First Time Adoption of International Financial Reporting standard ("IFRS")

Introduction to IFRS

The International Accounting Standard Board ("IASB"), a private sector body, develops and approves IFRS. The IASB replaced the International Accounting Standard Committee ("IASC") in 2001. IASC issued International Accounting Standard ("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.

Background

ICAI has announced full convergence with IFRS issued by IASB from accounting period commencing on or after April 1, 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.

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 area needs to be identified.

Main features of the IFRS

IFRS requires an entity to comply with each IFRS effective at the reporting date for its first IFRS financial statements. IFRS requires an entity to do the following in the opening IFRS balance sheet that it prepares as a starting point for its accounting under IFRSs:

(a) recognize all assets and liabilities whose recognition is required by IFRSs;
(b) not recognize items as assets or liabilities if IFRSs do not permit such recognition;
(c) reclassify items that it recognized under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under IFRSs; and
(d) apply IFRSs in measuring all recognized assets and liabilities.

The IFRS requires disclosures that explained how the transition from previous GAAP to IFRS affected the entity's reported financial position, financial performance and cash flows.

International Financial Reporting Standards (IFRSs)

IFRS1	First-time adoption of International Financial Reporting Standards
IFRS2	Share-based payments
IFRS3	Business combinations
IFRS4	Insurance contracts
IFRS5	Non-current Assets held for sale and discontinued operations
IFRS6	Exploration for and evaluation of mineral resources
IFRS7	Financial instruments: disclosure
IFRS 8	Operating segments

International Accounting Standards (IASs)

IAS1	Presentation of financial statements
IAS2	Inventories
IAS7	Cash flow statements
IAS8	Accounting policies, changes in accounting estimates and errors
IAS10	Events after the balance sheet date
IAS11	Construction contracts
IAS12	Income tax
IAS 16	Property, plant and equipment
IAS17	Leases
IAS18	Revenue
IAS19	Employee benefits
IAS20	Accounting for government grants and disclosure of government assistance
IAS21	The effects of changes in foreign exchange rates
IAS23	Borrowing costs
IAS24	Related party disclosures
IAS26	Accounting and reporting by retirement benefit plans
IAS27	Consolidated and separate financial statements
IAS28	Investment in associates
IAS29	Financial reporting in hyperinflationary economics
IAS31	Interest in joint ventures
IAS32	Financial instruments: presentation
IAS33	Earning per share
IAS34	Interim financial reporting
IAS36	Impairment of assets
IAS37	Provisions, contingent liabilities and contingent assets
IAS38	Intangible assets
IAS39	Financial instruments: recognition and measurement
IAS40	Investment property
IAS41	Agriculture

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.

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 March 31, 2012, it needs to give the financial information for the year ended March 31, 2011 as 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 April 1, 2010, needs to be in compliance with IFRS. This is refereed as the opening balance sheet. In simple words, three balance sheet and two profit and loss account would be required. Though IFRS will be mandatory from accounting periods commencing on or after April 1, 2011, the requirement for an IFRS compliant balance sheet as at April 1, 2010 and IFRS compliant interim financial statements will mean that the 2011 date in practice would be significantly advance.

Key differences between IFRS and Indian GAAP

- Financial reporting
- Business combinations
- Group accounts
- Financial instruments
- Income taxes
- Employee benefit and shared based payments
- Impairment of assets
- Fixed assets, intangibles, investment property and leases
- Related party disclosures
- Segment reporting
- Revenue recognition

Transition from Indian GAAP to IFRS

Assets and liabilities in the opening balance sheet not meeting IFRS definitions

Assets and liabilities recognized 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, where as IFRS requires such disclosures. 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 recognized in Indian GAAP

Some of the examples are:

All derivative financial assets and liabilities and embedded derivatives need to be recognized 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 recognized based on constructive obligation. Indian GAAP permits recognizing such provision only when legal obligation arises. Therefore, if an entity had constructive obligation on the opening balance sheet date, it needs to be 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 recognized based on the income statement liability approach. Therefore, temporary differences for which deferred tax is not recognized under Indian GAAP need to be identified on the opening balance sheet date and deferred tax should be recognized accordingly under IFRS.

IFRS classification of assets and liabilities

Asset and liability classification under Indian GAAP balance sheet does not conform to IFRS. Therefore, the assets and liabilities need to be classified to draw up the opening 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 Consolidated Financial Statements under Indian GAAP or has not consolidated any subsidiary in its Indian GAAP consolidated financial statements, 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.

Impact of adoption of IFRS in Banking: Key impact areas:

Income recognition

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

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

Identification of impaired loan

RBI has prescribed the guidelines for identification of impaired loans. Under IFRS, a financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Credit losses expected as a result of future events, are generally not recognized.

Impairment provision

In India, the impaired assets (NPAs) are classified into three categories: sub-standard assets, doubtful assets and loss assets as per the time buckets prescribed by RBI. The impairment provision is made on the basis of the above three categories prescribed by RBI at the prescribed minimum percentage of the asset value. Under IFRS, if there is objective evidence that an impairment loss on loans & receivables or HTM investment carried at amortized cost has occurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. Under IFRS, the formula prescribed by the RBI will be considered as acceptable only if it can be demonstrated to produce an estimate sufficiently close to one determined under the methodology specified in IAS 39. In practice, there may be significant differences between IFRS loan loss provision and RBI loan loss provision.

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

Hedge accounting

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

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

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

Embedded derivatives

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

Accounting for financial assets

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

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

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

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

Loan commitments to provide loan at a below-market interest rate and financial guarantees

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

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

Priority sector loans and restricted assets

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

Other contentious issues

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

Share based Payments

Under Indian GAAP share-based payments are accounted as per the guideline issued by SEBI (for listed companies) and the Guidance Note on Accounting for Employee Share-based Payments, both of which permit the use of the intrinsic value method as an alternate to the fair value method. However, a majority of the entities in India presently follow the intrinsic value method. On transition to IFRS, share-based payments would need to be accounted as per the fair value method.

Outsourcing contracts

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