. Media and Entertainment

The Indian M&E industry has transformed in the last 15 years. The segments within the industry broadly include TV broadcasting, Publishing, Radio, New Media, Filmed Entertainment, Software Production, Music and Events. Considering that M&E sector is service oriented and depends on intellectual property, accounting challenges mainly arise in the areas of revenue recognition and intangible assets. Some significant challenges which M&E entities will face on transition to IFRS are mentioned below.

Key Impact Areas

Sale of Rights on a Minimum Guarantee Basis

Film copyright are exploited in theatres either on a commission basis or a minimum guarantee basis. While revenues from commission based arrangements are recognised on receipt of the information from the exhibitors or distributors, recognition of "Minimum Guarantee" (MG)

poses challenges as the distributor agrees to pay a minimum licence fee and a revenue share over a threshold amount for the right to exploit the film in a specific market for a limited period. Disparate practices are followed by various M&E entities under Indian GAAP– some entities recognize upfront revenue whereas some entities defer recognition of revenue until the commencement of exploitation period. IAS 18 *Revenue* provides additional guidance on revenue recognition for license fees and royalties which states that an assignment of rights for a fixed fee or non refundable guarantee under a non cancellable contract which permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform is, in substance, a sale. On conversion to IFRS, M&E entities will have to assess the terms of the arrangement with the provisions of IAS 18 to evaluate whether upfront revenue can be recognised or not.

Multiple Element Contracts

A common practice amongst media owners is the bundling and marketing of space across various products / programmes / channels / publications / portals. The accounting of revenues or costs becomes challenging in cases where such space is marketed for a consolidated amount. While AS 9 addresses accounting of revenue on providing space based on the display of the advertisements, it does not specifically address accounting of multiple elements within a consolidated contract. Industry Practice is to account for revenue for such contracts based on values specified in the contract or do an apportionment of the contract values on some suitable basis. When values stated in the contract or revenue arrived based on apportionment do not prima-facie appear to be fair, no adjustment is carried out. These issues have not been addressed in IFRS also. IAS 18 provides limited guidance with respect to multiple element contracts. It requires application of recognition criteria to be applied separately to each transaction. However, in certain circumstances, it mandates application of recognition criteria to separately identifiable components of a single transaction in order to reflect the substance of the transaction.

Sale of Future Rights

In certain cases, a producer or a copyright owner licenses rights to a broadcaster for a pre-defined future period before commencement of such period. The consideration in such cases (i.e. royalty) is received by the producer / copyright owner on entering into the agreement. The issue generally faced is whether such receipt should be recorded as income on entering the agreement or whether the revenue should be recognised on the commencement of the licence period.

There is no specific guidance for the same in Indian GAAP and hence disparate practices are followed by various M&E entities – some entities recognize upfront revenue whereas some entities defer recognition of revenue until commencement of the exploitation period. IFRS also do not have any media specific guidance. However, IAS 18 *Revenue* provides additional guidance on revenue recognition for license fees and royalties which states that an assignment of rights for a fixed fee or non refundable guarantee under a non cancellable contract which permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform is, in substance, a sale. On conversion to IFRS, M&E entities will have to assess the terms of the arrangement with the provisions of IAS 18 to evaluate whether upfront revenue can be recognised or not. However, accounting treatment under US GAAP differs as commencement of the licence period is a significant condition to recognise revenue.

Barter Transactions

Media companies enter into transactions wherein services are rendered in exchange of services received. Part consideration could also be settled in cash. Examples of common barter transactions prevalent in the industry include the following:

» Broadcasters enter into transactions in which they exchange rights to place advertisements on each other's channels,

» Publishers exchange space on each other's media,

» Internet entities enter into barter transactions in which they exchange rights to place advertisements on each other's web sites,

» The media exchange space with service providers; such as hotels or travel agencies, in exchange for those services.

In IFRS, revenue from barter transaction is recognised only when goods are sold or services are rendered in exchange for dissimilar goods or services. In such cases, the revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred. When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred. Under Indian GAAP, only available accounting literature is the *Guidance note on accounting for Dot-Com Companies* which has similar fair value requirements as IFRS. The guidance note goes on to add that where reliable estimates of fair value are not available it may not be appropriate to record the revenues and the associated costs.

Artist Compensation

At times, artist's viz. actors, directors, etc. agree to acquire share in the copyrights as full/part consideration of their services which could include distribution rights to a particular market or media. The determination of the compensation impacts the overall project revenue and cost.

The following two sources of information could be utilized for estimating the artist's compensation.

a. Revenue foregone by the producer for a particular market/media.

b. Compensation ordinarily charged by the artist, had no distribution rights been awarded to the artist.

From the above, the second option would seem more feasible. However facts and information surrounding each transaction must be considered before making the estimate.

Amortisation of Copyrights and Production Cost

A film copyright owner either develops the copyright, for e.g. a producer of a film, or acquires from a producer. These rights can be exploited in several ways viz. theatrical release, television broadcast, home video, etc., by selling the same to distributors, broadcasters, etc. A producer may sell these rights on the basis of each predefined market/ territory or even medium viz. television broadcasting or for a fixed period.

Both IFRS and Indian GAAP do not provide industry-specific guidance. However, principles of accounting including amortization of intangibles are similar in both the GAAP. The amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method shall be used. IAS 8 permits reference to the most recent pronouncement of other standard -setting bodies that use a similar conceptual framework, to the extent it does not conflict other standards, interpretations, or the framework of IFRS. US GAAP provides detailed guidance on amortization of copyrights and production costs of film and prescribes individual film forecast method for the purpose of amortization. However, a key challenge would be to develop robust systems and processes to reliably estimate revenue which can be generated from the films.

Component Accounting

The film exhibition business has been transformed in the last five years with several new players having developed multiplexes on premises obtained on long term non-cancellable lease arrangements. Significant expenditure is incurred for developing such properties including the designing of the property and providing the necessary ambience and comforts to viewers. Normally, such expenditure is capitalized as leasehold improvements in Indian GAAP and subsequent replacements and overhauling are charged off to profit and loss account if they do not increase originally assessed standard of performance. Under IFRS, property, plant and equipment is to be accounted on a component basis whereby each significant component of the leasehold improvement having a different useful life has to be capitalised and depreciated separately. This facilitates appropriate accounting of the periodic replacement or overhauling which is required for assets having a lower useful life as such costs are capitalised and the written down value of the asset being replaced is decapitalised.

Lease Accounting

Multiplexes are generally set up in leased premises wherein the rentals increase over a period of time. Where the lease is an operating lease, it leads to an issue of straight-lining of the lease rentals. As per an EAC opinion straight-lining is required. However, this matter is not fully tested under IFRS.

4.9. Real Estate and Infrastructure

In Indian GAAP, ICAI has issued a *Guidance Note on Recognition of Revenue by Real Estate Developers*. Under IFRS, IFRIC has issued Draft Interpretation D 21 *Real Estate Sales*. These pronouncements and other practices developed in this industry, over the period, result in significant differences in accounting under the two frameworks. There is no specific guidance for the Infrastructure Industry in Indian GAAP. Under IFRS, IFRIC 12 *Service Concession Arrangements* deals with accounting for infrastructure for public services.

Key Impact Areas

Real Estate Developers

Under Indian GAAP when the seller has transferred all significant risks and rewards of ownership to the buyer, it would be appropriate to recognise revenue at that stage, subject to the fulfilment of other conditions, namely, (i) no significant uncertainty exists regarding the amount of the consideration that will be derived from the real estate sales and (ii) it is not unreasonable to expect ultimate collection, provided the seller has no further substantial acts to complete under the contract. However, in case the seller is obliged to perform any substantial acts after the transfer of all significant risks and rewards of ownership, revenue is recognised on proportionate basis as the acts are performed, i.e., by applying the percentage of completion method in the manner explained in AS 7 *Construction Contracts.*

Under IFRS, whether to apply IAS 11 *Construction Contracts* or IAS 18 *Revenue* is determined by whether the sale agreement meets the definition of a construction contract under IAS 11 or not. If the seller agreement is to provide construction services to the buyer's specifications, then it is a construction contract.

Accounting for Investment Property

Once the construction is complete, IFRS requires the land and/or building held for earning rentals to be classified as an investment property under IAS 40. The entity has an option to measure such property at cost or using Fair Value Model when certain conditions are satisfied. Under Indian GAAP there is no Accounting Standard corresponding to IAS 40 dealing with investment property in a comprehensive manner. AS 13, which deals with investment property in a brief manner, requires investment property to be accounted for at cost less other than temporary diminution in value of the property. Further, such property is required to be depreciated over the useful life.

Infrastructure for public use

Under IFRS the operator cannot recognise infrastructure as own asset as the operator does not control the use of public service infrastructure, such as roads, bridges and tunnels, but is merely a service provider. Under IFRS, IFRIC 12 *Service Concession Arrangements* gives guidance on accounting by operators for public-to-private service concession arrangements. It applies to public-to-private service concession arrangements if (i) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price and (ii) the grantor controls any significant residual interest in the infrastructure at the end of the term of the arrangement. Before its issuance, there was widespread concern about the lack of such guidance. In particular, operators wished to know how to account for infrastructure that they either constructed or acquired for the purpose of public-to-private service concession arrangement or were given access to for the purpose of providing public service. In terms of IFRIC 12 the operator cannot recognise infrastructure as its own asset since it does not control the use of the public service infrastructure. The operator acts as a service provider. Therefore, the operator recognises the revenue and costs relating to construction or upgrade

service in accordance with IAS 11 *Construction Contracts* and revenue in accordance with IAS 18 *Revenue* for services it performs. The consideration received for construction or upgrade services is recognised at its fair value. In India, in the absence of an IFRIC 12 equivalent, infrastructure companies account for the infrastructure as fixed assets rather than as an intangible asset or financial asset.

4.10. Power

The Power Industry is a regulated and very capital intensive industry. Critical activities in operational cycle of power entities are fuel sourcing, generation, transmission and distribution, and retail. On transition to IFRS, various issues arise in all phases. Some of the critical issues are addressed in this section.

Key Impact Areas

Long Term Fuel Purchase

Utility entities usually conclude long term purchase contracts for oil, gas, coal and/or power to be able to meet their contractual obligations to supply to their customers. Generally, these purchase contracts are entered into for the purpose of the receipt of a commodity (oil, gas, coal and/or power) in accordance with an entity's expected purchase, sale or usage requirements and are therefore in nature of executory contracts. Many times, however, a utility entity may have a practice of net-settling these purchase contracts or similar contracts (in cash, another financial instrument, or by exchanging financial instruments) or they might have a practice of taking delivery of the commodity and selling it within a short period, for the purpose of generating a profit from short-term price fluctuations or broker-dealer's margin. In such cases, the contracts may meet the definition of a derivative. In Indian GAAP such derivatives are not required to be recognised. Under IFRS it will have to be fair valued. Clearly long term fuel purchase contracts that are fair valued may significantly increase income statement volatility.

Fixed Assets

Accounting for fixed assets is also an important issue for utility entities as most are capital intensive. An issue that is relevant to almost every entity in this industry is the application of the components approach. To apply the components approach appropriately, an in-depth analysis is required to identify significant components that make up a plant or a grid. These components need to be depreciated over their own useful lives, rather than the life of the asset as a whole. The application of the components approach in this industry is a challenging task as it requires technical knowledge that usually cannot be provided by the accounting department on its own. Experience of IFRS implementation elsewhere in the world indicates that there is considerable disparity in the way in which components were identified for power plants.

Power Purchase Agreements / Transmission Contracts/ Capacity Contracts

It is a common practice in India for various entities to enter into power purchase agreements to fulfil their energy demand. Also, many utility entities enter into a contractual arrangement conveying the right to use a part of its grid to third parties. Such contracts are normally accounted as sales/service contracts in Indian GAAP. On transition to IFRS, such an arrangement needs to be analysed to identify whether it contains a lease. This can have significant implications on the balance sheet of power entities as an asset under consideration may have to be derecognised if the arrangement is assessed as finance lease.

Re-optimisation and Own Use Exemption

The planned utilisation of a power plant depends on external market and internal factors. External market factors which need to be considered for determining generation profiles are the utility entity's expectations of prices (for fuel sourcing, power purchases, and sales as well as for emission allowances and power demand). Internal factors include the power plant's marginal costs of production and power plant technical constraints, such as load capacities, will need to be considered. When actual prices (for fuel, power and/or emission allowances) or demand volumes deviate from previous expectations, a utility entity will need to re-optimise the generation profile (i.e., adjust the utilisation) in the short term within the defined technical constraints of generation capacity in order to maximise profits. Consequently, the utility entity may need to enter into financial or derivative contracts simultaneously. For example, to buy power on the wholesale market to meet its obligations to its customers and to adjust the fuel sourcing for the power plant. In Indian GAAP Accounting Standard on derivatives comes into effect in respect of accounting periods commencing on or after 1 April 2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory in respect of accounting periods commencing on or after 1 April 2011 for all commercial, industrial and business entities except to a small and medium-sized entities. In IFRS, IAS 39 deals with derivatives comprehensively. In IFRS these contracts might require derivatives accounting and would usually have a major impact on the income statement. Therefore, a utility entity must look carefully at the scope, scale, and structure of its re-optimisation activities to ensure that these activities do not have unexpected consequences.

The above are few critical issues, which may arise on transition to IFRS. There are many other issues, such as accounting for emission rights, service concession contracts, tolling rights, accounting for regulatory assets and liabilities, which power entities will have to deal with on transition to IFRS.

4.11. Retail

Even though Indian GAAP is inspired from IFRS, there are significant differences between both the GAAPs. In many instances, existing industry practices do not always coincide with the current IFRS guidance. The consequences of GAAP differences need to be analysed and appropriately applied for certain retail and consumer specific issues.

Key Impact Areas

Capitalisation of Refurbishment Cost of Existing Stores

In Indian GAAP the cost of construction, painting, false ceiling, furnishing etc., of existing stores, is capitalised to the extent that it increases the future economic benefits in excess of the original assessed standard of performance. Thus, if the expenditure incurred was to increase the available space in the store or add a new outlet the same is capitalised, otherwise it is

expensed. The cost of overhaul that does not increase the benefit beyond the originally assessed standard of performance is not capitalised. For example, the management may have a policy to undertake major refurbishment (e.g., floor carpets and paint) of a store once every four years to keep it at the required operating standard. Such expenditure under existing AS 10 cannot be capitalised. Under IFRS retail entities will have to identify cost of refurbishment and major overhauls as a separate component and capitalise such cost when incurred. The capitalised cost is amortised over the period when the next overhaul is expected.

Accounting for Pre-opening Cost

Retailers typically spend a huge amount on developing new stores. For example, a store may require 3 months for developing, during which expenditure on construction, painting, false ceiling, furnishing etc. would be incurred. Also, staff costs are incurred since they may have already been hired in anticipation of the opening of the store. The issue arises is whether such pre-opening cost should be capitalised or expensed off. The cost of construction, painting, false ceiling, furnishing, etc. would be capitalised. However the cost of the staff is not capitalised as it is not necessary for bringing the asset to its working condition and hence should be expensed. Whilst this is true for both IFRS and Indian GAAP, in practice, some companies may have interpreted Indian GAAP as allowing capitalisation.

Accounting for Leases

Retail entities normally enter into leasing arrangements for their buildings and stores. Even though accounting for leases under Indian GAAP and IFRS is similar, classification of these leases under IAS 17 could be different due to additional guidance provided under IFRS for composite lease, lease contracts embedded in service contracts, embedded derivatives etc.

In many cases, retail entities pay rentals based on revenue or profit generated by them from that outlet or premises. Indian GAAP does not prescribe any specific accounting treatment for derivatives. Under IFRS, such contracts will have to be analysed to identify any embedded derivatives, which requires separate accounting. Where the embedded derivative exception applies, such features would be accounted as contingent rentals.

Retailers often pay premiums to a previous tenant or to the owner of the premises in order to obtain prime leasehold premises. These payments, commonly known as ‘key money’, can take several forms, including payment to existing leaseholders to exit the lease or payment of a non-refundable deposit on the commencement of the lease. The accounting treatment will depend on the lease classification. Under Indian GAAP and IFRS, such initial direct costs are capitalised if the lease is classified as finance lease. There is no specific accounting treatment specified for such cost if the lease is classified as operating lease under IFRS and Indian GAAP.

Straight-lining of lease rentals in an operating lease is another issue. For Indian GAAP, the EAC has opined that straight-lining would be required. Under IFRS the final verdict is not yet known.

Corners in Department Stores / Concession Agreements

Retail entities do business on a ‘store-in-store’ or concessionary basis, where the retail entity allocates a corner for another store and sells the products of that store. The industry practice is to disclose the gross value of sales, including sales made from the store. Critical analysis of the arrangement should be made to determine whether the retail entity is acting as an agent or principal. If retail entities are acting as an agent for the vendor, they should account only for commission as revenue.

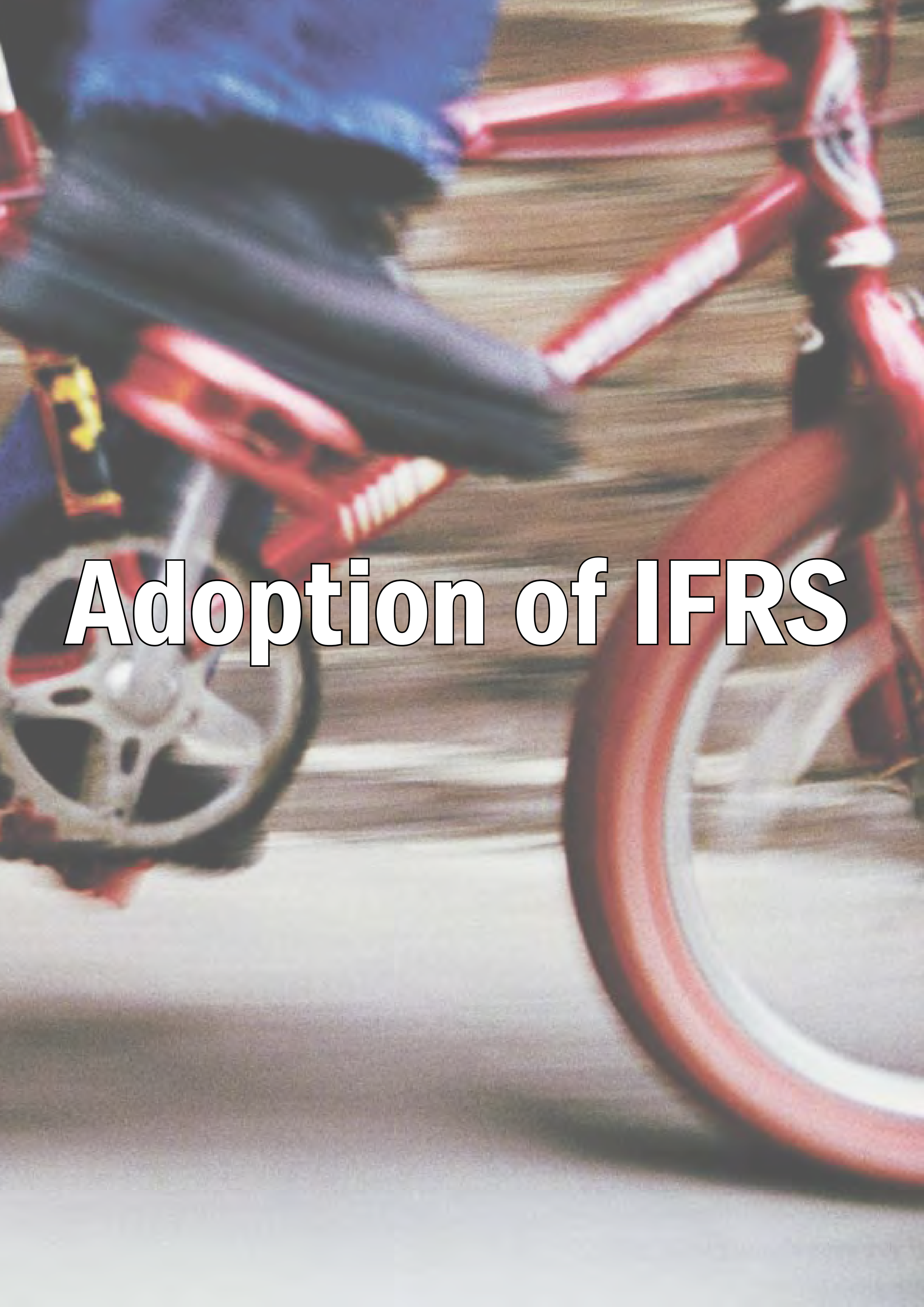
Brands

Many retail and consumer entities have intangible assets in brand names that they have built up over the years through acquisitions and mergers. Key points to consider are the valuation of these intangibles, annual impairment reviews, and the allocation of valuation of these assets to business segments. Accounting principles for brands are very similar in Indian GAAP and IFRS except for identification of brands with indefinite life. Indian GAAP does not recognise the concept of indefinite life. IFRS permits entities to estimate that intangible assets can have indefinite life and subject them to an impairment test annually. Retail entities may review the classification of brands to make the split between definite and indefinite brands as per guidance given in IAS 38.

Impairment of Assets

Every retailer has underperforming assets. The toughest challenges are likely to be for retailers (i) to set up adequate procedures to identify impairment indicators (ii) to establish annual impairment tests on goodwill and intangible assets with an indefinite useful life, and (iii) to define the CGU at which non-current assets and goodwill are regularly tested for impairment. The question that arises is the level of detail required. For example, will retailers need to go down to country, region, store or department level for the identification of CGUs? This is an interesting issue both under Indian GAAP and IFRS.

First-time



Adoption of IFRS

5. First-time Adoption of IFRS

5.1. Background

ICAI has announced full convergence with IFRS issued by IASB from accounting periods commencing on or after 1 April 2011. All listed entities and public interest entities such as banks, insurance entities, and large-sized entities shall adopt IFRS. This is subject to regulatory endorsements. Presently more than 100 countries require or permit the use of IFRS.

5.2. Preparation for Adopting IFRS

Entities need to develop the work plan for smooth transition to IFRS. The staff needs to be trained for IFRS to allow them to effectively implement IFRS. Certain areas in IFRS will have impact on the entity in a significant way. These areas need to be identified.

5.3. First-time Adoption

IFRS 1 *First-time Adoption of International Financial Reporting Standards* prescribes the procedures that an entity is required to follow when adopting IFRS for the first-time. An entity that makes an explicit and unreserved statement of compliance with IFRS for the first time is the first-time adopter. Even if the entity has prepared IFRS information for internal management use, it will be the first time adopter only when such statement is made in its financial statements. Even if the entity has complied with some of the IFRS in the earlier years, it will be a first-time adopter when it makes the above mentioned statement in its financial statements.

5.4. What does IFRS 1 Entail?

Entities need to apply accounting policies in its IFRS financial statements that are in compliance with IFRS, effective as of the balance sheet date of the first IFRS financial statements. IFRS requires minimum one year of comparatives to be presented. Therefore, when an entity follows IFRS for the first time in its financial statements for the year-end 31 March 2012, it needs to give the financial information for the year ended 31 March 2011 as a comparative. This comparative information also needs to be in compliance with IFRS. Therefore, the opening balance sheet of the comparative year, i.e., balance sheet as at 1 April 2010, needs to be in compliance with IFRS. This is referred as the opening balance sheet. In simple words, three balance sheets and two profit and loss accounts would be required. Though IFRS will be mandatory from accounting periods commencing on or after 1 April 2011, the requirement for an IFRS compliant balance sheet as at 1 April 2010 and IFRS compliant interim financial statements will mean that the 2011 date in practice would be significantly advanced.

5.5. Transition from Indian GAAP to IFRS

Assets and Liabilities in the Opening Balance Sheet Not Meeting IFRS Definitions

Assets and liabilities recognised under Indian GAAP that do not qualify for recognition under IFRS need to be eliminated from the opening balance sheet. For example, deferred revenue expenditure of share issue expenses does not meet the definition of intangible asset under IAS 38. Therefore, it cannot be carried in the IFRS opening balance sheet. Entities also need to gather information required to be disclosed in the IFRS balance sheet that is not disclosed in Indian GAAP. For example, Indian GAAP prohibits disclosure of contingent assets, whereas IFRS require such disclosure. Therefore, entities need to develop the system to capture such information. Proposed dividends cannot be disclosed as liability in IFRS. Therefore, this liability will be eliminated in the opening IFRS balance sheet.

Assets and Liabilities Not Recognised in Indian GAAP

Some of the examples are:

» All derivative financial assets and liabilities and embedded derivatives need to be recognised in IFRS opening balance sheet. If these are not recorded under Indian GAAP, entities need to bring them on the IFRS balance sheet

» IFRS require restructuring provisions to be recognised based on constructive obligation. Indian GAAP permits recognising such provision only when legal obligation arises. Therefore, if an entity had constructive obligation on the opening balance sheet date, it needs to record the provision in the IFRS balance sheet. If there was no legal obligation by that date, Indian GAAP balance sheet would not have recorded such provision

» IAS 12 is based on the balance sheet liability approach. AS 22 requires deferred taxes to be recognised based on the income statement liability approach. Therefore, temporary differences for which deferred tax is not recognised under Indian GAAP need to be identified on the opening balance sheet date and deferred tax should be recognised accordingly under IFRS

IFRS Classification of Assets and Liabilities

Asset and liability classifications under Indian GAAP balance sheet does not conform to IFRS. Therefore, the assets and liabilities need to be classified to draw up the opening IFRS balance sheet in accordance with IFRS requirements

» Indian GAAP balance sheet does not have a separate class as equity. Therefore, items which meet the definition of equity under IFRS need to be identified first and then to be classified into this class in the opening IFRS balance sheet

» There may be acquired intangible assets in the past business combinations, which do not meet the definition of intangible assets under IFRS. These need to be classified as goodwill and vice versa in the opening balance sheet

» IFRS 1 provides exemption from split accounting of compound financial instruments when certain conditions are satisfied. When this exemption cannot be availed by the entity, compound financial instruments need to be split into equity and liability portions for their appropriate classification. Those items which are liabilities but are classified as equity under Indian GAAP, such as mandatory redeemable preference shares, need to be reclassified as liability in the opening balance sheet

» IAS 27 does not provide any exemption from consolidating subsidiaries. Therefore, if the entity has not prepared CFS under Indian GAAP or has not consolidated any subsidiary in its Indian GAAP CFS, opening IFRS balance sheet needs to be redrawn to ensure all subsidiaries are recorded in the consolidated opening balance sheet

Carrying Values of Assets and Liabilities

All assets and liabilities need to be measured using IFRS principles. IFRS 1 provides certain exemptions which the entity can choose for measuring assets and liabilities. The difference between the carrying values under Indian GAAP and carrying values under IFRS will be accounted in the retained earnings in the opening balance sheet.

Entities have sufficient time in hand to plan for their smooth transition. They should utilise this time wisely to avoid last minute rush. Some of the IFRS provisions are very complex. Applying them in the time crunch situations carries the risk of misapplication of these requirements.

Global Experience of

Conversion to IFRS

6. Global Experience of Conversion to IFRS

Purpose of IFRS

IFRS is adopted by various countries so that all entities in those countries speak a common accounting language. Adopting IFRS in the financial statements increases comparability of entities within the country and also with their global counterparts. IFRS is also looked upon as the reliable framework by users of financial statements. It helps entities for cross-border capital listing. The preparation of financial statements for the preparers and understanding those financial statements for the users provides an objective basis due to uniform framework of IFRS. It also helps reporting to the management, which may be in another country. This helps to follow uniform systems of reporting across the group in entities with worldwide presence.

Countries Adopting IFRS

Many countries in EU adopted IFRS for the accounting periods beginning on or after 1 January 2005. Approximately 8,000 entities listed in EU are required to follow IFRS in their CFS. All these entities have undergone the conversion exercise from their local GAAP to IFRS. The experience of these entities has been:

- Certain IFRS requirements are highly complex
- Some of the entities did not have the required data to implement IFRS
- The accounting staff is not trained enough to implement IFRS
- Regulatory requirements are not in compliance with IFRS

Issues in Implementing IFRS

Some of the issues faced by entities while transiting to IFRS are as follows:

- Lack of guidance on IFRS conversion
- Entity specific issues requiring detailed analysis of facts and circumstances to apply IFRS
- Untrained staff
- Time spent for converting to IFRS was under budgeted
- Collating the data required for conversion
- Use of experts for valuations
- IFRS application involves management to exercise judgement and estimations in many areas, since it is a principle based framework and not rule based
- Being the initial years, IFRS was interpreted differently by different people
- Increased communication was required for keeping analysts and stakeholders informed about the implications of IFRS conversion

- In some cases, IFRS dictated the business decision due to significant accounting impact
- Conversion exercise was handled casually, leading to critical problems as the target date drew closer

Expected Difficulties

When Indian entities will adopt IFRS, the following difficulties are expected. To overcome these difficulties one needs careful planning and a good advisor. There is sufficient time to overcome these difficulties. However, as the time passes by, the difficulties would become overwhelming.

- IFRS is significantly different from Indian GAAP in the areas of financial instruments, business combinations, and group accounts. For some entities this may result in complete wipe off of their retained earnings, whereas for others it may significantly add to the retained earnings
- IFRS knowledge, resources, and literature is very scarce in the country
- Analysts and stakeholders including regulators do not understand IFRS financial statements
- Difficulties in fair valuation due to:
  - Very few valuers have the expertise to perform valuations required by IFRS
  - Lack of data for the valuers to perform valuation
  - Non-availability of statistical models
- Non-availability of competitors data
- Regulatory requirements may continue to require different accounting treatment as compared to IFRS, such as in the case of tax accounts


How Ernst &

Young Can Help

7. How Ernst & Young can Help

Without careful study, the full impact of converting to IFRS will not be clear. The Ernst & Young approach to IFRS conversions - diagnostic, design and planning, solution development, implementation, and post-implementation review - enables management to find out in advance the extent to which their business will be affected by these fundamental issues and to address these business issues appropriately.

Diagnostic and Design

Ernst & Young starts with diagnostic assessment of the effects of IFRS on the entity. This impact study should last no longer than three weeks for even the largest business and considerably less for smaller ones. The basic elements of the diagnostic include collecting financial reporting information, assessing the IFRS impact of changes in financial reporting on your entity's business and conducting a comparison with the industry peer group.

From the diagnostic impact study, a customised report is produced that enables us to work together with you in mapping out a critical path from your current state to full IFRS implementation. We also pinpoint business issues of importance to the management. This report forms the basis of a practical transformation report and project plan that facilitates conversion with minimum disruption to your business.

Solution Development

The entity's demonstrated readiness for conversion determines the next steps. Ernst & Young will work with the entity in developing appropriate solutions to the issues identified during the diagnostic. These solutions may address issues in the areas of training, reporting, model accounts and policies, functional and technical design, building and testing systems, process changes, and internal and external communications.

Implementation and Maintenance

We will work with your entity to implement solutions and provide training, as needed, to relevant personnel. We will assist you in implementing the system and process changes, communicating with investors and other stakeholders, restating prior year financial statements or auditing restated financial statements.

Once your entity's IFRS conversion is complete and your financial statements under IFRS are prepared, we will undertake a post-implementation review and audit of those statements. We can also provide on-going support for other business issues that may arise as a result of the conversion.

Ernst & Young Online

A private, global internet site for clients that provides continuous access to important International GAAP® information, including:

Global Accounting & Auditing Information Tool (GAAIT)

- **Multinational GAAP research tool**
- **International GAAP® *online***

  Includes Ernst & Young's *International GAAP® 2007* book, along with Ernst & Young's illustrative financial statements and disclosure checklists. Also included are all the official IASB standards, exposure drafts, discussion papers and full sets of IFRS reporting entities' annual reports and accounts

- **International GAAP and GAAS**

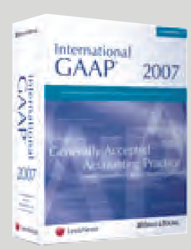
  Contains IFRS, International Auditing Standards issued by the IFAC and Ernst & Young commentary, guidance and tools

International GAAP® & GAAS Digest

Continuous coverage of developments from the IASB and IFAC and Ernst & Young Insights

International GAAP® 2007

Comprehensive book from Ernst & Young provides definitive and practical guidance for understanding and interpreting IFRS on a globally consistent basis.



ey.com/ifrs

IFRS Technical Publications

Technical publications – including *IFRS Alert and Developments in IFRS for financial instruments*

Global EYe on IFRS

- Online version and archived issues
- *Ernst & Young global contacts*

Appendix – Listing of IFRS

IFRS:

- IFRS 1 First-time Adoption of International Financial Reporting Standards
- IFRS 2 Share-based Payment
- IFRS 3 Business Combinations
- IFRS 4 Insurance Contracts
- IFRS 5 Non-current Assets Held for Sale and Discontinued Operations
- IFRS 6 Exploration for and evaluation of Mineral Resources
- IFRS 7 Financial Instruments: Disclosures
- IFRS 8 Operating Segments

IAS:

- IAS 1 Presentation of Financial Statements (IASB has issued IAS 1 (revised) which is applicable from accounting period starting on or after 1 January, 2009).
- IAS 2 Inventories
- IAS 7 Cash Flow Statements
- IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
- IAS 10 Events After the Balance Sheet Date
- IAS 11 Construction Contracts
- IAS 12 Income Taxes
- IAS 14 Segment Reporting
- IAS 16 Property, Plant and Equipment
- IAS 17 Leases
- IAS 18 Revenue
- IAS 19 Employee Benefits
- IAS 20 Accounting for Government Grants and Disclosure of Government Assistance
- IAS 21 The Effects of Changes in Foreign Exchange Rates
- IAS 23 Borrowing Costs (IASB has issued IAS 23 (revised) which is applicable from accounting period starting on or after 1 January, 2009).
- IAS 24 Related Party Disclosures
- IAS 26 Accounting and Reporting by Retirement Benefit Plans
- IAS 27 Consolidated and Separate Financial Statements
- IAS 28 Investments in Associates
- IAS 29 Financial Reporting in Hyperinflationary Economies
- IAS 31 Interests in Joint Ventures
- IAS 32 Financial Instruments: Presentation
- IAS 33 Earnings per Share
- IAS 34 Interim Financial Reporting
- IAS 36 Impairment of Assets
- IAS 37 Provisions, Contingent Liabilities and Contingent Assets
- IAS 38 Intangible Assets
- IAS 39 Financial Instruments: Recognition and Measurement
- IAS 40 Investment Property
- IAS 41 Agriculture

IFRIC

- IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities
- IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments
- IFRIC 4 Determining whether an Arrangement contains a Lease
- IFRIC 5 Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
- IFRIC 6 Liabilities arising from Participating in a Specific Market-Waste Electrical and Electronic Equipment
- IFRIC 7 Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies
- IFRIC 8 Scope of IFRS 2
- IFRIC 9 Reassessment of Embedded Derivatives
- IFRIC 10 Interim Financial Reporting and Impairment
- IFRIC 11 IFRS 2 - Group and Treasury Share Transactions
- IFRIC 12 Service Concession Arrangements
- IFRIC 13 Customer Loyalty Programmes
- IFRIC 14 IAS 19 - The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction

SIC

- SIC 7 Introduction of the Euro
- SIC 10 Government Assistance - No Specific Relation to Operating Activities
- SIC 12 Consolidation - Special Purpose Entities
- SIC 13 Jointly Controlled Entities - Non-Monetary Contributions by Venturers
- SIC 15 Operating Leases - Incentives
- SIC 21 Income Taxes - Recovery of Revalued Non-Depreciable Assets
- SIC 25 Income Taxes - Changes in the Tax Status of an Entity or its Shareholders
- SIC 27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease
- SIC 29 Disclosure - Service Concession Arrangements
- SIC 31 Revenue - Barter Transactions Involving Advertising Services
- SIC 32 Intangible Assets - Website Costs

List of Abbreviations

AFS	Available-for-Sale
ARO	Asset Retirement Obligations
ASB	Accounting Standards Board
AS	Indian Accounting Standards
CFS	Consolidated Financial Statements
CGU	Cash-Generating Unit
CODM	Chief Operating Decision Maker
ESOP	Employee Stock Option Plan
EPS	Earning Per Share
EAS	Expert Advisory Committee of ICAI
FVPL	Fair Value through Profit or Loss
GAAP	Generally Accepted Accounting Principles
HFT	Held-for-Trading
HTM	Held-to-Maturity
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standard Committee
ICAI	The Institute of Chartered Accountants of India
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IRDA	Insurance Regulatory and Development Authority
IRU	Indefeasible Right to Use
L&R	Loans & Receivables
M&E	Media and Entertainment
NACAS	National Advisory Committee on Accounting Standards
RBI	Reserve Bank of India
ROI	Return on Investments
SEBI	Securities and Exchange Board of India
SEC	U. S. Securities and Exchange Commission
SIC	Standing Interpretations Committee
SOCIE	Statement of Changes in Equity
SORIE	Statement of Recognised Income and Expenses
SOX	Sarbanes-Oxley
SPE	Special Purpose Entities
SPV	Special Purpose Vehicle
VCF	Venture Capital Funds
VCC	Venture Capital Company

OUR OFFICES

Bangalore
"UB City", Canberra Block
12th & 13th Floor
No.24, Vittal Mallya Road
Bangalore 560 001
Tel: +91 80 4027 5000
Fax: +91 80 2210 6000

Chennai
TPL House, 2nd Floor
No 3, Cenotaph Road
Teynampet
Chennai 600 018
Tel: +91 44 2431 1440
Fax: +91 44 2431 1450

Gurgaon
Golf View Corporate Tower - B
Near DLF Golf Course
Sector 42
Gurgaon - 122002
Tel: +91-124 464 4000
Fax: +91-124 464 4050

Hyderabad
205, 2nd Floor
Ashoka Bhoopal Chambers
Sardar Patel Road
Secunderabad 500 003
Tel: +91 40 2789 8850
Fax: +91 40 2789 8851

Kolkata
22, Camac Street
Block 'C', 3rd Floor
Kolkata 700 016
Tel: +91 33 2281 1224 - 29
Fax: +91 33 2281 7750

Mumbai
6th floor & 18th Floor Express Towers
Nariman Point
Mumbai 400 021
Tel: +91 22 6657 9200 (6th floor)
+91 22 6665 5000 (18th floor)
Fax: +91 22 6630 1222

New Delhi
6th Floor, HT House
18-20 Kasturba Gandhi Marg
New Delhi 110 001
Tel: +91 11 4363 3000
Fax: +91 11 4363 3200

Pune
C-401, 4th Floor
Panchshil Tech Park
Yerwada (Near Don Bosco School)
Pune 411 006
Tel: +91 20 6601 6000
Fax: +91 20 6601 5900

ERNST & YOUNG PVT. LTD.

www.ey.com/india
www.ey.com/ifrs