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Deliberating Upon the IFRS Norms and Compliance Issues in Developing Countries Like India

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ABSTRACT

The harmonization of accounting standards is a fast-growing international trend with International Financial Reporting Standards (IFRS) as the front runner having broad-based acceptance. The paper seeks to summarize the findings of various studies regarding the adoption of IFRS by developing countries. It deliberates the reasons for IFRS adoption by these nations, the issues and challenges of the transition, the economic impact of the process, and the recommendations by various authors. The paper examines the existing literature for studies on the ongoing IFRS convergence through Ind AS adoption in India and concludes that there is paucity of studies with specific reference to India. It recommends further case-based studies on Indian corporates for analyzing the impact of IFRS convergence on their performance as well as business perception survey to assess the level of preparedness in the corporate setup for this transition. In view of the ongoing phased mandatory adoption of Ind AS by Indian corporates, the paper attempts value addition by highlighting specific areas of concern for Indian corporates, particularly multinationals listed on foreign stock exchanges. Financial impact on the companies could have broader ramifications for the Indian economy. The paper seeks to identify future research areas that may assist the corporates in risk identification and mitigation strategies for Ind AS transition. This paper is limited in its scope to existing research on the impact of IFRS on developing countries. It has practical implications for researchers, accountants, corporates and policy-makers about IFRS convergence in India.

Keywords: *accounting standards, economic impact, financial impact, IFRS, Ind AS*

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INTRODUCTION

Economics has been defined as the science of optimization of choices under the constraint of scarcity of factors of production (like land, labor, capital and entrepreneur) with the objective to maximize the utility for people at minimum opportunity cost. The economic problem is that, while factors of production are finite, human requirements are unlimited. Thus, exercising choice of utilization of a factor of production results in the 'opportunity cost' of its non-utilization for alternative uses. The cost of any goods or services may also be determined by considering the prevalent market value of inputs and production of any goods or services that occurs if an entrepreneur is able to employ the resources at the least opportunity cost. Over time, this results into production of goods and services having the least opportunity cost. Many times, this leads to over-exploitation of selected resources and some under-utilized or idle resources. This translates the economic problem into one of making a rational choice to maximize the benefits while considering the potential trade-offs to minimize the opportunity cost. The three fundamental questions of economics for every society are what to produce, how to produce and for whom to produce. Markets are the spontaneous tool of exchange that have arisen historically in all civilizations and cultures as people find value in trade. The voluntary exchange of resources through market trading creates wealth with prices guiding the terms of the trade (quantity, quality, time duration, total value, delivery place, etc.).

Global economics is concerned with the objective of maximization of utility for the individuals as well as collective human society within the constraint of scarcity of resources. It encompasses the production, distribution, and consumption of goods and services across the globe from producers to consumers.

Global trade is thereby driven by producers and consumers seeking to minimize their opportunity cost by making choices with the highest utility. Cross-border transactions increase the size and depth of markets increasing the available options for both buyers and sellers to match their different payoffs, preferences and incentives.

Economic theory propounds that individuals as well as business entities are rational, i.e., they take decisions to maximize their utility or profits and that decisions are taken at the margin. This implies that the marginal benefit of an option should outweigh the marginal cost for it to be exercised. From an economic standpoint, investments are the giving up of present-day utility for a higher value in the long term. The free flow of international capital is a natural progression of lenders seeking lucrative investment opportunities and borrowers seeking funding at the cheapest cost. A free and fair transfer process is an essential pre-requisite for the growth of trade. Advancements in technology, travel, communication, medicine, etc. are shaping the demand and supply of goods and services across the globe.

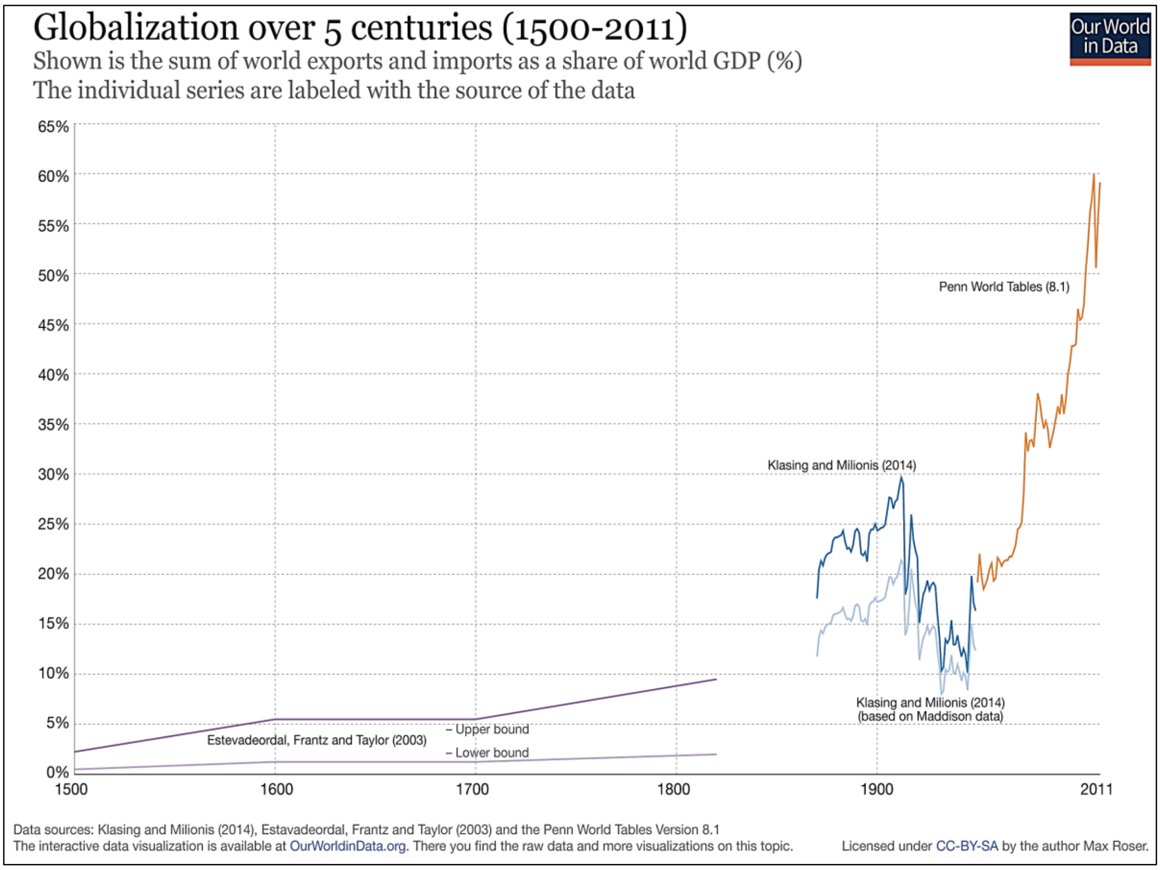

***Fig. 1**. Growth in Globalization from 1500 to 2011.*

The advent of digital payment mechanisms in the global economy in the past few decades is an enabler for financial capital markets worldwide as well as cross-border transactions. These financial transaction mechanisms serve the cause of free markets by standardizing the transfer process, making it fair, transparent, cheaper and easier to access for retail.

The following graph of world trade historical data lends credence to the view that events of significant human progress are characterized by quantum jumps in international trade flows (Figure 1). It depicts the growth in share of international trade as a percentage of world gross domestic production (GDP).

The per capita purchasing power parity (PPP) gross world product (GWP) is estimated at US$ 127 trillion for 2017, as reported by the CIA World Factbook.

DEVELOPING ECONOMIES AND FOREIGN INVESTMENT IN GLOBAL TRADE

Fiscal year 2019 onwards, the World Bank has changed its classification of economies to gross net income (GNI) per capita, the calculation of which is to be done in accordance with the World Bank Atlas method applicable in 2017. The revised method considers countries with a GNI per capita of $995 or less as low-income economies. Countries with GNI per capita between $996 and $3895 are deemed as lower middle-income; upper middle-income economies have this metric between $3896 and $12,055; while high-income economies have a calculated GNI per capita of $12,056 or more.

The World Trade Organization allows countries to classify themselves as developing or developed, with the consent of other members. The United Nations classifies about 159 countries as developing for monitoring purposes, even though it does not espouse a formal definition for the term. Even in the absence of a universally accepted definition and list of developing nations or emerging market economies, it is observed that most of these nations are typically characterized by higher growth rates since the late 1990s and lower standards of human development than those of developed nations.

Importance of FDI and FII in Developing Economies

The high growth trajectory necessitates infusion of capital through foreign direct investment (FDI) and foreign institutional investment (FII) in these economies apart from the domestic sources of capital. Economic growth necessitates the cycling of funds from savings surplus (e.g., domestic households) to savings deficit (e.g., industry) entities. As the world increasingly becomes a global village, the matching of requirements and transfer of funds from surplus to deficit entities on a global scale even in real time has become a possibility. The surplus capital in developed countries is often powering the growth of emerging economies through FDI, FII, multinational subsidiaries, etc., and in return generating higher returns for the lenders than prevailing rate of return for capital in the home countries. The channeling of surplus funds into economic activity leads to the creation of further surplus units and thereby drives economic growth through optimal utilization of surpluses toward optimization of deficit or neutral units. Stock exchanges at New York, London and Tokyo allow listing of international company’s equity, bonds and other hybrid instruments, and international investors can purchase these instruments denominated in foreign currency. Global trade of goods, services and capital is contributing substantially to the increase of GWP.

Changing Nature of Global Trade and Financial Transactions

The data indicates that there is change over time in the fundamental nature of the items of trade, say changes in percentage trade share of items such as basic commodities like food-grains, high-value goods like electronics, and intangibles like software service. There appears to be increasing bilateral trade between nations as compared to unilateral flows and the share of emerging economies in percentage of total trade has increased. Also, it appears that the developing economies display greater changes in composition of exported goods in terms of shift from food-based exports to higher volumes of other merchandise and services. Statistics illustrate the role of factors, viz., technological progress, increased human lifespans on account of medical advancements, changes in human lifestyle, and ease of transportation and their impact on the changes in supply and demand of goods and services. Global trade flows and volumes are also influenced by socio-economic and geopolitical dynamics of various nations and trading blocs.

Over one-third of global financial transactions occur across borders and this number is expected to grow. The Boston Consulting Group estimated the value of global payment transactions for 2016 at USD 420 trillion, i.e., 5.5 times global GDP. Cross-border financial transactions are driven by investors seeking lucrative investment opportunities and diversification of risk, companies seeking to raise lower cost capital, undertaking transactions or having international operations and subsidiaries in multiple countries.

ROLE OF ACCOUNTING STANDARDS IN INTERNATIONAL TRADE

Accounting is the record-keeping of transactions in order to assess the gain or loss and prepare the periodical financial statements of the business entity to determine financial performance over time as well as compare with other entities. Accounting standards are the codified rules pertaining to measurement, treatment and disclosures of accounting transactions. They provide the standard nomenclature, policies and practices to be followed and disclosures to be made. This standardization eliminates the subjectivity in financial statements and increases their comparability across entities, making the information useful for investors, regulators and corporate managements. The book-keeping of cross-border activities was historically complicated on account of compliance requirements of national accounting standards of different countries. Investment decisions based on these financial statements became costlier and more complex owing to the need to interpret multiple financial statements filed in accordance with various compliance and accounting standards requirements. The basis for calculating the same figure, say depreciation or net equity, would be different under various national accounting standards; and therefore, the reported amounts under different standards would not be easily comparable. The minute details of various accounting standards were required to be studied as even minor variations in requirements could translate into major impact on a company's reported financials – for example, applying one set of national accounting standards may result in a company reporting profits as compared to losses under another.

HARMONIZATION OF INTERNATIONAL ACCOUNTING STANDARDS

Global efforts were initiated in the late 1950s toward 'harmonization', i.e., reducing differences among various sets of accounting principles in practice across major capital markets, located primarily in the European Union. There was an impetus toward convergence of international accounting standards as the volume of global cross-border transactions and shareholdings increased over time. The idea of a singular set of high-quality, globally acceptable accounting standards has found widespread support from the G20 and other major international organizations, many governments, business associations, investors and worldwide members of the accountancy profession.

The first international standards-setting body was the International Accounting Standards Committee (IASC) set up in 1973. In 2001, the International Financial Reporting Standards (IFRS) Foundation established the International Accounting Standards Board (IASB) as an independent standard setting body of the IFRS. The IFRS Foundation and the IASB define the IFRS as standards issued by them so as to provide a common global language for business affairs in order that company accounts are understandable and comparable across international boundaries and therefore reliable and relevant for internal and external users. The Board develops and maintains IFRS with the objective of being a set of high-quality, understandable, enforceable and globally accepted standards based upon clearly articulated accounting principles. The Board is not empowered with any authority, whatsoever, to ensure the compliance with the prescribed standards. Entities that comply with IFRS voluntarily, or in compliance with requirements of a particular jurisdiction, must comply with all of the individual IFRS and IFRS Interpretations (Interpretations) issued by the Board. The standards generally contain principles and accompanying application guidance, both of which are mandatory and carry equal weight.

Economic efficiency requires informed decision-making by investors and other market participants. The information asymmetry between firms and external capital providers and overall lack of transparency in the system are factors contributing to suboptimal financing and funding decisions by market players. These also give rise to opportunity for unethical gains by insider trading, information trading, etc., as evidenced by the number of cases like Enron and Harshad Mehta in the history of stock markets worldwide. Thus, it is fair to infer that increased information symmetry in markets on a global scale would support reduced number of instances of moral hazard as well as minimize costs due to mis-selection of projects for funding on account of lack of information. Availability of financial information that is of high quality and internationally comparable would go a long way in improving the symmetric dissemination of information to all market players and thereby enhanced economic efficiency through optimal capital rationing and utilization.

Impact of IFRS Adoption on Foreign Investment Inflows

Inconsistency in financial reporting between national and international standards may lead to time lags between public dissemination and interpretation of the financial results by international investors and thereby reduce their interest. Akpomi et al. [1] tested a sample of 48 African countries in using the fixed-effect model for regression to identify impact of IFRS adoption on the flow of FDIs. They concluded that that there was enough evidence to support the hypothesis that IFRS adoption has a positive effect on the flow of FDIs. The study also identified expected increases in comparability of financial reporting, improvement in regulatory quality, and reduced information asymmetries as well as foreign investors' cost as incentives for IFRS compliance. The results were supported by the existence of positive co-relation between IFRS adoption and increased FDI, and that it is more visible in countries with lower quality of financial information and hence by, regulatory quality prior to IFRS adoption.

Singleton-Green [2] examined more than 200 research papers on “the impact of mandatory IFRS adoption in the EU”. It was deduced from the research that IFRS adoption affects positively the quality of financial reporting and its international comparability, market liquidity, cross-border flows, cost of funds (capital) and economic efficiency of corporate investments. It was also observed that the results varied across a spectrum depending on the company selected for research and the applicable operating countries. The impacts of IFRS adoption and that of improved regulatory enforcement appeared to be overlapping and could not be segregated in a quantitative manner and so the magnitude of impact of IFRS adoption could not be determined in quantitative terms.

M´arquez-Ramos [3] analyzed the impact of IFRS adoption on macro-economics of countries in the European Union using gravity framework. The results support the positive impact of accounting harmonization on trade and FDI, with greater benefits observed in transition economies. Also, the paper states that the results vary across countries on account of their behavioral variation in aversion to unfamiliarity.

Kapellas & Siougle [4] examined the impact of IFRS adoption worldwide on investment assets, FDIs, mergers and acquisitions (cross-border investments), and ownership by foreign mutual funds (FIIs). The researchers found evidence to support the view that there is a positive correlation between IFRS adoption and investment efficiencies, firm-level capital efficiency, demand for equities by institutional investors, and foreign equity portfolio investments (FDIs). The results of the study also inferred the positive impact of IFRS adoption on accountability in financial reporting through increases in quality and volume of financial disclosures, the greater comparability of financial statements with global peers, reduction in transaction costs that were previously incurred by global investors for understanding the financial statements and thereby increased FDI flows between countries. They also noted that IFRS adoption leads to the reduction in information asymmetry between foreign investors and domestic investors, and this contributes to better results for global IPOs as compared to domestic IPOs, thus leading to positive impact on IPO underpricing. The study also noted that regulators around the world are also benefitted by availability of globally comparable information.

IFRS can contribute to economic efficiency and capital allocation. The implementation of a single accounting language would reduce the cost of international reporting. This would enable the comparison of sources of funding internationally, thereby lowering the cost of capital. Investors would be able to use the comparable data to identify opportunities and risks across the world. Results of a study by Lungu, Caraiani, & Dascalu [5] on the impact of IFRS adoption on FDI conducted on Eastern European countries indicated that the benefit of higher FDI inflows is likely to accrue to IFRS adopting countries as compared to non-adopters. Further, it also concluded that the listed companies are likely to benefit more as compared to non-listed companies. Gordon, Loeb, & Zhu [6] concluded that there is statistically significant positive association between IFRS adoption and enhanced FDI inflows for developing countries, while the same could not be observed for developed countries.

Studies undertaken by the IFRS Foundation have documented benefits of IFRS adoption for some companies such as a lower cost of capital, ease of a common standard in internal reporting, improved ability to compare operating units in different jurisdictions, reduction in number of reporting systems, and flexibility to move staff with IFRS experience around the organization. Other studies reportedly cited increased investment in jurisdictions adopting IFRS.

In respect of Japanese firms, voluntary IFRS adoption has been allowed since 2010. The Japanese Financial Services Agency conducted a study on the key factors accounting for the high proportion of Japanese companies choosing to voluntarily adopt IFRS. The study stated that the factors most often cited by these companies as driving IFRS adoption were increased efficiency in business, greater comparability with international standards, and better understanding by overseas investors.

Global Trend in IFRS Adoption and Convergence

The IFRS are being adopted worldwide by countries in various versions ranging from the original issued by the IASB; IFRS as issued by the European Union or a variant locally adopted to converge the national standards with IFRS (notably India). In some countries, the adoption is mandatory while elsewhere it is optional. There are also countries, notably the United States, that support the IFRS usage by subsidiaries of foreign companies operating in the United States but require reporting for domestic companies under US GAAP. With backing from the SEC, the International Organization of Securities Commissions (IOSC), and the IASB, IFRS may soon be a mandatory requirement for businesses in every country. Over 12,000 companies in more than 100 countries have complied with IFRS norms. The report, 'International Standards: 2017 Global Status Report', published by International Federation of Accountants [7], (IFAC), on the results of a survey conducted on its 104-member countries concludes that 58% have adopted IFRS, 32% have done partial adoption, and 10% have not adopted IFRS.

A report on IFRS adoption by country published by PricewaterhouseCoopers LLP states that, in 2017, 89% of countries with stock exchanges required or permitted listed companies to adopt a version of IFRS. It is surmised that, in the foreseeable future, increased worldwide IFRS adoption is likely to drive convergence of the various forms of IFRS currently in practice toward a common unified IFRS.

The Ministry of Corporate Affairs (MCA), Government of India, notified the Companies (Indian Accounting Standards [Ind AS]) Rules, 2015, on 16 February 2015. The Ind AS are applicable by certain dates to certain classes of company's contingent on the respective firm meeting the criteria laid down in the Act. As notified by The Ministry of Corporate Affairs on 25 February 2011, the Ind AS are to be implemented in a phased manner (Phases 1, 2 and 3) and are to be converged with IFRS. In their prevalent form, the Ind AS are divergent from IFRS on various aspects.

ISSUES IN ADOPTING IFRS CONVERGENCE

Transitioning to IFRS does not come without cost and effort. The transition entails changes to the systems and practices in reporting companies. The users of financial information say investors will need to understand how the information under IFRS is different from the previous regime. Securities regulators and accounting professionals will also have to change their processes.

The foremost obstacle to IFRS convergence is the incremental cost related to switching, training and education of accounting professionals, setting up organizational accounting controls, and underlying hardware and software infrastructure for companies. Hester [8] estimated that the switch from US GAAP to IFRS could cost US investors five trillion dollars on account of the costs as well as the resulting loss of market capitalizations as companies pass on the switching costs to investors through fall in income and share price. Governments, accounting professionals and regulatory bodies would also incur initial switching costs. Reduced earnings and market valuations in the transitional phase could diminish investor confidence.

Lack of investor, academic, finance professional, auditor education in interpreting financial statements under IFRS is cited by Rezaee et al. [9] as one of the greatest obstacles to IFRS convergence.

Alali and Cao [10] deliberated on the vulnerability of the IFRS to external pressures from its voluntary contributors, as the IASB does not have an independent and guaranteed source of funds.

IFRS ADOPTION IN DEVELOPING COUNTRIES

Zehri and Abdelbaki [11] conducted an empirical study on historical data of 74 developing countries (DCs) for period till 2008 to identify the key reasons for their adoption of IFRS. High economic growth rates, superior standards of education and a legal system based on common law were concluded as the key common aspects. Further, the study also suggested that the IFRS transition process, infrastructure requirements, phasing and other modalities for developing countries would differ from those of developed countries.

Thompson [12] examined the issues and challenges for developing countries in adopting IFRS and concluded that IFRS modified to suit each country can provide the most value at minimum costs under conditions of appropriate implementation and continual improvements thereon. The study stated that benefits would outweigh the costs in a scenario of effective and efficient implementation. Enabling factors were identified as surrounding infrastructure, legislation, education and assistance from international bodies. The author recommended a gradual phased implementation with ample communication to all stakeholders and continuous monitoring. The study also underlined the need for developing countries to have a voice in IFRS setting.

Gingrich and Kratz [13] studied survey data from the World Economic Forum’s Global Competitiveness Report to assess business leaders’ perceptions of the accounting and financial environments post mandatory adoption of IFRS in eight developing countries across Latin America, Africa and Asia. The study found mostly positive impact in the accounting environment for three survey variables in eight countries. The authors inferred that the results indicate the essentiality of tightening auditing and enforcement mechanisms in a developing economy for deriving positive impact from IFRS adoption. They also attributed the disparate results of the study to be likely caused by heterogeneous enforcement mechanisms and cultural influences on financial statement preparation. The study concludes that there is insufficient evidence to support the theory that developing countries yet to fully adopt IFRS should postpone or roll back IFRS adoption.

Surianti and Yadianti [14] tested sample financial data of manufacturing companies listed on the Indonesian Stock Exchange to examine whether IFRS adoption leads to improvement of information quality and thereby lower cost of equity capital. The study tested secondary data and time series using path analysis. It concluded that there was no evidence to support positive impact of IFRS adoption on the quality of information and cost of equity capital. The researchers recommended greater incentives from regulators and policy-makers to market participants along with stricter enforcement of rules in order to improve information symmetry and pricing in the Indonesian capital market.

Odia and Ogiedu [15] examined the issues and challenges for Nigeria and other adopters of IFRS. They noted that IFRS are gaining popularity on account of the perceived 'network effects' and identified some of the key issues for successful adoption. The authors concluded that effective implementation is contingent on public education, awareness, resource mobilization for training, communications systems, corporate governance controls, strong accounting institutional framework, independent oversight body, support from accounting bodies and implementation in a gradual way.

Lasmin [16] examined the macro-level effects of IFRS adoption in developing countries and concluded that the results do not support positive relation between IFRS adoption and higher volumes of international trade and investments. The paper attributes this to differences between socio-economic and political-economic environments of developing and developed countries. It suggests that apart from adopting IFRS, developing countries should do capacity building in areas of effective corporate governance practices, internal control mechanisms, robust auditing practices, and strict enforcement and oversight mechanisms.

Fino [17] analyzed the applicability of IFRS in developing countries and the impact of accounting systems on the economic growth. The paper states that the adoption process is dependent more on the ability of governments and regulatory bodies to impose and enforce the standards as compared to their applicability. The author concluded that a long transitional period is required for the adoption of IFRS in a developing country in order to have enough fully trained accounting professionals.

FINDINGS

A substantial part of the existing literature surveyed on IFRS adoption in developing countries dwells on the reasons for adoption by these countries. Mixed results are reported on whether IFRS adoption leads to positive impacts on the economic growth of adopting countries. Some researchers have even taken the view that IFRS adoption is a trend being imposed by developed countries. A substantial portion of existing research focuses on the impact of IFRS adoption on two parameters, viz., quality of accounting information and cost of equity capital, as a proxy for economic impact on the adopting country. There is no unanimity in consensus regarding positive economic impact post adoption of IFRS. However, the general view is that IFRS convergence as a global trend is inevitable, though it will entail challenges in the form of increased short-term costs, requirement of increased infrastructure, regulatory framework changes, greater compliance oversight and investment in manpower training. The researchers generally recommend IFRS adoption with some caveats for a smooth transition to IFRS adoption with minimal costs and disruptions to the economy.

Some studies also focus on country-wise issues and challenges for IFRS adoption. The common areas of recommendations relate to training of accounting professionals, effective corporate governance practices, internal control mechanisms, robust auditing practices, and strict enforcement and oversight mechanisms.

The literature survey did not reveal many deliberations on IFRS adoption in India, particularly about Indian multinationals operating overseas and that are also listed on foreign stock exchanges. This appeared to be a gap in the existing literature and further study in this area could add valuable insight for the ongoing IFRS convergence in India from corporate, auditing, government, regulatory and policy-makers' perspectives.

CONCLUSIONS

The results of various studies appear to conclude that the benefits of IFRS adoption outweigh the costs, even though the modalities of adoption need to be customized for each economic jurisdiction. Further in-depth analysis is required to assess business perception toward IFRS adoption in India in terms of level of preparedness, critical factors for successful adoption and the expected benefits. Quantitative analysis of financial results of key Indian corporates who have undertaken mandatory compliance with Ind AS would also be beneficial for assessing the potential impact on Indian economy post IFRS convergence in the country.

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