

Convergence to IFRS & its Challenges to Indian Banking

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Abstract: The Accounting world is abuzz with the words, "Convergence with International Financial Reporting standards (IFRS)." IFRS is being accepted as a universal financial reporting language by the corporate world. Globalization, Liberalization, cross border business transactions, multinational investments and dismantling barriers have been transformed business during the last decade opening a single market for the whole globe coining as world as a single market place knitting total integration of economy. This rapid changing scenario has compelled the need for quality and timely information. To confront the challenges of critical global market economy quality of the information served. We believe that for Indian banks, the financial impact of convergence with IFRS will be significant, particularly in area relation to loan loss provisioning, financial instruments and derivative accountings. We also expect that in addition to the financial accounting impact, the convergence process is likely to entail several changes to financial reporting system and processes adopted by bank in India.

This is likely to have significant impact on the financial position and financial performance, directly affecting key parameters such as capital adequacy ratio and the outcome of valuation metrics that analysis use to measure and evaluate performance. Though this paper we want to focus some challenges that faced by banking sector and some approaches that banks can adopt to address these challenges.

I. INTRODUCTION

In the present era of globalization and liberalization, the world has become an economic village. The globalization of the business and the development of e-commerce make it imperative to have a single globally accepted financial reporting system for that convergence of IFRS necessary.

In this scenario of globalization India has retained its position as the second most preferred global location for foreign investment in 2008 and will continue to do so till 2010 lagging only behind china. ICAI, in order to keep pace with the global trends and to embrace the development taking place worldwide, declared convergence to IFRS. Reporting in Telecom Sector, Mutual Funds, Venture Capital funds, Technology Infrastructure, Power, Retail and the biggest impact would be on Indian Banking sector. (Ernst & Young in detailed comparative statement on Indian GAAP & IFRS, 2008.

II. CHALLENGES FOR BANKS

LOANS/INVESTMENTS IMPAIRMENT: Currently, banks consider provisions of loan based on RBI guidelines,

which are very prescriptive and require limited use of judgment.

However, IFRS require a case by case judgment (for significant exposures) of the facts and circumstances surrounding the recoverability and timing of future cash flow relating to the credit exposure. For investment similar analysis is conducted, the key difference that the fair value of investment is also consider as on input in addition to the financial/credit standing of the issuer.

To meet this challenges bank should focus on –

- ✓ Develop/strengthen a data capture system to enable the impairment assessment
- ✓ Use and align this process of information gathering and assessment to strengthen the credit risk management function and feed into other strategic initiatives.
- ✓ Certain system changes would need to be made for accounting impairment.

III. FAIR VALUE:

Fair value measurements infrequently used under Indian GAAP and in most cases where its aim is primarily to capture a lower of cost or fair value measurement base. Under IFRS, there may be a significant increase in the extent that fair value measurement needs to be used. To meet this challenges bank should focus on –

- ✓ Fair valuation methodologies and practices would need to be re-examined.
- ✓ Adequate trained personnel need to be made responsible.
- ✓ Profit planning and budgeting control need to be fine tuned to incorporate the expected increase in income statement volatility arising of the increased use of fair values as an measurement attribute.

IV. DERIVATIVES AND HEDGE ACCOUNTING:

Under IFRS, all derivatives are recognized, on the balance sheet at fair value. Application of hedge accounting would bring down reducing income statement volatility; however, this will entail onerous and stringent documentation

requirement, mandatory effectiveness tests and determination of fair value, based on observation inputs. This will also call for a much heightened awareness of rules for hedge relationship, certain processes and system changes and documentation. To meet this challenges bank should focus on-

- Derivative valuation models need to be validated and back tested.
- Hedge relationships are a specialized area of accounting and it is crucial that organizational awareness of the rules are enhanced. Certain strategic decisions will need to be made as to where and when hedge accounting is to be applied.

De-recognition of financial ASSETS: Under IFRS desrecognition of financial assets is a complex, multi layered area that follow the practice 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 derecognized principles enumerate in IAS-39.
- This will result in failure of the de recognition test under IFRS and lead to collapse of securitization vehicles into the transferor's balance.

Consolidation: Under IFRS, consolidation is not driven 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 assessment as early as possible particularly for non- shareholding related factors that impact consolidation to assess its impact.

V. CONCLUSION

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 challenge 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 flow suit.

In addition to the general accounting standards and practices that constitute Indian GAAP, banking companies are currently required to adhere to accounting policies and principles that are prescribed by the Reserve Bank of India.

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