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Adoption of International Financial Reporting Standards (IFRS standards) and benefits to emerging economies

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This article focus on the benefits of adopting IFRS standards, including IFRS for SMEs, and why International Financial Reporting Standards (IFRS) are important for global economic stability and development in an integrated world. Considering the importance of the recent global financial crisis, it details the responses by the International Accounting Standards Board (IASB), stressing the expected benefits for avoiding future crises. It concludes detailing briefly the work plan strategy of the IASB for the period 2017-2021, identifying areas for further research by academics.

Keywords: IFRS, international accounting, accounting and development.

1. IFRS use around the world

As of November 2016, according to the IFRS Foundation, more than 120 countries require or permit the use of IFRS standards1 by listed companies.

The progress since 2015 has been particularly strong in Asia. Chinese standards are similar to IFRS and China reconfirmed its commitment to work towards full adoption. India introduced in 2016 a new set of standards that are almost word-for-word IFRS. In Japan, since 2010 companies can voluntarily use IFRS and the Japan Exchange Group (JEG) informed that by the fiscal year ended March 31, 2016, listed companies that have adopted, have decided to adopt, or are planning to adopt IFRS are above 140, representing 29 per cent of the of the market capitalisation. The JEG also indicated that more than 230 companies are «considering IFRS adoption».

In the United States of America (US), domestic listed companies apply US GAAP, and the Securities and Exchange Commission (SEC) has not yet indicated when will

1 http://www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx
it adopt IFRS. However, many subsidiaries of US companies located abroad use IFRS. In addition, since 2007 the SEC allows foreign companies listed in US stock exchanges to use IFRS.

As for the IFRS for SMEs, 83 countries require or permit its use. The Standard was issued in response to strong international demand from developed and emerging economies, due to the important role of small- and medium-sized entities (SMEs) in the global economy. Amongst the challenges identified with SMEs, the most important is their access to financial resources or, at least, access on the best possible terms. One of the reasons is the lack of confidence in the financial information presented by the SMEs. Providers of such resources end up concluding for the inability to make capital allocation decisions.

Adoption of IFRS for SMEs help SMEs access capital by improving the quality of reporting when compared with many existing national accounting requirements, enhancing comparability and the overall confidence in the financial statements. The standard focus on information about cash flows, liquidity and solvency considers the costs and the capabilities of SMEs to prepare financial reporting. In addition, the adoption can reduce the costs of developing and maintaining standards on a national basis, not to mention the impact on education.

The IFRS for SMEs is not aimed to be used by all non-listed companies. It is designed for companies that are required by governments or regulators, or that choose to produce general purpose financial statements, directed to the needs of users such as lenders, creditors, investors, employees, and governments. Small entities (commonly referred as ‘micro’) often produce financial reporting only for the use of the owner’s management or tax and other authorities, and thus they are not general purpose financial statements.

2. Benefits of adopting IFRS standards for companies, capital markets and economic growth

Amongst the benefits of adopting IFRS standards, the one most overlooked is the operational benefit. Having international common standards greatly benefits the management of companies operating worldwide, particularly through subsidiaries and joint ventures. Information systems are easily integrated, the financial reporting process is less costly and risky, more effective and efficient, and other costs like training and auditing, for example, can be significantly reduced. Ultimately, the transparency resulting from IFRS application can help companies and their boards make better, more informed decisions. In Japan, most companies that decided to adopt IFRS are
internationally-oriented and the standards are cited as one of the main reasons for their management efficiency.

In addition, research from different parts of the world, like the European Union (European Commission, 2015) and Korea (Korea Accounting Standards Board, 2013), has shown that the introduction of IFRS lowered the cost of capital and attracted foreign investment, with benefits largely outweighing the costs.

The reality is that companies, in search for growth, need capital. Some seek domestic growth and others pursue stronger presence in the world moving into new markets and jurisdictions. And they are backed by investors seeking global opportunities and diversification. In such an environment, it is increasingly costly and difficult to understand the often incompatible national accounting standards, and investors’ efforts in the decision-making process will translate in higher risk premiums.

Considering global financial markets integration, with a growing volume of foreign direct investment, there is significant demand by investors for high quality, understandable, accessible and timely information regarding their investments.

The most recent global financial crisis provided a real example of how integrated financial markets are. At the beginning of the crisis in 2007, the International Monetary Fund (IMF) reported that the US sub-prime crisis was containable and posed little threat to the global economy (Giles 2007), what showed the lack of knowledge of the extent of the interconnectedness and mutual dependence of financial markets.

The crisis was not, of course, the result of poor or inadequate accounting, but showed that financial markets are connected and that to achieve global stability the quality of information and the timeliness of its flow are of utmost importance.

In this sense, it is believed that the greater transparency resulting from enhancements to IFRS published by the IASB since 2009 can play an important role in avoiding future crises, thus contributing to financial stability and long term development. A good example is the IFRS 13 *Fair Value Measurement*, which consolidated the then scattered requirements for valuation, and provides investors with much better information about the assumptions involved in applying fair value measurement. Another is IFRS 9 *Financial Instruments*, which will substantially enhance the information associated with the use of financial instruments, hedge accounting and provisioning.

Those improvements are expected to help investors to better understand risks that were not clearly disclosed or identified, and also help regulators to have greater visibility of risks building in the system, effectively contributing to the development of financial markets, particularly capital markets.
There is strong evidence that the development of capital markets is very important to a country's economic growth and prosperity. Put simply, as companies grow, they need capital. This can be basically provided by government, banks, and investors. However, governments around the world and particularly in emerging countries, are under severe pressure to achieve fiscal balance, with ever growing demands for basic public services. In the case of banks, they are operating in a much stricter regulatory framework that has not yet been completely assimilated in their asset-liability management and capital allocation strategies; the resources offered are not always adequate in terms of timing, amount and cost, especially for long term investment projects. This brings us to investors, both foreign and domestic, who are willing to provide funding to long term projects and who are actually seeking investment opportunities that would generate superior average returns when compared with alternatives in mature markets experiencing low rates of growth.

Financial information is the lifeblood of capital markets. A requisite for investors—and especially for those who are geographically far from the projects and companies they invest in—to entrust their money to companies is access to financial information they can trust. And adoption of IFRS is of utmost importance. They provide transparency, accountability and help developing efficient capital markets. IFRS standards enable investors to understand and to compare the financial statements of companies despite its location. This in turn fosters trust, growth and long-term stability in the global economy through a better informed decision-making process of economic resources allocation.

3. The IASB priorities and the future of global accounting

The IASB have delivered substantial improvements to the quality of IFRS, working in close cooperation with the worldwide standard-setting community. It could be argued that the best ideas from around the world have become global standards. The projects on financial instruments, revenue recognition and lease accounting represent significant improvements that will enhance the quality of financial reporting as they become effective into 2018 and 2019.

The one remaining major project is related to insurance contracts. The current IFRS 4 allows the use of highly diverse national accounting standards and, as a result, there is little comparability around the world. In addition, some of the practices used for insurance contracts are at odds with generally accepted accounting for other industries.

Apart from insurance, the focus of the IASB will be on the priorities for the period 2017-2021, as published in November 2016, being better communication
its central theme. The objective is to better align the demands of investors and the interests of companies, both presently complaining about the requirements in place for presentation and disclosure, and obviously with distinct perceptions. The companies argue that the overwhelming demands associated with financial reporting have turned the process in a compliance exercise and judgement about what should be presented is not viable in practice. On the other hand, investors often assert that financial statements depict performance in an insufficiently clear manner and there is far too much irrelevant information distracting their attention.

In reality, present IFRS standards prescribe very little about the format and structure of the income statement. There are definitions for revenue and profit or loss, but not much more in between. With that, companies can basically present whatever they want, resulting in little comparability above profit or loss. In addition, companies are increasingly presenting alternative performance measures (APMs) to investors, which are basically adjusted IFRS numbers.

The IASB will assess how the financial information is presented, how it is grouped together, and in what form it is made available with the objective of making sure that companies can better communicate through the financial statements, in a way that is clear, objective and consistent, without increasing the information requirements.

The central project of this work is the Primary Financial Statements, focusing on improving the structure of the statement of profit or loss, the statement of cash flows and the statement of financial position. For the statement of profit or loss, for example, it will look at the possibility of defining commonly used subtotals in the income statement — such as operating income and earnings before interest and tax (EBIT) —, creating more disciplined ways for companies to adjust their earnings for infrequently occurring components of income.

Other priority projects are the Disclosure Initiative, including the Materiality Practice Statement and the Principles of Disclosure, as well as digital reporting, the latter taking into consideration the fact that financial information is increasingly being consumed electronically.

4. Conclusion

Increasing the attractiveness of capital providers is crucial to strengthen the economy, and is a key element in many governments’ long term macroeconomic strategies. For that to succeed it is necessary to improve financial markets structures and systems, and the adoption of IFRS standards is widely recognised by international organisations — such as the Financial Stability Board, the World Bank and IOSCO — as one of the important aspects for financial stability.
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The results will, of course, vary from country to country, but emerging economies can benefit most from IFRS adoption, because it immediately contributes to the credibility of the financial reporting environment and thus can enhance the potential attractiveness of investors and providers of capital in general.

Given such environment, accountants have a very important and demanding role. It is necessary to be familiar with developments in IFRS, because investors and other providers of capital will be, and will expect accountants to be prepared. In addition, it is necessary to get actively involved in the process of IFRS development, including researching the issues identified as priorities by the IASB, in order to effectively contribute and to exert influence. IFRS standards can only be generally accepted around the world if they are the result of global collaboration across both developed and emerging economies.

Global standards are an inevitable consequence of continued economic integration and IFRS are the de-facto global language for business. Accountants are, thus, key actors in the global arena.

BIBLIOGRAPHY


