# IFRS: In Search of a New Financial Order

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***Abstract***
*The International Accounting Standards Board (IASB) London, evolved and adopted global standards for accounting and financial reporting, designated as International Financial Reporting Standards (IFRS) to serve as a possible pathway for establishing uniform global accounting standards for the preparation of public company financial statements. The move to IFRS is being hailed as the most important initiative in the financial reporting world. It is expected to result in comparability of financial statements across borders, easier access to foreign capital markets, low cost of capital to companies and several other benefits. But, converting to IFRS is not just a technical accounting exercise- it requires fundamental change on multiple levels, can take up to several years, and affects virtually every function within an organisation. This paper discusses the advantages and the challenges that arise due to adoption of or convergence to IFRS.*

## Introduction

Consistent, comparable & understandable financial information is the lifeblood of commerce & investing. In the last few years, because of emergence of the global economy & growing integration of world's capital markets, financial reporting has undergone significant changes. Regulators & market participants are considering the question of whether it is possible or desirable to move towards a single "globally accepted financial reporting standard" so that these entities can speak a uniform global "language" for financial reporting. It was argued that a uniform set of global accounting standards, supported by strong corporate governance, independent standard – setting and a sound regulatory framework, could benefit investors & businesses alike.

To achieve this objective, the "International Accounting Standards Board" (IASB) London, attempted to evolve a set of international accounting and reporting standards that would help harmonise company financial information, improve the transparency of accounting & ensure that investors receive more accurate & consistent reports. In 2001, the IASB evolved & adopted global standards for accounting and financial reporting, designated as "International Financial Reporting Standards" to serve as a possible pathway for establishing uniform global accounting standards for the preparation of public company financial statements. Since then, IFRS has been adopted or permitted in over 100 countries across the globe.

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## Rationale of the Study

The move to IFRS is being hailed as the most important initiative in the financial reporting world. In order to breathe meaning in the numbers generated by financial reporting & to enable inter-period comparison, it is essential that similar accounting principles should have been used from one period to another. Similarly, users of financial statements are in a better position to assesss the prospects of one company versus another provided both the companies use the same set of rules to report similar transactions and events. So, the most obvious benefit of convergence to globally accepted accounting standards is comparability. India is among the 100- odd countries that have decided to converge to International Financial Reporting Standards (IFRS) in 2011. This will give Indian corporates the benefit of improvement in comparability of financial information and financial performance with global peers and industry standards. It will also result in more transparent financial reporting of a company's activities which will benefit investors, customers and other key stakeholders. But, converting to IFRS is not just a technical accounting exercise – it requires fundamental change on multiple levels, can take up to several years, and affects virtually every function within an organisation. Indian business environment will face a sea of changes when Indian corporates will converge to IFRS in 2011. This paper discusses the advantages and the challenges that arise due to adoption of or convergence to IFRS.

## IFRS

IFRS is an accounting standard that establishes recognition, measurement, presentation and disclosure requirements relating to transactions & events that are reflected in the financial statements. IFRS was developed by the London based IASB in public interest to provide a single set of high quality, understandable and uniform accounting standards.Since 2001, over 100 countries have required or permitted the use of IFRS. All remaining major economies have established timelines to converge with or adopt IFRSs in the near future.

Broadly, the needs/objectives for the development of IFRS are:

- Synchronisation of accounting standards across the globe.
- To create comparable, reliable and transparent financial statements.
- To facilitate greater cross-border capital raising & trade.
- To have company-wide one accounting language for companies which have subsidiaries in different countries.

## Convergence with IFRS

IASB recognised two ways of adopting IFRS by the member countries. These ways are:

- Adopting IFRS in verbatim
- Convergence with IFRS

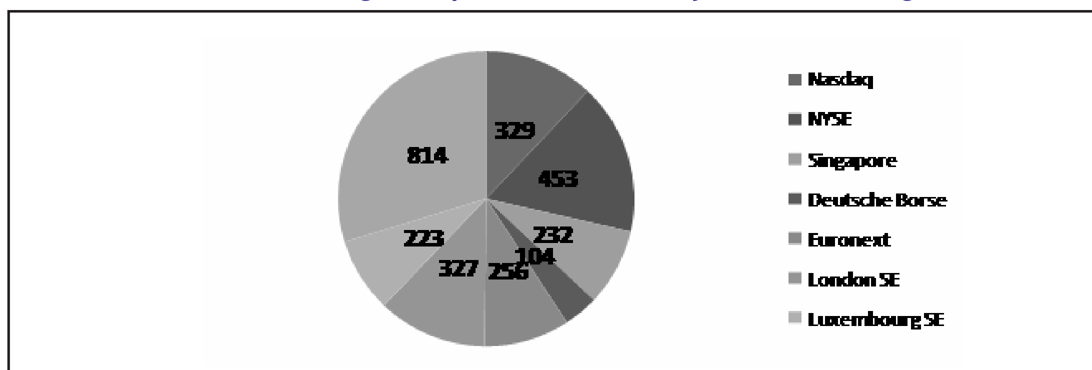
While the former refers to replacing the national accounting standards with IFRS, the latter refers to harmonisation of national accounting standards in a way that financial statements prepared with national accounting standards are in compliance with IFRS. Convergence implies allowable differences in presentation, measurement, recognition and disclosures.

Hence, when Indian GAAPs will be harmonised with IFRS, the compliance with Indian Accounting Standards would automatically ensure compliance with IFRS.

## Reasons for International Convergence in Accounting Standards

National standards made sense when companies raised money in, & investors looked for investment opportunities in, only their home country. But that is no longer the case. There has been a globalisation of capital markets across the world. Now, investors seek investment opportunities all over the world and companies seek capital at the lowest price anywhere. Driving this global integration is the services revolution which has led to an extraordinary reduction in the cost of international communication & transacting. Informed cross-border transacting in product markets & factor markets (including capital & labour markets) has grown rapidly as a consequence. There has been a revolutionary internationalisation of business, markets and politics, and cross-border capital flows & mergers have become commonplace. On many stock exchanges, foreign listings are a large percentage of total. On 51 stock exchanges in the world, there were 2700 foreign (cross border listings) out of 40,000companies listed. (See Fig.1)

***Fig.1***
***Number of foreign companies listed on major stock exchanges***




***Source: www.nirc-icai.org***

There is growing movement for corporate governance & accountability as big corporate reporting failures shake up markets & investor faith. The accounting scandals of the past few years – Enron, WorldCom, Global Crossing and Satyam back home convey a clear lesson that "accounting does matter". This inevitably creates a demand for international convergence in financial reporting as the application of IFRS will lead to better financial comparisons and enhanced transparency in financial reporting.

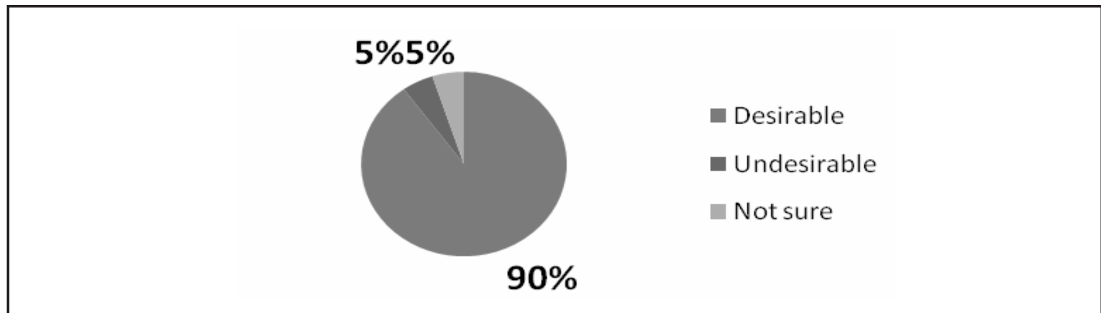
Mc. Kinsey Global Investor Opinion on Corporate Governance in 2002 surveyed 201 professional investors from 31 countries, from institutions with an estimated $ 9 trillion under management on the following issues:

- To what extent is a single global accounting standard desirable.
- What are the clear issues at all levels that impact on the investment decision.
- What are the top reform priorities for policymakers.

The survey results showed that:

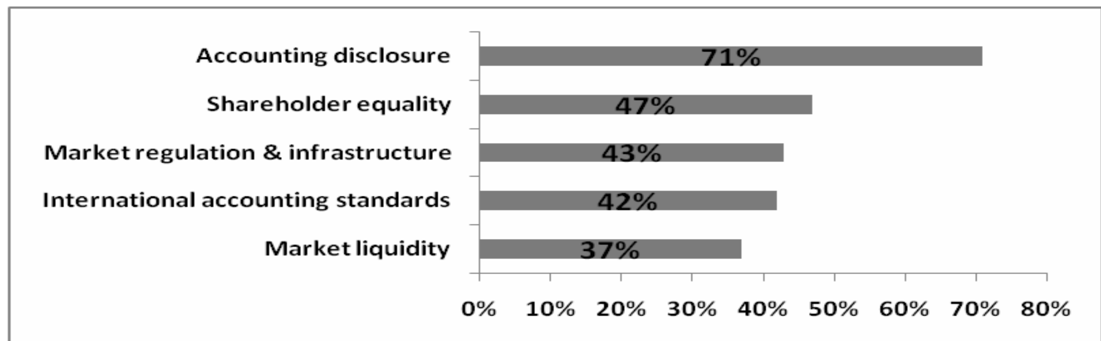
Almost unanimous (90% desirable) agreement that their accounting and reporting standard should be one. (See Fig. 2)

*Figure - 2*
*Single Accounting Standard*



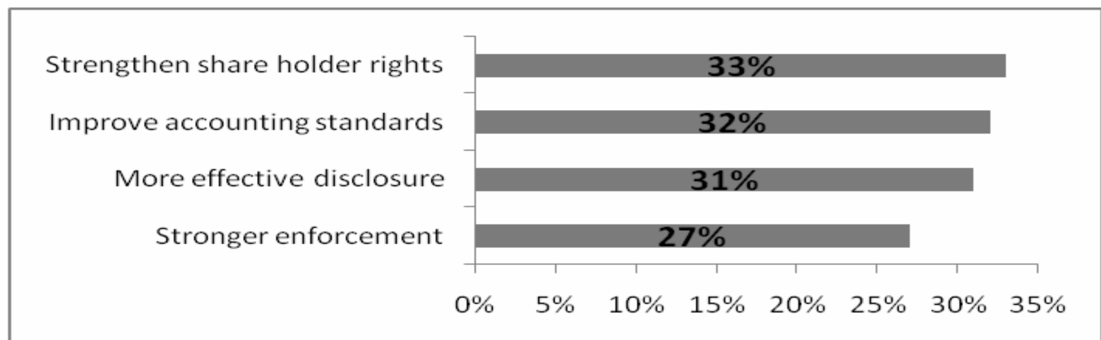

***Source: www.pfsprogram.org/file***

*Fig.3*
*Issues that impact the investment decisions Top 5*




71% of the investors surveyed cited “Accounting disclosure” as the issue that impacted their investment decisions & “International Accounting Standards” was included in the list by 42% of the investors. (The above findings represent percentage of investors selecting the issue, multiple responses were given by each). (See fig.4)

*Fig 4*
*Top reform priorities for policymakers*

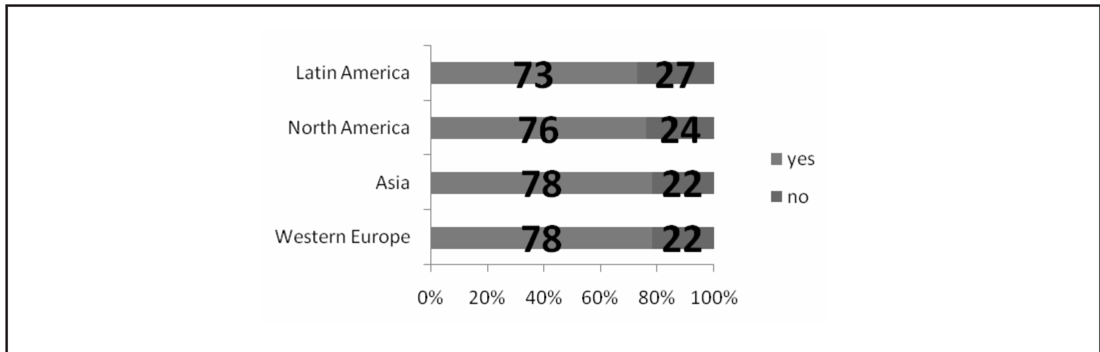



***Source: www.pfsprogram.org/file***

"Improving accounting standards" and "More effective disclosure" were selected by 32% & 31% of the investors respectively. (See Fig. 5)

**Fig 5**

**Significant majority of investors say they are willing to pay a premium for a well governed company (% of investors)**

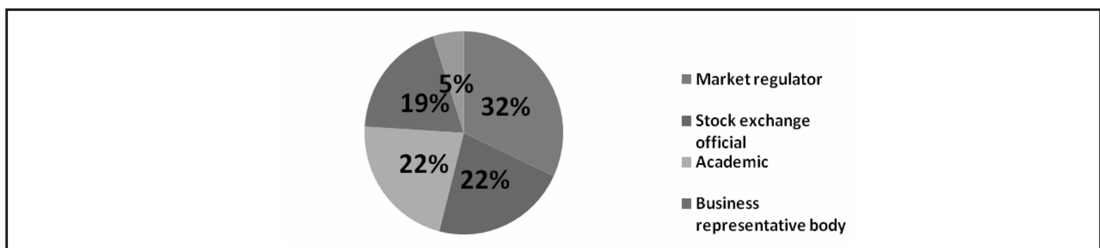



*Source: www.mckinsey.com/governance*

A recent *Mc Kinsey Global Investor & Emerging Market Policymaker Opinion Survey* surveyed 44 responses from leading policymakers & academics covering 20 countries in Asia, eastern Europe & Latin America. Survey results show that:

**Fig 6**

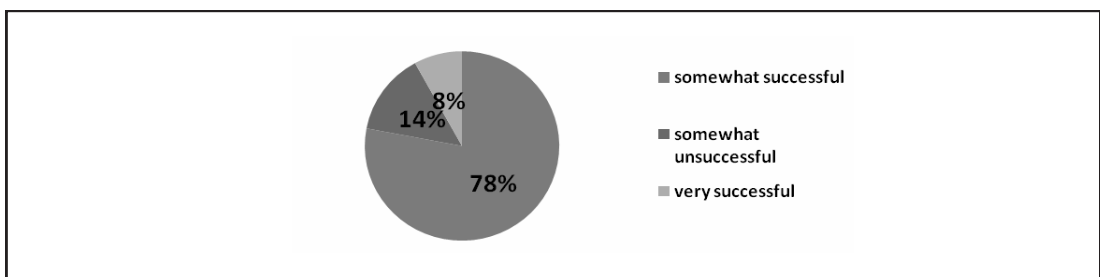
**Type of policymaker**




*Source : www.mckinsey.com/governance*

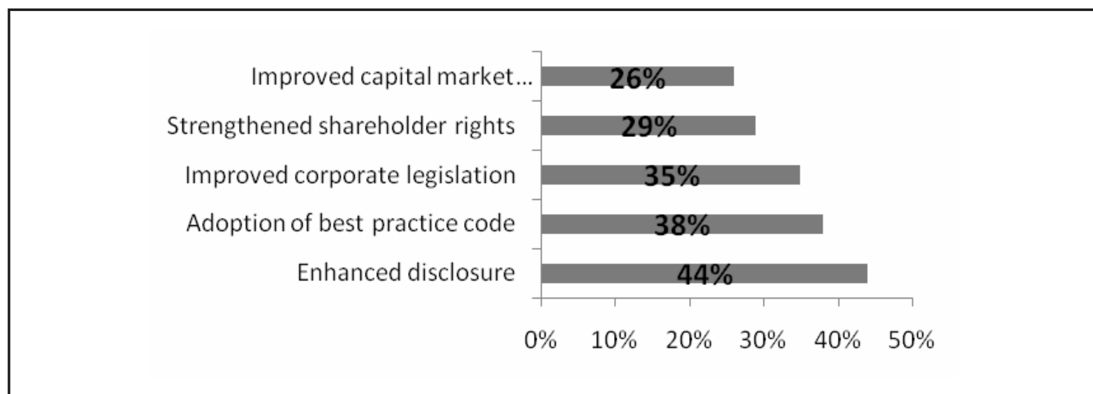
**Fig 7**

**Policymakers believe implementation till now has been relatively successful, but with room for improvement (% of respondents)**




*Source : www.mckinsey.com/governance*

*Fig 8*
*Policymakers highlight significant corporate governance changes in recent years*
*% of respondents, multiple responses possible*
*Top 5 changes*




*Source : www.mckinsey.com/governance*

These survey results indicate that investors view the development of a single accounting standard as necessary & accounting disclosures as an important determinant of their investment decision. They also want policymakers to improve accounting standards to obtain more effective disclosures. This shows the significance of accounting standards & disclosures in the present business scenario.

## Developments in India – IFRS

The issue of convergence with IFRS has gained significant momentum in India. The Institute of Chartered Accountants of India (ICAI) which formulates & issues accounting standards has released a concept paper on "Convergence with IFRS in India", and pronounced that Indian GAAP will converge into IFRS with effect from April 1, 2011. The Ministry of Corporate Affairs (MCA) confirmed the timeline for convergence with IFRS in India by 2011 but announced in January 2010 that India would implement IFRS in a phased manner. The table below sets out the applicability of First set of standards to specified class of companies in phased manner:

| Phase I | Phase II | Phase III |
|---|---|---|
| **April 1, 2011** | **April 1, 2013** | **April 1, 2014** |
| Companies in Nifty 50<br><br>Companies in Sensex 30<br><br>Companies shares or other securities listed on stock exchanges outside India<br><br>Companies (whether listed or not) having net worth in excess of Rs 1,000 crores | Companies (whether listed or not) having net worth in excess of Rs 500 crores but less than Rs. 1, 000 crores<br><br>Insurance companies | All listed companies with net worth less than Rs 500 crores<br><br>Banks |

But, the Indian GAAP is influenced by several standard setters and statutes like Companies Act, Income Tax Act, Banking Regulation Act, Insurance Act, etc.. and by directions from regulatory bodies like RBI, SEBI & IRDA. The legal or regulatory requirement will prevail over the IFRS requirement, in case of conflicts. Therefore, preconditions for IFRS adoption by India to be effective are amendments in required legislations & clarity on impact of IFRS adoption on direct and indirect taxes.

### Benefits of Convergence with IFRS

The convergence with IFRS entails the following benefits

Benefits to investors

- The adoption of IFRS is expected to result in better quality of financial reporting due to consistent application of accounting principles & improvement in reliability of financial statements. Investors will be benefitted as the accounting information made available to them will be more reliable, relevant, timely and most importantly, the information will be comparable across different legal frameworks. It will develop better understanding & confidence among the investors. This, in turn, will lead to increased trust & reliance placed by investors, analysts and other stakeholders in a company's financial statements.
- IFRS promise more accurate, comprehensive and timely financial statement information, relative to the national standards they replace for public financial reporting in most of the countries adopting them. To the extent that financial statement information is not known from other sources, this leads to more-informed valuation in the equity markets, and hence lower risk to investors.
- Small investors are less likely than investment professionals to be able to anticipate financial statement information from other sources. Improving financial reporting quality allows them to compete better with professionals, and hence reduces the risk they are trading with a better-informed professional (known as 'adverse selection').
- Because higher information quality should reduce both the risk to all investors from owning shares and the risk to less-informed investors due to adverse selection in theory it should lead to a reduction in firms' costs of equity capital. This would increase share prices, and would make new investments more attractive, other things equal.
- By eliminating many international differences in accounting standards, and standardising reporting formats, IFRS eliminate many of the adjustments that analysts make in order to make companies' financials more comparable internationally. IFRS adoption therefore could reduce the cost to investors of processing financial information. The gain would be greatest for institutions that create large, standardised-format financial databases.
- A bonus is that reducing the cost of processing financial information most likely increases the efficiency with which the stock market incorporates it in prices. Most investors can be expected to gain from increased market efficiency.
- Reducing international differences in accounting standards assists to some degree in removing barriers to cross-border acquisitions and divestitures, which in theory will reward investors with increased takeover premiums.

- Increased transparency promised by IFRS causes managers to act more in the interests of shareholders leading to potential gains for them. In particular, timelier loss recognition in the financial statements increases the incentives of managers to attend to existing loss-making investments and strategies more quickly, and to undertake fewer new investments with negative NPVs.

- The increased transparency promised by IFRS also could cause a similar increase in the efficiency of contracting between firms and lenders.

## Benefits to Corporates

- IFRS leads to improvement in comparability of financial information & financial performance with global peers &industry standards. Adoption of IFRS will enable companies to look beyond country and regional milestones and set targets & milestones based on global business environment rather than local ones.

- Majority of stock exchanges require financial information prepared under IFRS. Migration to IFRS will enable Indian entities to have access to international capital markets, removing the risk premium that is added to those reporting under Indian GAAP since IFRS are now accepted as a financial reporting framework for companies seeking to raise funds from most capital markets across the globe. It thus, helps in better access to international capital markets and reduction in the cost of capital raised from global capital markets leading to higher FII inflow.

- Convergence to IFRS by all group entities of multinationals having global operations in IFRS driven countries will enable company managements to view all components of the group on one financial reporting platform. It will lead to cost savings & eliminate the need for multiple reports and significant adjustments for preparing consolidated financial statements.

## Benefits to Professionals

- Adoption of IFRS will open up a host of opportunities in the services sector. There is a lack of adequate professionals with practical IFRS conversion experience. With a wide pool of accounting professionals, India can emerge as an accounting services hub for the global community & Indian professionals will be able to provide their services in various parts of the world, as few years later all or most of the countries will follow the same reporting standards.

- As IFRS is fair value focused, it will provide significant opportunities to other professionals like valuations experts and actuaries, which in-turn, will boost the growth prospects for the BPO/ KPO segment in India.

- It is an opportunity for the Indian professionals to rise to global standards & be amongst the premier & much sought after professionals of the world.

According to a report titled "Assessment of accounting standards from a financial stability perspective" published by European Central Bank in December 2006, (Source: www.nirc-icai.org ), adoption of IFRS results in :

- Overall increase in comparability & transparency

- Enables level playing fields & strengthens market discipline
- Provides early warning signals on exposure to risks

Despite these benefits to various interest groups, several challenges will be faced on the way to IFRS convergence and it will require significant amount of work to get there.

## Challenges

Convergence with IFRS with effect from April 1, 2011 means that from 2011, the results of Indian companies will be comparable to those of their counterparts in European nations, Australia, Singapore, China, Brazil & Canada and in the near future, the US & Japan too. A survey GAAP Convergence 2002 surveyed 59 countries to know the concerns expressed about impediments to achieving IFRS convergence.

| % | | |
|---|---|---|
| 51 | - | Complicated nature of particular standards |
| 47 | - | Tax driven nature of national accounting regime |
| 39 | - | Disagreement with certain significant IFRS |
| 35 | - | Insufficient guidance on first time application of IFRS |
| 21 | - | Satisfaction with national accounting standards among investors/users |
| 18 | - | Translation difficulties |

***Source: www.pfsprogram.org/file***

51% respondents felt that the complicated nature of particular standards was the biggest impediment to convergence while the tax driven nature of national accounting regime ranked second as perceived impediment with 47%. There are many other impediments on the road to convergence. Converting or converging to IFRS is not exclusively an accounting project– it is a significant project that will require support from multiple business functions including information technology, tax, treasury & human resources.

## IFRS Transition Challenges for Management

### HR Challenges

- Organising the project team – It is a crucial part of the IFRS adoption process to organise a team structure & know the impact of conversion on internal controls, IT systems and internal policies. The major problem that industries are likely to face is a talent crunch since, even in the current scenario, there is a scarcity of qualified resources. With the convergence to IFRS, strengthening of corporate governance norms and increasing financial regulations, accountants are most sought after globally. Getting trained accounting resources having expert knowledge of IFRSs is a major challenge. So, there is a need to give own internal accounting staff appropriate training. Accounting teams should be conversant not only with new standards but also with information technology to support the new financial reporting architecture.

- Training all stakeholders – IFRS impacts all functions which generate, use or transmit financial information including HR, Sales/ Marketing, Investor relations, Treasury, budgeting, MIS and corporate strategies. For IFRS to be uniformly understood and consistently applied, all the stakeholders including top management & employees need to be trained in IFRS.

- Companies need to draw up detailed plans for migrating to IFRS as early as possible, to make the transition smooth and flawless. Top management needs to sponsor and identify the fundamental shifts in approach, related regulatory challenges, complexities in financial reporting processes, implementation costs and other conversion challenges.

## IT Challenges

- IFRS is accounting driven but it can drive major changes to IT systems as well. The main effect will be the changes for the updation of the existing to the newer version of IFRS enabled accounting software. 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. Retrospective application of change in accounting policies & rectification of errors will cause considerable difficulties in the post-IFRS era. Local accounting software should be effective enough to capture retrospective application and retrospective restatement.

- As financial accounting and reporting systems are modified and strengthened to deliver information in accordance with IFRS, entities would need to enhance their IT security in order to minimise the risk of business interruption and the risk of fraud, cyber terrorism and data corruption. Experience from other countries indicates that IT costs generally constitute more than 50% of IFRS conversion costs. But, organisations benefit when they identify & integrate the efforts of the IT team early in the IFRS conversion process.

## Communication Challenges

- IFRS may significantly change reported earnings and various other performance indicators. The 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. The increased use of fair values and the restriction on existing practices such as hedge accounting may lead to reported profits being different from expected profit performance. Consequently, the indicators for assessing both business and managerial performance will need revision.

## Management Compensation & Debt Covenants

- Remuneration and compensation calculated and paid under performance-based executive plans , and employee compensation plans may be materially different under IFRS, as the entity's financial results may be considerably different. Under the new regime, significant changes to the plan may be required to adequately reward the management and employees for contribution to the entity's success. For e.g., the variable pay component of most TCS employees is about 30% of the total compensation package and this variable pay being based on items of Profit/Loss Account will be defined differently under IFRS, so the entire compensation package will need to be revised.

Also, contracts that refer to reported accounting figures such as bank covenants will have to be renegotiated on convergence to IFRS.

### Tax Planning Challenges

- Entities will have to review existing tax planning strategies due to the change in reported profits caused by different treatment of various accounting items under IFRS. Entities will have to consider taxes and other regulatory issues and plan their operations accordingly. For example, Daimler Chrysler's first report using IFRS increased its tax earnings by $819 million to $5.2 billion, EPS increased by 68 cents while operating profit dropped by $38 million to $7.5 billion under IFRS. This was largely attributed to the way pension obligations are booked under the IFRS.

### Distributable Profits

- IFRS is based on the fair value concept for revenue recognition, which often results in unrealised gains and losses. Management should consider whether or not they are distributable profits so that the distribution of such unrealised profits does not lead to reduction of share capital.

### Regulatory Challenges

- Taxes: IFRS convergence will have a significant impact on financial statements and consequently on tax liabilities. Tax authorities should ensure that there is clarity on the tax treatment of items and issues arising from convergence to IFRS. There are several taxation issues which remain unanswered at this point of time & suitable clarifications are awaited from the concerned regulatory authorities on:
  - Deferred tax assets/ liabilities arising out of retrospective application of IFRS in transition year
  - Applicability of Minimum Alternative Tax(MAT) in transition year as the impact of transition from present Accounting Standards to the converged Accounting Standards on the financial statements & book profits is estimated to be huge.
  - Unrealised gains & losses on derivatives are required to be marked-to-market under IFRS. Taxation issues arising out of these notional gains & losses are still awaited to be clarified.
- Schedule VI of the Companies Act,1956 is also not in complete compliance with the IFRS and should be reconciled as well.
- The RBI prescribes accounting requirements for banks, such as accounting for derivatives or provision for non-performing assets, and these requirements of the RBI are currently at variance with the IFRS.

### Convergence Challenges for Accounting fraternity

- While applying IFRSs, a large number of application issues arise due to the wide & deep-routed differences between Indian GAAP and IFRS in areas like – Plant Property & Equipment accounting, Financial Instruments accounting, Business consolidation, Impairment of loans/ investments, Share based payment, etc.. to name a few.

- A major feature of IFRS is the fair value approach (aka mark- to-market accounting), which emphasises the measuring of fair values of company's assets & liabilities. This poses a big challenge as the markets of many economies such as India do not have adequate depth & breadth for reliable determination of fair values. For assets with unobservable inputs where value is based on management assumptions, auditors using conservative accounting principles may coerce management into adopting valuations close to 'fire sale valuations'. This will lead to a vicious circle because if assets are marked down excessively, the solvency of the financial system could be eroded.

- Fair valuation principles are very subjective & would result in significant volatility in periodic results. IFRS is fair – value driven and this often produces unrealised gains & losses. Income tax treatment of these unrealised gains & losses and their distribution as dividend (Under the Companies Act, 1956) are debatable issues of which no viable solution is available, till date.

- Fair valuation of liabilities & expenses may give rise to unusual situations as happened in the case of MBIA which threw up a pre-tax loss of $3.5 billion on mark-to-market basis though it was actually expected to incur loss of only $200million. In India, State Bank of India (SBI), ICICI bank, Bank of Baroda(BOB) & Bank of India(BOI) are all set to book mark-to-market losses from 5-10%, their exposures to subprime loans are $1billion, $1.5 billion, $150 million & $300 million respectively. Infact, the world's biggest banks would have been insolvent if their loan books had been valued realistically. In the event of a financial crisis, there is strong political pressure to not mark banks' balance sheets to market, in order to avoid bank closures resulting from violating prudential ratios, as witnessed in Japan over the last decade. Episodes like this are bound to occur in the future, whenever reports prepared under the IFRS produce outcomes that adversely affect local interests.

- For an entity's first set of IFRS financial statements, full retrospective application of IFRSs effective at the reporting date is required with material errors corrected retrospectively which is a major challenge.

- IFRS prescribes a model which uses more informed judgement and timing of cash flows relating to a credit exposure whereas Indian GAAP uses limited judgement.

### General Challenges

- SMEs face problems in implementing IFRSs because of scarcity of resources & expertise available with them to achieve compliance and the costs of compliance not being commensurate with the expected benefits.

- Some IFRSs are complex. There is lack of adequate skills amongst the preparers & users of financial statements to apply IFRSs. Proper implementation of such IFRSs requires extensive education of preparers.

- Last, but not the least, achieving the timeline for IFRS convergence i.e. April 1, 2011 is a big challenge.

### Conclusions

Awareness about IFRS and the implementation issues are gradually building up within corporate India. However, the awareness needs to increase more rapidly if we are to

achieve the proposed timelines for convergence. In the words of Ken Wild, Global IFRS Leader, Deloitte, on the preparation of US companies to implement IFRS,"No one anticipated how big it was going to be. Every company was too late & too slow in preparing – even the good ones". There is a huge need to train professionals about IFRS in India in order to get prepared for IFRS convergence by 2011. Companies need to thoroughly assess the effects for their organisations and start thinking in terms of IFRSs. The IFRS conversion effort provides opportunities for achieving synergies with other IT projects & strategic initiatives.

Companies should be aware of the importance of creating a business strategy to support a smooth transition to IFRS. There is no single path to convergence, but an open-minded pursuit of the highest quality guidance from experts. The implementation of IFRS is not easy, and only if companies start following certain common standards now, would they be able to shift towards the new standards from 2011. Keeping in mind the challenges and the timeline for convergence, the companies should : –

- Prepare IFRS teams and assess if their "designated teams" have the required skill set for IFRS convergence.
- Develop training programmes for employees and stakeholders.
- Develop back-up plan if some team members are not available.
- Decide on top management personnel & external consultants to be involved in the conversion process besides the "designated teams".
- Identify the impact of IFRS convergence.
- Quantify the differences in IFRS & GAAP reporting.
- Ensure accountability of impacted divisions for change implementation.
- Identify new data / resolution requirements for their IT systems and configure systems to handle IFRS data.
- Identify the modifications required for internal controls.
- Assess the impact on controls.
- Design new IFRS policies and reporting procedures and tools.
- Seek external expertise /assistance for data migration / reconciliation efforts.
- Align systems for reporting for statutory, regulatory & internal purposes.

Finally, companies must realise that IFRS conversion / convergence presents opportunities as well as challenges & they should be prepared for both. The keywords for successful transition by companies are:

- Start early
- Leverage technology &
- Optimise your business.

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