Effect of IFRS and Financial Statements: Implications on FDI and Indian Economy

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Abstract:

IFRS (International Financial Reporting Standard) convergence, in recent years, has gained momentum all over the world. The capital markets are becoming global in nature more investors are looking for common set of accounting standards. The application of IFRS (International Financial Reporting Standard) not only standardize the accounting treatments but also helpful in producing true and fair financial statements. Almost all the countries using IFRS (International Financial Reporting Standard) can easily make comparisons of their financial statements across the industries and countries. Because of its fair results these are highly reliable standards for the allocation of resources and for keeping the accounting records.

The IFRS adoption is an issue of global relevance among various countries of the world because of its uniformity, reliability and comparability of financial statements of companies. India being one of the key global players, migration to IFRS will enable Indian entities to have access to international capital markets without having to go through the cumbersome conversion and filing process. IFRS is expected to lower the cost of raising the funds, reduce accountant fees and enable faster access to all major capital markets it also facilitate companies to set targets and milestones based on a global business environment.

This research paper attempts to study the relationship between IFRS adoption and FDI and effect on Indian economy. The population consists of quoted companies in Bombay Stock Exchange (Preparers) and Investment Analysts (Users). Stratified Random sampling method is being adopted and primary data shall be used to elicit responses with structured questionnaires.

Keywords: IFRS, Capital Markets, Foreign Direct Investment, Indian Economy

Introduction

Accountants all around the world decided to speak the same accounting language and present the same accounting format which has resulted in uniform accounting standard across the world – International Financial Reporting Standard. Over 100 countries across the globe had already implemented IFRS instead of their National Standard. India has not yet mandated the adoption of IFRS in toto, but is in the process of harmonizing its Indian accounting standard with IFRS. In an attempt, schedule VI has been revised aligning with International Accounting standard 1 and other International Accounting standards. All the Indian companies are mandated to follow the revised schedule VI from 1st April 2011 which is a step towards harmonizing with IFRS. One of significant changes in the revised schedule VI is reclassification of current and noncurrent assets and liabilities which gives clear understanding on short term assets/liabilities and long term assets / liabilities position to the investors and other stakeholders at large.

Financial statements of an organization provides information such as the value added, changes in equity if any and cash flows of the enterprise within a defined period time to which it relates (Iyoha and Faboyede, 2011). This information is useful to a wide range of users making informed economic decisions. The implementation of IFRS would reduce information irregularity and strengthens the communication link between all stakeholders (Bushman and Smith, 2001).

The general objective of this research is to examine the effect of IFRS adoption on FDI and Indian economy. The main research questions upon which an attempt is meant to provide answers in the course of the study includes (i) is there any significant relationship between the adoption of IFRS and FDI? (ii) To what extent will IFRS adoption enhanced the uniformity, comparability, transparency and reliability of the financial statements of companies in India? And (iii) how does FDI inflow affect economic growth in India?

Literature review

The increasing growth in international trade, inter countries financial transactions and investments which unavoidably involves the preparation and presentation of accounting reports that is useful across the nations, has brought about the adoption of IFRS by both the developed and developing countries (Armstrong et al., 2007). The process of adoption received a significant boost in 2002 when the European Union adopted a regulation 1606/2002 requiring all public companies in the territory to convert to IFRSs beginning in 2005 (Iyoha and Faboyede, 2011).

Pownall and Schipper (1999) discuss the body of research using Form 20-F reconciliation data, observing that prior research documents differences between US GAAP and both non-US GAAPs and IAS, and offers some evidence that the differences are value-relevant. For example, Amir, Harris, and Venuti (1993) investigate the value relevance of reconciling items between domestic and US GAAP earnings and shareholders' equity using a sample of 101 cross-listed companies during the period 1981-1991. Their results suggest that the reconciliations are value relevant, both in aggregate and for some specific components (property revaluations and capitalized goodwill). Harris and Muller (1997), examining only reconciliations between US GAAP and IAS for 31 companies from 1992 to 1996, provide inconclusive evidence of the usefulness of the reconciliations. They find US GAAP earnings reconciliation is value relevant and US GAAP is associated more highly with market measures after controlling for IAS amounts in certain models (market value and returns) but not all models (per-share).

There are proponents as well as opponents who have arguments for and against the global adoption of IFRS. According to Barth (2007), the adoption of a common body of international standards is expected to have the following benefits: lower the cost of financial information processing and auditing to capital market participants as users, familiarity with one common set of international accounting standards instead of various local accounting standards by Accountants and Auditors of financial reports, comparability and uniformity of financial statements among companies and countries making the work of investment analysts easy, attraction of foreign investors in addition to general capital market liberalization. Ball (2006) stated that many developing countries where the quality of local governance institutions is low, the decision to adopt IFRS will be beneficial. Lipsey and Chrystal (2003) noted that FDI often generates somewhat higher-paying jobs than might otherwise be available to local citizens, it generates investment that may not be possible with the local resources only, it links the recipient economy into the world economy in manners that would be hard to achieve by new firms of a purely local origin. According to Lipsey and Chrystal (2003) the FDI alters country's comparative advantages and improves its competitiveness through technology transfer and effects myriad externalities, domestic investment which can alter a country's volume and pattern of trade in many income enhancing directions. Countries that suffer from corruption, slow-moving, or ineffectual government are likely to resistant the change (La Porta et al., 1999) but in such countries, the opportunity and switching costs are lower which makes the possibility of adopting IFRS advantageous. Kumar (2007) the foreign capital has the potential to deliver enormous benefits to developing countries like India. It helps in bridging the gap between savings and investment in capital-scarce economies, capital often brings with it modern technology and encourages development of more mature financial sectors. Capital flows have proven effective in promoting growth and productivity in countries that have enough skilled workers and infrastructure. Some economists believe capital flows also help discipline governments' macroeconomic policies

GAB (2012) stated that one of the demerits that will be experienced by countries adopting of IFRS include: forgoing the benefits of any past and potential future innovations in local reporting standards specific to their economies. Single set of accounting standards cannot reflect the differences in national business practices arising from differences in institutions and cultures (Armstrong et al., 2007). The Nigeria accounting regulatory includes: the Companies and Allied Matters Act 1990 which stipulate the format, content and scope of the financial statements, disclosure requirement and auditing. It also requires that financial statements of companies comply with statements of accounting standards (SAS) issued from time to time by NASB and audit carried out in accordance with generally accepted auditing standards. Secondly, Nigerian Accounting Standards Board (NASB) Act No.22 of 2003 as the only independent body responsible for developing and issuing SAS for preparers and auditors of financial statements of business concern and government agencies (Madawaki, 2012). Although many countries have faced challenges in their decisions to adopt IFRS, its wide spread adoption has been promoted by the argument that the benefits outweigh the costs (Iyoha and Faboyede, 2011). The existing theoretical models imply that FDI is beneficial for host country's economic growth. According to traditional economic theory (law of diminishing returns), FDI will tend to concentrate in less developed countries, where there exist greater opportunities to achieve higher returns. In order for FDI to become productive in developing countries, the following conditions should exist: (i) the existence of a minimum threshold level of human capital (Borensztein et al, 1998), improved domestic infrastructures (de Mello, 1999), and a developed local financial systems (Alfaro et al, 2006). Out of all, the last prerequisite seems to have more weight in order for FDI to flow into any developing country and have a measurable impact on economic growth. Lack of these requirements has resulted in imbalanced in the FDI distribution across many developing countries. Some of the countries are facing difficulties in attracting foreign investors. FDI is considered as an important channel for direct technology distribution and may be the major vital conduit for technology transfer because of the scarcity of financial resources and the urgent need for reconstruction in many developing countries (Hossein & Yazdan, 2012). Within this framework it is expected that FDI will contribute to economic growth, indirectly by accelerating the diffusion of general purpose technologies (Hossein & Yazdan, 2012).

Methodology

The population of this study consist preparers and users of financial reports. The preparers have being selected top 100 Companies listed in Bombay Stock Exchange between 2012 and 2013 represented by Directors / Finance Managers responsible for the preparation of financial statements. The users of financial reports are investors.

Investment Analyst are selected as respondents as they are the principal users of financial reports they have good investment knowledge which aids analysis of financial reports and decision making (Baker, 1998) and lastly they provide analytical information that meets the needs of their clients.

The response rate for questionnaire given to preparers was 67% and of users 80%.

The instrument was a 7 - term survey questionnaire with a - 5 Likert scale response options divided into two sections. Very Relevant (VR), Relevant (R), No Effect (NE) Irrelevant (I), and Very Irrelevant (VI). The validity of the questionnaire was confirmed by the Experts. Survey was adopted to check the reliability and it yielded correlation coefficient of 0.83. It was structured in line with the research questions and hypothesis of the study. Pearson Correlation Coefficient was used for data analysis

$$r = \frac{n\Sigma xy - (\Sigma x)(\Sigma y)}{\sqrt{n[\Sigma x2 - (\Sigma x)2][n\Sigma y2 - (\Sigma y2)}}$$

Data Analysis

Test of statistical Hypothesis

Hypothesis 1

Ho: There is no relation between IFRS adoption and implementation and FDI Inflows in India.
H1: There is relation between IFRS adoption and implementation and FDI Inflows in India.

Table 1: Response on key Issues relating to the relationship between IFRS adoption and implementation and FDI inflow into the India.

Sl. No	Variable Responses (in %)	Preparers of Financial Statements (Finance Managers)					Users of Financial Statements (Investment Analyst)				
		VR	R	NE	I	VI	VR	R	NE	I	VI

1	IFRS improves quality of financial statements and increase access to global capital market	43 64%	13 20%	3 4%	4 6%	4 6 %	61 76%	14 17%	3 2%	2 2%	0
2	IFRS adoption ensures the use of one standard for both the parent and subsidiary companies	62 93%	5 7%	0	0	0	53 66%	27 34%	0	8 10%	0
3	IFRS has positive effect on the information for control and decision making by investors	38 57%	5 8%	7 10%	13 20 %	3 5 %	486 0%	24 30%	5 6%	3 4%	0
4	IFRS adoption has significant effect on FDI inflows	60 80%	5 8%	2 3%	0	0	72 90%	6 7%	2 3%	0	0

Table 2: Calculation of Correlation

Question of IFRS adoption effect on FDI inflows from questionnaire administered: IFRS adoption has significant effect on FDI in flows in India

Options	**Preparers of Financial reports**					**Users of financial reports**			
	Point(x)	Response(y)	Xy	x^2	y^2	Point(x)	Response(y)	x^2	y^2
VR	5	60	300	25	3600	5	72	25	5184
R	4	5	20	16	25	4	6	16	36
NE	3	2	6	9	4	3	2	9	4
I	2	0	0	4	0	2	0	4	0
VR	1	0	0	1	0	1	0	1	0
Total	15	67	326	55	3629	15	80	55	5224

Table 3: Calculation of Correlation

Options	**AA Point(x)**	**AA Response (y)**	**AA (xy)**	**AA (x^2)**	**AA (y^2)**
VR	5	66	330	25	4356
R	4	5.5	22	16	30.25
NE	3	2	6	9	4
I	2	0	0	4	0

VR	1	0	0	1	0
Total	15	73.5	358	55	4390.25

$$r = \frac{n\Sigma xy - (\Sigma x)(\Sigma y)}{\sqrt{n[\Sigma x2 - (\Sigma x)2][n\Sigma y2 - (\Sigma y2)}}$$

Where: n = 5, Σx = 15, Σy = 73.5, Σxy = 358, Σx2 = 55, Σy2 = 4390.25

r=0.7557 or 75.57%

Decision: The r value calculated is 0.75 which is greater than the 0.05 level of significance. The alternate hypothesis is accepted. Therefore it can be said there is a significant relation between IFRS adoption and implementation and FDI Inflows in India

<u>Hypothesis 2</u>
Ho: The stock of FDI inflow does not lead to economic growth in India.
H1: The stock of FDI inflow leads to economic growth in India.

Table 4: Responses on key Issues relating to the relationship between FDI inflows and Economic growth the India

Sl. No	Variable Responses(in %)	Preparers of Financial Statements (Finance Managers)					Users of Financial Statement (Investment Analyst)				
		VR	R	NE	I	VI	VR	R	NE	I	VI
5	FDI inflows ensures that technologies and funds are available to the local industry	50 74%	11 16%	3 5%	2 3%	3 5%	61 76%	13 16%	4 5%	2 2%	1 1%
6	FDI inflows leads to the mobilization of more resource input	46 68%	9 14%	5 8%	3 5%	3 5%	49 61%	19 24%	8 10%	2 3%	2 2%
7	economic growth depend on injection of capital and technologies not available to local investors	53 80%	7 10%	0	3 4%	4 6%	46 57%	22 27%	5 8%	5 8%	3 4%

Table 5: Calculation of Correlation
Question on economic growth on injection of capital of questionnaire administered: Economic growth depend on the injection of capital and technologies not available to local investors (FDI inflows)

Options	**Preparers of Financial reports**					**Users of financial reports**			
	Point(x)	Response(y)	xy	x^2	y^2	Point(x)	Response(y)	x^2	y^2
VR	5	53	270	25	2916	5	46	25	2116
R	4	7	28	16	49	4	22	16	484
NE	3	0	0	9	0	3	5	9	25
I	2	3	6	4	9	2	5	4	25
VR	1	4	4	1	16	1	3	1	9
Total	15	67	308	55	2990	15	81	55	2659

Table 6: Calculation of Correlation

Options	**AA Point(x)**	**AA Response (y)**	**AA (xy)**	**AA (x^2)**	**AA (y^2)**
VR	5	49.5	247.5	25	2450.25
R	4	14.5	58	16	210.25
NE	3	2.5	7.5	9	6.25
I	2	4	8	4	16
VR	1	3.5	3.5	1	12.25
Total	15	74	324.5	55	2695

$$r = \frac{n\Sigma xy - (\Sigma x)(\Sigma y)}{\sqrt{n[\Sigma x2 - (\Sigma x)2][n\Sigma y2 - (\Sigma y2)}}$$

Where: n = 5, Σx = 15, Σy = 74, Σxy = 324.5, Σx2 = 55, Σy2 = 2695

r= 0.8102 or 81.02%

Decision: The r calculated of 0.8102 is greater than the 0.05 level of significance. The H_1 is accepted. The stock of FDI inflow is leading to economic growth in India

Discussion of result

By this research work it is possible to determine the relation between adoption of IFRS and FDI inflow as basis for economic growth in India. The hypothesis testing reveled that there is a significant relationship between IFRS adoption and FDI of the country. The issues include the rigorous process of conversion of existing record, the cost involved in training and employment of manpower, and the existing accounting infrastructure in the country. The implication of IFRS on the economy is the fact that financial reporting among the countries that have adopted standards is uniformity and comparability as well as the ease on interpretation of financial statements. It may boost the investors' confidence and leads to inter country financial transaction. The survey also revealed that the adoption of IFRS will promote companies' access to global capital markets thereby exposing them to cross-border investments. However, the responses revealed that IFRS adoption has neither made much impact in making timely and accurate reports available nor has it made the financial statements more reliable.

Findings

The research findings are

1. The relationship between IFRS adoption by companies and FDI in India is significant.
2. The adoption of standard accounting format will increase the level of confidence of global investors and investment analysts in the financial statements of companies in India.
3. The IFRS is an effective tool for enhancing the uniformity and comparability of financial statements of companies which have adopted it in India.
4. The listed companies which have adopted IFRS will be able to generate more funds from foreign sources.
5. There are many challenges against the successful adoption and implementation of IFRS but government has put adequate infrastructure and regulatory framework in place to address those issues.
6. IFRS adoption has not made much impact on making available timely and accurate financial reports.

Conclusion

The study was conducted to assess the relationship between IFRS adoption and FDI and the effect on the Indian economy. Based on the findings, the adoption of IFRS is a right step in the right direction. Although it is facing implementation issues and challenges, the benefits is going to outweigh the challenge. With adoption, Indian companies will produce more credible financial statements that will not only be uniform but also provide a basis for better interpretation. They invariably boost investors' confidence and attract cross border financial transactions which is the basis for economic growth.

Recommendations

The recommendation to ensure a successful adoption and implementation of IFRS in India are as below:

1. Government and the regulators should ensure that there is availability of training facilities and materials for professional accountants on the concept of IFRS and issues relating to its implementation and conversion.

2. Compliance with IFRS timetable should be mandatory and failure should be marched with appropriate sanctions.
3. Government should Release more fund to educate all stakeholders with special reference to the academic staff and accounting students who will uphold the future IFRS in the country and developing a plan to help properly equip the company for upcoming changes
4. Professional accounting bodies in India should make IFRS training a part of MCPE at a reduce cost.
5. While monitoring the IFRS implementation timetable, the government, the Reserve Bank of India and other regulatory bodies should ensure that ethical environment and corporate transparency are observed.

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