

EFFECT OF IFRS IN INDIAN BANKING SECTOR

Dr. Atul Bansal, Principal

C.Z. Patel College of Business and Management,
4th Floor, SICART Building, Mota Bazar,
Near V.P. Science College,
Vallabh Vidyanagar, Anand (Gujarat)

Abstract

While regulators, standard setters and law makers sit together to rollout the road map for implementation of International Financial Reporting Standards (IFRS) in India, a wide section of the industry is already debating the impact and the implementation challenges of transitioning into IFRS.

A remarkable and important element of smooth transition into IFRS is the convergence of RBI guidelines with the principles laid down in IFRS. This paper explores the adoption of International Financial Reporting Standards (IFRS) and understanding the impending changes in accounting standards and their impact on valuation of assets specially loan loss provisions and Need to create the enabling environment in individual banks. In other words, the successful adoption of IFRS is based on flexibility and acceptability of IFRS by RBI. Banks will have to soon adjust to accounting changes that are enforced by IFRS.

Key-words: IFRS, Fair-Value, Cost Model, Revaluation Model,

CONVERGENCE TO IFRS- ISSUES FOR BANKING SECTOR

Institute of Chartered Accountants of India announced that with effect from April 1, 2011 all listed and public sector entities should converge their reporting systems with IFRS. Because of this requirement Banks should start working on this right now. Major areas likely to be impacted because of this convergence are

- Business combinations
- up accounts
- Fixe Financial instruments
- Good assets and investments in property
- Presentation of financial statements
- Share based payments

Experts feel that because of the convergence which is aimed for a uniform method of reporting globally, method of calculating certain financial ratios will undergo change, profitability will be affected. Banks are hence required to study their risk management systems and other procedures to face

the impending challenges. In the case of our banking the significant impact will be related to

1. Financial instruments and derivative accounting

In the case of financial instrument accounting the major difference between Indian GAAP and IFRS pertain to investments, convertible debt and preference shares and derivative instruments. While under Indian GAAP, investments are treated differently based on their classification into held to maturity, available for sale and available for trade, they are all mostly required to be treated under IFRS as available for sale and should be carried at fair value. This fair value is an exit price which is an estimate of its future value depending upon market interactions and hence needing expert's opinion.

Convertible debt is required to be apportioned into equity and financial liability. This bifurcation involves another problem related to the accounting treatment of income from such an investment. The non convertible portion is required to be booked using the fair value concept discussed above and equity portion taken directly to equity. This is in contrast with the present system where the entire amount is treated as debt.

Redeemable preference share is required to be treated as a financial liability and dividend is treated as an interest expense. This naturally will impact the P& L account.

In case of derivative instruments, the problem is more serious as all such instruments are required to be recognized at fair value on the balance sheet. Banks will have to consider such transactions of their clients and their impact. Further with all such derivatives to be booked at fair value will have considerable impact on banks' balance sheets and also their Capital adequacy ratio?

2. Loan loss provisioning

With respect to loan loss provisions, the implications will be heavier. Under fair value method of accounting, impact of anticipated loan losses are to be significantly brought to the balance sheet using their prudence to ascertain the risk associated with each loan and provide for where default is

anticipated. While there is no judgmental action is needed under present conditions, with the implementation of IFRS, banks will be required to judge and anticipate the loan delinquencies and provide for losses.

3. Accounting for fee income and also accounting for ESOP

Under current rules of Indian GAAP, ESOPs are recognized using either intrinsic value method or fair value method. Under IFRS this choice will not be available and such options are required to be valued at fair value method using some option pricing formula. This would usually result in recognition of compensation cost even if the options are “in the money” on the day of granting them. Further after 1.4.2011, companies have to account for the compensation costs of already issued options.

Banks have to initiate action by themselves on the following aspects if not already done while RBI and GOI have to give needed guidelines and road map for a smooth and successful transition.

- Form a core group for the identifying key areas of impact
- Discuss the issues at all the different levels in the bank
- Impart necessary training
- Rework on the risk management practices, systems and procedures and train the concerned staff on the new methods
- Educate all the stakeholders regarding the impact and bank's position in the market

Accounting Adoptability Challenges in Banking Sector:

Experts are of the opinion that there would be a major impact on the profitability and the way in which business management is looked at by various stakeholders due to the convergence to IFRS. The changes anticipated will affect the banks on several important aspects of their working since major credit dispensation and pricing decisions are based on the financial statements. Major challenges before the Banking sector for adoption of IFRS are as under :

1. Financial Instruments Accounting:

Financial instruments where Indian GAAP differs significantly from IFRS include financial assets such as investments, financial liabilities such as convertible debt and preference shares and derivative instruments. As per the present practices being followed under the Indian GAAP, long-term investments are generally carried 'at cost' less

impairment. Current Investments are carried at 'lower of cost' or 'market value'. IFRS requires that investments be categorized into three categories:

- ❖ Trading or Investment carried at fair value.
- ❖ Held to Maturity and
- ❖ Available for Sale. Except for Held-to-Maturity investments (where the entity has the intent and ability to hold the investment till maturity), all investments should be carried at fair value.

For investments categorized as trading, all unrealized gains and losses are to be recorded in the income statement. For investments classified as available – for – sale, the unrealized gains and losses should be generally recorded directly as an adjustment to shareholders funds. Held-to-Maturity investments are to be carried at amortized cost. On adoption of IFRS, most investment securities held by public interest entities would be categorized as available-for-sale and accordingly would be carried at “fair value”. “Fair Value” concept is “an estimate of the price, an entity would have realized if it had sold an asset or paid if it had been relieved of a liability on the reporting date in an arm's-length exchange motivated by normal business considerations.” That is, it is an estimate of an exit price determined by market interactions. This would affect the reported value of the investment portfolio and net worth. The application of the fair value principles would require and entity's management to use considerable judgment in making estimates about the future, and the role of valuation experts in the preparation of financial statements would increase significantly.

IFRS requires that a financial instrument should be classified in accordance with the substance of the contractual agreement rather than its legal form (substance over form). Thus, redeemable preference share would be a financial liability and dividends on redeemable preference shares would be recognized as an interest expense under IFRS which would then impact the profits and loss for the year. But under the Indian GAAP, redeemable preference shares are classified as equity and the related presentation of dividends on such preference shares as appropriation of profits. This would impact financial structures and debt-equity ratios.

Similarly under IFRS, convertible debt is split into a liability and equity portion whereby the proceeds from the insurance of the debt are allocated to the two components as stated above. The liability

components is recognized at fair value by discounting at a market rate for non-convertible debt, while the balance proceeds are allocated to the equity component and recorded directly in equity. This results in recognizing effective interest expense using rates applicable to non-convertible debt. Presently, there is no specific accounting guidance for convertible debt. The interest expense is generally recognized based on the stated rate of interest. Thus, if the stated rate of interest is lower than the market rate on convertible debt (due to the presence of the conversion feature), adoption of IFRS will result in additional interest expense based on this 'split-allocation' approach.

2. Loan / Investment Impairment:

IFRS prescribes an impairment model for case to case and assessment of information related to recoverability, and timing of future cash flows related to credit exposure. If the cash flows are not recovered on the contracts, the account will be classified as 'impaired' and impairment which will be calculated on present value basis, using effective interest rate as 'discount rate'. In case of group loans, impairment can be calculated on collective basis. The basis aim is to capture the loss incurred on a specific portfolio. Provisions are permissible, only to the extent that, they relate to specific risks which can be measured. For future losses, no provisions are permissible. In case of investments, analysis fair value is considered. The basic focus of impairment calculation is that all the facts and circumstances are taken into consideration. There is a huge gap from Indian GAAP for banks in India. Indian GAAP generally required a limited use of judgment and is mechanistic in nature with prescribed provisioning rates.

The primary focus of banks is on strengthening and developing a data capture system regarding the impairment of assets to meet the challenge. The second focus is on the usage and alignment of the process of information, gathering and strengthening the credit risk management function, and putting into the initiative stage itself. The third focus is on the improvement and strengthening the loss forecasting system in the organization.

3. Derivatives and Hedge Accounting:

In the balance sheet, all the derivatives are recognized at fair values as per IFRS and any changes in the fair values except a qualifying cash flow hedge relationship are generally recognized in the income statement. Equity conversion options should be

separated from host contracts and accounted for separately. Indian GAAP has not mentioned specifically how to address the more difficult to apply provisions of fair value as well as hedge accounting. The above challenge can be faced by validating derivative valuation models and back tested because of the increasing usage. Documentation and hedge effectiveness testing processes need to be incorporated as hedge relationships are specialized areas of accounting and organizations should be aware of rules and regulations. Banks are supposed to implement certain strategies decision regarding the application of hedge accounting.

4. De-recognition of Financial Assets:

Under IFRS, de-recognition of Financial Assets is a complex, multilayered area with the de-recognition decision dependent largely on whether there has been a transfer of risks & rewards. In many cases, this can not be restricted to qualitative assessments and needs to be necessarily a quantitative assessment.

A major area impacted would be securitization activity – most Indian securitization vehicles are currently structured to meet GAAP de-recognition norms. Substantially all those securitization vehicles would collapse into the transferor's balance sheet and assets would fail the de-recognition test under IFRS. For example, securitization transactions where credit collaterals, area provided / 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.

5. Consolidation of entities:

Under IFRS, consolidation is not driven purely by the ownership structure of an entity. Instead the focus is more on the power to control an entity to obtain economic benefits this power to control could be expressed as ownership of equity securities but is not limited to it. For instance, this will include a consideration of currently exercisable potential voting rights / shares; management and other agreements, de-facto control and other arrangements that provide power to control an entity. IFRS also provides guidance on how consolidation decisions for special purpose entity should be arrived at. In a number of ways, IFRS provides more rigorous consolidation tests and in practice can result in the consolidation of a larger number of entities as compared to Indian GAAP which focuses on a narrow set of tests (majority of ownership & control over a majority of the composition of the board of

directors or similar body.)

What should Banks stress on to meet these challenges?

- Develop or strengthen a data capture system to enable the impairment assessment after determining where information will be collected/who will make the impairment assessment / templates and information gathering and storage systems etc.
- Certain system changes would need to be made for accounting for impairment; for example, computation of discounted future cash flows to facilitate the booking of the required accounting adjustments.
- Fair valuation methodologies & practices would need to be reexamined to ensure that they are current, up-to-date and are validated and back tested in the current market conditions.
- Decisions about where and when hedge accounting is to be applied should be taken.
- Work towards developing new securitization structures that are design to meet the de-recognition norms under IFRS.
- Ensure that the common accounting policies are applied across the group for the challenge of a consolidation of entities.

Indian Banking against Global Benchmark

In an increasingly integrated and complex world market it is necessary that the Indian Banking System should compare its performance against the world benchmarks. Some important ratios are given below for an understanding as to what is the position of the health of Indian schedule banks vis a vis the global banks.

Table 1

The Indian economy is fairly insulated from the global financial crisis at present since Indian banking system is not directly exposed to sub-prime US mortgage market or the failed institutions or their stressed assets in any significant way. The same is not the case with the liquidity since the overseas borrowing markets have shrunk. However, looking to the increasing depressed performance of the corporate in general banks are required to take care of their performance by imbibing more effective risk management tools and taking effective measures.

Impact of IFRS on Indian Banking System
The Following are a few areas of impact:

1. Loan / Investment impairment:

Currently, banks consider provisions on loans based on RBI guidelines, which are very

prescriptive and require limited use of judgment. However, IFRS require a case by case assessment (for significant exposures) of the facts and circumstances surrounding the recoverability and timing of future cash flows relating to the credit exposure. For investments, fair value is also considered as an input in addition to the financial/ credit standing of the issuer.

2. Fair Value:

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 or 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. Derivatives and hedge accounting:

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. De-recognition of financial assets:

Under IFRS, de-recognition of financial assets is a complex, multi-layered area that follows the principle of transfer of risks 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 de-recognition test under IFRS and lead to collapse of securitization vehicles into the transferor's balance sheets. Banks will need to assess the impact and consider the potential impact on capital adequacy and ratios such as return on assets.\

5. Consolidation:

Under IFRS, consolidation is not driven purely by the ownership structure of an entity but will have to focus on the power to control an entity to obtain economic benefit. IFRS provides more rigorous consolidation tests and in practice can result in the consolidation of a larger number of entities as compared to under Indian GAAP. Banks will need to perform consolidation assessments as early as

possible, particularly for non-shareholding related factors that impact consolidation, to assess its impact.

6. Are banks ready?

Convergence to IFRS is likely to pose significant challenges for banks, as shown by global experience. Certain large Indian banks, which have the benefit of going through the process of international GAAP such as US GAAP in the past, have recognized the challenges of convergence and have already started planning their detailed roadmap to achieve a smooth convergence. It is time for other banks to take the cue and follow suit. Critical to the successful implementation of IFRS in the Indian context would be the level of regulatory sponsorship, the appropriate level of investment in systems and processes and consistency in market practices for areas where judgment is critical. A move to IFRS can be compared to the mountain peak which can certainly be scaled if well planned and appropriately executed!!

Suggestions for IFRS Implementation on Indian Banking System

1. Indian banks are hiring consultants to train their employees in International Financial Reporting Standards (IFRS) as they take the lead in ensuring compliance with the new global accounting standard that kicks in from 2011.
2. Part of the reason is practical: Banking, more than any other business, will feel the impact of the new rules the most as banking operations involve multiple financial instruments that face the brunt of the changeover.
3. Indian firms are required to maintain their accounts under the new standard, starting April 2011. However, a comparative figure for the previous year has also to be provided, effectively advancing the transition to April 2010.
4. With barely six months to go, banks are setting up internal cells dedicated to IFRS accounting, according to bankers, although banking regulator Reserve Bank of India (RBI) is yet to clarify its position on the new accounting standard.
5. To come up with the guidelines on the new accounting norm, a working group committee has been formed by the Indian Banks' Association (IBA), the apex bankers' lobby in the country, and RBI.
6. Meanwhile, audit firms of International repute

such as PricewaterhouseCoopers (PwC), KPMG, and Ernst and Young are working with banks to help them meet the deadline.

Conclusion

IFRS implementation is very much beneficial to the corporate world because it will provide uniformity, comparability and Reliability. But, yet in India, it is a lengthy and difficult process of convergence particularly for Banking Sector, there should be a co-ordination between RBI, ministry of finance, SEBI, ministry of company affairs & ICAI. The workshops & seminars should be organised for preparing the roadmap. There is a need for common software programmes, skilled recruited staff, effective communication system & training programme for employees. If IFRS convergence can be made effectively, it will be a great achievement for Indian corporate world.

Looking at the present scenario of the world economy and the position of India convergence with IFRS can be strongly recommended. But at the same time it can also be said that this transition to IFRS will not be a swift and painless process. Implementing IFRS would rather require change in formats of accounts, change in different accounting policies and more extensive disclosure requirements. Therefore all parties concerned with financial reporting also need to share the responsibility of international harmonization and convergence. Keeping in mind the fact that IFRS is more a principle based approach with limited implementation and application guidance and moves away from prescribing specific accounting treatment all accountants whether practicing or non-practicing have to participate and contribute effectively to the convergence process. This would lead to subsequent revisions from time to time arising from its global implementation and would help in formulation of future international accounting standards. A continuous research is in fact needed to harmonize and converge with the international standards and this in fact can be achieved only through mutual international understanding both of corporate objectives and rankings attached to it.

References:

- Lantto, Anna-Maija and Sahlström, Petri (2009). Impact of International Financial Reporting Standard adoption on key financial ratios. *Accounting and Finance*, 49, 341–361.
- Armstrong, Chris S., Barth, Mary E., Jagolinzer, Alan D. and Riedl, Edward J. (2009). Market Reaction to the Adoption of IFRS in Europe. *Accounting Review* Forthcoming.

- Ball, Ray (2005). International Financial Reporting Standards (IFRS): Pros and Cons for Investors. Accounting and Business Research, Forthcoming.
- Daske, Holger, Hail, Luzi, Leuz, Christian and Verdi, Rodrigo S. (2008). Mandatory IFRS Reporting Around the World: Early Evidence on the Economic Consequences. ECGI - Finance Working Paper No. 198/2008; Chicago GSB Research Paper No. 12.
- De Jong, Abe, Rosellón Cifuentes, Miguel Angel and Verwijmeren, Patrick (2006). The Economic Consequences of IFRS: The Impact of IAS 32 on Preference Shares in the Netherlands. ERIM Report Series Reference No. ERS-2006-021-F&A.
- Hboxma (2008). Economics and IFRS. Retrieved on October 14, 2009 from <http://www.oppapers.com/essays/Economics-Ifrs/177415>.
- Callao, Susana, Ferrer, Cristina, Jarne, Jose I. and Lainez, Jose A. (2009). The impact of IFRS on the European Union: Is it related to the accounting tradition of the countries?. Journal of Applied Accounting Research, 10(1), 33 – 55.
- Carmona, Salvador and Trombetta, Marco (2008). On the Global Acceptance of IAS/IFRS Accounting Standards: The Logic and Implications of the Principles-Based System. Journal of Accounting and Public Policy, 27(6).
- Ramanna, Karthik and Sletten, Ewa (2009). Why do Countries Adopt International Financial Reporting Standards?. Harvard Business School Accounting & Management Unit Working Paper No. 09-102.
- KPMG Report on “IFRS: Implementation Challenges and Approach for Banks in India: March 2008”
- KPMG report on “IFRS: Developing a Roadmap to Convergence: March 2008”
- UNCTAD: INTERNATIONAL ACCOUNTING and REPORTING ISSUES 2009 Review
<http://www.iasplus.com/standard/ias39.htm>
Deloitte guidance on IFRSs for Financial Instruments
<http://www.ifrs.org/Home.htm>

Table 1

Item	Global average	Indian average International	RBI norm Norm if any	if any
CRAR	7.1% - 34.9%	12.3%	8%	9%
ROA	0.2% – 4.3%	0.9%	-	-
NII	1.2% - 6.2%	2.9%	-	-
CIR	0.46% -0.68%	0.5%	-	-
GROSS NPA	0.2% - 24.7%	2.8%	-	-
PROV. TO NPA	23.15 -229.1%	56.1%	-	-
CAP/ASSET VOLATILE	4%-22%	6.30%	-	-
LIAB./ASSETS	0.71% -0.11%	-17%		