GLOBAL CONVERGENCE OF FINANCIAL REPORTING

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ABSTRACT

All major economies have established time lines to converge with or adopt IFRSs in the near future. The international convergence efforts of the organisation are also supported by the Group of 20 Leaders (G20) who, at their September 2009 meeting in Pittsburgh, US, called on international accounting bodies to redouble their efforts to achieve this objective within the context of their independent standard-setting process. In particular, they asked the IASB and the US FASB to complete their convergence project by June 2011. Adopting a single global accounting language will ensure relevance, completeness, understandability, reliability, timeliness, neutrality, verifiability, consistency, comparability and transparency of financial statements and these bring about a qualitative change in the accounting information reports which will strengthen the confidence and empower investors and other users of accounting information around the world. It will also help acquirers to assess the actual worth of the target companies in cross border deals and thereby furthering the economic growth and business expansion globally. For a decade the companies in India have been using both – US GAAPs and more recently International Financial Reporting Standards (IFRS) to raise funds from US and European Markets. The Institute of Chartered Accountants of India has announced that it will align existing accounting standards with IFRS w.e.f. April 1, 2011 to join the group of 100 countries reporting under IFRS.

Key Words: Reporting, Standards, Convergence, Corporate, Liberalization

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Introduction:

Globalization and liberalization of economic policies initiated by the Government since 1991 have brought about significant changes in the attitudes and perceptions of investors, management financial institutions, financial and stock markets, Bankers and the corporate world as a whole. The explosion of knowledge in the field of information technology has made the world a global village. For corporates the whole world is a market with global customers and global investors. With Global capital markets companies are getting listed at several stock-exchanges located in different countries, the decision regarding investments in companies of other countries requires an understanding, analysis and interpretation of financial statements of these companies which are primarily based on the accounting concepts conventions and practices of that country. Hence, the difference in accounting practices and reporting requirements make the financial statements and reports ambiguous and unfriendly for the global investors. Hence there is an urge to converge accounting information into global common reporting standards. The presence of multinational companies, international auditing firms, growth in international business and the ongoing global Mergers and Acquisitions trend and the resulting need for timely and reliable financial information have provided a momentum towards developing global set of high quality financial reporting standards. There has been significant progress towards global convergence of the International Financial Reporting Standards (IFRS) in recent years. These standards are single set of accounting principles and less reliant on detailed rules and guidance notes that currently make up generally accounting principles (US-GAAPs) in the U.S.

Adopting a single global accounting language will ensure relevance, completeness, understandability, reliability, timeliness, neutrality, verifiability, consistency, comparability and transparency of financial statements and these bring about a qualitative change in the accounting information reports which will strengthen the confidence and empower investors and other users of accounting information around the world. It will also help acquirers to assess the actual worth of the target companies in cross border deals and thereby furthering the economic growth and business expansion globally. India Incorporation has long recognized the need to use globally acceptable standards for financial reporting. For a decade the companies in India have been using both – US GAAPs and more recently International Financial Reporting Standards (IFRS) to raise funds from US and European Markets.

The Institute of Chartered Accountants of India has announced that it will align existing accounting standards with IFRS w.e.f. April 1, 2011 to join the group of 100 countries reporting under IFRS. For this purpose the ICAI has released a concept paper on convergence with IFRS in India. This has been strengthened by a recent announcement from Ministry of Corporate affairs (MCA) confirming the agenda for convergence with IFRS in India. Even in the US there is an ongoing debate regarding the adoption of IFRS replacing US GAAPs. And in this direction some significant steps have been taken by the Securities and Exchange Commission (SEC). The SEC has eliminated the requirement that foreign issuers must reconcile IFRS statements with US GAAPs. In addition the SEC issued a concept release proposing that US filers be allowed to use IFRS or US GAAPs to report their financial results (2008)1.

The European Union adopted IFRS in the year 2005. Other Countries have announced to embrace IFRS in next few years including China and South Korea in 2009, Brazil 2010 and Canada in 2011. As already reported India will adopt IFRS by 2011 because accounting standards used in India have been incorporated into law and hence adopting IFRS would require India to make dramatic legislative changes and concomitant changes to taxation and securities laws. It is therefore, probable that India's scheduled move towards gradually aligning its standards by 2011 with these of IFRS may fall short of wholesale, adoption. However, such an effort is expected to result in producing IFRS – like financial statements. This may be the safest and quickest move in the direction of convergence in the short term.

THE IMPACT AND CHALLENGES

Financial statements are prepared for external users around the world. Although such financial statements may appear similar from country to country yet there are differences in preparation of its inter relation. This is due to differences in economic and social environment, diverse accounting practices and legal circumstances and requirements. In different countries there is a different view on what is or should be the primary purpose of financial statements. In US and in some countries the investors or their decisions are considered to be the most important while in Germany and other countries, creditors are considered on top. In France, the information needs of the Government play a major role. As a result it has led to the use of variety of definitions of the elements of financial statements. The IFRS is committed to narrowing rather removing the differences through standard definitions and procedures relating to preparation and presentation of financial statements.

However, adopting IFRS by Indian Corporate is going to be very challenging but at the same time could also be rewarding. Indian corporate sector is likely to reap significant benefits from adopting IFRS. The European Union's experience highlights many perceived benefits as a result of adopting IFRS. Overall most investors, corporate, auditors and other users of financial statements agreed that IFRS improved the quality of financial statements and that IFRS implementation is the positive development for financial reporting (2008).

The adoption of IFRS in its entirely will improve comparability of financial information and financial performance with global peers and industry standards. This will result in more transparent financial reporting of a company's activities which will benefit investors, customers and other key stakeholders in India and overseas. IFRS are expected to result in better quality of financial reporting due to consistent application of accounting principles and improvement in reliability of financial statements. This in turn will lead to increased trust and reliance placed by investors, analysts and stakeholders in a company's financial statements.

IFRS are expected to reduce cost of capital through better access to global capital markets. A recent decision by the US Securities and Exchange Commission (SEC) permits foreign companies listed in the US to present financial statements in accordance with IFRS. This means such companies will not be required to prepare separate financial statements under US GAAPs. Therefore, Indian Companies listed in the US would benefit from having to prepare only a single set of IFRS compliant financial statements and consequent saving in financial and compliance costs.

Further, consistently good financial reporting should have a favorable long run effect on company's cost of capital – over a period of time, good reporting leads to informed investors to pay a fair price for its securities. Minimum or inconsistent reporting often leads to some loss of investors' confidence in the quality of company's information and ultimately in the price, they will pay in the market. Credibility is the subtle intangible of great importance to any company's corporate reporting have a major effect on it. There is an obvious connection between corporate reporting and cost of capital.

CURRENT SLOWDOWN AND FAIR VALUE PRINCIPLE

The fair value principle has exacerbated the current credit crisis which has result in declining housing prices, reduced value of all Mortgaged Based Securities (MBS) since the housing collateral protecting them much less. Because of mark-to-market losses companies have to raise capital for meeting capital adequacy requirements. When MBS or other assets are sold to raise capital the market value is driven down further. Worse still, the distress prices become the new price for valuation of all similar instruments held by all companies. The domino effect results in a downward death spiral. The credit rating agencies downgrade the company's credit ratings, making borrowings to meet capital requirements more difficult. In normal time, fair value principle would not have been a subject of great debate. However, any accounting which fails to highlight the liquidity risk – in the way that the fair value accounting does – would not the serve the interest of investors and other stakeholders.

These perceived benefits are based on the experience of IFRS compliant countries under normal conditions. Thus the current decline in market confidence in India and overseas coupled with tougher economic conditions may pose significant challenges to Indian companies. IFRS requires application of fair value principles in certain situations and this would result in significant differences from financial information currently presented especially relating to financial instruments, mergers and acquisitions and other forms of business combinations. Considering the present economic scenario this would result in significant volatility in reported earnings and key performance measures like EPS and P/E ratios. Indian companies will have to create awareness among investors and other users of financial statements to explain the reasons for this volatility in order to improve understanding and transparency reliability and verifiability of their financial statements. However, there is lack of availability of actuaries (professionals with adequate valuation skill) to assist Indian companies in arriving at reliable "fair value". Infact, it is one of the significant resource constraints that would affect comparability of financial statements and thus render some of benefits from IFRS ineffective.

IFRS are "principle based standards" and offer certain accounting policy choices to prepare financial statements. For example in accounting for Investment Properties the use of cost-based model or revaluation model may be adopted. This would reduce the consistency and comparability of financial statements to some extent and hence this would affect the credibility and reliability of the financial position of the enterprise.

Further there is need to change several laws and regulations governing financial accounting reporting in India. In addition to "Accounting Standards" there are legal and regulatory requirements that determine in the manner in which financial information is presented and reported through financial statements. For example Companies Act 1956 determines the classification and accounting treatment for redeemable preference shares as equity instruments of a company whereas these may be considered to be a financial liability under IFRS. The Schedule VI of Companies Act 1956 also provides the format for presentation of financial statements whereas the requirements of presentation under IFRS are entirely different. Similarly the accounting for the banking and financial companies including the presentation format and accounting treatment for certain types of transactions is regulated by RBI through Banking Regulation Act. There is lack of adequate IFRS professionals with practical IFRS convergence experience and therefore the companies have to rely on auditors and external advisors. It is a serious challenge and will required time to prepare and groom such professionals. Since IFRS convergence will involve a fundamental change in financial reporting systems and processes it requires a detailed knowledge of the standards and ability to assess their impact on business transactions performance measures. Further the convergence process will need to disseminate and embed IFRS knowledge throughout the organization to ensure its application on an ongoing basis.

The potential challenge is to bridge the gap between the IFRS and Indian Accounting Standards with regard to practical implementation and policy interpretation. Certain Indian Accounting Standards offer accounting policy choices which are not available under IFRS. For example use of pooling of interest method in accounting for amalgamations. However the major change the IFRS will bring is the application of 'Fair value' in the financial statements which is known as "Mark to Market" accounting. The politicians in US and UK are blaming IFRS for the current financial crisis. When the $ 700 billion bailout plan failed to pass the US Congress, some politicians said only one measure was necessary instead – scrap fair value accounting (2008)4. The developments abroad might make companies and investors apprehensive and may lead to delay or to avoid IFRS implementation. The Savings and loans crisis in the US during 1980's and the Japanese Crisis of 1990's prolonged for lack of fair value accounting. In both cases many banks had became insolvent because of market values of their assets had fallen below their liabilities. These banks however, continued to operate because then the prevailing accounting rules permitted them to hide their losses by recognizing the assets at their unrealistically high historical cost. These banks were therefore, solvent because financial statements so prepared did not reflect their de-facto insolvency.

EMERGING MARKETS AND IFRS

Several emerging markets – such as Russia, India and China have experienced remarkable economic and foreign direct investment (FDI) growth in recent years and strong growth is expected to continue for many years to come the Current slowdown in a temporary phase and in the outcome of liquidity crunch which can be termed as purely a temporary technical insolvency situation. According to data compiled by Goldman Sachs and IMF the share of RIC (Russia, India and China) in global GDP will be doubled in next ten years (2006-2016) period, i.e. from 9.5 per cent in 2006 to 18.1 per cent in 2016 (2008). This kind of dramatic growth serves to highlight what is at stake for emerging markets like India and Underscores why these markets should continue to Endeavour to fully integrate with the new financial reporting and accounting standards and adopt IFRS in its entirely without any notification or country specific interpretations. It is, all about sustainability, moving to a global set of standards should have the free flow and efficient use and allocation of capital. It is in the long term self interest of emerging markets and other to enhance sustainable growth by making sure they are beneficiaries of free flow of capital. Achieving a single set of accounting standards is the first building block toward a truly global capital market. The ultimate goal is the creation of a truly global barrier free capital market, one that improves the over-all quality, effectiveness and efficiency of capital flow around the world. That is the real key to sustainable growth and prosperity in the world.

Therefore, current market values are more relevant for decision making purposes. However corporates hate "mark to market" accounting because it makes their results volatile, uncontrollable and unpredictable. Under historical cost accounting, managers can control the reported results by a practice called "Cherry picking" selling appreciated investments selectively to achieve the desired results. Mark to Market accounting currently reflects the underlying market volatility which is the reality and shows the actual financial position on that date. Any other practice to conceal the real market value of the assets may be temporarily comforting but it will lead to misrepresentation and will misguide the users of financial statements.

Hence, there is an urgent need to address all those challenges and work towards full adoption of IFRS in India. The most significant need is to build adequate IFRS skill and expansive knowledge base amongst Indian accounting professionals to manage the convergence for India Incorporation. This can be done by leveraging the knowledge and experience gained from IFRS convergence in other countries and incorporating the IFRS into the curriculum for professional accounting (CA) courses so that we have quite good number of professionals to manage the pressure of convergence.

CONCLUDING OBSERVATIONS

Adopting International Financial Reporting Standards (IFRS) by Indian Corporate is going to be very challenging but at the same time could be very rewarding. With the liberalization policies started yielding result and consequent changes in the perceptions of investors, markets and customers there is an urgent urge, to converge towards global reporting platform to win the confidence of global investors. Convergence of standards will break the ice for convergence in other areas including auditing and help in efficient functioning of the economy because investors, creditors auditors and other rely on credible, transparent and comparable financial information. This will further ensure free flow of funds across globe because convergence will enhance the ability of investors to compare investments on global basis and lower the risk of errors of judgment.

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