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IFRSs Adoption in India : A Review of Regulatory and Accounting Issues

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Listed companies will have to adopt International Financial Reporting Standards in respect of accounting period commencing from 1st April, 2011. Adoption of IFRS is going to be an arduous and difficult process and there is an urgent need to get acquainted with the important aspects.

BACKGROUND

1. IFRSs adoption for financial reporting is order of the day to which India's announcement to adopt IFRSs with effect from the reporting period 2011-12 along with Brazil, Canada, Chile, Japan, Mexico and South Korea is a timely action to remain at par with the global standardisation process despite criticalities involved in fair value accounting as well as rationale of reporting financial information based on unstable market determined fair value or market unobservable inputs driven fair value. On the contrary, the observed slow-paced IFRSs adoption preparation in India causes obvious concern among the preparers, and various interest-groups. Any last-moment IFRSs adoption guidelines will create unnecessary pressure on the accounting system. Contrary to the illusory belief of availability of longer preparation time, Box 1 explains the IFRSs adoption timeframe.

Box 1 : IFRSs Adoption Timeframe and Actions

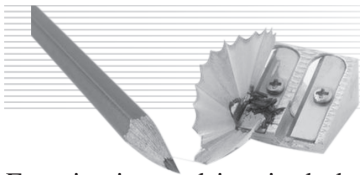
1.4.2010 Date of Transition to IFRSs	To prepare opening Statement of Financial Position on the basis of Indian GAAP Balance Sheet as on 31.3.2010 To prepare a reconciliation statement explaining changes in equity reported in accordance with Indian GAAP as on 31.3.2010 and equity presented in the Opening Statement of Financial Position in accordance with IFRSs. Measurement of assets and liabilities shall be carried out on the basis of the condition prevailing on the date of transition.
2010-2011 Comparative reporting period	Preparation of IFRSs financial statements for comparatives

2011-12 First IFRSs reporting period	Preparation of first IFRSs compliant financial statements
31.3.2012 First IFRSs reporting date	Adopt IFRSs effective as on 31.3.2012 for all actions stated. A responsible entity should start preparation for IFRSs adoption based on particular set of IFRSs, say, IFRSs as on 1.4.2010 and thereafter to amend the workings to comply with changes in IFRSs.

IFRS Education

Apart from educating the preparers and the auditors on the IFRSs, there is a huge social responsibility of the Government to educate the investors and overhauling the accounting education system. University Grants Commission (UGC) and All India Council for Technical Education (AICTE) have to take urgent lead in revamping accounting education in India. Universities and MBA Institutions should incorporate IFRSs as a subject of study. There is an urgent need for relooking under- and post-graduate commerce education curriculum such that Indian graduates by 2011-12 become aware of IFRSs. The ICAI, the ICWAI and the ICSI, the leading professional institutes in India, should take urgent initiative to include a dedicated subject on IFRSs in their basic curriculum. Separate certificate course on IFRSs is just intended for updating the qualified professionals as part of continuing education. The students undergoing professional courses in a chartered accountancy, cost accountancy or chartered secretary programme should be fully conversant as well as wherever applicable gain expert knowledge in IFRSs.

The AICPA Board of Examiners (the United States) in May 2008 released an exposure draft regarding content for the CPA



Examination and inquired about adding IFRSs. Comment letters showed support for such a move. Workshops are being held during the current year and the next step is to develop IFRSs questions for the examination. Coverage of IFRSs on the examination has been proposed to begin by 2012, but possibly sooner.

Essentially, India is lagging behind in the academic front even if it is progressing in the IFRSs adoption front. There exists conceptual differences, differences in valuation and accounting between IFRSs and Indian GAAP (for example, IFRSs talk about different liability accounting, use of present value in accounting measurement, amortised cost concept, comprehensive income, statement of changes in equity, restatement of statement of financial position, various kinds of intangible assets, intangibles with indefinite life, separation of compound financial instruments and embedded derivatives, increasing rate preference shares, fair value through profit or loss and fair value through equity, hedge accounting, etc.) and most importantly there exists difference in presentation formats.

Pressing timeline

Interestingly, IFRSs adoption demands: (a) recognise all assets and liabilities whose recognition is required by IFRSs; (b) not recognise items as assets or liabilities if IFRSs do not permit such recognition; (c) reclassify items that it recognised 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 recognised assets and liabilities.

Accordingly, the opening Statement of Financial Position shall be prepared recognising and measuring assets, liabilities and equity in accordance with IFRSs. This important issue has been widely misunderstood in India. By virtue of this provision, even adoption of cost model for tangible and intangible assets for IFRSs adoption will require *purification of the cost* as per Indian GAAP accounts.

An attempt has been made in this article to articulate the major divergent issues between IFRSs and Indian GAAP including regulatory requirements, to propose regulatory amendments balancing with prudence, taxation effects of fair value accounting including pervasive impact on Minimum Alternate Tax, and to highlight the conflict in the issue of regulatory loan loss provision and minimum depreciation charge.

GLOBAL DEVELOPMENTS IN IFRSs ADOPTION

2. In this section global developments are highlighted along with a summary in Box 2.

Canadian Development

In the global platform, Canada has been leading the 2011 IFRSs adoption movement. The Canadian Accounting Standards Board (AcSB) has re-confirmed the “go date” for IFRS Canada for *publicly accountable enterprises*. The date will be for years beginning on or after January 1, 2011. This re-confirmation was essential in the context of economic downturn and financial crisis faced by globally acclaimed companies. The AcSB has issued its memorandum ‘Changeover to IFRSs: January 1, 2011’ *confirming* IFRSs adoption and reasons for them ¹.

Canada has been discussing three possible approaches to develop private enterprise GAAP:

- a top-down approach based on public enterprise GAAP (i.e., IFRSs) but providing for differences on a number of topics;
- adoption of the proposed IFRS for Small and Medium-sized Entities (IFRS SME) standard when finalized, possibly with some modification; and
- an independently developed set of standards.

Meanwhile, the International Accounting Standards Board (IASB) has issued in July 2009 SME Standards².

India has to decide whether it will adopt dual reporting standards developing a set of standards for SMEs or adopting IFRSs for SMEs. Perhaps accepting modified IFRSs applicable to publicly accountable enterprises is not a good idea.

South Korean Development

The Korea Accounting Institute (KAI), which is responsible for setting accounting standards in Korea, has released the Korean translation of International Financial Reporting Standards. This translation is part of a plan, announced in March 2007 by the KAI and the Korean Financial Supervisory Commission, for adopting Korean equivalents of IFRSs (K-IFRSs). All listed companies will be required to prepare their annual financial statements under K-IFRSs beginning in 2011. Listed companies other than financial institutions will be permitted to do so beginning in 2009. Unlisted companies will be allowed to use K-IFRSs.

Mexican Developments

The Mexican Comisión Nacional Bancaria y de Valores (CNBV), together with the Mexican Accounting Standards Board (CINIF), have announced that Mexico would

1. *Changeover to IFRSs: January 1, 2011*, <http://www.acsbcanada.org>

2. *International Financial Reporting Standard for Small and Medium-sized Entities (SMEs)*, IASB, July 2009.

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adopt IFRS for all listed entities from 2012. Early adoption for some entities would be permitted from 2008 subject to requirements that will be established by the CNBV.

Experience of Israel

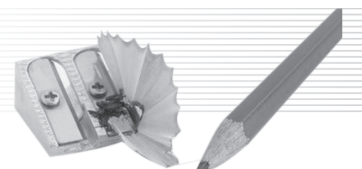
Israel is second only to Canada in the number of foreign private issuers that register with the SEC and has adopted IFRS with effect from 1.4. 2008. Listed companies had been permitted to use IFRSs since July 2006. Israel has adopted IFRSs as detailed out below ³:

- **Listed companies.** All companies listed on the Tel Aviv Stock Exchange (approximately 820 companies) are required to follow IFRSs, with one mandatory exception and one optional exception:
- **Banks.** Banks must continue to follow an accounting framework that is close to US GAAP.
- **Dual registrants.** Companies that are dually listed in the United States as well as in Israel may choose to use US GAAP instead of IFRSs. There are approximately 50 such companies. Some of them may now consider switching to IFRSs, now that the SEC no longer requires reconciliation for Foreign Private Issuers reporting under IFRSs.
- **Subsidiaries and associates of listed companies.** In practice, subsidiaries and associates of listed companies will also apply IFRSs in order to meet their shareholders' needs. Consequently, a few thousand Israeli companies are expected to use IFRSs with effect from 1 January 2008.
- **Unlisted companies.** All unlisted companies except banks are permitted to follow IFRSs as an alternative to Israeli GAAP.
- **Interim reports.** Companies using IFRSs will begin doing so in their interim reports for 2008. Listed companies are required by law to report on a quarterly basis.

Brazilian Development

The Brazilian Central Bank and the Brazilian Securities and Exchange Commission (CVM) defined 2010 as the deadline for adoption of International Financial Reporting Standards (IFRS) for the consolidated financial statements of financial institutions and publicly-held companies. Recently, Law 11.638/07 has been published by virtue of which the transition to IFRS

3. IAS Plus, Accounting Standards Updates by Jurisdiction, Deloitte, <http://www.iasplus.com/country/israel.htm>



has also become a priority for other Brazilian companies. The new law has revised the accounting aspects of Company Law 6.404/76, effective from January 1, 2008 which is considered as the most significant change in Brazilian corporate legislation in the last 31 years.⁴

Developments in Japan

In March 2009, there was ninth meeting between the IASB and its Japanese counterpart, the Accounting Standards Board of Japan (ASBJ) in the hope of achieving convergence between their rules by 2011.

Planning and Coordination Committee, the Business Accounting Council of the Financial Services Agency ("FSA") in Japan has recently developed an interim road map of IFRS adoption :

The main points of the Interim IFRS Roadmap are as follows (illustrated in Figure 1)

- The acceptance of voluntary adoption of IFRS in consolidated financial statements from fiscal years ending 31 March 2010 for "companies with global financial / operating activities" as defined in the Initial Draft of the Revised Consolidation Regulation.
- The consideration of the possibility of mandatory application of IFRS in Japan with a decision on this to be made around 2012.
- Through the allowance of a period of at least three years to ensure proper preparation and practical implementation, if mandatory application of IFRS is decided around 2012, application beginning from 2015 or 2016.

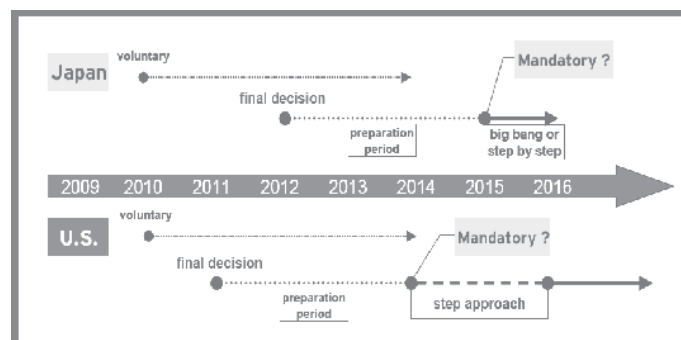


Figure 1: Interim Road Map of Japanese adoption / convergence to IFRSs⁵

4. Brazil and International Financial Reporting Standards (IFRS): First-time adoption of IFRS, KPMG, 2008

5. Decision on the Financial Services Agency of Japan's Roadmap regarding the adoption of IFRS by Japanese companies, Ernst and Young Sinnihon LLC, June 2009.



It appears from the timeline described in Figure 1 that Japan is buying the US timeline of IFRSs convergence.

Sir David Tweedie⁶, the IASB Chair, has recently explained that the SEC IFRS Roadmap provides for the U.S. to adopt IFRS by 2014. Recently, doubt has been cast on that date by many U.S. issuers. However, the U.S. may be forced to adopt IFRS by 2011 because of political and economic pressure. Regardless of when the United States decides to converge, Canada, South Korea, India and Japan to adapt or adopt by 2011, Brazil goes in 2010, while Mexico and Argentina will have completed convergence by 2012. Israel had completed convergence in 2008 and Chile converges during 2009. China completed convergence in 2007. Altogether 117 countries are currently using the IFRS system.

Box 2 IFRSs Adoption Timeline & Process

1.China China adapted IFRS	Converged to IFRSs in 2007. There are major differences between Chinese adopted IFRSs and IASB issued IFRSs.
	May be comparatively Indian GAAP differences with the IASB issued IFRSs will be of little higher degree only. But India is considered as IFRSs non-compliant.
2.Israel Adapted IFRS with two differences	Israel is second only to Canada in the number of foreign private issuers that register with the SEC and has adopted IFRS with effect from 1.4. 2008.
3.Chile	Adopting IFRS in 2009 -2011 in a phased manner. Banks and other financial institutions and major listed (open) companies to adopt IFRSs with effect from 1.1.2009.
4.Brazil	Adopting IFRS in 2010, The accounting aspects of the company law has been changed.
5.Canada May follow adoption model	Publicly accountable enterprises to adopt IFRSs with effect from 1.1.2011
6.South Korea	Korean Financial Supervisory Commission announced that all listed companies will be

6. Sir David Tweedie Takes On IFRS, AICPA Corporate Finance Insider, and 4 June, 2009.

Pursuing convergence model	required to prepare their annual financial statements under K-IFRSs beginning in 2011. All listed companies other than financial institutions are allowed make early application with effect from 2009.
7.Mexico	To adopt IFRSs by 2012. Early adoption with effect from 2008 permitted.
8.Japan	To adopt voluntarily by 2010

Surprisingly, on question ‘What is the best way to adopt IFRSs?’ Sir David Tweedie thinks it’s best to follow Japan’s subtle steps and then go with EU’s big bang method. While the transition costs will be there, bringing the standards closer similar to what Japan is doing with the JGAAP and running it parallel with IFRS for sometime may work, “and then just go for it.”

Should India go for voluntary and mandatory phases?

XBRL - EXTENSIBLE BUSINESS REPORTING LANGUAGE

XBRL is standard that was developed to improve the way in which financial data is communicated, making it easier to compile and share this data. XBRL is a type of XML (extensible mark-up language), which is a specification that is used for organizing and defining data. XBRL uses tags to identify each piece of financial data, which then allows it to be used programmatically by an XBRL-compatible program. XLBR is used for data presentation and analysis.

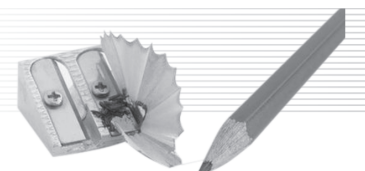
The International Accounting Standards Committee (IASC) Foundation today published two Requests for Information on *Concept naming and change management in the IFRS Taxonomy* and *Extending the use of dimensions in the IFRS Taxonomy*.

Infosys Technologies Limited voluntarily furnished eXtensible Business Reporting Language (XBRL) data to the United States Securities and Exchange Commission (SEC) electronically in a 6-K exhibit way back on May 3, 2005. Infosys is participating in SEC’s new Voluntary Program for Reporting Financial Information on EDGAR Using XBRL.

Recently, the United Arab Emirates has set up a provisional XBRL jurisdiction under the sponsorship of the Abu Dhabi Securities Exchange (ADX). This is the first XBRL jurisdiction to be set up in the Middle East. Taking clue from this development, the National Stock Exchange (NSE) should arrange for forming of the jurisdiction which will enable India to recruit local XBRL members and progress the use of the electronic language.

A jurisdiction is a local legal entity which has the exclusive right to represent XBRL International (XII) in its area. It will provide official support to XBRL projects and initiatives and

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responsible for encouraging the development and adoption of XBRL in its area. Jurisdictions are initially classed as provisional and become classed as established after achieving targets on growth of membership and other criteria. The Government has to ask the NSE to play necessary roles for the use of the XBRL technology based on IFRS taxonomy to support financial reporting in XBRL under international standards by Indian companies.

MAJOR ISSUES IN FIRST TIME ADOPTION OF IFRSs

Classification of assets and liabilities into current and non-current

This difference arises out of Schedule VI to the Companies Act. Actions to be taken are -

- (i) Classification of financial assets into current and non-current;
- (ii) Adopting operating cycle concept for classification of trade debtors, inventories and trade creditors.
- (iii) Introduction of the concept property, plant and equipment (PPE) in place of Fixed Assets;
- (iv) Classification of PPE into held for sale and discontinued operations and carrying them out at *fair value less costs to sell* and no depreciation charge on such block of assets;
- (v) Carving out investment property (land and building which are not owner Occupied) from PPE;
- (vi) Carving out leasehold property out of PPE in accordance with IAS 17 Leases and accounting it as prepaid leases (IAS 19 classifies leasehold land as operating lease) ;
- (vii) Re-classification of goodwill into intangible assets in accordance with IFRS 3 Business Combinations if those intangible assets require recognition in Accordance with IAS 38 on the date of transition;
- (viii) Classification of current liabilities out instalment due within 12 months from the reporting date out of non-current liabilities;
- (ix) Taking cognizance of breaches of loan conditions and discretion to roll over while classifying current/non-current liabilities;
- (x) Evaluating preference shares and classifying as liability if the definition of equity is not satisfied;
- (xi) Accounting for preference dividend as borrowing cost if it is classified as Liability;
- (xii) Classifying puttable instruments as liability rather than equity in accordance with IAS 32.
- (xiii) Deferred tax asset (liability) is not classified as current.

These classification issues could be settled and implemented through modified format of financial statements at the earliest. Adopting the new format during 2009-10 with Indian GAAP measurement and accounting will be step forward. That will make the job of preparation of transition balance sheet easier.

Adopting two-part Statement of Other Comprehensive income

In India, unrealised gain or loss on (i) revaluation of PPE and Intangible Assets and (ii) currency translation reserve are directly shown as part of the Reserves and Surplus. IAS 1 requires an entity to present a Statement of Other Comprehensive Income and routes such positive/negative revaluations and translation gains/losses through that Statement. In the US, it is called Statement of Realized Income. Other three items to be included in the Statement of Other Comprehensive Income are – (iii) fair value gains/loss of financial assets carried through equity (presently they are termed as Available for Sale Financial Assets), (iv) actuarial gains/losses arising out of applying *corridor approach* in accordance with IAS 19 Employee Benefits (In India, they are directly charged to profit or loss) and (v) cash flow hedge reserve. Any current/deferred tax effect of these items is also presented in the Statement of Other Comprehensive Income.

Comment: While designing new Schedule VI this aspect has been missed. Even Dr. R. Kannan Committee which have designed draft financial statements for insurance companies have not considered the issue of two-part Statement of Comprehensive Income.

Adopting Statement of Changes in Equity

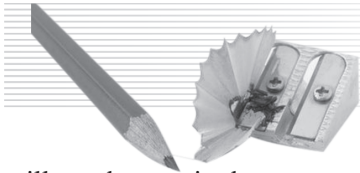
Elimination of Appropriation section of the Profit and Loss Account and introducing Statement of Changes in Equity as provided in the IFRSs will improve presentation of financial statements.

Adopting Liquidity Based presentation for banks, insurance companies and other financial institutions

Applying exception to current non-current classification as stated in Para 66 of IAS 1 *Presentation of Financial Statements* an entity may adopt presentation based on liquidity if that presentation helps to provide more reliable and relevant information. When an entity applies this exception, it will present all assets and liabilities in order of liquidity.

Liquidity based presentation has been adopted by Banks and insurance companies in the EU. Dr. R. Kannan Committee also recommended for liquidity based presentation of the Statement of Financial Position of insurance companies.

It is to mention that under IFRSs format insurance companies



will not be required to prepare revenue account. However, revenue accounts can be presented by way of notes applying Para 112 (c) of IAS 1 if notes *shall provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them*. The insurance regulator will definitely agree that information presented in the revenue accounts using important line of business concept provide important insights which can not be captured through reporting by operating segment under IFRS 8. The IRDA should retain the existing revenue accounts introducing additional disclosures.

Offsetting

Para 32, IAS 1 does not generally allow offsetting of income and expense, and assets and liabilities. Offsetting is allowed only when that reflects the substance of the transaction. Therefore, insurance companies shall not offset re-insurance assets against insurance liabilities.

Consistency of presentation

Para 45, IAS 1 requires an entity to maintain consistency of presentation unless there is significant change in the entity's operations that requires re-classification of items of financial statements or IFRSs require re-classification.

Do IFRSs demand consolidated financial statements?

IAS 1 *Presentation of Financial Statements* do not explicitly require that primary set of financial statements of entity will be consolidated financial statements. Also Para 9, IAS 27 requires just presentation of financial statements.

Therefore, India may continue with the stand-alone financial statements as main financial statements (with revision of components of financial statements) and require additional consolidated financial statements. Scrapping requirements of Section 212 of the Companies need to reviewed. However, that does not stand in the way of IFRSs compliance. Of course, consolidated financial statements are presented as main set of financial statements in the EU, the US and other IFRSs jurisdictions.

As per Para 10, IAS 1, a complete set of financial statements comprises :

- (a) a statement of financial position as at the end of the period;
- (b) a statement of comprehensive income for the period;
- (c) a statement of changes in equity for the period;
- (d) a statement of cash flows for the period;
- (e) notes, comprising a summary of significant accounting policies and other explanatory information; and
- (f) a statement of financial position as at the beginning of the earliest comparative period when an entity applies an

accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

An entity may use titles for the statements other than those used in this Standard.

Financial statements shall be fairly presented . Replacement of '*true and fair presentation*' by '*fair presentation*' does not affect the quality of the financial statements.

Comparative information

As per IFRSs an entity has to provide Statement of Comprehensive Income, Statement of Changes in Equity and Statement of Cash Flows for one comparative reporting period and Statement of Financial Position for two reporting periods. For 2012-13, Statement of Financial Position will carry comparatives for 2011-12 & 2010-11.

Accounting Policies, Changes in Accounting Estimates and Errors

IAS 8 requires retrospective application of change in accounting policies, retrospective restatement for errors and re-classification of items of financial statements. For effects of change in accounting policies, errors and re-classification that are beyond the comparative period presented, IFRSs demand restatement of the Statement of Financial Position at the beginning of the earliest comparative period. This means for the reporting period 2012-13, if there arises change in accounting policies, error or re-classification that has effect on the financial statements information of 2009-10 (beyond the date of transition 1.4.2010), the opening Statement of Financial Position is to be restated. Similarly, for 2013-14, there shall be restated financial position as on 31.3.2011.

The company law shall have to provide for restatement of accounts which should form part of financial statements.

Proposed dividend and other post-reporting period information

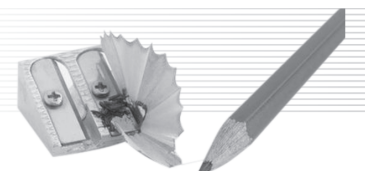
The statutory requirement of presenting proposed dividend, which is normally a post-reporting period event, is to be scrapped to comply with the requirements of IAS 10 Events After the Reporting Period. Information of proposed dividend can be presented by way of note.

By virtue of IAS 10 the meaning of *adjusting events* will be quite different compared to AS 4 in India. Even the post-reporting period product prices are to be captured for inventory valuation. Most importantly, post-reporting period authoritative decisions would impact provisioning requirements.

Estimation

IFRS 1 First Time Adoption of International Financial

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Reporting Standards does not permit change in accounting estimation for the purpose IFRSs adoption. The implication is that estimates about (a) useful life of the tangible and intangible assets and their residual lives, (b) provisioning for warranty and other obligations, (c) other accounting estimates applied. Of course, errors in estimation or difference in estimation arising out difference between Indian GAAP and IFRSs are to be given effect in the first time adoption. The major difference arises out of discounting of provisions having expected maturity of more than 12 months beyond the reporting date. One example of such estimation is provision for decommissioning, restoration and similar liabilities.

Financial Liability

India has not implemented financial instruments standards which becomes a major area of reconciliation in the first time adoption of IFRSs. Normally, Indian GAAP recognise a liability at the maturity value whereas IAS 39 uses amortised cost (other than held for trading liabilities which are at fair value through profit or loss). Financial liability like Zero Coupon Bonds is recorded in India at maturity value not at fair value. IAS 39 has designed a best method in form of amortised cost which is derived applying implicit interest rate on the basis of net cash flows inclusive directly attributable costs of raising the bond and discount / premium on issue or redemption. This method presents liability at fair value (amortised cost is appropriate fair value of liability) but maturity value of the liability is not reflected in the Statement of Financial Position. The precaution could be to disclose the maturity date and value of liability measured at amortised cost.

Financial Assets

Similarly, principle of accounting for investments (long term investments at cost with charge for permanent diminution in value and current investments at lower of cost or market value) will undergo a fair value test. IAS 39 presently offers four classifications (fair value through profit or loss, held to maturity, loans and receivables, and available for sale) and proposes to simplify into financial assets at fair value and financial assets at amortised costs.

In India, loans and receivables are accounted for at maturity value net of provisions for bad and doubtful debts. Whereas all loans and receivables are to be accounted for applying amortised cost. Inter-corporate loans at concessional rate and subsidised loans to employees will have fair value impairment at the time of first time adoption. Also investment in debt instruments are measured at amortised cost. Transformation of existing cost based investments into amortised cost based investments is another major area of divergence. Accordingly, computation of interest income will change. The issue of maturity value information can be handled through additional disclosures.

Amortised cost based interest income/expense

In accordance with IAS 39, amortised cost based interest expense/interest income are different from coupon rate based interest on the face value of the instrument. Coupon rate based interest accounting seems to be cash basis accounting. Accordingly, tax basis of such interest expense/income should also change. There should be withdrawal of tax allowance on amortisation of issue expense, issue discount and redemption premium of debt instruments which are part of interest expense under amortised cost method.

Separation of compound financial instruments

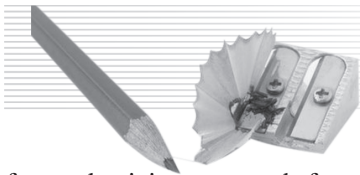
Convertible debentures and similar compound financial instruments are accounted for at maturity value ignoring option component which carries risks different from the risks of the host debt instrument. Indian GAAP facilitate a practice of charging the issue discount of zero coupon bonds to securities premium account. This is a gross violation of accounting principles which hides the interest element. Application of IAS 39 will improve the accounting practice. In the first time adoption, securities premium balance is to be restored and retained earning should take the hit of amortised cost based interest component for the expired period of the compound financial instruments. Arrear tax allowance of this amortised cost migration requires evaluation.

Separation of embedded derivatives

Investors of convertible debentures and similar other equity derivative embedded debt instruments (in general embedded derivatives that carry different risks than the host instrument) have to separate the embedded derivative. An insurer may elect to segregate the embedded derivatives from the insurance contracts applying IFRS 4 Insurance Contracts.

Guidance for measurement of fair value of derivatives and unquoted financial instruments

The issue of separation of compound financial instruments by the borrowers and embedded derivatives by the investors require valuation of non-traded derivatives. In general, non-traded options, forwards and swap valuation will be part and parcel of accounting measurement under IFRSs. It will be appropriate to adopt a generalised view as regards valuation approach for these derivative instruments for guiding the preparers as well as to introduce prudential practice. Although customised derivatives have differential features, there are common features of these instruments which can be assessed applying generalised valuation models. It is necessary to appoint a sub-committee to formulate fair value models (may be Black-Scholes option pricing model for equity option valuation and its variation for interest rate options and currency options;



forward pricing approach for currency forward and interest rate swap valuation). Of course, these guidelines would comply with the requirements of IAS 39 and general principles of the forthcoming Fair Value Measurement standard.

Similarly, valuation of unquoted debt instruments normally follows bond valuation approach. There will be need for guidance as regards selection of benchmark interest rate. Parameters to be used and valuation approach to be adopted for unquoted equity instruments should also be another issue of Guidance.

In this context The International Valuation Standards (IVS) issued by the the International Valuation Standards Board (IVSB) are gaining importance. As per the IVSB International Valuation Standards (IVS) are already recognised and accepted by a wide range of organizations, such as :

- IVS adopted as national standards, for example, in Australia, New Zealand, Romania, Turkey, South Africa;
- IVS adopted within national standards, for example, in UK and Ireland ;
- Countries working towards adoption of IVS include the Philippines and Columbia ;
- IVS recommended for use for real estate valuation for financial reporting purposes by European Public Real Estate Association and European Association for Investors in Non-listed Real Estate Vehicles. The Asian Public Real Estate Association is developing a best practices handbook that recommends use of IVS;
- The UK Financial Services Authority required valuation reports for property companies to be prepared under either UK national standards or IVS ;
- Hong Kong Securities and Futures Commission Code on Real Estate Investment Trusts (REITs) require valuations under HK national standards or IVS. Draft REITs legislation published by the Securities and Exchange Board of India proposes similar requirement.
- In July 08, the Spanish Comisión Nacional del Mercado de Valores (CNMV) published recommendations to valuation companies and real estate companies stating, *inter alia*, that a valuation report must comply with requirements established by IVS and IFRS
- European Commission proposing draft regulation that for EU mortgage credit markets, member states have valuation standards that comply with IVS or European valuation standards

Para 40 of the Draft Securities and Exchange Board of India (Real estate Investment Trusts) Regulations, 2008 state that “ The valuation methodology shall follow the “ Valuation

Standards on Properties” published from time to time by the concerned Indian Institute or the International Valuation Standards issued from time to time by the International Valuation Standards Committee. Perhaps this is right time to promote Indian Valuation Standards.

Fair value model for Property, Plant and Equipment (PPE) and Intangible Assets

Fair value option in subsequent measurement for PPE and intangible assets are permitted in IAS 16 and IAS 38 respectively. Indian companies may of course prefer to continue with cost model with periodic revaluation. However, IAS 16 explains that in case of PPE with high volatility of fair value annual revaluation approach is to be adopted. There will be need for establishing range of volatility which can be treated as normal and 3-5 years revaluation phase can be adopted.

Purification of cost of PPE and intangible assets

A popular misconception in many quarters that Indian GAAP cost can be used as cost under IFRSs for the purpose of first time adoption if an entity adopts cost model of IAS 16 and IAS 38 needs to be removed. IFRS 1 demands that assets and liabilities for the first time adoption shall be measured applying principles enshrined in the IFRSs. Since Indian GAAP cost is impacted by minimum depreciation imposed by Schedule XIV to the Companies Act, and capitalisation of currency loss, Indian GAAP cost to IFRSs cost transition will not be without ‘cost purification’ carried out. Perhaps it will be easier to adopt ‘*fair value as deemed cost*’.

Reconciling depreciation charge of IFRSs with minimum depreciation

Minimum depreciation concept is part of prudential policy of capital maintenance. An entity can charge depreciation higher than the minimum depreciation specified in the Schedule XIV to the Companies Act but it provides the floor for depreciation charge. IFRSs require depreciation charge based on the depreciable amount, estimated residual value and useful life of the PPE. A reasonable compromise of maintaining the existing minimum depreciation policy in the IFRSs regime is creating *regulatory reserve*. IFRSs do not allow overcharging of expense but maintaining different components equity within retained earning is not prohibited.

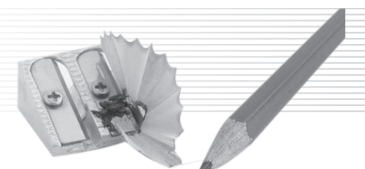
Intangible assets having indefinite life

IAS 38 classifies intangible assets with indefinite life for which amortisation charge is prohibited. Unrestricted broadcasting license, insurance license, etc. may fall within this category.

Amortisation policy

In accordance with IAS 38 amortisation policy is also linked

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to useful life of the intangible assets. Alignment of the tax allowance may be linked to accounting amortisation.

Deferred Taxation

IAS 12 Income Taxes is based on balance sheet liability method as compared to income statement approach adopted in AS 22. IFRSs adoption will require change in methodology of computing deferred tax asset or liability. Most importantly, IAS 12 requires computation of deferred tax liability/ asset on revaluation gain/loss. It is based on the concept that the fair value gain / loss on PPE or intangible asset will be recovered through future economic benefits.

Fair value and Minimum Alternate Tax

Under IAS 39 unrealised fair value gain /loss of financial assets and liabilities are recognised for the measurement of profit or loss. Electing fair value option for investment property under IAS 40, fair value gain/loss is recognised in profit or loss. Similarly, fair value gain /loss of non-current assets held for sale and discontinued operations is recognised in profit or loss in accordance with IFRS 5. Impact of fair value/gain or loss is expected to affect the *book profit* significantly. Presently, only fair loss of investments is recognised in profit or loss. Tax law should take cognizance of this affect and appropriately modify the definition of *book profit*.

Loan loss provision and impairment of financial assets

As per prudential provisioning norms expected *loss* on financial assets are provided for banks and other financial institutions. This may be found in excess or deficit of the impairment loss determined in accordance with IAS 39(referred to as incurred loss model). As per IAS 39, losses are recognised only when they are incurred. Impairment loss is charged on the basis of objective evidence of impairment based on past events. Consequently, creation of general provision for future losses on portfolios (losses that have not yet been incurred) is not permitted. Indeed, a loss event must have a reliably measurable effect on the present value of estimated future cash flows and be supported by observable data.

Conflict of loan loss provision and impairment testing has been highlighted by various authors, for example Russell Krueger (2002)⁷ pointed out inconsistencies between financial soundness indicators based provisioning and IAS 39 impairment testing. The Joint Paper of the IASB and the FASB⁸ has explained the incurred loss model followed for impairment

7. *International Standards for Impairment and Provisions and their Implications for Financial Soundness Indicators (FSIs)*, Russell Krueger, July 2002, www.imf.org.

8. *Document of IASB –FASB Meeting on March 2009 on Loan Loss Provisioning – Analysis of Alternatives*, www.iasb.org.

analysis as compared to expected loss model. The paper has concluded that the expected loss model has an element of arbitrariness. It defers the effects of some events and accelerates the effects of others. In some situations, it would necessarily defer the effects of incurred losses. In some situations, the effects of changes in expected losses might be more significant in an expected loss model than in an incurred loss model.

For the purpose of IFRSs adoption, expected loss provision based on prudential norm can be made part of regulatory reserve. Of course, reported profit or loss remains unaffected by creation of regulatory reserve which is just transfer from one component of equity to another.

Recognition of intangible assets

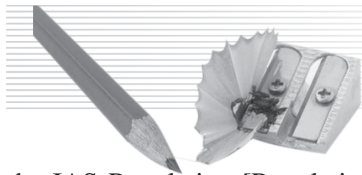
IFRS 3 *Business Combinations* describes different types of intangible assets namely, market related intangible assets, customer related intangible assets, technology related intangible assets, artistic related intangible assets and contract related intangible assets. However, IFRS 3 does not provide detailed guidance on the valuation approach. For example, if purchased brand is recognised there should be a valuation technique in place.

Of course, the countries which adopted IFRSs did not attempt to put in place the guidance on valuation techniques to be followed for various kinds of intangible assets [other than progress of developing valuation standards discussed in Section 4(17)]. Applying specific exemption of IFRS 1, an entity may apply IFRS 3 to business combinations occurred after the date of transition. But there may remain intangible assets, which arose out previous business combinations, but remained unrecognised. On the date of transition all assets and liabilities shall be recognised which should be recognised in accordance with IFRSs. This would require recognition of intangible assets which were not recognised as per Indian GAAP and derecognition of intangible (may be partial derecognition of goodwill) assets which shall not be recognised. Goodwill in acquisition represents the excess of consideration over the net assets which are not explained by identifiable intangible assets.

The issues discussed above are, of course, do not provide an exhaustive list of divergences to be taken care. Other important issues would include application of corridor approach under IAS 19, Customer Loyalty Programmes under IFRIC 13, Transfers of Assets from Owners under IFRIC 18, Service Concession Arrangements under IFRIC 12, Share Based Payments under IFRS 2 etc.

ORGANISATIONAL FRAMEWORK FOR IFRSs ADOPTION AND CONTINUATION WITH IFRSs

The European Union has set up IFRSs endorsement mechanism



the IAS Regulation [Regulation (EC) No. 1606/2002]. The endorsement process is explained through nine processes marked in Figure 2.

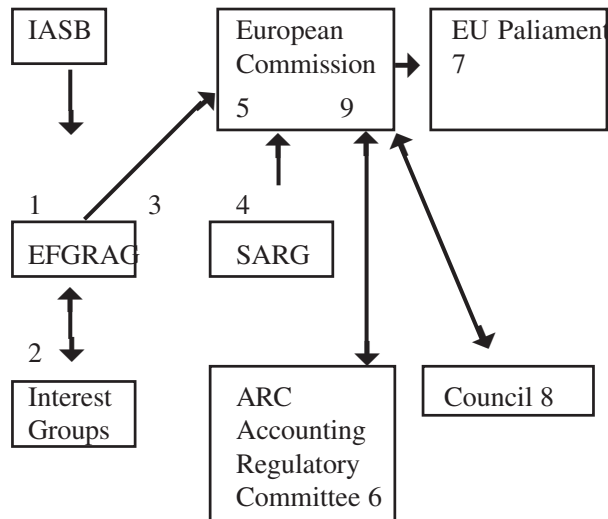


Figure 2 : IFRSs Endorsement Process

Notes :

1. The IASB (The International Accounting Standards Board) issues a standard.
2. The EFRAG (the European Financial Reporting Advisory Group) holds consultations with interest groups.
3. The EFRAG delivers its advice to the Commission whether the standard meets the criteria of endorsement. The criteria examined are set forth in Article 3(2) in the IAS Regulation (not contrary to the true and fair view principle set out in the 4th and 7th Company Law Directives 2, conducive to the European public good, understandability, relevance, reliability and comparability). EFRAG also prepares in cooperation with the Commission an effect study about the potential economic effects of the given standard's application in the EU.
4. The SARG (the Standards Advice Review Group) issues its opinion whether the EFRAG's endorsement advice is well-balanced and objective. The legal basis of this body and its opinion is Commission Decision No. 2006/505/EC.
5. Based on the advice of the EFRAG and the opinion of the SARG, the Commission prepares a draft endorsement Regulation. The adoption of the Regulation follows a regulatory comitology procedure with scrutiny, in accordance with Articles 5a and 8 of the Council Decision 1999/468.

Based on the favourable opinion of If the European Parliament and the Council or elapse of 3 months without opposition from their side, the Commission adopts the draft Regulation and publish in the Official Journal and enters into force on the day laid down in the Regulation itself.

6. ARC (Accounting Regulatory Committee), set up in accordance with Article 6 of the IAS Regulation votes on the Commission proposal. The qualified majority rule applies. If the vote is favourable (which is the case for the vast majority of the standards to be endorsed).
- 7 & 8. The European Parliament and the Council of the European Union have 3 months to oppose the adoption of the draft Regulation by the Commission.
9. The Commission adopts the draft Regulation and publish in the Official Journal and enters into force on the day laid down in the Regulation itself.

The entire endorsement process takes about 9 ½ months.

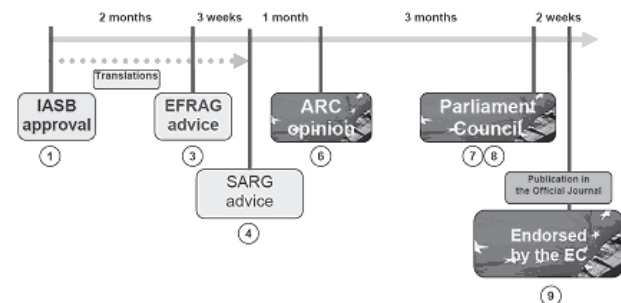


Figure 3 : Timeline for EU Endorsement Process of IFRSs

Source: *International Accounting Standards and Interpretations endorsement process in the EU.*

<http://ec.europa.eu>

It is to mention that other than the regulatory framework of financial reporting, Indian Parliament does not approve adoption of a standard. As regards regulatory framework, an Endorsement Process should be put in place that will facilitate change in the Framework necessitated by the change in the IFRSs such that the accounting system does not fall in loop of sometime compliant and sometime non-compliant.

The same Endorsement process can be followed (short of Parliamentary approval) for adoption of any IFRSs that does not conflict with the controlling law. The Government has to fit NACAS and the Accounting Standard of India within this Endorsement process. □