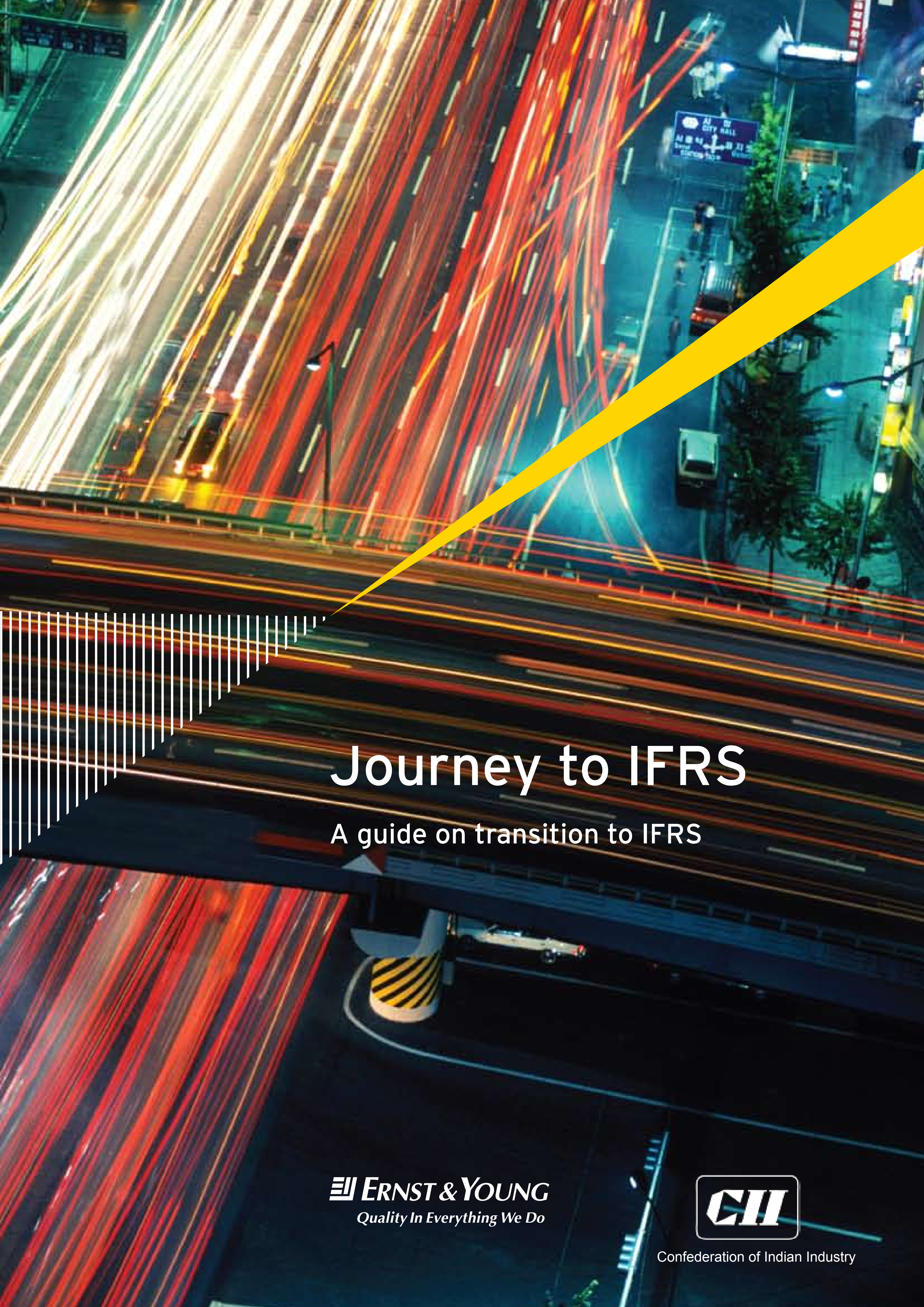

Journey to IFRS

A guide on transition to IFRS

Ernst & Young
Quality In Everything We Do

CII
Confederation of Indian Industry

Journey to IFRS

A guide on transition to IFRS

Foreword

I am happy to present this seminal work on transition to the International Financial Reporting Standards "Journey to IFRS?" from the Confederation of Indian Industry and Ernst & Young. This is a key initiative to map the process of integrating internationally recognized financial standards with the financial statements as presented in India.

Over a 100 countries across the world have formally accepted IFRS in order to bring about standardization and therefore, greater comparability in presentation of financial statements. In the Indian context, the Institute of Chartered Accountants of India (ICAI) has also mandated convergence with IFRS from the accounting period commencing on or after April 1, 2011 for listed and other public interest entities such as banks, insurance and large–sized entities. The Ministry of Corporate Affairs has also affirmed that its initiative for harmonization of the Indian Accounting Standards with IFRS would now be continued with the intention of achieving convergence with IFRS by 2011 for large public interest entities.

While convergence is desirable and would be facilitated by the fact that historically Indian standards have been principle-based; given the nature of accounting and peculiarities of the Indian economic environment, implementation of convergence would have its own set of complexities. The level of technical preparedness of industry, accounting professionals' experience with international standards and economic environment prevailing in the country would pose challenges to convergence. The Industry should be aware of these challenges and tackle them through advance planning, without delaying the IFRS convergence target of April 1, 2011 set by ICAI. It is in this context that this 'Guide on Transition to IFRS' would be useful in answering the questions relating to the impact on financial statements delineating the significant dissimilarities between IFRS and Indian GAAP and the implementation and maintenance process.

We are thankful to Ernst & Young, our partner in this endeavour, for sharing their knowledge for preparing the Indian industry to gear up to the challenge of transition to IFRS.

C. Banerjee
Director General – CII

Foreword

The International Financial Reporting Standards (IFRS) are rapidly emerging as a globally accepted accounting framework with over 100 countries mandating or permitting IFRS.

IFRS was implemented in January 2005 with more than 8,000 EU listed companies adopting these standards. With its inherent benefits in the global economy, countries like Australia, Hongkong, China and the Middle East have mandated IFRS compliance for publicly listed companies. In what is seen as a strong endorsement for IFRS, the U.S Securities & Exchange Commission (SEC) has also allowed foreign private filers in the U.S. to file IFRS-compliant financial statements.

In line with this emerging global trend, the Institute of Chartered Accountants of India (ICAI) has announced a Convergence Declaration for all public interest entities from 1 April 2011. This will result in significant benefits for cross-border investments, capital flow, enhanced comparability, reporting transparency and reduction in the cost of capital and compliance for enterprises.

While the convergence declaration and the impending deadline are becoming common knowledge, how many of us have actually started any preparations?

As our experiences in other parts of the world have shown, IFRS cannot be looked as a mere technical exercise limited to change from one set of accounting principles to another. The consequences are far more than financial reporting issues and extend to significant business and regulatory matters including implications on performance indicators, compliance with debt covenants, structuring of ESOP schemes, training of employees, modification of IT systems, implication of mergers and acquisitions and tax planning. With IFRS, basic definitions will change. Preference equity will become loans; dividends will become interest while hedge accounting and fair value will arrive in all its glory and complexity.

Our latest publication, 'Journey to IFRS' is an integrated endeavour to address issues and recommend measures around first-time IFRS adoption challenges, conversion efforts and resource requirements. We have talked about strategies which companies can adopt for transitioning to IFRS, the key differences between Indian GAAP and IFRS as also its impact on an organisation's financial reporting.

Notwithstanding its benefits, the transition to IFRS will be challenging, as some of us are already witnessing. It is therefore imperative to assess the impact of IFRS and immediately embark upon taking the first steps towards a conversion plan. What is required is a positive and pro-active approach from all stakeholders – the regulators, the ICAI, the profession and the industry.

Rajiv Memani
Country Managing Partner -
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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. 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
	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 organisations.

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 minimise 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.

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, AS 31 and 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.

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.

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. 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.

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

3. First-time adoption of IFRS

3.1. 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.

3.2. 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.

3.3. 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.

3.4. 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.

3.5. 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.

4. Impact of key differences

4.1. 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:

1. **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.

2. **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.

3. **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.

4.2. 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

1. **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.

2. **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.

3. **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.

4. **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

1. **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

2. 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.

3. 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.

4.3. 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

1. 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.

2. **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.

3. **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

1. **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.

2. **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.

3. **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.

4.4. 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 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, ICAI has issued

an announcement which requres entities to provide for losses in respect of outstanding derivative contract by marking them to market.

- 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 approved 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

1. **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.

2. **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.

3. **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.

4. 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*.

5. 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

4.5. 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

1. **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.

2. **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.

3. **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.

4.6. 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 Method 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

1. **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.

2. **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.

3. **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.

4. **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.

5. **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.

4.7. 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

1. **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.

2. **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.

3. **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.

4. **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.

5. 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.

4.8. 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

1. **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.

2. **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.

3. 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

1. 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.

2. 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.

4.9. 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

1. **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.

2. **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.

3. **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.

List of abbreviations

AFS	Available-for-Sale
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
FVPL	Fair Value through Profit or Loss
GAAP	Generally Accepted Accounting Principles
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
L&R	Loans & Receivables
NACAS	National Advisory Committee on Accounting Standards
RBI	Reserve Bank of India
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

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