

How IFRS will impact financial statements

With Indian GAAP (generally accepted accounting principles) converging with the International Financial Reporting Standards (IFRS), most accounting areas will undergo a significant change. The impact on financial statements of some of the changes are outlined in this article.

Business combinations

Under Indian GAAP, acquisitions are accounted at book values of identifiable assets and liabilities of the acquiree, with the excess of consideration over the net book value recognized as goodwill. Under IFRS, accounting is done for all assets including hidden intangibles at fair value. As the assets are recognized at fair value, amortization of these assets will reduce future year profits under IFRS.

IFRS requires expensing of acquisition-related costs, whereas the practice under Indian GAAP is to capitalize such expenses as cost of investment. Performance-related consideration paid to the acquiree, known as contingent consideration, is accounted at fair value under IFRS, with subsequent changes included in the profit and loss (P&L) account. Under Indian GAAP, the impact of contingent consideration is generally included in the cost of investment.

Generally, it is expected that IFRS accounting of business combinations will have a negative impact on the future P&L account of Indian companies.

Consolidation

Many Indian companies, for legal or operational reasons, operate through structured entities known as special purpose entities (SPEs). SPEs are common in securitization transaction, land acquisitions, outsourcing and sub-contracting arrangements. Many of these arrangements are not consolidated under Indian GAAP as they do not meet the definition of a subsidiary under the Companies Act. Under IFRS, many such SPEs may have to be consolidated as these entities are in substance controlled through an auto-pilot mechanism or through legal/contractual provisions determined at inception. The consolidation of SPEs under IFRS may have a substantial impact on the P&L account, net asset and gearing position, and also certain key ratios such as debt-equity.

Employee stock ownership plans (ESOPs)

Under IFRS, ESOPs are accounted using the fair value method, which results in a P&L charge. In contrast, Indian GAAP permits ESOPs to be accounted for using either the intrinsic value method or the fair value method, and most entities follow the intrinsic method. The intrinsic method does not result in a P&L charge unless the ESOPs are priced at a discount over the intrinsic price. Compared to Indian GAAP, IFRS will result in lower profits for companies that use ESOPs for remunerating employees.

Financial instruments

IFRS requires a financial instrument to be classified as a liability or equity in accordance with its substance. For example, mandatorily redeemable preference shares are treated as a liability and the preference dividend is recognized as interest cost. Under Indian GAAP, classification is normally based on form rather than substance. Thus, these shares are recorded as equity and the preference dividend as dividend rather than as interest cost. Compared to Indian GAAP, IFRS will show the firm as more geared and profits would be lower as a result of preference dividends being treated as interest.

Many Indian companies use foreign currency convertible bonds (FCCBs) for their funding requirements. Under Indian GAAP, the redemption premium is charged to the securities premium, and the conversion option is not accounted for. Consequently, for many companies FCCBs result in minimal or no charge to the P&L account.

Under IFRS, FCCBs are split into two components—the loan liability and the conversion option. The loan liability accretes interest at market rates and is also adjusted for exchange rate movements. Thus, the charge to profits under IFRS are higher than under Indian GAAP. The conversion option is marked to market at each reporting date, and the impact is recognized in the P&L account. This will have a significant impact on the volatility of profits under IFRS. If the fair value of the underlying shares rises, mark to market of the conversion option would lead to losses in the P&L and vice-versa.

Derivatives

Under Indian GAAP, companies may not have fair-valued derivatives and embedded derivatives on their books as there are no mandatory standards. Many that have fair-valued derivatives have not recognized losses as they claim those to be for hedging purposes. Under IFRS, all derivatives and embedded derivatives are fair-valued, and hedging is permitted only where stringent criteria relating to documentation and effectiveness are fulfilled. Therefore, in practice, many Indian companies may not be able to apply hedge accounting unless they develop appropriate systems to be able to do so. Consequently, these companies are likely to experience significant volatility arising out of gains and losses on the derivative portfolio.

Revenue recognition

Under Indian GAAP, sales made on deferred payment terms are recognized at the nominal value of consideration. Under IFRS, they are accounted as a combination of financing and operating activity. The fair value of the revenue is recognized in the period of sale whereas the imputed interest amount is recognized as interest income over the credit term. Compared to Indian GAAP, revenue under IFRS will be lower, and earnings before interest, tax, depreciation and amortization will also be lower, as the financing component will be recognized as interest income.

Presentation and disclosure

IFRS will require companies to make significant new disclosures. The reviews of the 2005 financial statements of European companies indicate that financial disclosures under IFRS increased by more than 30%, compared with their previous disclosures.