

IFRS

The Complex Issues
Banks Face*

*connectedthinking



In summary



Many countries around the world have either fully adopted, or are about to adopt, International Financial Reporting Standards (IFRS or IAS). These include Australia, Malaysia, New Zealand, Japan and all member countries of the European Union. The United States and the International Accounting Standards Board has committed to harmonise accounting standards.

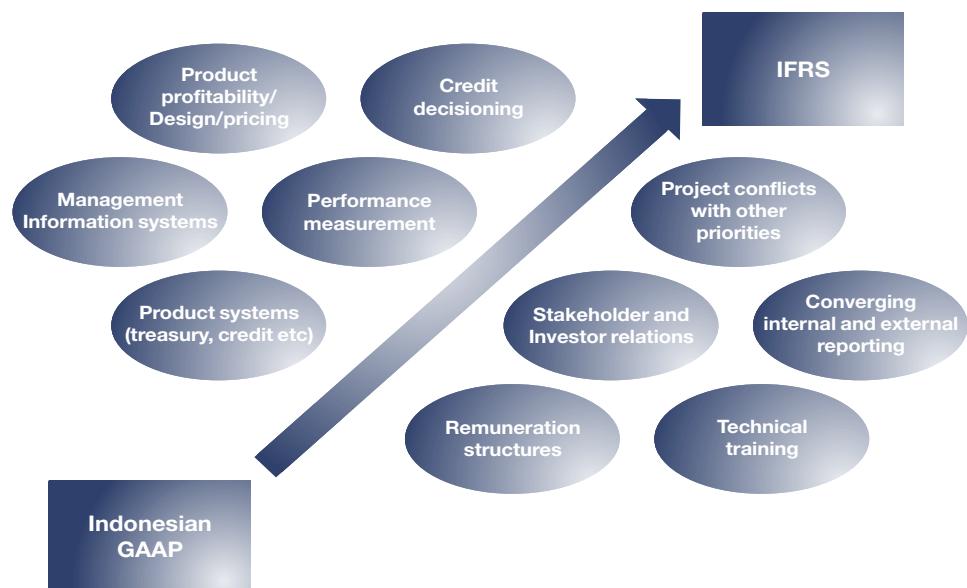
In our view, it is only a matter of time before Indonesian organisations are required to fully adopt these standards. It is the clear intention of the Indonesian Institute of Accountants (IAI) to remove differences between Indonesian Generally Accepted Accounting Principles (GAAP) and IFRS by 2008.

While many standards are similar to existing Indonesian GAAP, our involvement in IFRS projects around the world has demonstrated that the devil is in the detail. Many of the issues are not identified until a thorough analysis has been performed. This paper highlights some of the issues that need to be considered by Indonesian banks adopting IFRS.

IFRS will have a significant impact on the banking & capital markets industry. This will include earnings and capital volatility, market and stakeholder communications, strategic and financial planning, capital management, systems and process changes, performance measurement, training, credit evaluation tools, debt covenants, and certain product offerings.

Some banks in Indonesia, as a result of foreign reporting requirements, have performed a high-level analysis of the impacts of adopting IFRS. However, outside of these organisations, little has been done to assess the potential impact.

Implications of transitioning to IFRS



Concerns are likely to arise around the potential volatility of earnings especially if hedge accounting is not achieved. There are also potential conflicts with existing Bank Indonesia and taxation requirements.

The fact that many large foreign organisations have taken in excess of two years to prepare their response to IFRS, and in many cases are still finalising their response, is evidence of the complexity of some of the issues.

Progress has also been complicated by many of the ongoing changes to some standards which are critical to the Banking & Capital Markets industry.

At the time of writing this article, while no official announcement has been made in Indonesia about the adoption of IFRS, there is a clear intention by the IAI to move towards standards that are consistent with IFRS. At this time, the IAI are preparing a standard consistent with IAS 39 *Financial Instruments: Recognition and Measurement*. The adoption of this standard in Indonesia will have a significant impact on the financial reporting of banks.

Our experience in other jurisdictions has identified that, even in circumstances where the standards are exactly the same as local GAAP, often interpretational differences arise, resulting in a change in accounting treatment.

Examples of some Potential Issues

Provision for loan losses

Currently provisions for loan losses in Indonesia are set based upon, at a minimum, the requirements of Bank Indonesia. These are prescriptive in detailing the minimum provisions to be held against certain classes and ratings of lending assets.

IAS 39 mandates the use of an 'incurred loss' methodology for provisioning for loan losses. This approach means that a provision can only be recognised when there is objective evidence of impairment such as: the deterioration in the creditworthiness of counterparty, an actual breach of

contract, or a high probability of a bankruptcy; and the impact of the event on estimated cash flows can be reliably measured. This requirement means that losses cannot be recognised when a loan is initially originated and provisions cannot be recognised for future losses. The measurement of individually significant assets is based upon discounting expected future cash flows using the original effective interest rate taking into consideration any proceeds from collateral. Non-individually significant impaired loans are evaluated collectively for impairment. 'Buffer' provisions are not permissible.

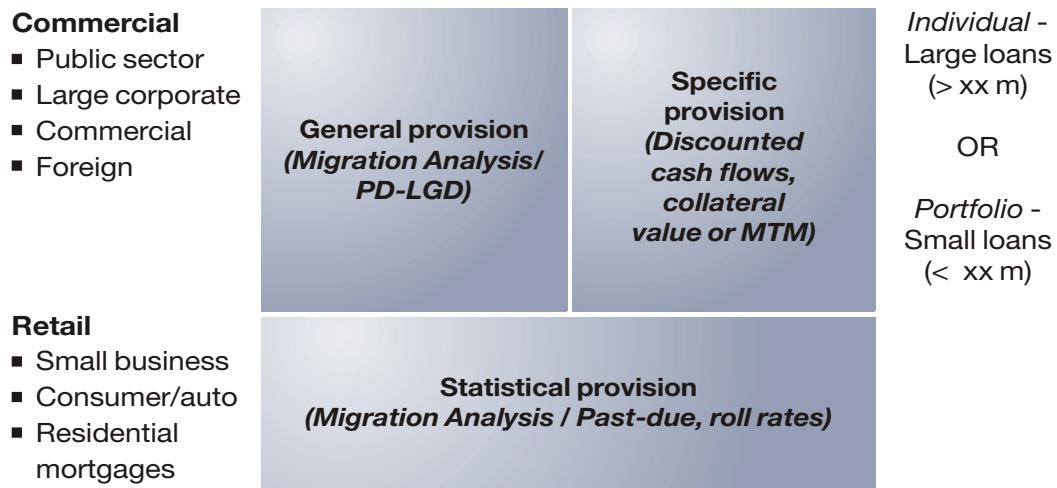
Under the standard, for loans that have previously been treated as non-accrual, there is a requirement to continue to recognise interest income on the impaired assets using the original effective interest rate inherent in the loan. Given the high and growing level of impaired assets in Indonesia, this will result in a significant increase in the interest income recognised in the Income Statement. This will be offset by a higher loan loss expense.

Our experience in other jurisdictions has indicated that IAS 39 generally results in a reduction in the provision for loan losses. In some cases, the possibility exists that the IFRS standards will result in a provision less than that mandated by Bank Indonesia. This creates an issue about whether the accounting standards or banking regulator's regulations should have priority in preparing financial statements.

In moving towards an incurred loss methodology under IAS 39, most banking regulators have responded in one of two ways:

1. Insisting that the local regulators provisioning methodology must continue to be applied for financial reporting purposes until Basel II comes into effect. In this situation, it is accepted that full IFRS has not been adopted.
2. Accepting the IFRS outcome for financial reporting purposes, however, requiring banks to hold capital against expected credit losses using the current risk weighting methodology. This approach recognises that in some circumstances, the objectives of regulators and accounting standards are not always aligned.

$$LLP = EAD \times PD \times LGD$$



At this stage, it is difficult to determine what approach will be adopted in Indonesia. This is an issue where Bank Indonesia will need to identify a solution.

Many organisations are also preparing themselves for Basel II. Under Basel II, banks are required to hold capital against credit risk by using either a Standardised, Foundation or Advanced approach. For those banks moving towards the adoption of an Advanced approach, some of the information prepared for Basel II can be used in developing an incurred loss model. Examples include the Basel II internal estimation required to determine the Loss Given Default and Exposure at Default.

The modelling required under IAS 39 can be complex. To recognise a provision, the onus is on management to demonstrate that based on recent loss experience, using objective evidence of impairment, that there are losses inherent in the portfolio at balance date. While the standard does permit additional provisions for certain economic risks, these provisions also need to be supported with objective evidence. General overlay provisions are not permissible.

The diagram above demonstrates the common methodologies used to calculate the loan loss provision (LLP) using the exposure at default (EAD), probability of default (PD) and loss given default (LGD).

In our experience, organisations that have moved towards adopting an 'incurred' losses methodology in accordance with IAS 39 have spent significant effort in building models to comply with the requirements of the standard.

Effective interest rate method

Under IAS 39, certain financial instruments are required to be carried at amortised cost. This needs to be calculated on an effective yield basis and include fees that are integral to the loan and related costs where incremental or directly attributable. Such fees and related costs are required to be capitalised and amortised to the Income Statement over the expected life of the loan using an effective yield methodology.

While sounding relatively simple in concept, this requirement opens up a complex web of questions that financial institutions around the world are trying to grapple with.

A detailed analysis needs to be performed of all interest earning assets and financial liabilities to identify all associated fees and incremental / directly attributable external costs. To the extent that these fees are integral to the loan or that directly attributable external costs to the loan are identified, then these are required to be included within the amortised cost base of the asset or liability. These

are then amortised on an effective yield basis over the life of the loan.

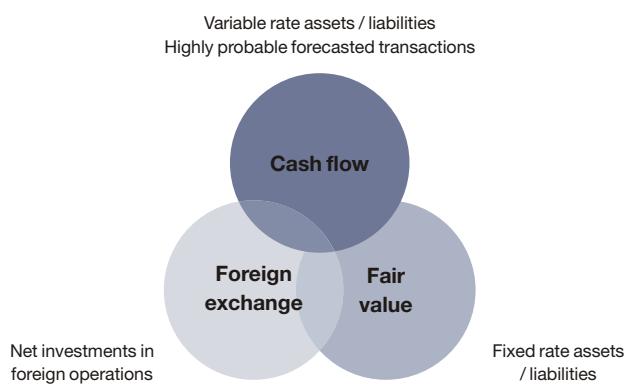
The issues here can be complex. For example, identifying the fees received and costs incurred associated with syndicated loans, and attributing these as part of the effective yield can be an area of significant judgement. In addition, there are complexities in applying this methodology to consumer loan portfolio's.

This may also have a significant impact on those banks that recognise interest income on a coupon basis for their available for sale securities. Under IAS 39, interest income will need to be recognised using the effective interest rate method.

Accounting for derivatives

PSAK 55 *Accounting for Derivative Instruments and Hedging Activities* details the accounting for derivatives in Indonesia. The requirements of this standard are similar to the United States standard FAS 133. In summary, there are three different types of hedges: fair value, cash flow and hedges of foreign exchange hedges relating to net investments in foreign operations.

Different types of hedges under IAS 39

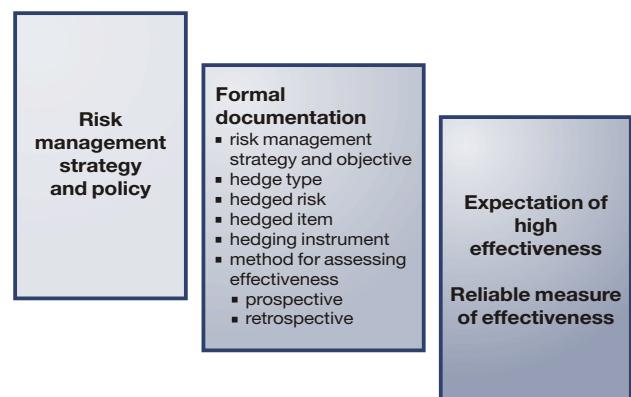


While at a conceptual level PSAK 55 is similar to IAS 39, there are differences in the requirements in accounting for derivatives. In particular, the requirements to achieve hedge accounting differ, and in many cases, are more stringent than the requirements of PSAK 55. In addition, certain hedging techniques permissible under PSAK 55 will not work under IAS 39.

For example, under PSAK 55 the short-cut method can be used where the terms and conditions of the hedged item and hedge match. This allows for organisations to assume the hedge is effective without being required to undertake the hedge effectiveness tests or to separately account for any ineffectiveness. Under IAS 39, this approach is not permissible. The hedge effectiveness test needs to be performed and any ineffectiveness taken to the Income Statement.

Most banks in Indonesia have elected not to hedge account derivatives due to the complexities of PSAK 55. The consequences are that banks in Indonesia have Income Statement volatility arising from the requirement to carry these derivatives at fair value. We believe that as the Indonesian banks increase their complexity through writing more fixed rate business, and they start to access the global capital markets for long term wholesale funding, they will need to enter into more derivatives to hedge the economic risks that arise. As a result, to avoid significant Income Statement volatility, it will be necessary to meet the requirements of IAS 39 to achieve hedge accounting. In our experience, further analysis is required to assess whether certain hedging solutions used in other markets will work here.

Hedge criteria under IAS 39



Our global experience is that to implement an effective hedging solution under IAS 39 is complex. Usually a system based solution is required and there is often extensive changes required to existing processes both prior to, and after, executing hedging contracts. Not only are the documentation and effectiveness tests operationally difficult to

implement, the associated accounting entries are complex.

Globally we are seeing many organisations that have implemented hedging solutions in prior periods where it is now being discovered that the documentation or processes to achieve hedge accounting were not appropriate. This is resulting in the restatement of financial statements.

Derecognition of financial assets and liabilities

Indonesian GAAP does not currently have any derecognition rules with respect to financial assets or financial liabilities. However, IAS 39 has a series of detailed 'rules' regarding derecognition especially for financial assets.

In our experience, the rules can be difficult to navigate. They often require certain assets that may have previously been derecognised to be treated as a collateralised borrowing (i.e. on-balance sheet). The area most impacted is securitisation transactions. In many countries, assets that may have been 'sold' through a securitisation are required to be re-recognised under IAS 39. This means that not only are the assets on-balance sheet, but a gain or loss upon securitisation is not recognised when the assets are 'sold'. Similarly, the proposal by State Banks to sell non-performing loans to Special Purpose Vehicles may fail the derecognition rules.

The financial asset derecognition rules often require an asset to only be recognised to the extent of an

organisations on-going involvement. For example, if an entity retains control of a financial asset, but does not retain or transfer substantially all the risks and rewards, the asset is recognised only to the extent of the entities continuing involvement.

The derecognition rules for liabilities can also be difficult to apply. Under IAS 39, a liability can only be derecognised when it is extinguished, that is when the obligation is discharged, cancelled or expired. We have seen examples where *prima facie*, liability derecognition makes logical sense, but the requirements of the standard have not been met. An example relates to Bank Indonesia that issue notes into an economy. Even though the Bank Indonesia may know that a certain proportion of notes have been lost or destroyed based upon past experience, they cannot reduce the liability as the derecognition criteria have not been satisfied as legally, the note is still on issue. Another example relates to dormant deposit accounts which cannot be derecognised unless they are extinguished.

In transitioning towards adopting IAS 39, a detailed analysis needs to be taken of financial assets and liabilities to ensure they continue to achieve derecognition.

Recognition and classification

Prima facie, the requirements of Indonesian GAAP are similar as IAS for the initial recognition and classification of financial assets. This is due to the similarity of classifying financial assets as 'at fair value', 'available for sale', or 'held to maturity'.

Financial assets – subsequent measurement

Financial Assets			
	Held to maturity	Loans and receivables	FV thru PL
Subsequent measurement	Amortised cost		Fair value
Changes in Carrying amount	Income statement		Equity

However, in the detail, important differences exist. For example, IAS 39 requires financial assets and liabilities to be initially recognised at fair value plus direct incremental transaction costs. Under Indonesian GAAP, transaction costs relating to originating loans are generally expensed as incurred. In addition, Indonesian GAAP does not insist on initial measurement being based on fair value. Therefore if loans are not at arms length, for example an interest free 2 year inter-company loan, this may cause some difficulty on initial measurement (as the fair value of the loan will not be its face amount) at the entity level.

Financial Liabilities		
	Other Fin. Liabilities	FV thru PL *
Subsequent measurement	Amortised cost	Fair value
Changes in Carrying amount	Income statement	

* The fair value option can only be applied in limited circumstances

There are also different tainting rules under IAS 39. For example, once an instrument is designated as 'at fair value through the Profit and Loss', the instrument cannot be subsequently reclassified to another asset class. In addition, the tainting rules for Held to Maturity securities are more onerous under IAS.

Impairment testing

AS 36 *Impairment of Assets* specifies the approach for assessing the impairment of assets including fixed assets, goodwill and other intangibles but excluding those assets covered by another accounting standard such as financial assets and deferred tax assets.

Unfortunately there is no guidance on how to apply this standard to a financial institution and the standard has not been written to deal with impairment issues in a financial institution. For example, the analysis for impairment under IAS 36 is required to be performed on a pre-financing basis. While this makes sense for non-banks, for banks the

cost of finance (i.e. the interest expense) should be included in any impairment test. As a result, building a robust impairment model can be very involved.

In undertaking an impairment test, care needs to be taken in determining the recoverable amount and carrying amount to ensure completeness, consistency and no double-counting. Accounting and valuation expertise are essential in developing an appropriate impairment model.

Do act now

This article only highlights some of the issues arising from the adoption of IAS 39 and other standards in Indonesia. There are many other potential areas that need to be considered such as business combinations (especially quasi reorganisations), consolidation of special purpose vehicles and reclassification of financial instruments between debt and equity.

Some of the IFRS conversion challenges for financial institutions include:

- Board of Directors / Commissioners buy-in and clear support
- inflexible legacy systems
- under estimation of the effort involved
- numerous data gaps – typically IFRS gives rise to hundreds of specific new data requirements
- conflicts with other projects (e.g. Basel II)
- system and process modifications and improvements
- rigorous and disciplined project management
- acceptance of change throughout the institution
- knowledge transfer and training
- mark-to-market, hedge effectiveness and loan allowance models can be difficult and expensive to develop
- IFRS is still evolving and modifications continue

As your institution progresses towards understanding and responding to the impacts of IFRS, be prepared for the unexpected and sometimes unpleasant surprises. If there are no concerns, you should question the depth and quality of your analysis.

Issues are likely to arise when performing the detailed calculations and attempting to design a solution that complies with the requirements and works on a practical level. The rules are not always intuitive.

We have seen many organisations lack access to the data they need (often historical), or existing systems cannot cope (e.g. with the revaluations required).

Strong technical accounting and business skills are

essential. Access to experts and / or knowledge resources is critical to ensure appropriate identification and resolution of the issues.

In transitioning towards IFRS, one matter that often gets overlooked is the complexity in the disclosures required in the financial statements. The disclosure requirements are substantially different and often new information needs to be captured to meet these requirements.

Of course, as Indonesia moves towards IFRS, no one institution is alone. Most issues have been considered in other jurisdictions that have already transitioned towards the adoption of IFRS.

The first step is awareness. The solutions are out there, but do not leave it too late to find them.

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To discuss how we can help you to make the change to International Financial Reporting Standards or with technical queries, please contact our Financial Services team:



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