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Cost-Benefit Analysis of Convergence with IFRS

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Abstract

In the present era of globalization uniform accounting standards for global business are generally expected. The International Accounting Standard Committee (IASC) is committed to fulfil this expectation by developing a single set of standards for reporting financial statements, i.e. IFRS. The benefits that would flow from convergence with IFRS would be the high degree of reliability, relevance and comparability of international financial information and uniformity in quality of financial reporting across national borders. The objective of this study is to present a short review of the costs and benefits of convergence of accounting standards with IFRS. This paper discusses that adoption of IFRS is going to be very challenging and quite surprisingly rewarding also. The vision of a global accounting convergence may inspire many minds but practically it is hard to go about embracing a situation where accounting principles and procedures are perfectly harmonized among countries throughout the world.

Keywords: *Accounting standard, comparability, consistency, convergence, reliability and uniformity*

Current accounting and reporting practices do not fulfil the information needs in the present global environment. The convergence of accounting standards and the potential adoption of International Financial Reporting Standards (IFRS) is a critically important element in the solution to this problem which provides the high degree of reliability, relevance and comparability of international financial information and uniformity in financial reporting across national borders. IFRS are guidelines and rules that corporates can follow when compiling financial statements. Convergence with IFRS is a valuable process that contributes to the free flow of global investment, eliminates the misleading financial information to investors, improves their ability to compare investments on a global basis, facilitates accounting and reporting for companies with global operations, minimizes exchange costs through correct and fair information, creates a new standard of accountability and greater transparency, benefits the accounting professionals in a way so that they are able to sell their expertise in different parts of the world and create an unprecedented opportunity for standard setters and other stakeholders to improve the reporting model.

In this paper, a modest effort has been made to make an analysis of costs and benefits in respect of convergence of accounting standards with IFRS.

Objectives of the Study

The objectives of the study are:

- To understand the evolution of IFRS and present a short review of global convergence of accounting standards.
- To justify the need and significance of convergence of accounting standards and to analyze

the benefits available to key stakeholders due to implementation of IFRS.

- To assess the costs, obstacles and practical challenges to be tackled on account of migrating to IFRS.
- To make suggestions to drive the maximum benefit of IFRS adoption at minimum cost.

Research Methodology

The study is based on secondary data. The data required for the analysis are collected from books, newspapers, reports and publications of professional bodies in India (like 1CAI) and other professional bodies in the world (like IASB), national and international journals, and relevant websites. The scope of the study is limited to review the different aspects of convergence and analyzing the costs and benefits of IFRS adoption with reference to India.

Review of Literature

In the following part, an attempt has been made to briefly review the earlier studies conducted by different scholars in the field of convergence of accounting standards with IFRS.

A. G. Piper (1985) argues that implementation of the uniform international accounting standards all over the world would benefit and improve the financial markets. **Anderson, A. (1993)** points out that adoption of common accounting standards all over the world is good for creation of value and global decision making about economic activities of an organization. **Belkaoui and Jones (1996)** opine that determining the best mechanism to employ in establishment of uniform accounting standards may be essential to the acceptability and usefulness of accounting standards. **Hossain (2000)** argues that it is not possible to provide desired information to international community without the adoption of 1AS for the preparation of financial statements. **S. Vikamsey (2001)** points out that those who invest overseas in any international business naturally want financial health of the securities issuers and objectives are fulfilled only when the business communities have uniform accounting standards. **Harvey Pitt (2002)** opines that high quality global accounting standards are needed to improve the ability of investors to make appropriate financial decisions as well as to protect their business credibility in the international market place. **Kim et al (2005)** argue that IFRS adopters have lower interest rates, larger amount of loan facility, less restrictive loan covenants, and attract more foreign lenders. **Kim & Shi (2005)** point out that the cost of equity capital is significantly lower for IFRS adopters. **K. Appa Rao (2006)** opines that adoption of international accounting standards is very essential because variations in practice are very large. **United Nations' Report (2006)** argues that most of the countries in Asia are under financial crisis, due to improper accounting standards and non-adoption of international accounting standard. **ICAI (2007)** points out that sound financial reporting standards underline the trust that investors place in financial reporting information and thus play an important role in contributing to the economic development of a country. **Ernstberger & Vogler (2008)** argue that the cost of equity capital is lower in the companies that adopted IFRS or US GAAP. **Hodgdon et al (2008)** opine that compliance with the disclosure requirements of IFRS enhances the ability of financial analysts to provide more accurate forecasts.

Thus it is clear from the above discussion that the IFRS are needed in order to ensure reliability, consistency and comparability of accounting information and uniformity in quality financial reporting about economic activities of organizations to create stability of world economy.

Defining IFRS

IFRS is an accounting framework that establishes recognition, measurement, presentation and disclosure requirements relating to transactions and events to improve and benchmark the quality of financial reporting. The main aim of IFRS is to provide norms and policies of accounting in order to guide the accounting authorities in respect of treatment of economic activities of organizations in the financial statement. In simple words, they appear with a set of authoritative statements stating how particular types of transactions and other events should be uniformly recognized and reported in financial statements. Convergence of accounting standards means achievement of harmony with IFRS. Convergence is aimed to design and maintain national accounting standards in a way that financial statements prepared in accordance with national accounting standards draw unreserved statement of compliance with IFRS. In other words, the national accounting standards comply with all the requirements of IFRS but it doesn't mean that IFRS should be adopted word for word.

Evolution of IFRS

International Financial Reporting Standards (IFRS) are issued by International Accounting Standard Board (IASB) which is the independent standard setting body of the IFRS Foundation based in London. IASB started its operations from April 1, 2001 by taking over the earlier standards issuing body which was known as International Accounting Standard Committee (IASC). The standards issued by IASC were known as International Accounting Standard (IAS) and the IASC worked from June 1973 till March 31, 2001. IASB adopted the existing IAS and continued developing the standards under the name IFRS. Interpretations of IAS and IFRS are developed by the IFRS Interpretation Committee. The Interpretations Committee replaced the former Standing Interpretation Committee (SIC) in March 2002. Presently there are in total 29 IAS and 9 IFRS.

IFRS came into limelight when the European Union decided to adopt it for all its member countries in 2005. Since then, IFRS has spread swiftly all over the world. In the EU countries, listed companies have been following IFRSs for their financial statements from January, 2005. Australia also adopted IFRSs with effect from January 2005. New Zealand has adopted IFRS in 2007. China migrated to IFRS in 2008. Brazil is expected to move in 2010, Canada will adopt the same in January 2011, India from 1st April 2011, whereas Japan will adopt this in July 2011. Mexico plans to adopt IFRS in 2012. US will adopt IFRS only as late as January 2014. As of now around 115 nations have implemented IFRS and it is estimated that the number of countries requiring or accepting IFRS could grow to 150 in the next few years.

Benefits of Convergence

The financial statements prepared by using different accounting frameworks in different countries create confusion among the users which leads to inefficiency in capital markets across the world. Globalization of capital markets recognized the need for a single set of high quality, universally acceptable accounting standards. The greatest benefit that would flow from convergence with IFRS would be the high degree of reliability, relevance and comparability of international financial information and uniformity in financial reporting across national borders.

The need and significance of convergence of accounting standards and the benefits available to key stakeholders due to implementation of IFRS are as follows:

- Convergence with IFRS significantly improves the quality, comparability and reliability of foreign financial statements, builds up trust and reliance among the stakeholders and augments the reputation and relationship of the corporate with the international financial community. IFRS provides cross-border listing of securities so that the companies may be able to attract and raise more funds from the global capital market at lower cost of capital. Besides, it reduces the costs by eliminating multiple reporting, simplifies the process and complexities of preparing the individual and group financial statements.

- Convergence of accounting standards with IFRS will help the investor to understand and compare the financial statements of the foreign companies and he will be able to compare the investment opportunities, which will help him to make the right investment decision. The investors can save time, money and the effort which are now involved consolidating divergent financial information when more than one set of reports are required to comply with different national laws or practices.
- The globalization has provoked many countries to pursue convergence of national accounting standards with IFRS. The convergence benefits the economy by boosting international trade, encouraging cross-border investment, increasing flow of capital into the economy, facilitating maintenance of orderly and efficient capital markets, accelerating capital formation and thereby contributing towards economic growth. It would be beneficial to those countries which still do not have adequate codified standards of accounting and auditing.
- Migrating to IFRS goes beyond a technical exercise for an accounting function and needs training not just for finance or accounting personnel but for the entire organization to impart new skills and knowledge to the employees. Thus, the employees will get an exposure to novel concepts and can expect more career avenues across the globe as well as better remuneration.
- Convergence with IFRS ensures adequate and acceptable accounting information to management to take right decisions about international business activities. It will make it easier for financial executives to conduct the comparative and operational analyses needed to run businesses and to manage critical relationships with customers, suppliers and others.
- Implementation of IFRS will offer ample opportunities to the international accounting professionals across the globe as the same accounting practices will prevail throughout the world. It will be less expensive for them to provide training to their staff. The movement of staff across national boundaries will become easier. This will enable them to sell their services in different parts of the world and can bring in attractive returns.
- The adoption of IFRS would be more beneficial to the multinational companies as the communication of financial information within the groups will become easier and with the uniformity in financial reporting standards it will be easier for them to fulfil the disclosure requirement for stock exchanges around the world.
- Implementation of IFRS will offer ample opportunities to the Banks, financial institutions and foreign lenders. As lender of funds they will be able to understand the financial statements of foreign companies, evaluate accurate risk of borrowers, compare the lending opportunities, offer their loan products at competitive prices and improve the relationship with their clients in the long run.
- Adoption of IFRS will be of great assistance to the national tax authorities around the world if net income was computed on similar accounting principles and practices as the taxes are levied on the total global income of an organization.
- Convergence with IFRS ensures standardized accounting information for policy formulation to world business communities and increases the accountability of the government. It will

be beneficial to regulators too, as a complexity associated with a need to understand various reporting regimes would be reduced.

Costs of Convergence

There are several obstacles and practical challenges in convergence and achieving full compliance with IFRS:

- The most fundamental obstacles to achieving full compliance with IFRS are the size of the present differences in cultural, social, legal, political and economic environment of different countries. The standards set internationally won't be flexible enough to adopt to different situations and they cannot possibly cater to the wide range of national circumstances, legal systems, stages of economic development, and cultural differences.
- The barriers to convergence include the differences between the accounting practices of different countries, lack of strong professional accounting bodies in some countries, lack of adequate depth and breadth for reliable determination of fair values in some countries, difference in users' needs in different nations, divergence between the needs of large multinationals and smaller business entities in developing countries, variation in involvement of government in standard-setting from country to country, different levels of sophistication and influence among different national accounting professions. These barriers hinder the conveying of certain company specific information which is incomparable with others.
- The success of convergence depends on the extent to which the national GAAP, legal and regulatory issues are amended to meet the requirements of IFRS. By and large, for every IFRS and IAS, there is a corresponding accounting standard in India but the regulations of Indian Accounting standards are quite different from those of IFRS. There are a few IFRS and IAS which can be adopted immediately. Many of them have differences from the corresponding Indian Accounting Standards. Some of them require technical preparation and some are there whose adoption would require change in law or regulations.
- Convergence with IFRS will require the dissemination of IFRS knowledge throughout the organization to ensure its application on an ongoing basis but there is a lack of awareness and understanding of the requirements and implications of IFRS transition and compliance. Many organizations are not prepared for full adoption of IFRS and they just consider this process as an accounting issue.
- Implementation of IFRS requires well-trained accounting professionals, auditors as well as their staff to function under IFRS environment but there is lack of trained accounting professionals with adequate practical experience of IFRS implementation process. As a result, the companies will have to face difficulty in preparing their financial statements in accordance with converged accounting standards.
- Convergence of accounting standards with IFRS has significant costs in terms of money, time and effort. Cost of converting to IFRS includes cost of internal personnel's time, cost of training accounting professionals and other employees, cost of educating all the stakeholders, implementing IT systems, cost to dismantling the standard setting infrastructure and application of revised reporting policies, processes etc.
- The convergence with IFRS is not made mandatory for small and medium enterprises but if any SME wants to implement IFRS voluntarily, it may find it too voluminous and face the barriers such as huge cost, shortage of resources, expertise, etc. However, the IASB has developed an IFRS for SMEs keeping in view the difficulties faced by them.

- The Indian GAAP has been formulated on the basis of principles of the IFRS but there are significant differences between Indian GAAP and IFRS in practical implementation and interpretation of similar standards. These differences must be harmonized to reap the real benefits of IFRS.
- Convergence with IFRS may have material impact on the financial performance of the companies as the standards could cut profits and inject volatility into the balance sheets of the companies. The areas such as tax planning, employee compensation, loan loss provisioning, impairment charges, structuring of ESOP schemes, capital adequacy ratios of financial institutions, compliance with debt covenants etc. may experience substantial change.
- IFRS is itself a moving target, with changes being introduced continually, refining the provisions and adding more areas for disclosures. Furthermore the IASB may find it difficult to reach unanimous agreement on some of the accounting standards and they may have to make compromises so that these accounting practices are accepted globally. This implies that these standards will be permissive and inadequate.

In addition to the above, educating all the stakeholders such as accounting professionals, auditors, investors, regulators, employees, lenders, teaching faculty etc., will be a greater challenge within the prescribed time limit.

Suggestions:

The following suggestions will help in achieving full compliance with IFRS at minimum cost:

- The regulatory authorities throughout the world need to get together and come to an agreement as to how the IFRS is going to be enforced. They need to have a common set of enforcement standards. This is especially important because IFRS standards are principle-based standards so there is a lot of judgment involved in applying them.
- In order to ensure the uniform application of accounting standards across cultural and political boundaries IASB needs to ensure that there are strong audit practices in order to bring about integrity of the standards. There has to be a convergence of auditing standards throughout the world.
- In India the government and other regulators that is the accounting standard setting bodies like SEBI, RBI, IRDA, should act in consensus to achieve high level of integration with IFRS without any bias.
- The laws and regulations should be amended to meet the requirement of full convergence of Indian accounting standards with IFRS.
- Convergence with IFRS may have material impact on the financial performance of the companies. Therefore the companies must educate their stakeholders about the convergence effects on their reported profits and liabilities.
- SMEs should be enabled to adopt simplified version of IFRS so that the financial statements of all entities irrespective of listed or unlisted, public or private and large or small may be synchronized across national borders.
- The accounting professionals, auditors as well as their staff need to be well trained to function under IFRS environment. Therefore, the professional bodies will conduct IFRS-specific training programmes for their members and others concerned to prepare them to implement IFRSs.

- The curriculum of universities and other professional accounting bodies should be reformulated to include IFRS principles to broaden the pool of trained resources and adequate training be provided to faculty members to facilitate teaching.

Conclusion:

The main objective of the IFRS is to follow every activity of the business by the same accounting standards in the world. The creation of international standards allows investors, organizations and governments to enhance the quality and comparability of financial disclosures, which in turn facilitates a firm access to international capital markets and thus cross-border investment flows. India is one of over 115 countries that have or are moving towards IFRS convergence. There are many challenges and hurdles about convergence of national standards with IFRS but the pressure of globalization is so strong that it should not take much time to identify methods to overcome the hurdles. The costs of implementing IFRS should be taken up as challenges or opportunities to encounter them in the right spirit to ensure smooth convergence with IFRS.

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