IFRS Implementation in India: Opportunities and Challenges

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Till 2005, Countries were having their own Financial Reporting System. Firms, Investors, Bankers who were interested in cross border investment were facing lot of trouble in taking Investment Decision on the basis of these multiple Financial Reporting System. In 2005, member countries of European Union adopted International Financial Reporting Standards. In subsequent years, other countries either adopted IFRS or converged to IFRS. India is no exception. This study tries to analyze the information available on IFRS adoption process in India. It also discusses the IFRS adoption procedure in India and the utility for India in adopting IFRS. The paper discuss the problems faced by the stakeholders (Regulators, Accountants, Firms etc) in the process of adoption of IFRS in India. In conclusion part, Paper brings out the ways through which these problems can be addressed.

Field of Study: Accounting, International Financial Reporting Standards (IFRS)

I. Introduction

Last decade has observed various changes of doing business across the world. The process of financial reporting of business activities also underwent a great change. This started in 2005 when European Union made it mandatory for publicly traded companies to present consolidated financial statements in conformity with International Financial Reporting Standards (IFRS) starting from January 01, 2005. Earlier, since the late 1990s, companies in some European and Asian countries were allowed to use International Accounting Standards (IAS)[i] as a substitute for their respective domestic Accounting Standards. But IFRSs were adopted legally first time in 2005 by European Union. Other countries with developed capital markets have adopted or in the process of adopting IFRS for reporting purposes. Many countries are replacing their national standards with IFRSs while some other countries have adopted this approach of first reviewing the IFRSs, ensure their suitability with their economic, political and social conditions and then adopt these IFRSs verbatim or with minor changes.

India, in 2007 announced that it would fully adopt[ii] IFRS by 2011 which is to be done in phases. First phase will include the companies which are part of Nifty 50 Index[iii], Sensex 30[iv], the companies which have shares or other securities listed on stock exchange outside India and the companies (whether listed or not) which have a net worth in excess of Rs 10 Billion. The companies covered in this phase will prepare an Opening Balance Sheet in accordance with IFRS converged standards as of April 01,

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2011 and will follow the IFRS converged standards from this date. The second phase will cover the Firms (listed or not) with a net worth in excess of Rs 5 Billion but less than Rs 10 Billion. These firms will prepare an opening Balance Sheet in accordance with IFRS converged standards as of April 01, 2013 and will follow IFRS converged standards from this date. Rest of the firms will follow the process from April 01, 2014 when these will prepare their opening Balance Sheet as on that date.

Researchers have given various opinions on the utility of adoption of IFRSs across the globe as a single set of Reporting Standards. Existing literature supports this view of researchers that adoption of IFRS as single set of reporting standards improves the quality of financial information and also ensures timely loss recognition. Summarily, adopting single set of Financial Reporting Standards bring many benefits to reporting entities, Investors, Bankers and other interested parties as in this period of international boundaries getting eliminated, they will not have to refer to Reporting Statements prepared on the basis of different Reporting standards.

The itinerary of the paper is as follows. Section II discusses the effect of globalization on Indian corporate financial reporting system. A brief literature review is provided in Section III. IFRS adoption procedure in India has been discussed in Section IV. Section V deals with the utility for India in adopting IFRS. Section VI talks of the challenges/problems faced by the stakeholders in the process of adoption of IFRSs. Section VII suggests ways to overcome these problems and also summarizes the paper.

The study is primarily qualitative in nature and do not use any quantitative tool to analyze the data. It has been conducted mainly on the basis of literature survey and secondary Information. Various journals, newspaper and magazines articles have been referred to in writing this paper.

The objectives of this study can be listed down as below:
1. To discuss the IFRS adoption procedure in India;
2. To discuss the utility for India in adopting IFRS;
3. To discuss the problems faced by the stakeholders in the process of adoption of IFRS in India; and
4. To discuss the ways through which these problems can be addressed.

Since EU was the first to adopt IFRS across the globe, most of the research has been carried out on IFRS analyzing the data from member countries of EU. Comparatively fewer numbers of studies have been carried out on data from other countries. This paper makes an attempt to bridge this gap and tries to study the Indian data with reference to IFRS adoption, utility of IFRS adoption for India, obstacles faced by the stakeholders in the process of adoption of IFRS in India and the ways to remove these obstacles.

II. Globalization and Financial Reporting in India

In recent past, India has seen a sea change in its way of financial reporting. The process of changes started in the late 1980s with the initiation of economic reforms and globalization process in India. Since independence in 1947 to mid-1980s, Indian industries were in complete control of the state. Price and quantity restrictions were in place and any entrepreneur interested in starting a new business venture (or, expansion of its existing capacity) had to take multiple permissions from various government departments. Rent seeking activity and excess capacity used to be the normal feature of the then Indian industries. Foreign Investment was negligible and funding for business was coming mainly in the form of loan from public sector commercial banks and financial institutions (e.g., IDBI).[v] In the aftermath of liberalization program initiated in 1991, India faced severe Balance of Payments crisis and had to pledge its gold reserve to the Bank of England to overcome the crisis. The then Congress Government took some revolutionary steps with regard to opening up of Indian economy to foreign competition and inviting foreign investments in various industrial sectors. Both the industrial and financial sectors were deregulated and rupee was made convertible on Current Account.[vi] Capital Markets were made more accessible for Indian companies. Corporate houses were allowed to tap the foreign financial markets for their fund requirement. Insurance, banking, telecom, retail, and software, among many others were opened for foreign investments. These developments have encouraged foreign companies to invest in India. These increasing investment trends in India from abroad demand a corporate financial reporting system fully harmonized with the one being used worldwide. The demand is further supported by the Indian companies which were either buying foreign companies or entering into joint ventures with foreign companies. Goldman Sachs (2003) also supported this phenomenon through a study on BRIC (Brazil, Russia, India & China) in which it suggested that these countries will become among the four most dominant economies by the year 2050.

Currently, Indian Companies are reporting their financial statements based on Indian Accounting Standards prepared by Institute of Chartered Accountants of India (ICAI).These Standards are quite similar to IFRS. Till date, ICAI has issued 32 Accounting Standards covering many areas.

III. Literature Review

As mentioned earlier, the available literature on IFRS and its implementation covers the data from European Union. Few studies have been carried out analyzing the data from other countries. Zhou et al (2009) in one such study of Chinese firms' data concluded that the firms adopting IFRS are less likely to smooth earnings in the post IFRS adoption period. Their findings also pointed out the need for a stricter enforcement mechanism of financial reporting standards in emerging markets. Working on the data of European firms, Armstrong et al (2010) found out a positive reaction to IFRS adoption events for firms with high quality pre adoption information, consistent with investors expecting net convergence benefits from IFRS adoption. In his study of 1084 European Union firms during the period of (1995-2006), Siqi Li (2010) concluded that on average, the IFRS mandate significantly reduces the cost of equity for mandatory adopters. He also suggested in his research that this reduction is present only in countries with strong legal enforcement and that increased disclosures and enhanced information comparability are two mechanisms behind the cost of equity reduction. Cai & Wong (2010) in their study of global capital markets summarized that the capital markets of the countries that have adopted IFRS have higher degree of integration among them after their IFRS adoption as compared to the period before the adoption. Paananen & Lin (2009) gave a contrary view to prior research that IFRS adoption ensures better quality of accounting information. Their analysis of German companies reporting showed that accounting information quality has worsened with the adoption of IFRS over time. They also suggested that this development is less likely to be driven by new adopters of IFRS but is driven by the changes of standards. Iatridis (2010) concluded, on the basis of data of firms listed on London stock exchange, that the IFRS implementation has favorably affected the financial performance (measured by profitability and growth potential) of firms. The study also demonstrated that following the fair value orientation of IFRS, the transition to IFRS appears to introduce volatility in Income statement figures. Lantto & Sahlstrom (2009) in their study of key financial ratios of companies of Finland found that the adoption of IFRS changes the magnitude of the key accounting ratios. The study also showed that the adoption of Fair Value Accounting rules and stricter requirements on certain Accounting issues are the reasons for the changes observed in Accounting Figures and financial ratios.

Chand & White (2007) in their paper on convergence of Domestic Accounting Standards and IFRS, demonstrated that the influence of Multinational Enterprises and large international accounting firms can lead to transfer of economic resources in their favour, wherein the public interests are usually ignored. The study carried out by Callao et al (2007) on financial data of Spanish firms revealed that local comparability is adversely affected if both IFRS and local Accounting Standards are applied in the same country at the same time. The study, therefore calls for an urgent convergence of local Accounting Standards with that of IFRS. Barth et al (2008) in their study of financial data of firms from 21 countries examined whether application of IAS/IFRS is associated with higher accounting quality. The findings of the study confirmed that firms applying IAS/IFRS evidence less earnings management, more timely loss recognition and more relevance of accounting numbers. The study also found out that the Firms applying IAS/IFRS experienced an improvement in accounting quality between the pre-adoption and post adoption period. Referring to a study carried out by Audit Integrity, Steffee (2009) in his article concluded that there are considerable differences in the approaches taken to implementing IFRS by individual Western European countries and companies. He viewed that corporations in Luxembourg, Austria and Switzerland demonstrate the most transparent accounting practices and best corporate governance, while European Banks with large capitalizations display very aggressive Accounting and Poor Governance Standards. Elena et al (2009) in their article dealing with the issues of convergence between US Generally Accepted Accounting Principles (GAAP) and IFRS were of the opinion that the adoption of IFRS in the USA undoubtedly would mark a significant change for many US companies. It would require a shift to a more principles-based approach, place for greater reliance on management (and auditor) judgment, and spur major changes in company processes and systems.

Ali & Ustundag (2009) in their paper on development process of Financial Reporting Standards around the World and its practical results in a developing country, Turkey. They observe that Turkey has encountered several complications in adaption of IFRS such as complex structure of the International standards, potential knowledge shortfalls and other difficulties in application and enforcement issues. Epstein (2009) in his article on Economic Effects of IFRS adoption emphasized on the fact that universal financial reporting standards will increase market liquidity, decrease transaction costs for investors, lower cost of capital and facilitate international capital formation and flows. Chen et al (2010) in their study of financial data of publicly listed companies in 15 member states of European Union (EU) before and after the full adoption of IFRS in 2005 found that the majority of Accounting Quality indicators improved after IFRS adoption in the EU. They found that there is less of managing earnings towards a target, a lower magnitude of absolute discretionary accruals and higher accruals quality. The study also showed that the improved accounting quality is attributable to IFRS, rather than changes in managerial incentives, institutional features of capital markets and general business environment. Devalle et al (2010) concluded that with adoption of IFRS by 3721 firms listed on 5 European Stock Exchanges, influence of earning on share price increased.

As evident from the literature review, good number of studies carried out in different countries have highlighted the benefits of having single set of financial reporting standards across the globe. Few of the studies have also brought out the procedural aspects of implementation of IFRS. Some of the studies have given a contradictory view wherein the articles talk about the difficulties and complications faced in implementing IFRS.

IV. IFRS Adoption Procedure in India

In 1949, Indian government to streamline accounting practices in the country established Institute of Chartered Accountants of India by passing ICAI Act, 1949. Accounting Standard Board was constituted by ICAI in 1977 with a view to harmonize the diverse accounting policies and practices in India. The other objectives of the Board are: (i) conceive of and suggest new areas in which Accounting Standards are needed, (ii) formulation of Accounting Standards, (iii) examine how far IAS and IFRS can be adapted while formulating the accounting standards and to adapt the same[vii], and (iv) review the existing Accounting Standards and revise them regularly as and when necessary, among others. In 2006, a task force was set up by ICAI. The objective of the task force was to lay down a road map for convergence of IFRS in India.

Based on the recommendation made by the Task Force and on the basis of outcome of discussions and public opinions on IFRS adoption procedure, a 3 step process was laid down by the Accounting Professionals in India. This three steps IFRS adoption procedure can be summarized as follows:

Step 1 – IFRS Impact Assessment

In this step, the firm will begin with the assessment of the impact of IFRS adoption on Accounting and Reporting Issues, on systems and processes, and on Business of the firm. The firm will then identify the key conversion dates and accordingly a IFRS training plan will be laid down. Once the training plan is in place, the firm will have to identify the key Financial Reporting Standards that will apply to the firm and also the differences among current financial reporting standards being followed by the firm and IFRS. The firm will also identify the loopholes in the existing systems and processes.

Step 2 – Preparations for IFRS Implementation

This step will carry out the activities required for IFRS implementation process. It will begin with documentation of IFRS Accounting Manual. The firm will than revamp the internal reporting systems and processes. IFRS 1 which deals with the first time adoption of IFRS will be followed to guide through the first time IFRS adoption procedure. To make the convergence process smooth, some exemptions are available under IFRS 1.These exemptions are identified and applied. To ensure that the IFRS are applied correctly and consistently, control systems are designed and put in place.

Step 3 – Implementation

This step involves actual implementation of IFRS. The first activity carried out in this phase is to prepare an opening Balance Sheet at the date of transition to IFRS.A proper understanding of the impact of the transition from Indian Accounting Standards to IFRS is to be developed. This will follow the complete application of IFRS as and when required. First time implementation of IFRS requires lot of training and some difficulties may also be experienced. To ensure a smooth transition from Indian Accounting Standards to IFRS, Continuous training to staff and addressing all the difficulties that would be experienced while carrying out the implementation is also required.

V. Utility for India in Adopting IFRS

Economies across the globe have benefitted by adopting IFRS for financial reporting purposes. Previous Studies have suggested various benefits of adopting IFRS, notably, Better financial information for shareholders, Better financial information for regulators, Enhanced comparability, Improved transparency of results, Increased ability to secure cross-border listing, Better Management of global operations and Decreased cost of capital.

This study will try to connect some of these and few other benefits with respect to the firms in India and also India as a country.

V.1. Better Access to Global Capital Markets

During the last decade, India has emerged as a strong economy on the global economy map. Indian Firms are expanding. These firms are not only setting plants in other countries but also acquiring other firms across the globe[viii]. For this they need funds at cheaper cost which is available in American ,European and Japanese Capital Markets[ix] .To meet the regulatory requirements of these markets, Indian Companies should report their financials as per IFRS. Thus adoption of IFRS not only helps Indian Firms in accessing global Capital Markets for funds but also availability of funds at cheaper cost.

V.2. Easier Global Comparability

Across the globe, Firma are using IFRS to report their financial results. With the adoption of IFRS by Indian firms, the comparison of two becomes easier. Investors, Bankers and Lenders also find it easy to compare the two financial statements following same reporting procedure. Indian companies in the process of raising funds from overseas capital markets have to provide financial results to interested parties. Since majority of Indian Firms are accessing European capital markets, preparation and presentation of financial statements on the basis of IFRS helps firms in getting easy accessibility to these capital markets.

V.3. Easy Cross Border Listing

As mentioned earlier, Indian firms require funds for their expansion plans which are not limited to the economic and political boundaries of India. Indian Firms are acquiring firms outside India also. They are also getting listed in European and American Capital Markets through raising funds from these markets. One of the major pre-requisites of getting listed on European Markets is preparation of Accounts as per IFRS requirements. A few Indian Companies which have raised funds through the European Capital Markets have started preparing their Financial Statements as per IFRS.

V.4. Better Quality of Financial Reporting

Adoption of IFRS is expected to result in better quality of financial reporting due to consistent application of Accounting Principles and improvement in reliability of financial statements. Among various latest trends-based concepts, IFRS follows a concept of fair value which can help Indian firms to reflect their true worth of Assets held in the financial statements. Since a single body (IASB, London) is preparing IFRS, these are very consistent, reliable and easy to adopt ensuring better quality of financial reporting.

V.5. Elimination of multiple Reporting

Large Business Houses in India like TATA, BIRLA, and AMBANI have firms registered in India and also firms registered outside India in European and American capital markets. Firms registered in India prepare their Accounts as per Indian Accounting Standards whereas firms registered in other countries prepare their financial statements as per the Reporting standards of the respective country. Adoption of IFRS ensures the elimination of multiple financial reporting standards by these firms as they are following single set of Financial Reporting.

The above benefits are perceived benefits of adoption of IFRS. Researches are yet to be carried out to understand actual benefits of adoption of IFRS. Such researches are negligible for Indian financial data, as India is yet to step in the era of IFRS. This calls for a future scope of study on impact of adoption of IFRS by Indian Companies on Indian Economy and Firms.

VI. Challenges in the process of adoption of IFRS in India

Institute of Chartered Accountants of India set up a task force in 2006 to study and suggest a path for adoption of IFRS in India. On the basis of the recommendation of task force, a 3 phased programme (already discussed somewhere in this paper) has been initiated to adapt to IFRS in India. Accounting Professionals in India and across the world have listed various benefits of adopting IFRS. In spite of these benefits, adoption of IFRS in India is difficult task and faces many challenges. Few of these have been listed as below:

VI.1. Awareness of International Financial Reporting Practices

Adoption of IFRS means a complete set of different reporting standards have to bring in. The awareness of these reporting standards is still not there among the stakeholders like Firms, Banks, Stock Exchanges, Commodity Exchanges etc.. To bring a complete awareness of these standards among these parties is a difficult task.

VI.2. Training

Professional Accountants are looked upon to ensure successful implementation of IFRS. Along with these Accountants, Government officials, Chief Executive Officers, Chief Information officers are also responsible for a smooth adoption process. India lack training facilities to train such a large group. As the implementation date draws closer (2011), It has been observed that India does not have enough number of fully trained professionals to carry out this task of adoption of IFRS in India.

VI.3. Amendments to the Existing Laws

In India, Accounting Practices are governed mainly by Companies Act 1956 and Indian Generally Accepted Accounting Principles (GAAP). Existing laws such as Securities Exchange Board of India regulations, Indian Banking Laws & Regulations, Foreign Exchange Management Act also provide some guidelines on preparation of Financial Statements in India. IFRS does not recognize the presence of these laws and the Accountants will have to follow the IFRS fully with no overriding provisions from these laws. Indian Lawmakers will have to make necessary amendments to ensure a smooth transition to IFRS.

VI.4. Taxation

IFRS adoption will affect most of the items in the Financial Statements and consequently, the tax liabilities would also undergo a change. Currently, Indian Tax Laws do not recognize the Accounting Standards. A complete overhaul of Tax laws is the major challenge faced by the Indian Law Makers immediately. Enough changes are to be made in Tax laws to ensure that tax authorities recognize IFRS-Compliant financial statements otherwise it will duplicate the administrative work for the Firms.

VI.5. Use of Fair Value as Measurement Base

IFRS uses fair value to measure majority items in financial statements. The use of Fair Value Accounting can bring a lot of volatility and subjectivity to the financial statements. Adjustments to fair value result in gains or losses which are reflected in the Income Statements and valuation is reflected in Balance Sheet. Indian Corporate World which has been preparing its Financial Statements on Historical Cost Basis will have tough time while shifting to Fair Value Accounting.

VI.6. Financial Reporting System

IFRS provide complete set of reporting system for companies to make their Financial Statements. In India, various laws and acts provide the financial reporting system but not as comprehensive as provided by the IFRS. Indian Firms will have to ensure that existing business reporting model is amended to suit the requirements of IFRS. The amended reporting system will take care of various new requirements of IFRS. Enough control systems have to be put in place to ensure the minimum business disruption at the time of transition.

All the challenges mentioned here can be worked out by bringing a proper Internal Control & Reporting system in place. Firms, Regulators and Stock Exchanges in India should take some guidelines from the countries which have adopted the IFRS and have similar economic, political and social conditions.

VII. Conclusion

Ensuring a high quality corporate financial reporting environment depends on effective Control & Enforcement Mechanism. Merely adopting International Financial Reporting Standards is not enough. Each interested party, namely Top Management and Directors of the Firms, Independent Auditors and Accountants and Regulators and Law Makers will have to come together and work as a team for a smooth IFRS adoption procedure. Top Management should ensure that the Financial Statements are prepared in compliance with the IFRS. Auditors and Accountants should prepare and audit Financial Statements in compliance with IFRS. Regulators and Law Makers must implement efficient monitoring system of regulatory compliance of IFRS. Along with this the Regulators should ensure that proper changes are to be made in existing laws for IFRS adoption process. Some other ways to tackle the obstacles in adoption of IFRS can be summarized as follows:

VII.1. The lawmakers in India will have to make necessary changes in the existing Companies Act 1956, Tax Laws, Foreign Exchange Management Act, Insurance Act etc. These changes are required to bring Indian Accounting Practices in line with IFRS. In July 2009, a committee has been formed by Ministry of Corporate Affairs Government of India, with a view to identify the various legal and regulatory changes required for convergence and to prepare a roadmap for achieving the same.
VII.2. In order to ensure timely adoption of IFRS in India, trained Accountants and Auditors in IFRS are required in large number. India currently does not have the sufficient number of IFRS trained Accountants and Auditors. The Institute of Chartered Accountants of India (ICAI) has started IFRS Training programmes for its members and other interested parties. Yet there exists a large gap in the Trained Professionals required and trained professional available.
VII.3. To ensure that all the Firms are complying with adoption procedure, Indian lawmakers and Accounting Body (ICAI) should have a Financial Reporting Compliance Monitoring Board. Other than the job of monitoring the compliance part, the board can play the advisory role also for the firms on IFRS Adoption Procedure.
To conclude, IFRS adoption in India is inevitable. Indian Government and Accounting Body are taking every possible step for a smooth transition process. In this regard, self regulation is the answer which will ensure a complete and smooth adoption procedure. Awareness and proper Training should contribute to that process. Only enforcement mechanism will not help the procedure but an Advisor is also required. With all these systems in places, the IFRS adoption in India will become very smooth and accurate.

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END NOTES

[i] International Financial Reporting Standards comprise of IFRS issued after 2001; International Accounting Standards(IAS) issued before 2001(after 2001, all financial reporting standards issued by IASB are known as IFRS, before 2001, these were issued by IASC and were known as IAS); Interpretations originated from International Financial Reporting Interpretation Committee issued after 2001; Standing Interpretation Committee issued before 2001.

[ii] In India, the adoption of IFRS will not be same as done by European Union Member countries, i.e., taking IFRS as their Main Financial Reporting Standards. Indian Accounting Standards will be converged with IFRS. Convergence of Indian Accounting Standards with IFRS means that the Indian Accounting Standards will be designed and maintained in a way that the financial statements prepared in accordance with the Indian Accounting Standards draw unreserved statement of compliance with IFRS. In this paper, the word "Adoption" has been used in this meaning.

[iii] The S&P CNX Nifty (Nifty 50 or simply Nifty) is a composite of the top 50 stocks listed on the National Stock Exchange (NSE) of India, representing 24 different sectors of the economy.

[iv] The BSE Sensex or BSE Sensitive Index is a value-weighted index composed of 30 companies listed on Bombay Stock Exchange, Mumbai, India.

[v] IDBI: Industrial Development Bank of India.

[vi] Deregulation does not mean non-regulation rather prudential regulation followed by the Narasimhan Committee Report. See, Narasimhan Committee Report, 1991 for details.

[vii] "The ICAI, being a full-fledged member of International Federation of Accountants (IFAC), is expected to promote the IASB pronouncements in the country with a view to facilitate global harmonization of accounting standards." (Compendium of Accounting Standards, the Institute of Chartered Accountants of India, New Delhi, India, 2006.)

[viii] Hindalco acquired Canada based Novelis. The deal involved transaction of $5,982 million. Tata Steel acquired Corus Group plc. The acquisition deal amounted to $12,000 million. Dr. Reddy's Labs acquired Betapharm through a deal worth of $597 million. Ranbaxy Labs acquired Terapia SA. The deal amounted to $324 million. Suzlon Energy acquired Hansen Group through a deal of $565 million.

[ix] The cost of capital in these countries ranges from 5% - 10% whereas in India, cost of capital is more than 15%.