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A Convergence to IFRS Some significant Challanges with respect to Finance Sector

Abstract ::

IFRS is a set of accounting standard which is accepted world wide. The IASC issued IAS for the fulfillment the objectives is to harmonize accounting between various countries to conduct international business smoothly and raise finance in global market. Strengthening the financial sector and improving the banking sector and financial markets. A financial reporting systems supported by strong governance, high quality standards and firm regulatory framework is the necessity to adopt IFRS for the economic development of any bank and financial institution. The globalization, liberalization and privatization prompt more and more banks to open their doors to international investment and as business expand across borders the need arises to recognize the benefit to having commonly accepted and understood financial reporting standards. IFRS are the globally accepted accounting standards and interpretation adopted by IASB. The financial impact of convergence with IFRS will be significant for financial sector and banks in India particularly in areas relating to loan, loss provisioning ,financial instrument and derivative accounting.

An attempt has been made in this paper some significant challenges in adoption of IFRS in finance sectors, need for convergence emerging issue and Indian financial sectors.

Introduction ::

The primary objective of accounting is to provide information to the decision makers. Financial accounting provides such information about the financial resources ,obligations and activities of an enterprise that is intended for use primarily by external users/ decision makers –investors and creditors . External users of accounting information are individuals and enterprises that have financial interest in the reporting organization, but have no involvement in day- to- day operations. The accounting profession has identified certain objectives of external financial reporting to help it to refine and improve the reporting of information to external decision makers. The main objectives of financial reporting are:

1. To provide information about the financial position, performance and changes in the financial position of an entity, that is useful to wide range of users in making quality decisions.
2. To assess the working results of an organization and the extent of steward function of accounting and management.
3. To provide useful information to the stakeholders for decision making.
4. To provide information for assessing the success of the management about utilization of resources in attaining organizational goals and objectives.

For the attainment of the above objectives, financial statements should have understandability, relevance, reliability ,and comparability.

According to Financial Accounting Standard Board (FASB) "Basic objective of financial reporting is to provide information to investors, both present and potential, and creditors and all other users to enable them to make investment, credit and similar decisions . The investors while making investment decisions consider the company's future earning power in order to estimate their future cash returns in dividends and capital appreciation .

With these objectives in view, they make a comparative study of different company's financial statements." The objectives of corporate financial reporting are fulfilled only when the companies

make proper disclosure in their financial and non financial statements. With rapid changes in the operating environment of business enterprises the legal, financial, economic and social obligations have undergone a tremendous change . Corporate financial reporting should enable the users to assess the impact of such environmental changes on the activities of the business and vice versa. The American Institute of Certified Public Accountants (AICPA) study group has recommended the following disclosures so that the corporate financial reports can fulfill their objectives:

1. Basic underlying assumptions.
2. Transactions and events , which are part of incomplete earnings cycle and current values when such values are different from historical values.
3. Changes in the values as reflected over a period of time.
4. Factors relating to the transactions of the enterprise having significant impact on the cash flows.
5. Supplementary quantitative information to disclose complexities by disclosure of ranges of precision, reliability and uncertainty.
6. Business forecasts, provided they enhance the reliability of users predictions."

Financial Reporting and Indian Accounting Standards:

The Institute of Chartered Accountants of India (ICAI) issued a framework for the preparation and presentation of financial statements in July 2000. Para 13 of this framework states that "Financial statements prepared under the framework may be able to satisfy the informational needs of most of the users but may be lacking in providing certain information for making prudent economic decisions." Financial reporting is based upon Indian Accounting Standards (IAS) . Indian Accounting Standards have been prepared in conformity with the provisions of the applicable laws, customs, usage, and business environment in India.

Need for Convergence to IFRS:

In the era of liberalization, Privatisation, and globalization financial reporting standards need a constant review to keep pace with the fast changing economic environment. In India financial reporting is in the stage of transition –where many changes are being introduced for convergence of international accounting standards. The Institute of Chartered Accountants of India has recently issued a concept paper on convergence with International Financial Reporting Standards (IFRS) to promote International Accounting Standard Board's (IASB) pronouncements in India with a view to facilitate global harmonization of accounting standards. IFRS are globally accepted accounting standards and interpretations adopted by IASB. Standards, which are a part of IFRS and issued by the board of International Accounting Standards Committee (IASC) before 2001are known as International Accounting Standard (IAS). In April 2001 the IASB adopted all IAS and developed them by renaming as IFRS. These IFRS refer to the new series of the pronouncements that the IASB is issuing, as distinct from the IAS series issued by its predecessor. IFRS comprise:

1. IFRS issued after 2001.
2. IAS issued before 2001.
3. Interpretations originated from the International Financial Reporting Interpretation Committee (IFRIC) issued after 2001,

Standing Interpretation Committee (SIC), issued before 2001. IFRS financial statements consist of (IAS 1-8) A balance sheet, income statement ,either a statement of change in equity or a "statement of recognized income or expense"(SORIE) ,a cash flow statement and notes including a summary of significant accounting policies. The objective behind IFRS is to make a common platform for better understanding of accounting, internationally ,synchronization of accounting standards across the globe is gaining importance day by day, as businesses are crossing their national boundaries .Its goal is to create comparable ,reliable and transparent financial statements that will facilitate greater cross border trading.

International accounting standards that focused on disclosure issues were not mandatory in India by the accounting and regulatory bodies until recently. The Kumar Mangalam Birla Report (2000) on corporate governance stressed the need for accounting standards in the areas of consolidation, segment reporting ,deferred tax accounting and related party transactions.

" The drive towards convergence of financial reporting standards is a logical one, born and driven in large part in response to the demands and the realities of the marketplace . Global market place will only continue demand high quality financial information as investors seek out new opportunities and companies and markets seek to reach new investors and pools of capital. The challenge in a global market is reducing the costs associated with the access to and comparability of, information that has historically been constrained by different accounting standards , legal and cultural traditions and regulatory regimes. To achieve this, a common accounting language is needed that can be translated and understood globally." This, in turn, requires convergence with IFRS.

ICAI has announced convergence of IFRS by 2011, which is not far away, since business organizations and accounting practitioners would need to start preparing themselves right now to adopt this change.

Transaction IFRS conversion methodology involves 3 steps in which in phase 1, preliminary study of project management, risk management, change control, stake holder management, communication, team building, skills and knowledge transfer, changing the number, changing the business and managing the change would be necessary. In second step, project setup and launch, evaluation of financial statement, components and operational analysis and initial accounts conversion would be required. And lastly, third step would be embedding the change.

Indian Financial Sector: Emerging Issues:

There has been a tectonic change in some components of the financial sector in the last decade or so. The capital market has seen phenomenal changes in technology, regulations, institutions and instruments. The banking sector has also witnessed important changes in terms of regulations and instruments. Growth of service sector financing of the non-corporate sector, concentric circle of banking institutions and integrating financial markets have posed new challenges before Indian financial sector. Perhaps, the greatest challenge that the banking sector will have to face is the one that emanates from foreign shores. With increased global interest in India, the number of foreign players eyeing the huge Indian market can only grow. It is well known fact that foreign banks have been exploring "good buys" in the banking sector for some time now. The hitch in their game plan has been the regularity issues which effectively debar them from such activities. Keeping in view Indian experience and recent global developments, following issues are important:

1. Extensive use of derivatives/arguably globalization has helped to bring down inflationary pressure.
2. Link between open capital account and growth performance is not confirmed.
3. Increasing importance of harmonized and coordinated response of public policies.
4. Regulation and supervision over banks. (off balance sheet and liquidity requirements of banks may warrant a closer examination in regard to banks)
5. Relative to trade in goods, externalities are more prevalent in regard to financial , especially the banking sector.
6. Simultaneous challenges from several angles to conduct the monetary policy emanating from recent financial turbulence.
7. Cross border linkages in the financial flows."

With the Reserve Bank of India (RBI) outlining a road map on foreign investment in banks throughout India, the stage is set for a full-fledged presence of foreign players in the Indian banking market, post April 2009. With the entry of foreign players with their huge resources , "size" is bound to be of great importance .Large scale consolidation in the banking sector will be required to face them on a more or less equal footing. Over time, traditional barriers between banking insurance and other financial sectors may disappear as it happened in the US, resulting in the formation of large financial conglomerates

IFRS and Indian Banking Sector:

Convergence to IFRS is likely to pose significant challenge before Indian Banks. A remarkable and important element of smooth transition into IFRS is the convergence of RBI guidelines with the principles laid down in IFRS. The successful adoption of IFRS is based on flexibility and acceptability of

IFRS by RBI. Indian banks will have to soon adjust to accounting changes that are enforced by IFRS. A few areas of impact of convergence to IFRS are:

1. Loan / investment impairment.
2. Fair value
3. Derivatives and hedge accounting.
4. De-recognition of financial assets, and
5. Consolidation.

1. Impairment is assessed using discounting cash flows. Reversal of impairment losses is some times allowed. At present Indian banks consider RBI guidelines and provisions for loans and investments, which are very prescriptive and require limited use of judgement. However IFRS require a case- by- case assessment, for significant exposure of the facts and circumstances surrounding the recoverability and timing of future cash flows relating to the credit exposure. Where as for investments, fair value is an important consideration as an input in addition to the financial/ credit standing of the issuer

2. During the embedding stage of IFRS, IASB focused on assets and liabilities as the key element s of financial statements which is in contrast to the 'traditional' approach practiced on historical cost basis. This is because these conventional methods were gradually used by corporate to inappropriately smooth their profits by creating hidden reserves and excessive provisions. In order to curtail such impairments, standard setters were encouraged to adopt assets/ liabilities approach and measure their items on 'fair value' basis. Such an approach is also important as fair values of balance sheet to that of other are determined as the components of company's performance. However, experts as well as IASB itself before adopting fair value approach have recommended for its explicit test against the four attributes namely understandability, relevance, reliability and comparability. Under IFRS a significant percentage of the balance sheet would have to be fair valued compared to the current practice of carrying it at historical cost/ lower than the cost of fair value. Accordingly, fair value methodologies and practices would need to be re-examined to ensure that they are current , up to date and are validated and back tested in current market conditions.

3. Application of hedge accounting would bring down reducing income statement volatility. However, this will entail onerous and stringent documentation requirements, mandatory effectiveness tests and determination of fair value based on observable inputs. This will also call for a much-heightened awareness of rules for hedge relationships and certain processes and system changes.

4. Under IFRS, de- recognition of financial assets is a complex, multi layered area that follows the principle of transfer of risk and rewards .In the Indian context , this will impact mainly the securitization activity. Securitization transactions, where credit collaterals are provided or guarantee is provided to cover credit losses in excess of the losses inherent in the portfolio of assets securitized – may not meet the de-recognition principles enunciated in IAS 39 . This will result in failure of recognition test under IFRS and will lead to collapse of securitization vehicles into the transferor's balance sheets. Banks will have to assess the impact and consider the potential impact on capital adequacy and ratios such as return on assets.

Under IFRS, consolidation is not driven purely by the owner ship structure of any entity to obtain economic benefit. IFRS provides more rigorous consolidation test and in practice can result in the consolidation of a larger number of entities as compared to Indian GAAP Indian banks will need to perform consolidation assessments as early as possible, particularly for non-share holding related factors that impact consolidation. Banks will need to review the effect in various impact areas. A number of significant changes are likely to be made to Indian GAAP with respect to , for example business combinations, income tax, and financial statement presentation.

Conclusion :

In the age of liberalization, privatization and globalization accounting professionals and economic decision makers are realizing the fact that day-by-day reporting requirements, the information needs of the clients and regulatory bodies are changing very quickly. This has compelled them to go beyond

the old accounting practices and reporting procedures. Globalization has laid down a way for all the countries to adopt a single set of accounting standards. More than 100 countries (including India) have converged or recognized the policy of convergence with the IFRS. IFRS are the globally accepted accounting standards and interpretations adopted by the IASB. India has decided to adopt the IFRS by April 2001.Therefore the knowledge of IFRS and their impact on financial sector specially in banking sector should be assessed very carefully. In Indian banking sector loan / investment impairment, fair value, derivatives and hedge-accounting, de-recognition of financial assets and consolidation are a few areas of impact .A remarkable and important element elements of smooth transition into IFRS is the convergence of RBI guidelines with the principles laid down in IFRS.

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