IFRS – Future of Accounting Profession

IFRS Basics -

- IFRS – stands for International Financial Reporting Standards
- With the globalization, there is great demand for adoption of International Best Practices in every function, product, process or activity.
- IFRS are thus International Best practices in the field of "Accounting and Financial Reporting"

IFRS AROUND THE WORLD

What change it will make ?

- It will drastically alter the way in which Accounting and Financial Reporting is currently done.
- It will impact the financial statements of all the companies.
- It will make your existing Accounting Knowledge - redundant !!!

What is the importance of financial statements ?

- Financial statements are very important as they are the basis for variety of decisions viz –
  - Purchase, hold or Sell of shares
  - Accountability of Management
  - Lending decisions
  - Ability to pay benefits to employees
  - Dividend decisions
  - Taxation Policies
  - Research, Policy decisions, Regulations etc.

Understanding financial statements -

- The analysis of financial statements is crucial for decision making.

- Let us take a case in Hand.
- Indian Company (ABC Co) in interested in purchasing US Co (XYZ Co)

Whether two companies are exactly same if US $ 1= Rs. 50 ?

ABC Co (Indian Origin)		XYZ Co (US Origin)	
	Amount in ₹		Amount US $
Share Capital	1,00,000	Share Capital	2,000
Loans	50,000	Loans	1,000
TOTAL	1,50,000	TOTAL	3,000
Fixed Assets	25,000	Fixed Assets	500
Current Assets (Nett)	1,25,000	Current Assets (Nett)	2,500
TOTAL	1,50,000	TOTAL	3,000

The answer is definitely NO, But Question is WHY ???

- Items included in the financial statements are called as "Elements of Financial Statements"
- And companies are not same because of three main reasons ?
- These elements may have been ***"Recognized"***, ***"Measured"*** and ***"Presented"*** in different manner by two companies.

Elements of financial statements -

- Elements of financial statement are – Income, Expense, Asset, Liability and Equity.
  - Recognition = When to include an element in the financial statement ?
  - Measurement = At what amount it is to be included in the financial statement ?
  - Presentation = How it should be presented in the financial statements ?

What is exactly "Recognition" -

Who can be recognized as an Asset in the Balance Sheet ?

We need to apply certain principles before we take the decision –

- Control over the asset ?
- Separately identifiable ?
- Cost can be ascertained ?

What is “measurement” ?

- Company constructed the Factory for which it made following expenses –
  - Material Rs. 10,00,000
  - Labour Rs. 5,00,000
  - Interest on borrowed capital Rs. 50,000
  - Allocated Head Office Cost Rs. 35,000
  - Labour relocation expenses Rs. 20,000
  - Opening ceremony cost Rs. 5,000
  - Initial losses due to low utilisation Rs. 15,000

What is “Presentation”-

- Presentation is disclosure in the financial statement.
- It need to be “faithful presentation”
- E.g. can be disclosure of contingent liabilities, Current vs Non Current Portion of Assets and Liabilities

Reasons for different basis -

- If we already know this, then why do companies use different basis for Recognition, Measurement and Presentation ?
- Because they come from different origin countries which makes their own Accounting Standards (AS) binding on them, and no two AS from different countries are suggesting same basis !

What problems it lead to ?

- No comparability between companies from same industry but from different countries.
- Less transparency in International decisions as we need to convert the financial statements into comparables.
- Manifold Duplication of work for Co raising finance through international markets – waste of time, money and energy.
- Same company for same year but having two financial statements & showing different Profit or Loss !!

Emergence of IFRS -

- IFRS which stands for International Financial Reporting Standards has emerged because of problems explained earlier.
- IFRS is a single set of high quality, understandable and globally enforceable accounting standards
- IFRS has emerged as the common business language of accounting worldover.

What IFRS is all about ?

- IFRS is basically all about –
- Substance over Legal Form
- Fair Value over Historical Cost
- Group Concept over Standalone

Substance over Legal Form -

Can it be compared with Iceberg ?

Substance over Legal Form ?

- ABC Ltd entered into Sale Agreement of its Land and Building with XYZ Ltd for Rs. 10 Crores on 01.04.2011 (wdv in the books Rs. 8 Crores)
- The terms of contract provide for option for ABC Ltd. at the end of 1st year for Rs. 11 Crores to purchase the Land and Building Back from XYZ Ltd.
- How transaction shall be recorded in the books of ABC Ltd ?

Preference Shares – Is it Debt ?

- IFRS recognizes it as Debt, since –
  - There exists an obligation on the issuer to deliver cash or other financial asset to the holder
  - To redeem the holder on a fixed or determinable future date

- So, Preference Share is treated as Debt

Historical cost vs Fair Value -

- In historical cost accounting –
  - Changing prices in the economy are not reflected as costs are outdated and make Balance Sheet (SOFP) irrelevant.
  - Lenders do not get latest values in which they are more interested rather than its acquisition cost.
  - Depreciation costs and cost of sales are understated
  - Inter co comparison is not possible as under – overstating of assets & liabilities lead to incorrect ratios

Who issues IFRS ?

- IFRS is issued by IFRS Foundation, not for profit private sector organization having main office at UK.
- Members of IASB Board involve representatives from different countries, incl India “Prabhakar Kalavacherla”
- ICAI issued concept paper on IFRS, MCA issued IND – AS (converged version of Indian IFRS). Revised Schedule VI captures some aspects of IFRS

- Whether it means current Indian Accounting Standards are inferior in quality and hence convergence with IFRS is being done since it is more Qualitative ?

Answer -

- Definitely NOT !!
- But as IFRS are being adopted / converged by almost 120 countries, it has become a common business language all over the world !

IFRS Impact – Small Trailer

Indian GAAP	IFRS
Fixed Assets	PPE (operating FA) Assets held for sale Investment Property (further aspects – component accounting, No depreciation rates, Major Overhaul as separate component)
Loans	Financial Instruments – At Amortized Cost
Employee Benefits	Disclosure of Asset, Liability and Actuarial gains and losses
Consolidation	Fair Value Approach, No capital reserve, Goodwill only tested for impairment
Intangible Assets	Research – expenses, Development "PIRATE"
Measurement	Present Value and un winding of cost

Property Plant & Equipment -

- Split entire Asset into components having cost significant in relation to total cost and having different useful economic life.
- Eg. Engine of Airplane and other parts are components.
- Depreciate it separately

Compound Financial Instruments (CFI) -

- CFI are those which contains debt element as well as equity element. Eg. – Convertible Bonds / Debenture
- ABC Co issued 5,000 convertible Bond with Face Value of Rs. 100. interest Rate is 5%. Debenture Holders have option of converting debentures into shares at the end of 4 years. Prevailing market rate for similar debt without conversion option is 7%. How to account for such transaction ?

Compound Financial Instrument-

Proceeds of Issue – Carrying amount of Liability = Carrying amount of Equity		
Proceeds of Issue	**A**	500,000
PV of Principle at the end of 4^{th} Year = 500,000 * 0.763 (PVF @ 7%)		381,500
PV of Interest 25,000 * 3.387 (AF @ 7%)		84,675
DEBT COMPONENT	**B**	466,175
So, Equity component	**A - B**	33,825

Effective Interest Method -

- Interest income to be recognised on the basis of effective interest method.
- On 1st January 2009 ABC Co purchased a Bond worth Rs. 5,000 from REC with an interest rate of 5% p.a. it will be redeemed on 31st December 2011 for Rs. 5,830. The effective interest rate is 10%
- How much interest income will be considered each year ?

Effective interest Method

Year	Opening Amortised cost	Int @ effective rate	Contractual Interest	Closing Amortised cost
2009	5,000	500	(250)	5,250
2010	5,250	525	(250)	5,525
2011	5,525	555	(250)	5,830

Simple Financial Instruments – Bank Loan

- Bank Loan – current practice vs. Amortised Cost Method
- XYZ obtained Machinery Term Loan of Rs. 10 Crores, paid Processing Fees Rs. 5 Lacs, Interest rate 12.50% but effective interest rate is 13.50%
- Reconciliation for Bank Loan ?? (we are well aware of Reco for Bank A/c but Reco for Bank Loan ??)
- What will happen when Base rate is changed by bank every now and then ?

New transactions in Indian markets -

- ESOP’s is well settled transaction
- But cash settled share based payment i.e. CA or consultant or Advocate for rendering professional services accepted consideration in equity options to be settled in Cash
- Accounting for such transactions.
- SBP to be recognized in SOCI over the vesting period

Valuation under IFRS -

- Business combinations (IFRS 3)
- NCA held for sale (IFRS 5)
- Investment Property (IAS 40)
- PPE – Revaluation Method (IAS 16)
- Impairment of Assets (IAS 36)
- Intangible Assets (IAS 38)

IFRS in India -

- India has decided to “converge” with IFRS rather than adopting it as it is !
- It is definitely in the interest of Indian Economy and a conscious decision is made by us !
- MCA has stated that converged IFRS (IND AS) will be implemented in phased manner in India. RBI & IRDA too has consented to it and are making similar efforts.

IFRS and Financial Statements -

- So, what we will be presenting in IFRS ?
- Same things which we report now – Income, Expense, Asset, Liability and Equity.
- Then what is the change ?
- The change is in its <u>RECOGNITION</u>, <u>MEASUREMENT</u> & <u>PRESENTATION</u>

Components of Financial Statement -

Components of Financial Statements					
SOCI	OCI	SOFP	SOCIE	Cash Flow Stat	Notes to Accounts
Profit & Loss A/c	Non realized Gains & Losses	Balance Sheet	Stat of changes in Equity	Cash Flow	Notes
Revenue Expense Profit / Loss	Gain / loss on revaluation	Asset Liability Equity	Increase or decrease of share capital, Dividend payments	Cash Inflow & Outflow	Accounting Policies disclosures

Elements of financial statements -

- Asset – it is a resource controlled by an entity arising as a result of past event which brings the future economic benefits to the entity.
- Liability – It is a present obligation arising as a result of past event the settlement of which will result in outflow of resources from the entity embodying economic benefits.

Elements of financial statements -

- Equity – residual interest in the entity or excess of assets over liabilities.
- Income -<u>Increases in economic benefits</u> during the accounting period in the form of inflows or Enhancement of assets or decrease of liabilities that result in increase of equity, other than contributions from equity participants

Elements of financial statements -

- Expenses - Decreases in economic benefits during the accounting period in the form of outflows or Depletion of assets or increase of liabilities that result in decrease of equity, other than distributions to equity participants

Qualitative characteristics of financial statements IFRS will achieve-

- Understandability
- Relevance
- Reliability
- Comparability

Measurement basis under IFRS-

- Historical cost
- Fair Value (recent change in definition)
- Present Value (discounting and un-widing of interest)
- Net Realizable Value

What is the coverage of IFRS ?

- It includes –
  - IAS – International Accounting Standards (issued by earlier IASC)
  - IFRS – issued by IASB
  - SIC & IFRIC – International Financial Reporting Standards Interpretations

IFRS List -

- IFRS gives guidance on elements to be included in financial statements. (e.g. IAS 16 – PPE)
- It also provides guidance for various transactions. (IFRS 2 – share based payment)
- It gives Industry wise guidance as well. (IAS 11– Construction contracts)

If IFRS is good, then why we are deferring its implementation ?

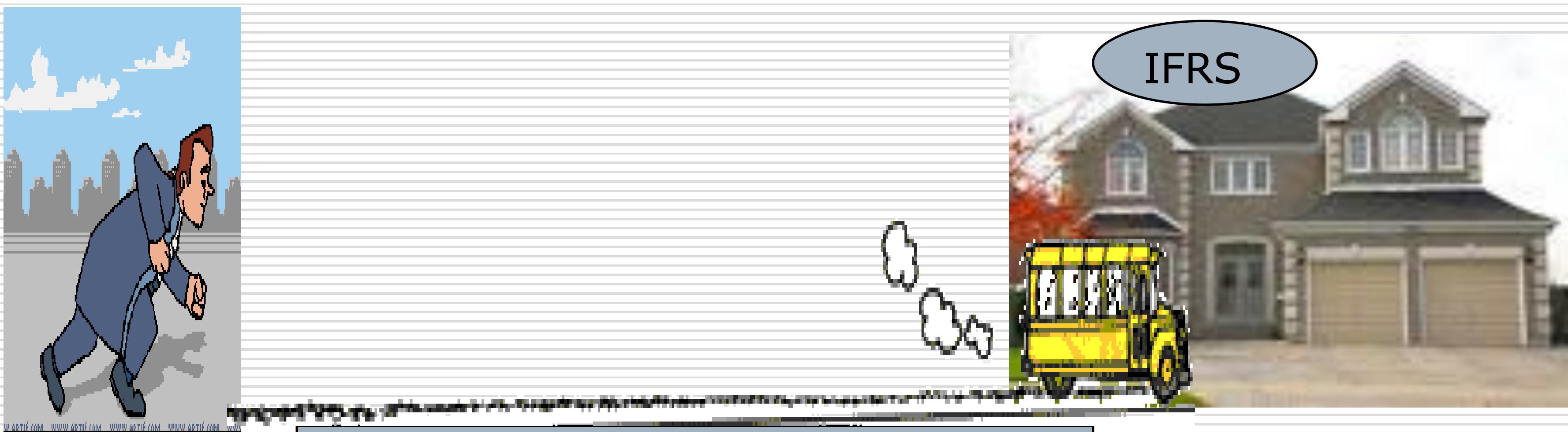
- Need to change existing systems, MIS, accounting methods
- Need to change Laws – Co Act, Income Tax, SEBI, RBI, IRDA etc
- Need for knowledgeable Professionals
- Actions on International Front mainly in US
- Need for “Change in Mindset”

Roadmap of IFRS in India -

- MCA issued IND – AS (converged Indian IFRS) in Feb 2011
- But deffered its implementation
- However changes have been made to Schedule VI in which companies present their accounts
- Schedule VI is applicable from 01.04.2011

Concluding remarks -

- Now, it is up to us whether we want to miss the bus or catch it and make use of this opportunity and succeed !!



Way to IFRS .... !


THANK
YOU

Questions & Answers