Introduction of IFRS- Issues and Challenges[1]

Dr Naresh Chandra, Principal, Birla College, Former Pro Vice Chancellor, Mumbai University, Dr Shyam Agrawal, eminent eye surgeon, Shri M. M. Chitale, veteran CA and Chairman NACAS, Shri U. Venkataraman, CEO- Currency Derivatives Segment & Whole Time Director, MCX-SX, Principal of PDL College of Commerce and Economics and my dear student Dr N. N. Pandey, Prof D. M. Kadhi, Convenor, other distinguished guests, ladies and gentlemen. I am delighted to be present here amongst you all on the occasion of the National Level Seminar on IFRS. Needless to say, it is a very topical area which has been engaging the attention of the standard setters, government authorities and regulatory bodies for quite some time. I shall share with you a few of my thoughts on the issue.

Reading Financial Statements

2. Let me begin by talking about the most elementary and fundamental area of commerce and accountancy which is “How to read a Financial Statement”. To a lay man, financial statements comprise the Balance Sheet and Profit and Loss Account. However, the numbers given in these alone do not give the correct picture to the reader unless one carefully goes through the notes to accounts, cash flow statements and qualifications, if any, in the Auditor’s Report and also appreciates the accounting policies followed by the enterprise. In some cases,

[1] Speech delivered by Dr. K C Chakrabarty, Deputy Governor, Reserve Bank of India at the inauguration of a national level seminar on IFRS- at Prahladrai Dalmia Lions College of Commerce & Economics, Mumbai on February 11, 2011

ratio analysis, trend analysis and an industry peer comparison can be done to obtain a better perspective. A thorough study of all these aspects is required before a user can make an informed decision.

3. The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions. Corporate financial statements with the notes and narratives surrounding them, are intended to enable investors to predict cash flows, determine returns generated on capital invested, assess the business liquidity, and evaluate management's performance. Financial statements are prepared by drawing an artificial line of cut-off at the year end, even though the business continues as a going concern. In many transactions, one leg of a transaction may be completed, while the other, leg may still have to take place. For instance, questions arise on several issues such as to whether unsold goods at the end of the accounting period can be valued at cost or realizable value and the applicable cost formula, alternative method for evaluating depreciated/amortized value of fixed assets, how to ascertain the value of a number of assets/liabilities, claims and counter-claims and the correct treatment of uncertainties involved in evaluating a particular transaction. Therefore, there is an imperative need for evolving appropriate accounting policies and accounting standards to deal with these questions.

Importance of Accounting Standards

4. Accounting as a "Language of Business" communicates the financial results and health of an enterprise to various interested parties by means of periodical

financial statements. Like any other language accounting should have its grammar and these sets of rules are Accounting Standards. The objective of Accounting Standards is three fold. Firstly, they help to standardize the diverse accounting policies and eliminate the incomparability of financial statements within an entity and across entities. Secondly, they facilitate the presentation of high quality, transparent and comparable information in financial statements. Thirdly, they reduce to accounting alternatives and thereby eliminate the element of subjectivity in financial statements.

5. India has a long tradition of framing accounting standards in the country. The Institute of Chartered Accountants of India (ICAI) set up under an act of Parliament had constituted an Accounting Standards Board (ASB) in April 1977 and the ASB has been framing the Indian Accounting Standards for the last three decades.

International Financial Reporting Standards

6. Globalization of financial markets has meant an increased focus on international standards in accounting and has intensified efforts towards a single set of high quality, globally acceptable set of accounting standards. Financial statements prepared in different countries according to different set of rules, mean numerous national sets of standards, each with its own set of interpretation about a similar transaction, making it difficult to compare, analyse and interpret financial statements across nations.

7. A financial reporting system supported by strong governance, high quality standards, and firm regulatory framework is the key to economic development. Indeed, sound financial reporting standards underline the trust that investors place in financial reporting information and thus play an important role in contributing to the economic development of a country. Needless to mention, internationally accepted accounting standards play a major role in this entire process.

8. It is in this context that the role of an independent, global standard-setting body such as the International Accounting Standards Board (IASB) is of critical importance. The principal objectives of the IASB are:

a. to develop a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRSs) through its standard-setting body, the IASB;

b. to promote the use and rigorous application of those standards;

c. to take account of the financial reporting needs of emerging economies and small and medium-sized entities (SMEs); and

d. to bring about convergence of national accounting standards and IFRSs to high quality solutions.

9. Converging to global accounting standards i.e. IFRS facilitates comparability between enterprises operating in different jurisdictions. Thus, global accounting standards would remove a frictional element to capital flows and lead to wider

and deeper investment in markets. Convergence with IFRS is also in the interest of the industry since compliance with them would be able to create greater confidence in the mind of investors and reduce the cost of raising foreign capital. It is also burdensome and costly for enterprises operating across several countries to comply with a multitude of national accounting standards and convert them to a single standard for group reporting purposes. Convergence would thus help reduce both the cost of capital and cost of compliance for industry.

10. In pursuit of its objectives, the IASB works in close cooperation with stakeholders around the world, including investors, national standard-setters, regulators, auditors, academics, and others who have an interest in the development of high-quality global standards. Progress toward this goal has been steady. All major economies have established time lines to converge with or adopt IFRSs in the near future and more than hundred countries require or permit the use of IFRSs.

11. Though Indian Accounting Standards are framed based on standards issued by the IASB, there are certain differences due to the legal and regulatory environment prevailing in the country, conceptual issues and the economic environment. In 2007 the ICAI decided that India should converge towards IFRS in a definite time frame in the wake of developments taking place in other major jurisdictions which had set up time schedules for migrating towards IFRS.

Lessons from the Financial Crisis - Review of standards for Financial Instruments

12. One of the most destabilizing elements of the global financial crisis has been the pro-cyclical amplification of financial shocks through the banking system, financial markets and the broader economy. The tendency of the market participants to behave in a pro-cyclical manner has been amplified through a variety of channels, including through accounting standards for both mark-to-market assets and held-to-maturity loans, margining practices and through the build up and release of leverage among the financial institutions, firms and consumers. Failure to capture major on-and off-balance sheet risks as well as derivative related exposures, was also a key destabilising factor.

13. The provisions of IAS 39-Financial Instruments-Recognition and Measurement issued by the International Accounting Standards Board (IASB), establishes the principles for recognizing and measuring financial assets and financial liabilities. This standard is of particular importance to the banking sector and NBFCs which deal primarily in financial instruments. IAS 39 includes provisions about classification of financial instruments, their ongoing measurement (including when impairment is required) and derecognition. The provisions of IAS 39 are currently applicable globally in respect of financial instruments.

14. Following the crisis, there was widespread criticism that the accounting standards, more so, fair value accounting significantly contributed to the financial

crisis or at the very least exacerbated the severity of the crisis, in view of its failure to deal with illiquid markets and distressed sales.

15. The G 20 Working Group on "Enhancing Sound Regulation and Strengthening Transparency" recommended that accounting standard setters should strengthen accounting recognition of loan loss provisions by considering alternative approaches for recognizing and measuring loan losses that incorporate a broader range of available credit information. The G 20 Working Group also recommended that the International Accounting Standards Board (IASB) should enhance its efforts to facilitate the global convergence towards a single set of high-quality accounting standards by sharing the experience of countries that have completed this process and by providing technical assistance. Another significant recommendation was that accounting standard setters should accelerate efforts to reduce the complexity of accounting standards for financial instruments and enhance presentation standards to allow the users of financial statements to better assess the uncertainty surrounding the valuation of financial instruments.

16. In April 2009, in response to the input received on its work responding to financial crisis, and following the conclusions of the G 20 leaders and the recommendations of international bodies such as the Financial Stability Board, the IASB announced an accelerated timetable for replacing the principal standard for recognition and measurement of financial instruments- IAS 39. IAS 39 is sought to be replaced by IFRS 9 in three phases. The first phase was completed with the issue of the portion of IFRS 9 which deals with the classification and

measurement of financial assets and financial liabilities. The second and third phases are in the area of Hedge Accounting and Impairment, where currently work is underway. It is expected that IFRS 9 will replace IAS 39 in its entirety by June 2011.

IFRS Convergence – Implementation in the Indian Context and Challenges

17. In the backdrop of the developments after the global financial crisis, the Ministry of Corporate Affairs (MCA), GOI set up a high-powered Core Group under the chairmanship of Secretary (MCA) to study the impact of IFRSs and to understand the preparedness of the Indian companies for converging with IFRSs. The Road map towards IFRS convergence for corporates from April 1, 2011 has been finalized by the Ministry of Corporate Affairs in January, 2010.

18. Convergence also entails maintaining consistency with legal and regulatory requirements prevalent in the country. Towards this end, amendments need to be made to existing laws and regulations, notably the Companies Act, 1956 provisions and schedules that detail the requirements of financial statements need to be harmonized with IFRS requirements and converged Indian Accounting Standards need to be notified under section 211 (3C) of the said Act. Additionally there are also issues relating to taxation under an IFRS converged environment.

19. There is also a need to improve awareness in general and build technical competence for the accounting and auditing profession on IFRS. The ICAI has already included a comparative study of Indian Accounting standards with

international standards in its syllabus for CA Final Advanced Accountancy and is also offering courses and seminars for its members to update them in the field. The RBI too has been holding periodical seminars and workshops to educate its staff on IFRS provisions.

Challenges for banks and non-banking financial companies

20. In respect of banks and NBFCs, in view of the special issues involved (finalisation of IFRS 9 expected in the middle of 2011), a separate road map was prepared in March 2010 for convergence with IFRS for the banking industry and NBFCs. The convergence process would be from period beginning April 1, 2013, with a phased approach for urban banks and NBFCs. This gives the banking system some time to adopt to the standards in a smooth and non-disruptive manner.

21. It has to be noted, however, that banks will be significantly affected by the IAS 39 replacement project and a number of other accounting developments including those relating to financial instruments, fair value measurement, financial statement presentation and consolidation. Some of the major changes pertain to certain critical areas such as classification and measurement of financial assets, classification and valuation of liabilities, impairment provisions and fair value measurement. One area of concern has been the drawback of the incurred loss model of IAS 39 and the need to introduce more forward looking provisioning.

22. The IFRS convergence process will involve significant challenges for the banking system in general. Banks would need to upgrade their infrastructure,

including IT and human resources, to face the complexities and challenges of IFRS. Some major technical issues arising for Indian banks during the convergence process would be differences between the IFRS and current regulatory guidelines on classification and measurement of financial assets, focus in the standard on the business model followed by banks and the challenges for management in this area, application of fair values for transactions where not much guidance is available in India in terms of market practices or benchmarks, and expected changes in impairment rules.

Key non-accounting issues

23. Let me now draw your attention towards certain key non-accounting issues which are equally crucial in the IFRS convergence process. The desired results will not come if non-accounting issues are not addressed along with the accounting issues. The first challenge is integrity of data and information. Most Scheduled Commercial Banks in India have either already migrated or are in the process of migrating to Core Banking Solutions (CBS). In this context, data integrity and data validity would be of critical importance especially due to data intensive requirements of IFRS converged standards. The present system of compilation and submission of data which forms the backbone of preparation of financial statements compromises on data quality. The scope of erroneous data entry of even malicious wrong reporting cannot be ruled out. Lack of adequate data results in absence of information on “returns” at activity level and segmental reporting in a granular manner. Incorporating suitable capability in CBS for enabling automated data flow/generation of MIS would be a facilitator in accurate

reporting and financial statements prepared from such data as the basis would reflect a "true and fair" picture of the financial position of the entity. RBI has set up a group to work on this area. Preparatory work in this regard would enable us to counter a basic challenge in our effort towards IFRS convergence.

24. Secondly, we come to the issue of "Ethical Standards" which are of critical importance in the field of accountancy where users rely heavily on the statements made by accounting professionals. Maintaining ethical standards and values is a key part of financial reporting. Without a strong code of ethics and adherence to those ethics, financial reporting would fail to inspire and ensure public and investor confidence in entities. Thus, along with high levels of technical competence, accounting professionals also need to have unquestionable and impeccable professional integrity. Therefore, professional bodies have codes of ethics for their members and disciplinary procedures for those who infringe upon these rules. However, one of the causes of the recent financial crisis was also the poor adherence to ethics by some accounting professionals who exploited "form over substance", rather than "substance over form" to hide weaknesses in their financial position and misstate profits.

25. Thirdly, adaptability and compatibility of existing IT solutions used by banks to the new requirements imposed by IFRS convergence is also a major challenge. Software which has been written keeping in mind Indian GAAP requirements may have to be modified substantially to incorporate features of IFRS requirements. Similarly, compatibility between software and hardware would have to be addressed to take care of the new requirement.

26. RBI has always believed in the fact that accounting standards and the integrity of its implementation has a very important role to play in the financial system as reflected in the Report of the Committee on Financial Sector Assessment, wherein the importance of the convergence process of Indian accounting standards with IFRSs has been emphasized. RBI has set up a Working Group to address Implementation Issues in IFRS for non-disruptive migration of the Indian banking system with members from ICAI, IBA and the regulatory and supervisory departments of RBI.

Conclusion

27. Training, education and skill development is one of the cornerstones of a successful IFRS implementation. All the stakeholders including investors, accountants, auditors, customers, software and hardware vendors, rating agencies, analysts, audit committees, actuaries, valuation experts and other specialists would need to develop and understanding of IFRS provisions to varying degrees and what they need to do. Educational institutions need to play a pro-active role and students must also strive to develop a strong conceptual understanding of the new framework and academic institutions should include it in their curriculum. It is not only the accounting issues but how we address the non-accounting issues that will determine how successfully we make a transition to IFRS. It is in this backdrop, and considering the ongoing changes in the standards both globally and in the Indian context as well as the amount of work involved in the convergence process, that this National Seminar on IFRS assumes importance. I wish the deliberations in this Seminar all success.