Managing transition to IFRS

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What is IFRS?

- IASB – Private sector organisation
- IFRS comprises:
  - 8 IFRSs and 29 IASs
  - 17 IFRICs and 11 SICs
- IFRS - Economic model focusing on balance sheet
- IFRS moving towards
  - Increased use of fair values; and
  - Getting the balance sheet right

IFRS snapshot

- 100 countries on IFRS; to increase to 150
- SEC accepts IFRS without reconciliation for FPI
- Roadmap on IFRS for US companies
- India to follow IFRS in 2011
- Actually means 1 April 2010, and even earlier !!

IFRS and US (cont'd.)

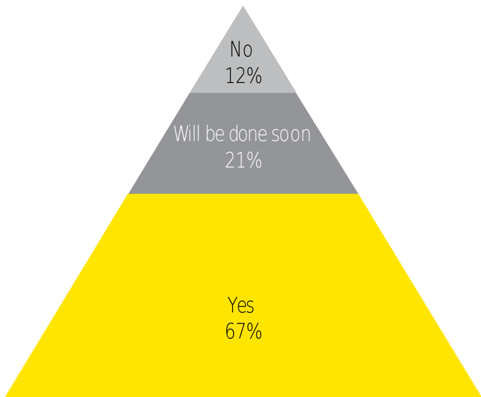
- Obama's Financial Regulatory Reform (June 2009) contains three action points in relation to accounting standards
  - Recommends accounting standard setters to clarify and make consistent the application of the fair value accounting standards, including impairment of financial instruments by the end of 2009
  - Improve standard on loan loss provisioning by the end of 2009 making it more forward looking but not compromising on transparency of financial instruments
    - FV model, expected loss model or dynamic provisioning
  - Make substantial progress by the end of 2009 toward single set of high quality global accounting standards
    - SEC considering comments on draft roadmap

IFRS convergence in India – fait accompli !!

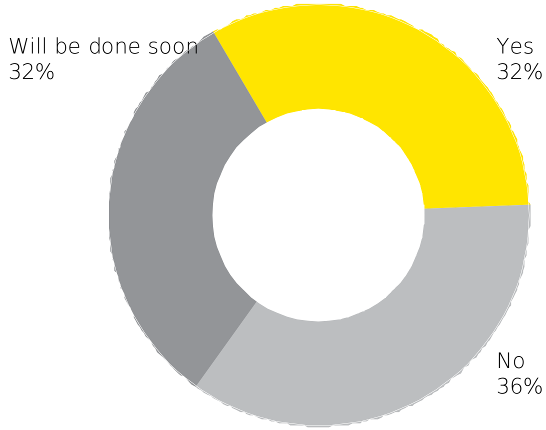
- ICAI issued a concept paper in October 2007 committing itself to IFRS adoption from 1 April 2011
- Similar commitment made by Ministry of Corporate Affairs and Finance Minister in the G20 summit
- SEBI keen on IFRS, since only few countries will be non IFRS in the next few years
- Recent developments reiterate MCA's and ICAI's commitment
  - AS-11 amendment applicable upto 31 March 2011
  - April 2009 edition of the “The Chartered Accountant” journal

Ernst & Young 2009 IFRS Readiness Survey Results

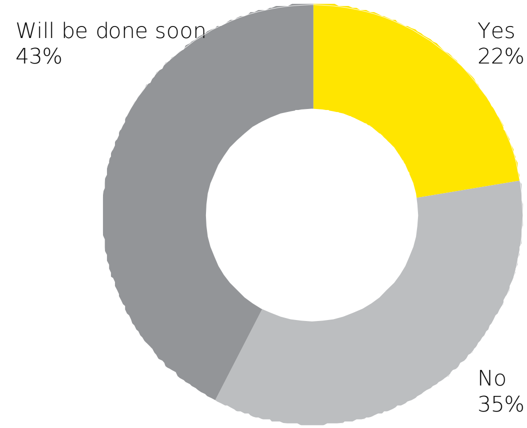
Has your company's transition to IFRS been discussed by the management?



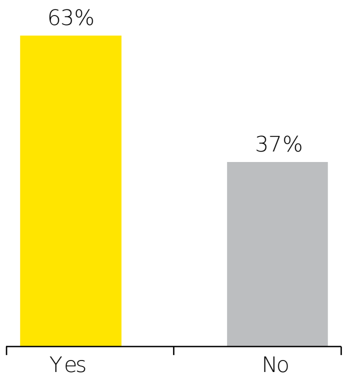
Have you assigned resources and responsbilities to evaluate and plan for IFRS implementation in your company?



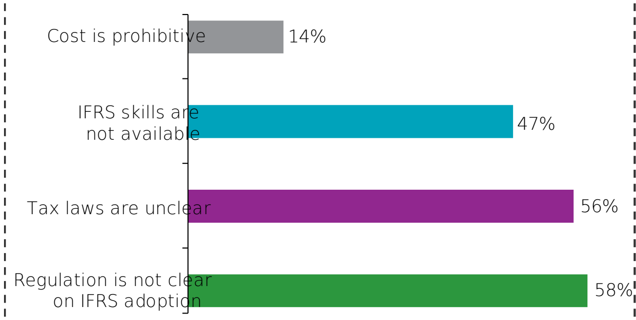
Have you established a timetable for the IFRS transition process in your company?



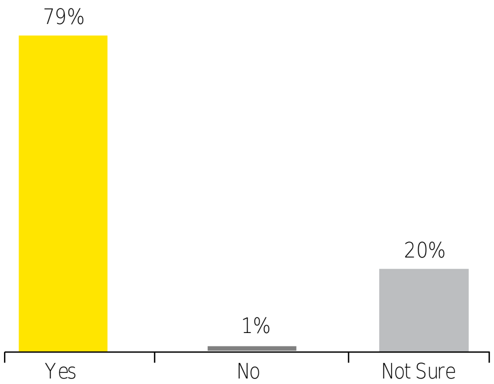
Do you know the key accounting and business areas in your company that IFRS will impact?



As per you, which of the following are significant hurdles to IFRS conversion in your company?



Do you think your company will be able to meet the IFRS 2011 deadline?



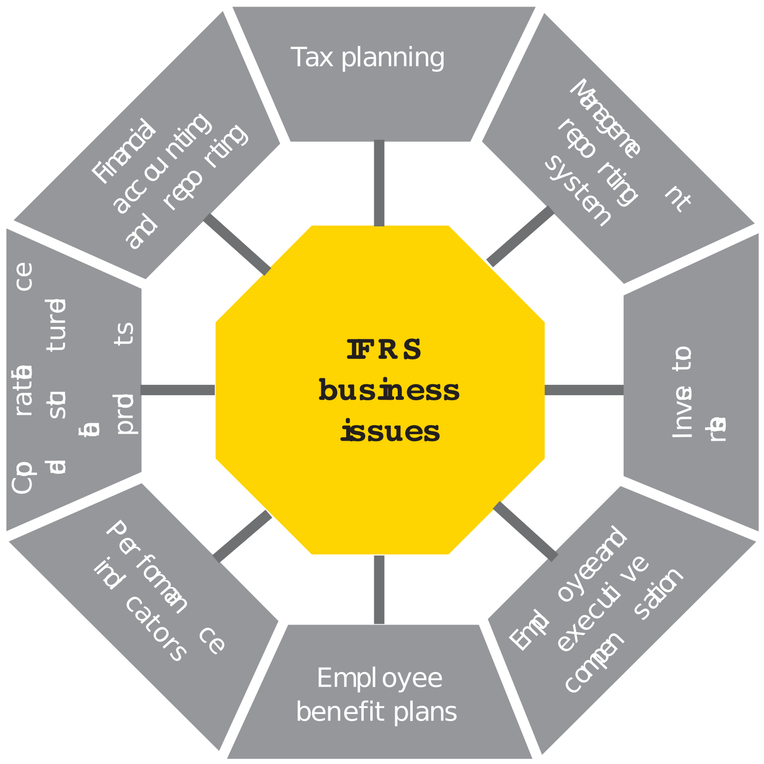
Few misconceptions about IFRS in India

- Indian GAAP is very closely aligned with IFRS
- Indian GAAP will be scrapped when IFRS gets implemented
- IFRS always has a negative impact on financial statements
- It is an accounting project-other functions like strategy, IT, marketing, etc., are not affected
- It is an extension of current accounting responsibilities-no dedicated staff required
- Abundant talent available in India
- Does not involve significant costs

Challenges

Key challenges

- Volatility
  - Impact on financial statements
  - Performance indicators
- IT/MIS systems
- Contractual obligations (debt covenant, compensation)
- Taxes
- Distributable profits
- Managing market, investors and analysts



SEC's study on mark to market valuation

- Shall not abandon mark to market valuation
- Accounts are prepared for investor and not to address the pro-cyclicality issue
- Crisis not because of FV but credit losses, investor confidence, balance sheet deleveraging, etc
- What is not fair valued?
  - Non financial assets and liabilities, eg, fixed assets, inventories, intangibles, etc
  - Investment property – choice not to fair value
  - Various financial instruments – HTM, L&R, AFS (FV thru equity)
  - Corridor approach for employee benefits
- Only 25% of assets fair valued – out of which for 90% there is a market reference price
- Key issues
  - Reliable basis for valuation of financial instrument as market liquidity has disappeared

Key differences

Property, plant and equipment

- Key differences
  - Depreciation based on useful life – Schedule XIV rates are not acceptable
  - Component accounting mandatory under IFRS
  - Depreciation method, residual value and useful life estimate to be reviewed annually
  - Revaluation model permitted – IFRS requires revaluation to be done for entire class of asset and revaluation needs to be done periodically
  - Depreciation on revalued portion charged to P&L
  - Exchange differences cannot be capitalised
  - Asset retirement obligation capitalised as a part of FA cost

Example – Component accounting

Example of component accounting

Various components identified at the time of capital expenditure request was made

	Useful life	Amount
1. Hearth brickwork, vault, walls	6 years	1,500,000
2. Heating system: burners, pipe work, lever, ventilators	10 years	600,000
3. Control mechanism, cervo motors, mechanism for controlling the temperature and operating parameters	5 years	300,000
4. Visits and overhauls by an external maintenance company every two years of the mechanical sections, input and output feeds, rollers, etc.	2 years	200,000
5. Furnace (main element and others)	20 years	2,400,000
Total capital expenditure		**5,000,000**

Property, plant and equipment

- Our experience
  - Most capital intensive companies use deemed cost exemption
  - Need for valuation expert with IFRS experience
  - Need to modify IT system for reconstructing FA register and master files
  - Need for technical experts to estimate useful life, residual value and identify components
  - Takes about 3-6 months to get valuation report (in case where proper records are not available, it can get stretched to one year as well !!!)

Business combination

- Key differences
  - Only purchase method of accounting permitted for business combination
  - Accounting based on fair values
  - Goodwill not allowed to be amortised
  - Amalgamation and high court orders
  - Reverse acquisitions
  - Contingent liabilities to be recognised
  - More intangibles recognised on balance sheet

Example - business combination

Infosys acquired Koninklijke Philips Electronics N.V. (Philips) in FY March 2008.

- Summary of accounting for business combination is given below

Rs in crore

	IFRS	Indian GAAP	Difference
Intangible asset (Customer contracts)	43	-	(43)
Other assets	24	24	
Goodwill	40	83	43
Total consideration	**107**	**107**	

Example - business combination

Dr. Reddy's acquired a unit of the Dow Chemical Co.

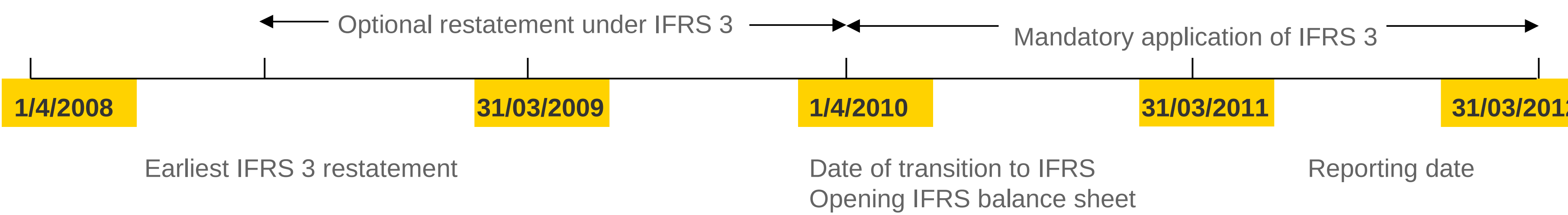
- Summary of accounting for business combination is given below

Rs in million

	IFRS	Indian GAAP	Difference
Property, plant & equipments	741	722	19
Intangible assets – customer contract/ product related intangibles	801	3	798
Inventories	231	231	0
Non-current liabilities	-71	-132	61
Deferred tax liabilities	-250	0	-250
Net identifiable assets & liabilities	1452	824	628
(Negative goodwill)/Goodwill	-150	478	628
Total consideration	**1302**	**1302**	**0**

Key exemptions - business combination

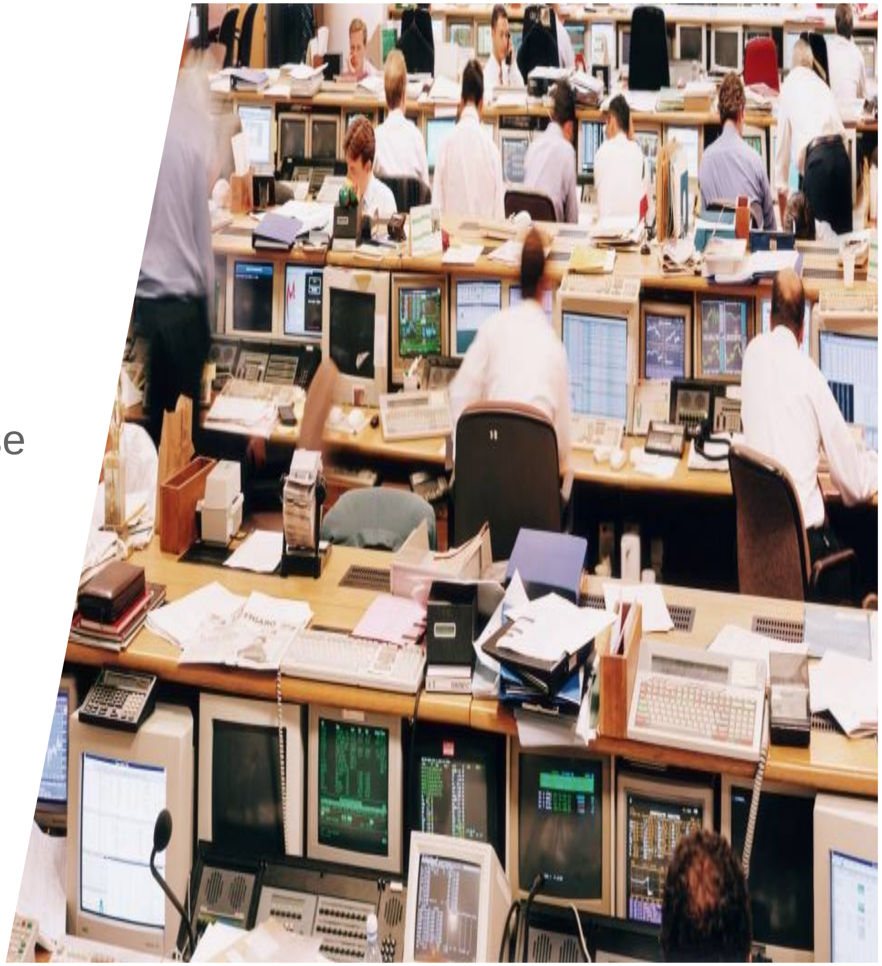
- Business combination – IFRS 3
  - First-time adopter can choose not to restate business combinations (in accordance with IFRS 3) that have occurred before transition date



  - However, if an entity chooses to restate one business combination under IFRS 3 prior to transition date, it will need to restate all the business combinations which occur after such restatement, for its opening IFRS balance sheet

Business combination

- Our experience
  - Most companies use the business combination exemption
  - A major acquisition could take as much as 4-7 months for accounting (in some cases, it can even take about 12 months !!!!)
  - Use of valuation experts with IFRS experience necessary for doing purchase price allocation exercise
  - Valuation exercise is extremely onerous
    - Subsequent changes in contingent liability and contingent consideration taken to P&L account
    - Share based payments
    - Cannibalisation of brands
  - Issues like common control (pooling method – acceptable), reverse merger very common in Indian scenario



Group accounts

- Key differences
  - Uniform accounting policy
  - More entities consolidated under IFRS
    - Defacto control
    - Potential voting rights considered for determining control
    - SIC 12 – consolidation of special purpose entities
    - Management contract

Examples – consolidation of SPE

Satyam Computer Services Ltd. (March 2008 IFRS FS)

- Satyam has employee benefit trust SC–Trust which purchases and holds ordinary shares of Satyam Computer Services (treasury shares) in connection with employee share-based payment schemes. Satyam controls the activities of the trust and pursuant to the criteria set out in SIC–12, Consolidated – Special Purpose Entities, consolidates the trust.

Barclays Plc (Dec 2008 IFRS FS)

- Although the Group's interest in the equity voting rights in certain entities exceeds 50%, or it may have the power to appoint a majority of their Boards of Directors, they are excluded from consolidation because the Group either does not direct the financial and operating policies of these entities, or on the grounds that another entity has a superior economic interest in them. Consequently, these entities are not deemed to be controlled by Barclays.

Group accounts

- Our experience
  - No consolidation exemptions other than investments in associates/JV which are held by venture capital organisations or mutual funds, unit trusts and similar entities that upon initial recognition are designated as FVPL or are classified as held for trading
  - Companies need to develop group accounting manual and reporting packages for preparing CFS based on uniform accounting policy
  - Difficulty in ensuring uniform policies in case of an associate
  - Difficulty in determination of functional currency (especially of intermediate parents within the group)
  - IFRS financial statements of companies hitherto never consolidated need to be prepared and audited
  - Consolidation of a complex group could take as much as 12 months

Employee benefits (including ESOP)

- Key differences
  - Recognition of actuarial gains and losses – corridor approach or recognition in other comprehensive income
  - ESOP – accounting to be done as per fair value method

Example - corridor approach

- Dr. Reddy chose to apply corridor approach in its first IFRS FS for Y.E March 09. Impact on financial statement is summarized below:
- Gratuity cost as per March 09 financial statements

Net gratuity cost under IFRS	Rs 45 million
Net gratuity cost under Indian GAAP	Rs 98 million
Unrecognized actuarial loss under IFRS	Rs 75 million
Unrecognized actuarial loss under Indian GAAP	Nil

Leases (IFRIC 4)

Example

- A Limited enters into an arrangement with a third party vendor (B Limited) to outsource a particular business process.
- B Limited designs and builds a facility to cater to A Limited’s requirement and maintains ownership and control over all significant aspects of operating the facility.
- The agreement provides for the following:
  - The facility is explicitly identified in the arrangement.
  - The facility is designed to meet only A Limited's needs.
  - B Limited must stand ready to render a minimum number of man hours each month stipulated in the agreement.
  - Each month, A Limited will pay a fixed capacity charge and a variable charge based on actual man hour of services rendered. A Limited must pay the fixed capacity charge irrespective of whether it avails any services from B Limited during a month.

Leases – example

Corus (2006 IFRS FS) – IFRIC 4 implication

- IFRIC 4, which has been adopted from 1 January 2006, resulted in the recognition of additional finance lease obligations of £145m and additional property, plant and equipment of £142m, thereby reducing opening net equity by £3m. These leases represent specific assets used to service certain long term supply arrangements.

Leases

- Our experience
  - IFRIC 4 impact was normally observed on
    - Outsourcing contracts (BPO),
    - Job work arrangements,
    - Contract R&D,
    - Power purchase agreements,
    - Telecom infrastructure, etc

Financial instruments - Measurement

Financial asset	Initial measurement	Transaction costs	Subsequent measurement	Recognition of gain/ loss
At fair value through profit or loss	Fair value	Expense	Fair value	Profit or loss
Held-to-maturity investments	Fair value	Capitalize	Amortised cost	Not applicable
Loans and receivables*	Fair value	Capitalise	Amortised cost	Not applicable
Available-for-sale financial assets	Fair value	Capitalize	Fair value	Equity

* Short-term receivables with no stated interest rate to be measured at original invoice amount where the effect of discounting is immaterial

Initial measurement

- Example
  - A lessee is required to pay a interest free deposit of INR 1 million to the lessor on an operating lease which is refunded at the end of the 3 year lease term.
  - The market interest rate is 10%. Thus fair value of deposit is Rs 750,000
  - Lessee recognizes deposit at Rs 750K and Rs 250K as prepaid lease
  - Recognizes interest income 250K on IRR basis 75, 85, 90
  - Rs 250k prepaid lease is charged equally over three years, i.e. Rs 83
- Our experience
  - Common issue
    - Interest free deposits
    - Loans and advances to related parties and employees
    - Retention money
    - Sales tax deferral loan
  - Determining fair value

Financial guarantee

- Example
  - Company A has given a guarantee to bank for Rs 100 million loan taken by its subsidiary Company B, repayable at end of year 1.
  - In case A would not have given this guarantee, bank would have charged higher interest @3% p.a. from B. Therefore the fair value of financial guarantee is Rs 3 million.
  - **Journal entry in the SFS of A at the date of origination of loan:**

Dr. Investment in Subsidiary B	Rs 3 million	
Cr. Financial Guarantee obligation		Rs 3 million

  - **Journal entry at the end of year 1:**

    At the end of year 1, B has repaid the entire loan and, therefore, financial guarantee obligation no longer exists for A. It would pass the following entry to derecognize the obligation

Dr. Financial Guarantee Obligation	Rs 3 million	
Cr. Profit and Loss Account		Rs 3 million

- Our experience
  - Difficulty in determining fair values

Derecognition

- Example
  - Entity A makes a sale of INR 1,000 on 1 January 2008, on a 6 month credit period
  - On 1 February 2008, A securitises the receivable whereby the receivable is transferred to bank B for Rs990.
  - Bank has full recourse to entity A for any default on the receivable.
  - A has lost control over the receivable. Thus, it meets derecognition criteria under Indian GAAP (ICAI GN on Securitisation).
  - Under IFRS, since A retains substantially all the risks and rewards of receivable, it will not derecognise receivable.
  - Rs 990 received from bank will be treated as loan secured against receivable
- Our experience
  - Many securitisation transaction does not satisfy derecognition rules
  - These arrangements will have to be looked into
  - Substantial modification of financial liabilities trigger derecogntion of old loans and recognition of new loan

Impairment - Broad Principles

- IAS 39 requires that impairment assessments should be performed as follows:
  - for assets that are individually significant, assessment should be made on an individual basis;
  - other assets may also be assessed individually, although such an assessment is not necessarily required;
  - assets that have been individually assessed, but for which there is no objective evidence of impairment, should be included within a group of assets with similar credit risk characteristics and collectively assessed for impairment;
  - assets that are individually assessed for impairment and for which an impairment loss is (or continues to be) recognised cannot be subject to a collective impairment assessment; and
  - any other assets, i.e. those that have not been individually assessed, should also be the subject of a collective assessment.

Embedded Derivative

- Entity A, an Indian company, sells a commodity to Entity B, which is also an Indian company.
- Selling price of the commodity is Rs. 42,000, if delivery after one year.
- At the date of entering into contract, USD-INR one year forward exchange rate is Rs. 42 per USD.
- Thus, Entity B agrees to pay USD 1,000 to Entity A, on delivery of commodity after one year.
  - Scenario 1: At the reporting date (six months later), exchange rate has increased to Rs. 44 per USD.
  - Scenario 2: At the reporting date (six months later), exchange rate has decreased to Rs. 40 per USD.

Hedging (written options)

- Example
  - India Auto Ltd has forecasted receipt of USD8,000, 6 months later on a highly probable sale.
  - Wishes to lock into a forward rate of 1USD = 44, hence buys a purchase option
  - To make it a zero cost option, correspondingly writes an option, that allows the bank to buy 1USD @ 47
  - Accordingly, Auto enters into an instrument under which it effectively:
    - purchases an option that allows it to sell 1000USD to the bank at 1 USD = INR 44; and
    - sells an option that allows the bank to buy USD2000 at 1 USD = INR 47
  - In the present case, company has in effect written an option and hence option cannot be treated as hedging instrument

Hedging (exotic instruments)

- Example
  - An Indian Company takes a loan of USD10 m in Feb 20x8 which is payable after one year
  - It enters into forward contract with a strike price of 1 USD = 43.5 INR
  - The contract knocks out on reaching cap of 46.5 or floor of 42.0
  - Fair value of contract at each period end is as under :

31 March 20x8	42.5
30 June 20x8	44.25
30 Sept 20x8	45.6
31 Dec 20x8	40.95

  - Contract ceases to be effective as at 31 Dec 20x8
  - The above contract will not satisfy hedge effectiveness criteria as it may cease to exist if the barrier is touched and hence may not be prevalent for the entire tenure of hedged item

Hedging using options

Spot rates and fair value calculation of option

Period	Spot rates	Future cash flow at spot rate	Option value		
			Intrinsic value	Time value	Total
0	82.0000	(164,000,000)	Nil	15,982,345	15,982,345
1	82.3245	(164,649,000)	649,000	11,678,234	12,327,234
2	82.5233	(165,046,600)	1,046,600	8,234,765	9,281,365
3	83.1564	(166,312,800)	2,312,800	4,134,256	6,447,056
4	83.4332	(166,866,400)	2,866,400	1,234,531	4,100,931
5	84.3278	(168,655,600)	4,655,600	Nil	4,655,600

Liability v Equity

- Example
  - A Ltd. Issues 100 convertible non-redeemable share warrants of Rs. 100 each to B Ltd.
  - **Scenario 1:** Each warrant is convertible into 10 equity shares of A Ltd.
  - **Scenario 2:** Each warrant is convertible into equity share of A Ltd. Number of shares to be issued would be decided based on fair value of shares at the date of issuance.

Impact of convertible instruments

- Entity A issues convertible bonds of Rs. 1,000 at face value.
- Bonds carry interest @ 2% p/a with a three year term.
- Each bond is convertible into 100 equity shares of Rs. 10 each any time at holders discretion.
- The prevailing market rate of interest without conversion is 9%.

Response – Impact of convertible instruments

Particulars	Cash outflow	PV factor	Present value
Year 1	20	0.92	18
Year 2	20	0.84	17
Year 3	1,020	0.77	788
Liability component			823
Equity			177
Total amount			1,000

Response – Impact of convertible instruments

Year	Amount outstanding	Interest @ 9%	Cash out flow	Balance
1	823	74	20	877
2	877	79	20	936
3	936	84	1020	0
		237		

Response – Impact of convertible instruments

- Indian GAAP
  - Charge to profit or loss : 60
  - Net effect on equity: 60
- IFRS
  - Charge to profit or loss : 237
  - Credit to equity : 177
  - Net effect on equity : 60

Financial instrument

- Our experience
  - Most complex area
  - P&L volatility experienced on accounting of embedded derivatives
  - Involvement of treasury professionals critical
  - Normally Hedge documentation requirements are not satisfied – entities need to create/update system to take advantage of hedge accounting
  - Use of experts critical
  - Many entities agree for exotic features to reduce cost of hedging – more exotic features, more chance of hedge accounting criteria not satisfied

Construction contract vs. sale of goods

Vestas Wind System A/S (2006)

Extracts - Accounting policies

Revenue [extract]

> "Contracts to deliver large wing turbine systems with a high degree of individual adaptation are included in revenue in line with construction, based on the individual contact's stage of completion (the percentage of completion method). Sales of individual wind turbines and small wind power systems based on standard solutions as well as of spare parts are recognised in the income statement provided that the risk has been transferred to the buyer prior to the year end, and provided that the income can be measured reliably and is expected to be received."

Multiple element contracts

- Entity A is engaged in selling two services, viz., P1 and P2.
- Service P1 is delivered immediately.
- Service is under development and will be delivered in next 6 months.
- The following is the pricing structure of the Company:
  - P1 only INR 100
  - P2 only INR 150
  - Package price (P1 + P2) INR 225
- How should entity allocate of selling price of INR 225 between P1 and P2?

Response

- IFRS
  - **Option 1: Relative fair value method**

    Price allocation to P1 = Package price * Price of P1 / (Price of P1 + Price of P2)

    = 225 * 100/ (100 + 150) = INR 90

    Price allocation to P2 = 225 * 150/ (100 + 150) = INR 135

  - **Option 2: Residual method**

    Price allocated to P1 = Package Price – Price of undelivered product (P2)

    = 225 – 150 = INR 75

    Price allocated to P2 = INR 150

  - **Option 3: Reverse Residual Method**

    Price allocated to P1 = INR 100

    Price allocated to P2 = Package Price – Price of P1

    = INR 225 – INR 100 = INR 125

Response

- IFRS
  - **Option 4: Cost Allocation Method**
    - Assume cost of P1 and P2 is INR 70 and INR 110 respectively.
    - This results in total cost INR 180 and margin of 25% on cost
    - Entity to allocate total margin in the ratio of cost.
    - Thus, price allocated to P1 = 70 + 25% = INR 87.5
    - Price allocated to P2 = 110 + 25% = INR 137.5
  - **Option 5: Margin Allocation Method**
    - Entity to determine appropriate margin for each product
    - Assume reasonable margin for P1 is 15%
    - Reasonable margin for P2 is approx. 31%
    - Price allocation on reasonable margin
      - P1 = INR 70 + 15% = INR 80.5
      - P2 = INR 110 + 31% = INR 144.5

Retention money – Implication on revenue recognition

- **Example**
  - Entity A entered into contract with entity B to sell villa for Rs.3000. Entity B will make payment in following manner :
    - 30% payment on delivery (Rs 1000)
    - 70% at the end of one year from completion of villa (Rs 2000)
  - Under Indian GAAP, Entity A will recognize revenue of Rs.3000 immediately on delivery of villa
  - Under IFRS, revenue is to be recognised at fair value of the consideration to be received. Fair value of consideration is present value of consideration discounted using market rate of interest. Revenue will be recognised in following manner:
    - Rs. 2834 i.e.Rs. 1000 + Rs. 2000 x 0.917 (assuming 9% discount rate)
    - Rs. 166 will be recognised as interest income over period of one year

Deferred taxes

- Key differences
  - Deferred tax recognition based on balance sheet approach as against income statement approach under Indian GAAP
    - Tax balance sheet will need to be prepared
    - Deferred tax also recognised on temporary differences such as:
      - Revaluation of fixed assets
      - Consolidation adjustments
      - Unrealised gains/ losses of subsidiaries/ associates/ joint ventures
      - Foreign currency translation adjustment
  - Recognition of DTA in case of tax losses based on probability criteria – No virtual certainty is required
  - Business combination
    - DTA/ DTL arising on fair valuation of assets/ liabilities need to be recognised
    - Corresponding amount will impact goodwill

Fringe benefits tax / Tonnage tax

Indian GAAP policy	IFRS requirement
FBT for expenses (other than ESOP), as specified in Income Tax Act, 1961, is recognised in P&L when the underlying expenses are incurred.	FBT does not fall in the definition of income taxes as per IAS 12. Therefore, should be treated as operating cost and not income tax charge.
Tonnage tax is presented as Income Tax	Tonnage tax is presented as Operating Costs

Presentation and disclosures

- Key differences
  - IFRS 7 disclosures
  - IAS 1 requirements
    - Current vs. Non current
    - Extra-ordinary items disclosure prohibited under IFRS
    - Capital management
    - Significant estimation uncertainties and management judgement
  - Prior period items – restatement of comparatives required under IFRS
  - Changes in accounting policies – restatement of comparatives required under IFRS
  - Impact of new pronouncements
  - Proposed dividends – No provision under IFRS
  - IFRS 8

IFRS conversion: not just an accounting exercise - comments from a CFO

- Not just a corporate-level exercise
- Management buy-in was one of the biggest initial challenges
- Do not underestimate the amount of work involved
- Definitely not just a technical exercise
- Changes the way performance is measured and basis of incentive schemes
- Interaction with internal controls and systems is key
- Increasing complexity of IFRS and speed of change is requiring more technical resources
- Has increased the volatility of results
- Important to align internal and external reporting
- Consider the impact on investor relations – timing and nature of communication
- Focus on education, resource and training – use experts, actuaries and valuer's
- Start early