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Uncertainties and Challenges of the Implementation of the International Financial Reporting Systems in Pre and Post Pandemic Environment: A Brief Review

Sonika Suman

Research Scholar

Department of Commerce

Sido Kanhu Murmu University

Dumka,Jharkhand

Email- sonika.dorado@gmail.com

Abstract

The IFRS is a set of accounting standards for establishing standardised accounting procedures across the world and have certain requirements that are relevant for companies in the context of the impact of the pandemic leading to expected credit losses which are known as ECL. The requirements for the financial instruments do not change, remove or even add to the already existing parameters of the IFRS 9. However, given the very shuddery financial situations of the companies in the wake of the lockdowns and business disruptions, to address the concerns of the ECL (Expected Credit Loss), it is necessary to have a consistent and robust application of the IFRS 9, more so in the banking sector.

Keywords

Accounting Standard, IFRS, Opportunities & Challenges of IFRS.

Introduction

Global Industry, Trade, Commerce, and Finance are in turmoil following the SARS-2 Corona Virus spreading across the world. There is a Global deceleration and the gains and pains have varied as well across countries and across industries, Trade and Commerce. Questions relating to the implementation of International

Financial Reporting Systems in different industries and countries rose up. The IFRS is a set of accounting standards for a standardised accounting procedure, across the world and have certain requirements that are relevant for companies in the context of the impact of the pandemic leading to expected credit losses which are known as ECL. The requirements for the financial instruments do not change, remove or even add to the already existing parameters of the IFRS 9. However, given the very shuddery financial situation of the companies in the wake of the lockdowns and business disruptions, to address the concerns of the ECL (Expected Credit Loss), it is necessary to have a consistent and robust application of the IFRS 9.

Objectives

Therefore, it is attempted to discuss the following in this paper:

i. To understand the applicability of the IFRS 9.
ii. To discuss the opportunities arising out of IFRS.
iii. To discuss the opportunities arising out of IFRS.
iv. To discuss the challenges of the transitional phase.
v. And to analyse IFRS in the context of the RBI Report.

Methodology

For the purpose of this paper, an analytical and descriptive methodology is adopted. The secondary data available in the published sources such as the research papers and RBI report are used to analyse and discuss the objectives in question.

Some previous studies:

A few research investigations carried out on IFRS are worth mentioning here. More specifically Agostino, Mariarosaria, Drago, Danilo and Silipo, B., Damiano (2010) investigated the accounting information of the market valuation in the European banking industry prior to the introduction of IFRS and later. It was found that introduction of IFRS increased the information contents of both earnings and book value for more transparent banks. In contrast, the less transparent institutions in the value relevance of the book value could not observe any beneficial increase. Some other studies of Cascino, Stefano and Gassen, Joachim (2010) pointed out that while 'mandatory adoption of IFRS increases the comparability of someprominent balance sheet line items across countries, it has no clear effect on the cross-country comparability of earnings attributes'. Their studies were based on 'the IFRS measurement and disclosure compliance choices for a handcollected sample of German and Italian firms and they found that predictable country, region and firm level incentives continue to shape the outcome of the financial reporting process and thus limit the cross-sectionalcomparability of financial accounting information'. Further investigations by Swaminathan, Shobhana and Sindhu (2011) brought out 'the effects on financial statements of the convergence to IFRS by taking a case study on Wipro Technologies Inc. and concluded that IFRS is fair value oriented and balancesheet oriented accounting where there are more transparent disclosures and Indian GAAP has conservative approach. Firoz, Mohammad, Aziz, Ansari, Akhtar, Kahkashan (2011) described the impact of IFRS on Indian banking sector by taking various areas like compliance burden, Taxreporting practices, Information Technology, Financial Instruments, HR, Impairment in advances, Investments, Derivatives and Hedge Accounting, Consolidation of Financial Statements. Lopez-Espinosa, Morino, A., Perez de Gracia, Fernando (2011) highlighted the impact of accounting standards on Net Interest Margin (NIM) by using multi way cluster estimation'. (Raj S. Dhankar et al, 2018).

Critical Role of IFRS

Despite the onslaught of the pandemic leading to the closing of the borders, the economic village remains more or less the same for the globalization to operate uninterruptedly. It is here that the role of IFRS becomes all the more critical with its ability to communicate with different financial accounting in different countries, yet having a common language for the purpose converging the national accounting standards. The single globally accepted financial reporting system which involves many transnational companies and multinational corporations engaged in cross-border business transactions is the IFRS. If the different countries use different accounting frameworks for different countries which need different treatments and disclosures for the same transactions, the confusion that will result might even impede the smooth conduct of business and eventually it will stifle the business growth. Therefore, it has to be realized that IFRS can help economy, banks, corporate, industry and the professionals working for the accounting sector. Adoption of IFRS will help all economies in transparent and reliable preparation of the financial statements. A very important aspect of the implementation of IFRS is that the standards of the system will make it possible for easy comparison of the financial information. The result is the emerging trust and confidence of the investors which will help the economy in the reduction of hoarding and facilitation of the fund flow. The accessibility to the global capital markets will be faster and hassle free and the cost of operation will be lower. Then, it is natural that the cross border mergers and acquisitions will increase and there will be more affiliations with partners and more ventures with the foreign establishments will be generated. It is important to note that the IFRS 9 parameters were developed because of the demands raised by the G20 nations and other to provide more encouraging and forward looking information about the loan losses because of the previous standards. IFRS 9 also gives better and far more transparent and timely information about the credit at risk, especially during this pandemic period when the businesses have greater risks and operations are far less. In this context, it is pertinent to quote the report of the RBI which says: "*International Financial Reporting Standard 9 (IFRS 9) came into force in January 2018 for European Banks, replacing International Accounting Standard (IAS 39). IFRS 9 introduces a forward looking approach for recognising credit losses in financial accounts viz., the 'expected credit loss' (ECL) approach. A survey by Risk Quantum consisting of 36 large banks from 11 European countries found an average decline of Common Equity Tier 1 (CET1) capital (between December 2017 when old accounting system IAS 39 was still in effect and March 2018, the first reporting date of IFRS 9 adoption) by 34 basis points (bps). This decline is computed by excluding banks who have adopted the transitional measures"(RBI Report, 2018).*

The IFRS 9 document is realistic in so far as it takes into account the fact that estimation of the Expected Credit Loss of the various financial instruments is challenging in the prevailing environment. It projects the importance of companies using all reasonable and supporting evidences like the data relating to historic, current and emerging situation as far as possible while deciding that the lifetime losses should be recognised on loans or estimating the Expected Credit Loss. However, it is made clear that IFRS 9 does not follow a mechanistic approach in accounting for Expected Credit Loss. Therefore, the companies will have to adjust their approaches to forecasting and deciding when lifetime losses should be recognised to reflect the prevailing circumstances.

In this context of the pandemic and the IFRS 9, it is aimed here to review the challenges of Implementation of the International Financial Reporting Systems in general discussing the opportunities and general benefits that are relating to the IFRS.

The Opportunities arising out of IFRS

The International Financial Reporting System opens up opportunities for the various professionals operating in the financial and accounting areas. For example, the Chartered Accountants can make use of their professional abilities and deep accounting knowledge anywhere in the world as the accounting systems and the accounting languages are commonly comprehensible for all the professionals of the area. Assets and liabilities need evaluations for the determination of their fair values. For value determination, there is a potential demand of Valuation Experts and such experts are qualified and are chartered accountants. This is an opportunity available to the qualified and trained Chartered Accountants who will be able to practice anywhere in the world due to the common use of the IFRS. Corporate organizations have now openings due to the implementation of International Financial Reporting Standards as specialised experts are needed within the companies. Chartered Accountants handling international operations need specialised training to handle financial statements of a complex nature according to the IFR Standards. The Banking Industry, especially in India, is most affected if the IFRS is completely implemented. This industry would require specialists to prepare financial statements as per the new IFR Standards. Most importantly and additionally, this is the occasion for taking initiatives to offer programmes in international accounting standards by opening appropriate educational and training institutions. Similarly, IFRS training is a sine qua non for the management experts dealing with finance and accounts. They can also be extended training in the standards that have been set under the IFRS. Thus, opportunities are available for the various personnel who can gain expertise and impart expertise to others due to the prevailing situation.

Challenges of the Transitional Phase

It is critical for the organizations adopting the IFRS to have their systems well organised in the pattern of the requirements of IFRS. This will include the preparation of the Balance sheet that requires recognition and reclassification of certain items of assets and liabilities. This will call for changes in policies. Old policies have to be shelved and new policies have to be carved out. The organizations have to evaluate the impact of such policy changes over a long period of time.

The current items have to be re-grouped and re-classified to conform to the IFRS pattern and the new methods of preparation of the details. Any detail otherwise required under the local regime will have to be prepared separately.

The shift to the new IFRS needs a fundamental change in financial reporting. Changes in the application of new policies, the configuration of systems and the controls of maintenance in the internal systems will affect the risks in audits, and mis-statements or fraudulent statements. However, it will impact the way the audits are carried out. Therefore, the entire exercise has to be with a detailed planning. The process of planning should involve:

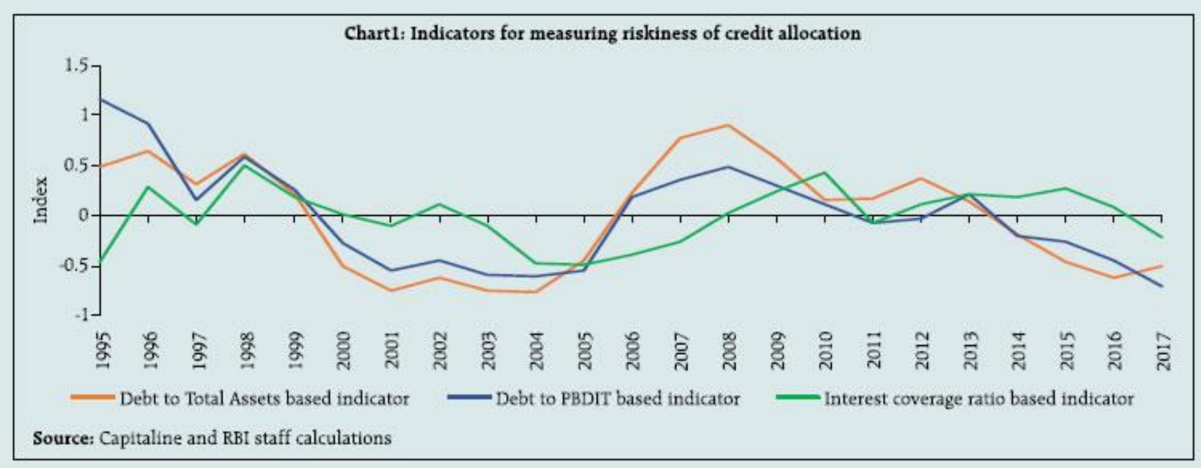
a. The organization's conversion strategy and process
b. The updating of the knowledge of the professionals like the Chartered or Certified Accountants

It has to be borne in mind that the financial statements of the organizations which have undergone IFRS will have the chance of scrutiny by various stakeholders, including financial supporters, investors, market analysts and regulators. There is always a challenge of the stakeholders getting concerned and the impact on audit engagements have to be addressed.

Another very crucial and critical issue is the manipulation of statements and numbers by the managements. The change-over phase is an opportunity for certain managements to play with numbers, hide the mistakes of the past which were not found out earlier. This will reflect in the opening balance adjustment. It would be useful and manageable if the auditors identify the files which are likely to be risky because of their complex nature and the requirements of IFRS vis-a-vis the previous accounting procedures. This will help them to take precautions needed in such situations. The audit professionals should be guided by professionalism and vigilant scepticisms.

There should be a well laid transition plan for the organization from their previous accounting practices to the IFRS. The audit personnel should be involved right from the beginning to plan, lay down conversion procedures, formats which are essential to be helpful for the correct implementation and useful benefits of the IFRS. This can address the high level professional risk and the adverse effects it will have in the process of transition from the traditional to the new IFRS.

To gain the best out of the new method, there should be certain ethical norms as well to be practiced. There should be a moral code of conduct. The auditors should be independent, impartial and transparent who will only be guided by the professional manuals. The current practices of devising the indicators are so faulty as to benefit the groups which should not get the benefit of credit. The RBI report points out the current imbroglio in this situation. *"A higher value of the indicator implies riskier firms getting more credit as compared to less riskier ones. All three indicators display cyclical patterns in the riskiness of credit allocations." This is shown in the chart provided below taken from the RBI Report itself.*



Conclusion

Adopting and converting to IFRS is a major challenge for all the organizations. Nevertheless, it provides a great opportunity to the organizations to lay down financial information on a clean slate, provide transparent information to stake holders, present opportunity to have international communication in a comprehensible manner and also give opportunity to the society to have more trust and confidence in the organizations which will ensure further scope for the advancements of actions towards growth. If the organizations have already adopted such a policy, IFRS 9 will also be helpful in the pandemic like unforeseen and uncertain situations. Therefore, there is a need to adopt and implement IFRS 9 especially in the banking sector in India. However, the banking industry and the RBI are yet to address the concerns of the brass-tacks. It is pertinent to note the statements as given by the RBI in its report as quoted here: *"The report highlights that both accounting and prudential requirements affect the identification and measurement of NPAs with practices varying across countries. While International Financial Reporting Standards (IFRS) is the prevailing global standard, a number of jurisdictions do not follow IFRS which can lead to differences in determining both the volume of impaired assets and also their associated provisions. Even in jurisdictions that apply IFRS, the judgmental nature of the collateral valuation process, particularly with respect to estimating collateral values under the Net Present Value (NPV) approach, can lead to vastly different provisioning outcomes across IFRS reporting jurisdictions. For instance, impaired assets under IFRS-9 require a more granular assessment of credit risk in comparison to International Accounting Standards (IAS) 39. Under IFRS-9, applicable entities must now place financial instruments in three distinct stages -- performing, underperforming and non-performing -- rather than the unimpaired and impaired categories under IAS 39. There are subtle differences between the treatment of "forborne" exposures under IFRS and existing US Generally Accepted Accounting Principles (GAAP). Under IFRS-9, a financial asset that has been re-negotiated (forborne) cannot be automatically upgraded to a higher quality status without evidence of demonstrated payment performance under the new terms over a period of time. IFRS-9 requires write-offs if the entity has no reasonable prospects of recovering a financial asset in its entirety or even a portion of it. Under the current US GAAP, the asset is required to be written off in the period in which it is deemed uncollectible."(RBI,2018*) Therefore, the banking industry in India under the post pandemic uncertainties confront several challenges of implementation of the international financial reporting systems which need to investigated both at the policy making levels and the implementation levels at the individual banks as some of the issues are not either uniform or common and they vary from one group of banks to other groups of bank.

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