Issues and challenges for Indian Banking Sector due to convergence with IFRS

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Abstract

The financial crisis over the period compels the authority for a single set of converged, global accounting standards. Transparency and comparability across the banking sector is the need of the hour. The Indian economy needs the global standard giant banks to give a momentum to its economy. To achieve this objective we have to adopt the global requirements.

Accounting globalisation is one of the important issues and challenge before the banking sector in India. Adoption of IFRS is the one step forward towards achievement of the goal. It will be a sea change in the accounting structure of Indian bank when IFRS will be adopted. The use of IFRS in the banking system improves transparency and comparability of accounts for investors and other stakeholders, and consequently can have a positive impact through improving access to capital and funding. The current study is made to analyze of the impact of IFRS on banking sector and to make a bird's eye view about the preparedness of banks to such change.

Keywords: IFRS, Transparency, Banking Sector, Banking System , Accounting Standard.

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BACKDROP OF THE STUDY

The ministry of corporate affairs has announced Indian version of IFRS i.e. Indian AS with a goal to create comparable, reliable and transparent financial statement which can be compared among countries. This will also facilitate cross boarder capital raising and trade with better corporate governance practices. Hence the change in reporting format has been gaining momentum worldwide. The Indian banking sector is ready to accept the convergence.

Currently the banks are preparing their financial statements as per RBI guidelines and Institute of Chartered Accountant's pronouncements. As per the new reporting standard, all the schedule banks has to convert their opening balance sheet as on 1st April 2013.It is obvious that banks will face different challenges in the convergence process. So the banks have to form strategies and action plan for such change. Dr. S. Ojha and Dr. D Tandon (2012)* observed that training, education and skill development is one of the cornerstones of a successful IFRS implementation.

BENEFITS OF THE CONVERGENCE OF IFRS:

Similar reporting basis will facilitate comparison among sectors, countries and companies. Global companies would benefit in the form of not having to prepare multiple set of accounting report and avoid significant adjustment for preparing consolidated financial statements. IFRS helps the company to raise capital abroad without the cumbersome process of conversion and filing procedures required by various stock exchanges across the world. Besides it would also reduce the cost of raising funds abroad by reducing the accountant's fees and avoiding the preparation of dual financial statements. It can improve and initiate new relationships with investors, customers and suppliers across the globe.

REVIEW OF RELATED LITERATURE

The following are some of important literatures are consider as base our research work: Dr. Swamy and Dr. Vijayalakshmi (2012), studied about the issues related to fair value accounting on commercial banks in their paper "Fair Value Accounting in Banking Sector - Issues in convergence to IFRS". They analyses the impact of fair value accounting on the financial statements of Indian banks.

The authors suggested that a great deal of work is required to be done in order to make fair value estimates more reliable, provable, and auditable.

R. Pavera and J. Khatri (2008), in their article "IFRS: Implementation Challenges and Approach for Banks in India" advocated that there is no need to be secretive about the results you are generating under IFRS, assuming you are comfortable with them and that you are able to tell a sensible story around them. The panel of authors recommended that banks must portray a proactive approach in disclosing information in the process of convergence.

CS S Rastogi Dr. Agarwal (2012), conducted research work on "implementation of IFRS on Indian banking industry". They pointed out that the convergence will not only impact the financial statements presentations or finance only but will also transcend various other functions. The authors believed that India banks have successfully taken first few steps in the right direction. It recognized the need for IFRS convergence. Even being aware of enormity of the job, Indian banks show eagerness towards time bound implementation, giving top priority to the convergence process.

CA M Firoz and Prof A Aziz Ansari (2011), pointed out that banks must have to appoint trained staffs to meet the challenges of accounting globalisation. In their research article "IFRS: Impact on Indian Bank", the authors believed that the trained staff can perform credit risk management, fair valuation of loans and advances, forecasting loss if any proper budgeting of income and expenditure if any.

A. Goyal (2010), states in his seminar paper named "Implementation of IFRS on Indian banks", adopting IFRS provides credibility to the financial statements of the Indian companies and help them integrate with the global economy. Financial statements prepared based on international reporting standards also help these entities to tap the global financial markets, with greater ease since the lenders and capital providers can better understand the relative standing of the company and can make well-informed estimates about the financial health of the entities.

S .Ojha and D Tandon (2011), summarised that banks are currently following the prudential norms of Reserve Bank of India (RBI) and Institute of Chartered Accountants of India (ICAI), which are very prescriptive and require limited use of judgment.

IFRS on the other hand gives a case by case assessment of the facts and circumstances regarding future cash flows. This clearly shows that convergence to IFRS will pose significant challenges for banks involving higher disclosures by banks.

RESEARCH METHODOLOGY

Research methodology portrays the ways and means to carry out the research work. In the course of research work data is collected both from primary and secondary sources. RBI bulletin, government reports, different research articles, seminar papers are analysed for such purpose. So far as primary sources are concerned opinion survey is made from two samples. Few predefined questions are asked and their answer is well observed. The size of both samples is fifty. First sample consists of bank employees not below than the rank of manager. Second sample includes professionals like Chartered Accountants (CAs), Company Secretaries (CSs), Lectures and Research Scholars. Sample units have knowledge about the research topic. Hypothesis is taken and tested accordingly by using chi square test.

OBJECTIVE OF THE STUDY

This study is conducted with following objectives.

- To analyse the impact of IFRS on Indian banking sector.
- To give a bird's eye view about the preparedness banks to such change.
- To study about the challenges of such accounting globalisation for banking industry.
- To give suggestion to nullify the resistance of Indian banks to such change.

HYPOTHESIS

In order to test the findings of the study the following hypothesis have been formulated:

- Null hypothesis (Ho) = IFRS have significant impact on Indian banking industry.
- Alternative hypothesis (H_1) IFRS have no significant impact on Indian banking industry.

ANALYSIS OF DATA

Two samples are purposively drawn for this study. At the time of analysis of data, reliability, suitability and adequacy of data is taken into consideration. Analysis of data is made to highlight useful information, suggesting conclusions, and supporting decision making. Following table can describe the collected data.

Table-1: Descriptive Statistics.

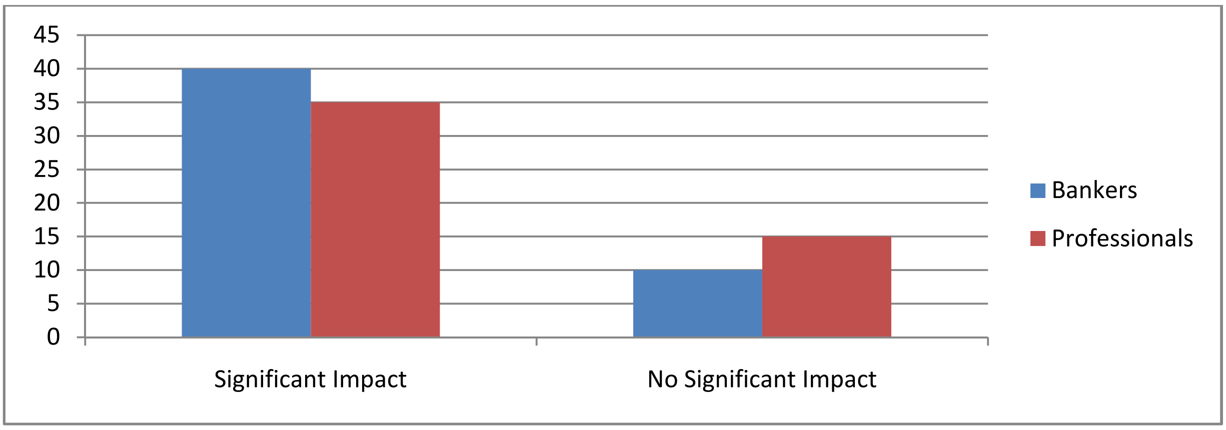
Parameter	**No of Respondents**	**Percentage**
Gender		
Male	76	76%
Female	24	24%
Total	100	100%
Type of Respondent		
Bankers	50	50%
CAs, CSs, Lectures.	40	40%
Research Scholars.	10	10%
Total	100	100%

The reaction of above respondents for the impact of IFRS on Indian Banks is shown in the following table.

Table-2: Reaction of sample unit towards the impact of IFRs

	Bankers	Professionals	Total
IFRS have significant Impact	40	35	75
IFRS have no significant impact	10	15	25
Total	50	50	100

Figure-1: Response towards Present Law and Proposed Law



Source-Collected and compiled data from field survey

The previous figure is the graphical presentation of response of sample unit towards impact of IFRS on banks.

In the first sample of forty bankers has supported the change and ten has denied the impact of change. In the second sample of thirty five units has opined the change has significant impact and fifteen professionals have given less importance to change.

TESTING OF HYPOTHESIS

Data of Table-2 is used as observed frequency and expected frequency is calculated accordingly by using the formula:

Expected Frequency = , Where, CT = Column Total and RT = Row Total

Table-3: Expected Frequency.

	Bankers	Professionals	Total
Significant Impact	37.5	37.5	75
No Significant Impact	12.5	12.5	25
Total	50	50	100

Source-Collected and compiled data from field survey

Table-4: Calculation chi square

Observed Frequency(O)	**Expected Frequency(E)**	**$(O-E)^2/E$**
40	37.5	0.167
10	12.5	0.5
35	37.5	0.167
15	12.5	0.5
		$\Sigma\ (O-E)^2/E=1.33$

Source: Collected and compiled data

v= (r-1) (c-1) = (2-1) (2-1) =1

v=1 chi square at 0.05 = 3.84

Here the table value is higher than the computed value. Hence the hypothesis is accepted. That means that IFRS has greater impact on banking sector of India.

EFFECT OF CONVERGENCE OF IFRS ON INDIAN BANKING SECTOR

Banks have to face new challenges of such convergence.

In the process to convergence The Institute of Chartered Accountants of India (ICAI) has issued Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement, Accounting Standard (AS) 31, Financial Instruments: Presentation.

As 30 and AS 31 are based on the corresponding International Accounting Standards, viz., IAS 39, Financial Instruments: Recognition and Measurement and IAS 32, Financial Instruments: Presentation, respectively There are no material differences between AS 30 and IAS 39, and AS 31 and IAS 32**.** But the requirements in IAS 39 are difficult to understand, apply and interpret. As a result IFRS 9, Financial Instruments: Classification and Measurement took the place of IAS 39.

Followings are the major challenges for banking industry of India.

FAIR VALUE ACCOUNTING

Presently the banks are carrying the values of their financial asset at historical cost. The new reporting standard focuses on the assets and liabilities of banks are carried in the balance sheet at Market Values, if they are available, or at fair values estimated as an approximation of the market value by using a Present Value model for discounting the expected future cash flow. Such valuation has immense importance as it has greater impact on the income of the industry as the gains and losses out of this valuation will be recognised in the income statement or in a reserve account.

The choice is required to be made at the inception of an instrument basis which is irrevocable.

In accounting fair value is used as a certainty of the market value of an asset (or liability) for which a market price cannot be determined (usually because there is no established market for the asset). Under US GAAP (FAS 157), fair value is the amount at which the asset could be bought or sold in a current transaction between willing parties, or transferred to an equivalent party, other than in a liquidation sale.[1] In this regard Swamy (2011)[2] observed that "Management bias, be it deliberate or inadvertent, quite often would result in inappropriate fair value estimations and misstatement".

TECHNOLOGICAL CHALLENGES

Currently banks have made significant investments in technology for providing different services as core banking, net banking off line banking etc.

Present technological support is attuned to Indian GAAP. The banks now have to change existing system to new environment which will correspond to classification and presentation of financial statement under IFRS. The IT challenges are absence of updated accounting software, Challenges related to IT operation, Lack of trained technicians, high cost involved, and obsolescence.

DISCLOSURES

IFRS specifies stringent disclosure norms for banking industry. Banks will face an extreme disclosure process once IFRS is adopted.

* Banks have to disclose methods and assumptions of valuation techniques
* Disclosures on risks - nature and extent of risks (credit, market, liquidity and any other risks); objectives, policies and processes for managing the risk and the methods used to measure the risk
* Detailed quantitative disclosures separately for credit, market and liquidity risks.
* Sensitivity analysis for each type of market risk. These are only a few areas out of a broad range of disclosures required by the IFRSs.

Besides, RBI has also prescribed a set of disclosure requirements. As such, the IFRS disclosures will place equal, and indeed even more, infrastructure demands on the Indian banks. While it is true that the usage of IFRS enhances the information quality, banks will face significant challenges in building up suitable MIS to facilitate information flow which would help them to have the necessary database to comply with the disclosure requirements.

IMPAIRMENT IN ADVANCES

Presently banks are following RBI guidelines for provision and writing off of its advances. The bank values the investment including advances on specified basis as per present value method with effective rate of interest for discounting. This method is tough for compliance.

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1. http://en.wikipedia.org/wiki/Fair_value
2. Fair value method in accounting-Issues in Convergence to IFRS, SSRN series of publications.

However IFRS prescribes collective method for group borrower and individual method for individual borrower for measurement of impairment of assets of the organisation.

CLASSIFICATION OF FINANCIAL ASSET

IFRS 9 classifies assets in to two categories unlikely IAS 39 which classifies assets in to four categories. Now the banks have to classify assets in the following manner.

Financial asset subsequently measured at amortized cost**:** a financial asset falls into this category if both of the following conditions are met:

- the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows, and
- the only contractual cash flows are payments of principal and related interest on specified dates.

Financial assets subsequently measured at fair value**:** all financial assets not falling to the above category.

DERIVATIVES AND HEDGE ACCOUNTING

Under the present accounting administration, derivatives are valued at fair value after making provisions for difference in income statement for such valuation of derivatives. The present rule does not pursue disclosure of the procedures of documents of fair valuation.

But IFRS makes mandatory of documentation of such things. Moreover for fair value measurement testing of effectiveness and ineffectiveness of such measurement can be counted. IFRS also states that if hedge relationship for qualifying cash flows can be established, fair valuation need not be applied to such derivatives.

CONSOLIDATION OF FINANCIAL STATEMENT

Accounting Standard 23(AS-23) on Consolidation of Financial Statement states that "ownership and control" over another organisation is the prime yardstick for consolidation of financial statement. The regulatory set up changes the meaning of "ownership and control" .It has shifted to potential voting right from actual stake holders. Potential voting right includes all those debts or shares are required to be converted into equity capital of the company. In addition IFRS makes compulsory of consolidation which was not operated in the present law.

HUMAN RESOURCE

IFRS implies significant changes in accounting system of banks. The change does not limit to finance and accounting department. It goes beyond and cascades the present accounting structure. As a result this convergence demands well trained professionals. However the new trained personnel can take time to familiar with the new system.

It also increase the wage cost. In this regard S .Ojha and D Tandon (2011) observed some HR challenges which are lack of trained professionals, high training and development costs, optimal use of external advisors and specialists, effective knowledge transfer to the team members, resistance from the bank employees.

SUGGESTION

1. It is hard to get liquid and transparent market for all assets and liabilities so as to get inputs and methods for fair valuation. When market information is not available about certain assets and liabilities for certain assets and liabilities then valuation in fair price of such assets and liabilities will be dubious.

In this context reliability of fair valuation can be questioned. Even financial statements may poise misstatements. Hence this concept may be re-examined.

2. Although FVA methods, entail the banks to value their assets employing current market prices they can accentuate downward price spirals.

In view of this, the approach could be that, the rules should permit banks and financial institutions with traded assets to allocate “valuation reserve” that grow up to reflect over-valuations during upswings and serve as a good buffer against any reverting to lower values during downturns.

3. Fair valuation may be affected by management bias which should be checked.

4. Banks should develop a data capture structure to see where the information will be collected, that will make the impairment assessment, storage systems etc. The loss forecasting mechanisms should be fine tuned along with the risk adjusted pricing for fresh loans being sanctioned by the banks.

5. Collate and inventories the full set of entities where consolidation assessment need to be made and perform those assessments as early as possible including a consideration of non shareholding related factors that impact consolidation

6. Ensure that common accounting policies are applied across the group.

7. Prepare for the impact of factors arising out of consolidation such as how disclosures at a group level can be collated and populated, chart of accounts, group reporting packages, reporting timelines

8. The fair valuation methods should be updated so that they are up to date with the current market conditions. Also trained personnel should be made responsible for significant areas. The budget areas should be fine tuned to incorporate volatility in the income statement due to fair values as a measurement attribute.

9. The impact of transactions that would fail de-recognition should be assessed and the impact on capital adequacy and certain ratios should also be studied.

CONCLUSION

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

Such aspect may include forming a core group for the identifying key areas of impact; discussing the issues at all the different levels in the bank; imparting necessary training to the employees on the risk management practices, systems and procedures and train the concerned staff on the new methods; and educating all the stakeholders regarding the impact and bank's position in the market.

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