

IFRS — fast gaining adoption and acceptance globally :

The use of International Financial Reporting Standards (IFRS) as a universal financial reporting language is gaining momentum across the globe, especially as compared to a few years ago when a number of different national accounting standards existed. More than 100 countries now require or allow use of IFRS and by 2011 the number is expected to increase to 150. Some of the major countries that are seeking to converge/adopt IFRS by 2011 include Canada, Korea, India and Brazil.

The last two years have also seen significant momentum in the United States on converging from US GAAP to IFRS. The momentum started with the US Securities and Exchange Commission allowing foreign companies listed in the US to file financial statements prepared in accordance with IFRS (without a reconciliation to US GAAP) and continued with a proposal to evaluate IFRS convergence for all US Listed companies between 2014 and 2016.

Convergence with IFRS in India :

In line with the global trend, the Institute of Chartered Accountants of India (ICAI) has proposed a roadmap for convergence with IFRS for certain defined entities (listed entities, banks and insurance entities and certain other large-sized entities) with effect from accounting periods commencing on or after April 1, 2011. Large-sized entities are defined as entities with turnover in excess of Rs.100 crores or borrowings in excess of Rs.25 crores.

Accordingly, as part of its convergence strategy, the ICAI has classified IFRS into the following broad categories :

Category I : IFRS which can be adopted immediately or in the immediate future in view of no or minor differences (for example, construction contracts, borrowing costs, inventories).

Category II : IFRS which may require some time to reach a level of technical preparedness by the industry and professionals, keeping in view the existing economic environment and other factors (for example, share-based payments).

Category III : IFRS which have conceptual differences with the corresponding Indian Accounting Standards and where further dialogue and discussions with the IASB may be required (consolidation,

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Convergence with International Financial Reporting Standards ('IFRS') — Impact on fundamental accounting practices and regulatory framework in India

associates, joint ventures, provisions and contingent liabilities).

Category IV : IFRS, the adoption of which would require changes in laws/regulations because compliance with such IFRS is not possible until the regulations/laws are amended (for example, accounting policies and errors, property and equipment, first-time adoption of IFRS).

Impact of IFRS convergence on fundamental accounting practices :

Harmonising existing Indian accounting standards with IFRS will have an impact on some fundamental accounting practices followed in India. A few of these are enumerated below :

Use of fair value concept :

Indian GAAP requires financial statements to be prepared on historical cost except for fixed assets which could be selectively revalued. Use of fair value is presently limited for testing of impairment of assets, measurement of retirement benefits and 'mark-to-market' accounting for derivatives. Under IFRS, there is a growing emphasis on fair value. In addition to the requirements under Indian GAAP, the carrying amounts of the following assets and liabilities are based on fair value under IFRS :

- Initial recognition of all financial assets and financial liabilities is at fair value
- Subsequent measurement of all derivatives, all financial assets and financial liabilities held for trading or designated at fair value through profit

or loss, and all financial assets classified as available-for-sale, are measured at fair value

- ➡ Non-current provisions are measured at fair value, which is derived by discounting estimated future cash flows
- ➡ Share-based payment awards are measured at fair value
- ➡ Option available for measurement of property, plant and equipment at fair value, subject to certain conditions
- ➡ Option available for measurement of intangible assets at fair value, subject to certain conditions
- ➡ Option available for measurement of Investment property at fair value.

Substance over form :

Considering the overall theme of substance over form, IFRS mandates preparation of consolidated financial statements to reflect the true picture of the net worth to various stakeholders. Exceptions for preparation of consolidated financial statements are very limited. In India, currently consolidated financial statements are mandatory only for listed companies and that also only for the annual financial statements and not the interim financial statements.

Similarly, Indian accounting continues to be driven by the written contract and the form of the transaction — as opposed to the substance. Consider, upfront fees charged by a telecom service provider. Under Indian GAAP, several companies recognise such upfront fees as income because it is contractually non-refundable and is contractually received as fees for the activation process. Under IFRS, the fee is accounted for in accordance with the substance of the transaction. Under this approach, the customer pays the upfront activation fee not for any service received by the customer, but in anticipation of the future services from the telecom company. Thus, despite the non-refundable nature of the fees, revenue recognition would be deferred over the estimated period that telecom services will be provided to the customer.

Inconsistencies with existing laws and regulations :

As per the preface to the Indian accounting standards, if a particular accounting standard is found to be not in conformity with a law, the provisions of the said law will prevail and the financial statements shall be prepared in conformity with such law. However, under IFRS, the entity

needs to comply with all the accounting standards and other authoritative literature issued by IASB in order to comply with IFRS. If entities adopt accounting practice as approved by another regulatory authority or in conformity with a law, which is not in accordance with IFRS, the financial statement so prepared would not be considered to be in compliance with IFRS.

Disclosures :

In India, Schedule VI to the Companies Act, 1956, which prescribes a detailed format for preparation and disclosure of financial statements, lays great emphasis on quantitative information such as quantitative details of sales, amount of transactions with related parties, production capacities, CIF value of imports and income and expenditure in foreign currency, etc. Contrary to the same, IFRS is more focused on qualitative information for the stakeholders, such as terms of related party transactions, risk management policies, currency exposure for the entity with sensitivity analysis, etc. To more correctly report the liquidity position of the entity, IFRS also requires segregation of all assets/liabilities into current and non-current portions. Presently under Indian GAAP even long-term deposits and advances are disclosed under current assets, loans and advances, thereby not reflecting the true position.

Exceptional and extraordinary items :

Indian GAAP requires companies to disclose significant events which are not in the ordinary course of business as extraordinary items and material items as exceptional to facilitate the reader to consider the impact of these items on the reported performance. Under IFRS there is no concept of extraordinary or exceptional since all events/transactions are in the normal course of business and if an item is material, it can be disclosed separately, but cannot be termed as 'extraordinary' or 'exceptional'.

Restatement of financial statements :

Under Indian GAAP, changes in accounting policies or rectification of errors (prior period items) are recognised in the current year's profit and loss account (for errors) and are generally recognised prospectively (for changes in accounting policies). Under IFRS, the prior period comparatives are restated in both cases. Indian GAAP does not have the concept of restatement of comparatives except in case of special-purpose financial statements prepared for public offering of securities.

Determination of functional currency :

Entities in India prepare their general purpose financial statements in Indian rupees. However under IFRS, an entity measures its assets, liabilities, revenues and expenses in its functional currency, which is the currency that best reflects the economic substance of the underlying events and circumstances relevant to the entity *i.e.*, the currency of the primary economic environment in which the entity operates. Functional currency of an entity may be different from the local currency.

For example, consider an Indian entity operating in the shipping industry. For such an entity it is possible that a significant portion of revenues may be derived in foreign currencies, pricing is determined by global factors, assets are routinely acquired from outside India and borrowings may be in foreign currencies. All these factors need to be considered to determine whether the Indian rupee is indeed the functional currency or whether another foreign currency better reflects the economic environment that most impacts the entity.

Other significant aspects :

Under Indian GAAP, provision has to be made for proposed dividend, although it may be declared by the entity and approved by the shareholders after the balance sheet date. Under IFRS, dividends that are proposed or declared after the balance sheet date are not recognised as liability at the balance sheet date. Proposed dividend is a non-adjusting event and is recorded as a liability in the period in which it is declared and approved.

Impact of existing laws and regulations :

Accounting standard-setting in India is subject to direct or indirect oversight by several regulators, such as the National Advisory Committee on Accounting Standards (NACAS) established by the Ministry of Corporate Affairs, the Reserve Bank of India (RBI), the Insurance Regulatory and Development Authority (IRDA) and the Securities and Exchange Board of India (SEBI). Further, the Indian Companies Act, 1956 (the Act) directly provides guidance on accounting and financial reporting matters. Courts in India also have the powers to endorse accounting for certain transactions — even if the proposed accounting treatment may not be consistent with Generally Accepted Accounting Principles.

Companies Act :

The requirements of Schedule VI of the Act, which currently prescribes the format for presentation of financial statements for Indian companies, is substantially different from the presentation and disclosure requirements under IFRS. For example, the Act determines the classification for redeemable preference shares as equity of an entity, whereas these are to be considered as a liability under IFRS. Also, Schedule XIV of the Act provides minimum rates of depreciation — such minimum depreciation rates are also inconsistent with the provisions of IFRS.

Regulatory guidelines :

The Reserve Bank of India (RBI) and Insurance Regulatory and Development Authority (IRDA) regulate the financial reporting for banks, financial institutions and insurance companies, respectively, including the presentation format and accounting treatment for certain types of transactions. For example, the RBI provides detailed guidance on provision relating to non-performing advances, classification and valuation of investments, etc. Several of these guidelines currently are not consistent with the requirements of IFRS.

The Securities and Exchange Board of India has also prescribed guidelines for listed companies with respect to presentation formats for quarterly and annual results and accounting for certain transactions, some of which are not in accordance with IFRS *e.g.*, Clause 41 of the Listing Agreement permits companies to publish and report only standalone quarterly financial results, however IFRS considers only consolidated financial statements as the primary financial statements for reporting purpose.

Court procedures :

Courts in India commonly approve accounting under amalgamation/restructuring schemes, which may not be in accordance with the accounting principles/standards. Under the current accounting/legal framework such legally approved deviations from the accounting standards/principles are acceptable.

Income tax :

Computation of taxable income is governed by detailed provisions of the Indian Income Tax Act, 1961. Convergence with IFRS will require significant changes/clarifications from the tax authorities on treatment of various accounting transactions.

For example, consider unrealised losses and gains on derivatives that are required to be marked-to-market under IFRS. Different taxation frameworks are possible for the tax treatment of such unrealised losses and gains. The treatment of such unrealised losses/gains will need to be addressed in line with the convergence time frame. It is imperative that tax authorities are engaged sufficiently in advance to decide on such critical aspects of taxation.

One of the risks of IFRS convergence without adequate involvement of all stakeholders and adequate regulatory changes is that financial statements prepared using the 'converged' Indian standards may still not fully comply with IFRS issued by the International Accounting Standards Board (IASB). This would be very unfortunate as Indian entities that may be required to present IFRS-compliant financial statements to stakeholders outside India (overseas stock exchanges, overseas regulators, investors and alliance partners) would still need to reconcile with such 'converged' IFRS financial statements prepared using the Indian frame-

work, with IFRS financial statements that are globally accepted.

Accordingly, at the onset of the convergence, there is a need to develop an enabling regulatory framework and infrastructure that would assist and facilitate IFRS convergence. The Government would need to frame and revise laws in consultation with the NACAS and the ICAI. Similarly, regulators such as the RBI, IRDA and SEBI would need to consider accepting IFRS in substitution of the present set of specific accounting rules prescribed by them.

As the timelines for convergence approach, all entities will have to consider their own roadmap and gear up for complying with the GAAP differences. Convergence to IFRS will be time-consuming, challenging and will require complete support and sponsorship of the Board of Directors/Members of Audit Committee/Senior Management. Given the task and challenges, all entities should ensure that their convergence plans are designed in a manner to achieve the objective of doing it once, but doing it right. □□

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