

*Financial Reporting in the context of Financial Stability: A Regulator's View on Some Accounting Issues**

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Dr. Ashraf Nabhan Al Nabhani, Dean, College of Banking and Financial Studies, Mr. Kishore Rabi, Chairman, ICAI Muscat Chapter and other delegates. It gives me great pleasure to address this august gathering organised by the Muscat Chapter of the Institute of Chartered Accountants of India (ICAI). I am given to understand that the Muscat Chapter, the 19th overseas chapter of the ICAI is amongst the most active chapters of the ICAI and has been engaging in capacity building for Omani accountants and imparting professional education in the Sultanate. A key initiative is its tie-up with the College of Banking and Financial Studies (CBFS) in assisting them with their accounting curriculum. This Chapter's engagement with the College of Banking and Financial Studies is just one of the many ways in which the banking community and regulators can benefit from the technical knowledge base of the accounting community.

2. The history of the Indian accounting profession can be traced back to the enactment of the Companies Act in 1857 that introduced for the first time the concept of preparing balance sheet on a voluntary basis by companies. We have come a long way since then and the ICAI, established in 1949 by an act of Parliament, is today the world's second largest professional accounting body after the American Institute of Certified Public Accountants (AICPA), with over 1,80,000 members. Over the six decades of its existence, it has played a vital role in nation-building through its services.

3. In line with its motto of '*Ya Aeshu Suptaeshu Jagruti*' (a person who is awake amongst those that

sleep) and its emblem of the Garuda, the '*Vahana*' of Lord Vishnu, the Institute is playing a key role in keeping a watchful eye on financial statements, ensuring that they represent a true and fair view of the state of affairs.

4. As regulators and supervisors of India's banking system, the Reserve Bank of India (RBI) places a significant amount of reliance on inputs provided to us by your profession through the statutory audit and long form audit reports of banks as well as our annual interactions with the statutory auditors of commercial banks. We also have periodic interactions with senior members of the Institute at various fora and take a keen interest in the latest developments in this field.

5. The Reserve Bank has closely worked with the Institute on accounting issues in the banking sector. In October 2001, the Reserve Bank set up a Working Group under the Chairmanship of Shri N. D. Gupta, the then President of the Institute to identify gaps in compliance with accounting standards issued by ICAI and also recommend steps to eliminate such gaps. Based on the recommendations of the Working Group, landmark guidelines on compliance with accounting standards were issued to banks in March 2003 to ensure strict compliance with accounting standards and avoid qualifications in financial statements.

6. The Reserve Bank had formed a committee in 2000 to study the observance of international standards and codes in India in various individual areas of the overall financial system. With respect to Indian accounting and auditing standards, it was found that there were several gaps when compared to the international standards and recommendations were made to reduce this gap. I am happy to note

* Address by Shri Anand Sinha, Deputy Governor, Reserve Bank of India, at the event organised by Muscat Chapter of ICAI at Muscat on December 21, 2011. Inputs provided by Shri P. R. Ravi Mohan and Amarvir Saran Das are gratefully acknowledged.

that the ICAI has since issued many accounting standards, which have substantially reduced this gap.

7. While on the subject of the Reserve Bank's insistence on adherence to international best practices and our ongoing benchmarking against these standards, I would like to draw your attention to the Report on Observance of Standards and Codes (ROSC), a joint initiative between the IMF and World Bank in 2004 which among others, reviewed the strengths and weaknesses of the corporate accounting and auditing practices in India. Some of the major recommendations were to bridge the gaps between International Financial Reporting Standards (IFRSs) and Indian accounting standards, strengthening the monitoring and enforcement mechanism, introducing practices to ensure compliance with code of ethics by auditors of public interest entities and taking steps for improving professional education and training arrangements.

8. India also participated in the Financial Sector – Assessment Programme (FSAP), a joint initiative of the International Monetary Fund and the World Bank that attempts to assess the stability and resilience of financial systems in member countries. Based on India's experience in the FSAP and subsequent self-assessments, the Government of India, in consultation with the Reserve Bank, constituted the Committee on Financial Sector Assessment (CFSA) to undertake a comprehensive self-assessment of India's financial sector, the report of which was submitted in 2009.

9. The CFSA made an assessment of Indian accounting and auditing standards and came up with some key recommendations that proved critical for the Institute. The report, *inter alia*, suggested convergence with IFRS at the earliest and creating awareness among auditors and others involved in the process to ensure that systems and procedures are in place to comply with the IFRSs. Another important recommendation is that India should contribute significantly in the agenda-setting of the International Accounting Standards Board (IASB) and its technical output. The challenge before the Institute is to take this up in right earnest by identifying persons with requisite competence to

participate in global forums, the benefits of which will flow to the profession at large.

Accounting Issues in the Context of the Financial Crisis

10. The global financial crisis and the consequences thereof exposed some weaknesses in the accounting and auditing aspects. During the course of my presentation here I would like to place before you some issues relating to financial reporting in the context of financial stability.

11. There was widespread criticism that certain accounting practices either contributed to or, at the very least, exacerbated the severity of the crisis, in view of its failure to deal with illiquid markets and distressed sales. The G-20 Working Group on 'Enhancing Sound Regulation and Strengthening Transparency', in which I had an occasion to work actively, recommended that accounting standard-setters should strengthen accounting recognition of loan-loss provisions by considering alternative approaches for recognising and measuring loan losses that incorporate a broader range of available credit information. Accounting standards-setters and prudential supervisors were advised to work together to identify solutions that are consistent with the complementary objectives of promoting the stability of the financial sector and of providing transparency of economic results in financial reports.

12. The G-20 report also recommended that the IASB should enhance its efforts to facilitate the global convergence towards a single set of high-quality accounting standards and also opined that accounting standard-setters should accelerate efforts to reduce the complexity of accounting standards for financial instruments and enhance presentation standards. These recommendations together with the recognition within the accounting and audit profession that there were certain drawbacks in the current standards has necessitated large-scale revision of various standards especially those relating to financial instruments and Fair Value Accounting. During the global financial crisis, the IASB and the US Financial Accounting Standards Board (FASB) established a Financial Crisis Advisory Group

comprising senior leaders with broad international experience to address accounting issues emerging from the global crisis. The key issues identified by the FCAG involved:

- the difficulty of applying fair value ('mark to-market') accounting in illiquid markets;
- the delayed recognition of losses associated with loans, structured credit products, and other financial instruments by banks, insurance companies and other financial institutions;
- issues surrounding the broad range of off-balance sheet financing structures, especially in the US; and
- the extraordinary complexity of accounting standards for financial instruments, including multiple approaches to recognising asset impairment. Some of these weaknesses also highlighted areas in which IFRS and US Generally Accepted Accounting Principles (US GAAP) diverged.

13. While these aspects were identified by accounting professionals, regulators expressed concerns on systemic risk arising out of pro-cyclicality in accounting standards. Procyclicality in policymaking refers to financial developments and policies that add momentum to the economic cycle and have an amplifying effect on economic fluctuations. The procyclicality embodied in capital regulation and accounting standards was among the identified causes underlying the global financial crisis. The in-built procyclicality amplified business cycles, affecting both the degree of credit expansion in benign conditions and the degree of credit contraction in the downturn.

14. The requirement of using fair value accounting for assets and liabilities in illiquid markets has serious disadvantages from the point of view of regulators, and of systemic financial risk. A mark-to-market approach, *i.e.*, fair value accounting contributes to excessive leverage during boom periods and leads to excessive write-downs in busts. Under such accounting, irrational exuberance in asset prices can feed through to high published profits and

perhaps bonuses, encouraging more irrational exuberance in a self-reinforcing fashion: when markets turn down, it can equally drive irrational despair. If all market participants attempt simultaneously to liquidate positions, markets which were previously reasonably liquid will also become illiquid, and realisable values may, for all banks, be significantly lower than the published accounts suggested.

15. Volatility in financial statements is also a concern for the regulator. Fair value accounting introduces volatility into financial statements through the following channels:

- Volatility on account of changes in underlying economic parameters. For instance, if interest rates increase, the fair value of bonds reduces and vice versa.
- Volatility produced due to measurement errors and/or changing views regarding the economic prospects through the business cycle. Fair value measures generally represent the present value of a stream of expected cash flows. Very often the determination of expected cash flows involves statistical techniques which may have some amount of estimation errors as well as other errors.
- Volatility arising on account of using a mixed measurement model, *i.e.*, one that uses fair value for some categories of assets and liabilities and amortised cost for others, thereby reducing the netting effects that a full fair valuation of assets and liabilities would produce.

16. Another area which has received focus is the delayed recognition of impaired assets. Accounting standards today rely more on an 'incurred loss' model to recognise losses where an event such as non-payment of dues for 90 days triggers the provisioning. Consequently, there is an overstatement of interest income in the early life of loan. When a series of defaults during a downturn trigger provisioning requirements, there is no stock of provisions available to absorb credit losses. These losses directly impact the income statement of the bank and constrain further bank lending, thus exacerbating

the procyclicality. This cycle-neutral approach to provisioning failed to account for the excessive deterioration in loan portfolio associated with excessive credit growth. There is broad international agreement on the need to have provisioning based instead on an 'expected loss' basis where life time losses are recognised early, *i.e.*, provisions are increased in good times for the possibility that the environment may deteriorate in future. However, the implementation of such a model has its own difficulties with regard to the estimation of expected losses and the IASB and the US FASB are still engaged in deliberations on the modalities of implementing such a model.

17. The IASB has issued exposure drafts with an expected loss model which attempts to mitigate these shortcomings by recognising losses and making provisions thereof earlier during the life of the loan. However, presently, IASB and FASB's deliberations revolve around a three-bucket approach to capture the pattern of deterioration in credit quality. Under this model, loans are classified into three categories depending upon the possibility of expected losses. Loans, where there are no events with a direct relation to possible future defaults, are placed in the first bucket. The second and third buckets are used for loans affected by events that have a relationship to possible future defaults such as a drop in housing prices, *i.e.*, a trigger event, to which the default possibility of a loan/portfolio of loans is sensitive to has occurred. In the second bucket, expected credit losses are not identifiable for individual loans whereas in the third bucket expected credit losses are individually identifiable. The provisioning requirements also differ according to the bucket. Whereas entities are expected to provide expected lifetime losses for the second and third buckets, the proposed approach for the first bucket is to make provision for 12 month of expected losses though this is yet to be agreed upon. Since there is no direct relationship to possible future defaults, lifetime expected losses are not required to be recognised for loans placed in the first bucket. Further, the criteria and guidelines for transfer between categories are still at the discussion stage.

18. Let me dwell upon some of the proactive measures initiated by the Reserve Bank to mitigate the effect of procyclicality in the Indian context. Recognising the procyclicality caused by provisioning norms, the RBI has tried to build buffers through provisioning requirements.

- Firstly, banks are required to maintain provisions on assets that are classified as standard and are not showing signs of impairment. Sector specific provisions requiring banks to provide more for standard assets in certain sensitive sectors have also been prescribed.
- Secondly, banks are required to classify accounts as non-performing assets (NPA) where there are inherent weaknesses observed in the account even if there are few credits recorded before balance sheet date to avoid NPA classification. Banks are also required to put in place appropriate internal systems to eliminate the tendency to delay or postpone the identification of NPAs, especially in respect of high value accounts.
- Thirdly, in 2009, observing the trend in profits being made by banks, the Provisioning Coverage Ratio (PCR) requirement for banks was introduced to address apprehensions about asset quality due to exuberant lending during the boom phase. Banks were required to build up a PCR of 70 per cent of gross NPAs by September 2010. PCR was intended to be an interim measure and it was hoped that it would be replaced by a forward-looking counter-cyclical provisioning methodology being developed by the Basel Committee on Banking Supervision (BCBS) and IASB. Since this is taking time, RBI is working on a methodology similar to Spanish dynamic provisioning framework as an interim measure.

19. As regards PCR, it was decided to freeze the PCR with reference to the gross NPA position in banks as on September 30, 2010 since in the absence of a calibrated methodology it would be difficult to allow banks to use the countercyclical provisions built up under PCR freely and there were certain design issues

too. The buffer (surplus of provisions over specific provisions) will be allowed to be used by banks for making specific provisions for NPAs during periods of system-wide downturn, with the prior approval of the Reserve Bank.

20. The financial crisis also led to heavy criticism of accounting rules that permitted certain structured/special purpose entities and exposure to remain off-balance sheet. A key concern with such instruments and vehicles is that they have a tendency to veil the risks off-balance sheet and a robust accounting framework that provides for the recognition and disclosure of these risks is a prerequisite to their introduction. The IASB has tried to rectify the situation by introducing IFRS 10 on Consolidated Financial Statements while the FASB has also worked towards toughening off-balance sheet accounting rules.

21. In India, the Reserve Bank of India has always followed a cautious and gradualist approach towards complex exotic financial products and has taken steps to reduce and contain the regulatory arbitrage between the banking and the shadow banking sectors (mainly the Non-Banking Financial Companies, *i.e.*, NBFCs) by considerably upgrading the prudential rules for NBFCs.

22. Overall accounting for financial instruments had become highly complex and rule-based in the period leading up to the crisis and IASB's project to replace IAS 39 with IFRS 9 is a welcome initiative. However, delays in finalising proposals relating to impairment and hedge accounting coupled with recent proposals to reopen classification and measurement of financial assets are a cause of concern. IASB's classification requirements for assets revolve around the business model approach whereas FASB's approach is based more on the characteristics of the instrument. Further, FASB's approach may also entail more items in the balance sheet being carried at fair value.

Implementation of IFRS in India

23. The convergence to IFRS in India is a work-in-progress and I would like to dwell upon the implementation issues and challenges with particular reference to the Indian banking system.

24. As part of the G-20's efforts to evolve a single set of global high quality standards, the Ministry of Corporate Affairs (MCA), Government of India released a roadmap that provided for a gradual convergence to IFRS in a phased manner commencing from April 1, 2011. In terms of the roadmap, commercial banks in India are required to converge with IFRS with effect from accounting periods beginning April 1, 2013. While the MCA placed on its website 35 IFRS-converged Indian Accounting Standards (Ind AS) in 2011, it stated that the standards will be implemented after various issues, including taxation, are resolved.

25. In order to address the implementation issues and facilitate formulation of operational guidelines to facilitate the IFRS convergence for the Indian banking system the Reserve Bank has formed a Working Group. Specific issues relating to (i) classification and measurement of financial assets, (ii) classification and measurement of financial liabilities and hedge accounting, (iii) amortised cost and impairment, (iv) fair value measurement, (v) presentation, disclosure and balance sheet formats and (vi) derecognition, consolidation and residuary issues are being dealt with by the Working Group.

26. With respect to the financial sector in India, there are special issues and challenges in view of the large-scale revision of standards pertaining to financial instruments (IAS 39) which are of central importance to the banking system. IASB had indicated that the period 2009 to 2011 will be kept as a stable platform by them to facilitate convergence by many countries during this period. However, the global financial turmoil and the consequences thereof in the accounting scenario necessitated large-scale revision of various standards especially those relating to financial instruments and fair value accounting.

27. As India attempts to transition to IFRS, the biggest challenge to the banking sector which is of equal concern to us as regulators, is the lack of clarity and uncertainty regarding the finalisation of IFRS 9: Financial Instruments (scheduled to replace IAS 39) and its convergence with US GAAP. One of the intentions behind scheduling banks for a later convergence was to avoid having them first apply IAS

39 and immediately transition thereafter to its replacement, viz. IFRS 9. Countries like Canada, which have recently converged to IFRS, found it easier on account of pre-existing standards being fairly well aligned with IAS 39, which is not the case in India. With the delay and uncertainty in finalisation of IFRS 9, the convergence process has become almost equal to chasing a fast-moving target.

28. The finalisation of impairment provisions of IFRS 9 at an early date is a critical issue which needs to be addressed by the IASB and FASB. Our apprehensions are that the current proposals contained in the exposure draft or the three-bucket model for provisioning are difficult to implement and operationalise. Further, in countries like India, there may not be enough data available to apply the highly quantitative and statistical techniques to implement a robust expected loss model to recognise impairment losses. Therefore, the Working Group has suggested through its comment letter to the IASB, the need for a practical expedient that allows for a simpler rule-based model specified by the regulator at least in the initial years. We hope that the IASB will consider this while finalising the requirements on impairment.

29. In a country like India, where financial markets are still developing and are not as deep and liquid as in developed countries, there are specific concerns regarding the implementation of fair value accounting in the absence of quoted prices and illiquid markets for several instruments. Consequently, the implementation of fair value accounting would necessitate a dependence on valuation techniques using unobservable inputs which would also bring in a fair share of estimation errors.

30. There are also some major technical issues arising for Indian banks in the course of convergence. Differences between the IFRS9 and current regulatory guidelines on classification and measurement of financial assets, focus in IFRS on the business model

followed by banks and the challenges for management in this area coupled with lack of adequate number of skilled staff and modifications to IT systems and processes which are some of the other challenges that may need to be tackled in due course.

31. Apart from being preparers of financial statements, banks are also significant users of financial statements and base their lending and investment decisions on the financial statements of their customers. This aspect makes skill-building all the more important for Indian banks as IFRS implementation will not only impact their accounts and finance teams but will pervade to their credit and investment analysts and decision-makers. The Reserve Bank has been proactive in facilitating skill-building by conducting seminars and training programmes as well as providing faculty support to some institutions. I am glad to learn that the ICAI too has incorporated IFRS in its curriculum for students and has introduced a certificate course on IFRS for its members. There is also scope for the Reserve Bank, banking system and the ICAI to work together to build skills in this area.

32. Let me conclude by stating that there are several areas of common interest between regulators, bankers and accountants and frequent interaction and interface between these groups would be of mutual benefit to all. I thank you for this opportunity to share a regulator's perspective on some current accounting issues.

References

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