

INTERNATIONAL FINANCIAL REPORTING STANDARDS : AN OVERVIEW

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Abstract

The application of IAS reflects combined effects of features of the financial reporting system, including standards, their interpretation, enforcement, and litigation. The firms applying IAS from various countries generally evidence less earnings management, more timely loss recognition, and more value relevance of accounting amounts than do matched sample firms applying non-U.S. domestic standards. Differences in accounting quality between the two groups of firms in the period before the IAS firms adopt IAS do not account for the post adoption differences. Firms applying IAS generally evidence an improvement in accounting quality between the pre- and post adoption periods. The study focused on the adoption process of International Financial Reporting Standards (IFRS) on a developing economy, with particular reference to India. The paper is based on the data obtained from literature survey and archival sources in the context of the globalization of International Financial Reporting and the adoption of International Financial Reporting Standards (IFRS).

Keywords: IASs, IFRS, IASB, IASC, SIC, Performance, Adoption, Compliance.

Introduction

IFRSs refers to the new numbered series of pronouncements that the International Accounting Standards Board (IASB) is issuing, as distinct from the International Accounting Standards (IASs) series issued by its predecessor International Accounting Standards Committee (IASC) from 1973 to 2000. More broadly, IFRSs refers to the entire body of IASB pronouncements, including standards and interpretations approved by the IASB and IASs and SIC interpretations approved by the predecessor IASC. Financial statements may not be described as complying with IFRSs unless they comply with all of the requirements of each applicable standard and each applicable interpretation. Objectives of the IASB is to bring about convergence of national accounting standards, IASs and IFRSs to high quality solutions.

Scope of IFRSs

- IFRSs apply to the general purpose financial statements and other financial reporting by profit-oriented entities-those engaged in commercial, industrial, financial, and similar activities, regardless of their legal form.

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- Entities other than profit-oriented business entities may also find IFRSs appropriate.
- General purpose financial statements are intended to meet the common needs of shareholders, creditors, employees, and the public at large for information about an entity's financial position, performance, and cash flows.
- Other financial reporting includes information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improves users' ability to make efficient economic decisions.
- IFRS apply to individual company and consolidated financial statements.
- A complete set of financial statements includes a balance sheet, an income statement, a cash flow statement, a statement showing either all changes in equity or changes in equity other than those arising from investments by and distributions to owners, a summary of accounting policies, and explanatory notes.
- If an IFRS allows both a 'benchmark' and an 'allowed alternative' treatment, financial statements may be described as conforming to IFRS whichever treatment is followed.

So far IASB has issued 8 IFRS (see Table 1) in addition to 41 IASs (Table 2) issued by IASC.

Table 1
International Financial Reporting Standards

• IFRS 1 First-time Adoption of International Financial Reporting Standards
• IFRS 2 Share-based Payment
• IFRS 3 Business Combinations
• IFRS 4 Insurance Contracts
• IFRS 5 Non-current Assets Held for Sale and Discontinued Operations
• IFRS 6 Exploration for and Evaluation of Mineral Assets
• IFRS 7 Financial Instruments: Disclosures
• IFRS 8 Operating Segments

Table 2
International Accounting Standards

• IAS 1 Presentation of Financial Statements
• IAS 2 Inventories
• IAS 3 Consolidated Financial Statements Originally issued 1976, effective 1 Jan 1977. Superseded in 1989 by IAS 27 and IAS 28 .
• IAS 4 Depreciation Accounting Withdrawn in 1999, replaced by IAS 16, 22, and 38, all of which were issued or revised in 1998.
• IAS 5 Information to Be Disclosed in Financial Statements Originally issued October 1976, effective 1 January 1997. Superseded by IAS 1 in 1997
• IAS 6 Accounting Responses to Changing Prices Superseded by IAS 15 , which was withdrawn December 2003

• IAS 7 Cash Flow Statements
• IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
• IAS 9 Accounting for Research and Development Activities Superseded by IAS 38 effective 1.7.99
• IAS 10 Events After the Balance Sheet Date
• IAS 11 Construction Contracts
• IAS 12 Income Taxes
• IAS 13 Presentation of Current Assets and Current Liabilities Superseded by IAS 1.
• IAS 14 Segment Reporting
• IAS 15 Information Reflecting the Effects of Changing Prices Withdrawn December 2003
• IAS 16 Property, Plant and Equipment
• IAS 17 Leases
• IAS 18 Revenue
• IAS 19 Employee Benefits
• IAS 20 Accounting for Government Grants and Disclosure of Government Assistance
• IAS 21 The Effects of Changes in Foreign Exchange Rates
• IAS 22 Business Combinations Superseded by IFRS 3 effective 31 March 2004.
• IAS 23 Borrowing Costs
• IAS 24 Related Party Disclosures
• IAS 25 Accounting for Investments Superseded by IAS 39 and IAS 40 effective 2001.
• IAS 26 Accounting and Reporting by Retirement Benefit Plans
• IAS 27 Consolidated and Separate Financial Statements
• IAS 28 Investments in Associates
• IAS 29 Financial Reporting in Hyperinflationary Economies
• IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions Superseded by IFRS 7 effective 2007.
• IAS 31 Interests In Joint Ventures
• IAS 32 Financial Instruments: Presentation, Disclosure provisions superseded by IFRS 7 effective 2007.
• IAS 33 Earnings Per Share
• IAS 34 Interim Financial Reporting
• IAS 35 Discontinuing Operations Superseded by IFRS 5 effective 2005.
• IAS 36 Impairment of Assets
• IAS 37 Provisions, Contingent Liabilities and Contingent Assets
• IAS 38 Intangible Assets
• IAS 39 Financial Instruments: Recognition and Measurement
• IAS 40 Investment Property
• IAS 41 Agriculture

The Institute of Chartered Accountants of India (ICAI) has decided to fully converge with IFRSs issued by the IASB from the accounting periods commencing on or after 1st April, 2011. The IFRSs will be adopted for the listed entities and other public interest entities such as banks, insurance companies and large-sized entities whose net worth is an excess of Rs. 100 crores for companies with less than 1000 crore and more than Rs. 500 crore worth, the implementation is from 1st April 2013. All listed companies which have a net worth less than 500 crores is from 1st April 2014. The decision is an important milestone in achieving full convergence with IFRSs as India will join 102 countries which presently require or permit use of IFRSs in preparation of financial statements in their countries. By 2011, the number is expected to reach 150.

Benefits of adopting IFRS

- **Improved access to international capital markets and reduction in cost of capital**
Migration to IFRS will enable Indian entities to have improved access to international capital markets. It is accepted as a financial reporting framework for companies seeking admission to almost all of the world's bourses. 16 of top 20 stock exchanges of the world require or permit IFRS financial statements. SEC also permits foreign filers to file IFRS complied financial statements, without requiring the presentation of reconciliation statement. Other exchanges such as Luxembourg Stock Exchange, London Stock Exchange or Alternate Investment Market require companies to convert their financial statements to IFRS to meet with regulatory requirements or expectations of investment bankers or investors. Thus IFRS eliminates hurdles to cross border listings. Financial statements prepared under IFRS are more transparent and understandable to global investor community. Even in cases where listing on overseas exchanges is permitted using local (Indian) GAAP, international investors generally ascribe an additional risk premium if the underlying financial information is not prepared in accordance with international standards. Similarly, even companies listed only on the local exchanges in India would be able to better attract international investors and reduce risk premium, by presenting financial statements as per IFRS.

- **Benchmarking with Global Peers**

Adoption of IFRS, the new global reporting standards, would improve comparability, transparency and credibility of financial statements and in a globalized world, would lead to greater economic efficiencies," CII said in a release. IFRS would improve the comparability of financial information and financial performance among sectors, countries and companies. It would both improve and initiate new relationships with investors, customers and suppliers across the globe, since financial statements in accordance with IFRS cut across borders. With Indian companies becoming global in terms of their operation and investor base, IFRS will facilitate better comparison of Indian companies with global peers. Now that 110+ countries already require or permit the use of IFRS, countries like India, Japan, Sri Lanka, Canada and Korea have committed to adopt IFRS from 2011, IFRS has become a single globally accepted financial reporting system. It has thus made it easy to benchmark the financial statements with that of the global peers.

- **Avoidance of Multiple Reporting**

Adoption of IFRS will enable entities across the group residing in different countries to adopt single financial reporting platform. Currently these entities are required to prepare multiple set of financial statements for domestic reporting or regulatory purposes & external financial reporting for consolidation purposes, which involves additional cost and time. Thus group wise adoption of IFRS will eliminate the need for such multiple reporting. It will harmonize internal and external reporting by creating a single accounting language across the group. It will also result in improvement in quality of management information system resulting in effective management of business. Besides, with global adoption of IFRS, companies seeking to list their securities on global bourses are not required to convert their financial statements to meet the regulatory requirements of that country. Thus the cost associated with the multiple reporting can be saved.

- **Reflecting True Value of Acquisitions**

Under Indian GAAP, business combinations, generally, are accounted at carrying value of assets and liabilities taken over, popularly known as 'Pooling of Interest Method'. IFRS prohibits the pooling of interest method and all business combinations are accounted for using 'Purchase Method' only. Application of purchase method requires assets, liabilities and contingent liabilities acquired under business combination to be recognised at fair value. IFRS also places lots of emphasis on Purchase Price Allocation (PPA). It requires enhanced disclosures in financial statements which provide investors more meaningful information about the performance of the company and success of the acquisition. Thus financial statements prepared under IFRS reflect true value of acquisition and resultant goodwill / negative goodwill. In the current economic environment where companies follow inorganic growth strategies for rapid business growth, IFRS adoption will have significant impact on financial statements.

Challenges in adopting IFRS

- Regulatory endorsement and acceptance
- Shortage of skilled resources
- Huge cost of enhancement of IT systems
- Acceptance by tax authorities
- Managing market expectations
- Distribution of unrealized profits arising due to fair value regime Whole lot of business issues – Management reporting systems, employee benefit plan, employee and executive compensation, tax planning, performance indicators, investor relationship, financial accounting and reporting, mergers and acquisitions, etc.

Key Divergences

The key divergences between Indian GAAP and IFRS have arisen due to:

- Conceptual differences
- Legal and regulatory requirements
- Present economic conditions
- Level of preparedness

Special Purpose Entities (SPE) falling under the definition of 'control' as per IAS 27 on "Consolidated and Separate Financial Statements" shall be consolidated

- 'Potential Voting Rights' that are currently exercisable or convertible shall be considered to assess the existence of 'control'
- All business combinations shall be accounted as per purchase method at fair values
- Contingent liabilities, taken over in a business combination, shall be included in Net Assets, measured at fair value, if contingencies have since been resolved, a reliable estimate can be made and payment is probable
- Negative goodwill arising on business combinations/consolidation shall be accounted as income instead of capital reserve
- Goodwill shall not be amortised. It shall only be tested for impairment
- PP&E and Intangible assets shall be measured either at cost or at revalued amount. Periodical valuation of entire classes of assets is required when revaluation option is chosen
- Intangible assets can be revalued only when there is an active market for the same
- Depreciation on revalued portion cannot be recouped out of revaluation reserve
- Depreciation to be calculated based on useful life, which along with residual value and depreciation method shall be reviewed annually
- Intangible assets may have an indefinite life e.g. Trademarks, Goodwill, Franchise
- Investment property, i.e. land or building held to earn rentals or for capital appreciation, shall be measured either at cost or fair value.
- If fair value model is adopted, changes in fair value, measured annually, shall be recognized in the income statement
- No distinction shall be made between integral and non-integral foreign operations. All foreign operations to be consolidated using nonintegral Approach
- Exchange differences shall not be capitalized except to the extent of that allowed by IAS 23 Borrowing Costs
- Share Based Payments shall be measured at fair value
- Deferred tax shall be created on temporary difference instead of timing differences.
- Liability portion of compound financial instruments, such as convertible debentures, shall be separately accounted for.
- Financial assets and liabilities shall be classified and measured accordingly as per the requirements of IAS 39 Financial Instruments: Recognition and Measurement
- All derivative financial assets and liabilities including embedded derivatives shall be accounted for as on the balance sheet items.
- Derivatives classified as 'hedge' shall have to comply with various requirements of IAS 39 viz. documentation, hedge effectiveness testing and ineffectiveness measurement
- Derecognition of financial assets, as in the case of securitization, shall be based on risks and rewards, transfer of 'control' being a secondary test

- Provisions shall be created only to the extent they relate to a specified risk that can be measured reliably and for incurred losses. No provisions are permitted for future or expected losses i.e. general provisions
- Interest income / expense on financial assets and liabilities, such as loans, shall be recorded on an effective interest rate basis after considering associated income and expenses e.g. agency commission, loan processing fees, etc.
- Prior period errors shall be adjusted in the opening balances of assets, liabilities and equity of the earliest period presented i.e. the figures relating to prior years are restated

IFRS Convergence Process

- Identifying the dates and the first IFRS financial statements (date of transition, date of adoption and reporting date)
- Identifying the differences between existing accounting policies and IFRS
- Applying the 16 optional exemptions
- Applying 4 mandatory exceptions
- Preparing the opening balance sheet at the date of transition to IFRS
- Preparing the comparative financial statements for one year prior to the first year of adoption as per IFRS
- Preparing the financial statements for the first year of adoption as per IFRS
- Identify the areas where extensive disclosures will be required

Optional Exemptions

- Business combinations and scope of consolidation
Not to restate Business combinations before the date of transition
- Fair value or revaluation To deem the cost of PPE, Intangible Assets and Investment Property to be either fair value on the date of transition or revaluation done previously or carrying value as per respective IFRS
- Employee benefits to adopt corridor approach prospectively from the date of transition for actuarial gains and losses Cumulative translation differences To apply IAS 21 prospectively and reset cumulative balances to zero
- Comparatives for financial instruments Not applicable for India
- Designation of financial instruments Permits instruments to be classified as available for sale or fair value through profit or loss
- Share based payments
May choose to apply IFRS 2 if previously fair value was publicly disclosed
- Insurance Contracts Not to restate existing contracts
- Compound financial instruments Not to identify the two elements of the equity component if the liability component is no longer outstanding
- Assets and liabilities of subsidiaries, associates and joint ventures- different dates adoption The exemption allows subsidiary to measure its assets and liabilities either at carrying amounts included in the parents' consolidated financial statements or on the basis of IFRS 1
- Investments in subsidiaries, jointly controlled entities and associates A first time adopter can, in its separate financial statements, measure such investments at either cost as per IAS 27 or Fair Value on transition date or carrying value

- Leases Not to revisit all existing lease transactions
- Fair Value measurement of Financial Assets and Liabilities Day 1 gains / losses may be recognized Prospectively Decommissioning liabilities included in the cost of property, plant and equipment Adjustments for such liabilities may be made on the date of transition.
- Service Concession Arrangements Transitional provisions of IFRIC 12 may be applied
- Borrowing Costs Not applicable for India

Mandatory Exceptions

- Estimates
- De-recognition of financial assets and financial liabilities
- Hedge Accounting
- Non controlling interest

Conclusion

FICCI notes that the new Companies Bill is pending finalization, as is the Draft Tax Code. This would also impact the industry as it will have to grapple with so many issues simultaneously. "There is lack of alignment between companies law and IFRS. Also there seems to be some thinking on asking companies to prepare dual set of financial statements, one as per erstwhile Indian GAAP and another as per IFRS. This would lead to immense confusion and increase the hardship and cost for these companies. Moreover, adoption of IFRS requires a lot of preparatory work for companies in terms of comprehending, training and modification of software and IT systems". Says the FICCI. FICCI therefore suggests deferring the implementation date of 1st April, 2011 to a date when Indian companies are better equipped to be.

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