

# **The Economic Analysis of the Institutional Background of the IFRS Convergence and Its Effects on Developing Countries**

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## **Abstract:**

The internationalization of business and finance has brought out a need for a uniform, international set of accounting standards. International Financial Reporting Standards (IFRS) came out as a result and its reporting is used in 85 countries for all domestic companies. This paper focuses on these main questions from a public choice perspective in order to enlighten the political interest problems related to the institutional background of the internationalization process of the IFRS; Is IFRS really suitable for all the countries? What are the political forces behind the standard setting institutions? Are the countries that had a voting power on the formation of these standards are the ones that benefit from this application most? A theoretical cost-benefit analysis (CBA) of IFRS convergence and investor reactions is used to show the difference between the expected economic earnings of the developing countries and the industrialized countries after the convergence. The representational structure of the International Accounting Standards Board (IASB) shall be clarified in order to see whether an international accounting model set by a private institution could be strong enough to fend off governmental political pressures. The paper concludes that with case studies in different countries after their convergence to IFRS, it can be clarified whether a more democratic standard setting board organization, where more countries are represented, could create a more efficient international set of standards.

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## **1. Implementation of IFRS**

The internationalization of business and finance has brought out a need for a uniform, international set of accounting standards. International Financial Reporting Standards (hereinafter referred as IFRS) came out as a result and its reporting is used in 85 countries for all domestic companies. EU decided to apply IFRS starting from 2005. The prospects of adopting IFRS represented a substantial shift in financial reporting for European firms because many requirements in IFRS differ from those in domestic standards of European countries. Also, the adoption of IFRS in Europe reflects an EU goal of achieving capital market integration; it is a necessary step towards convergence of financial reporting not only across Europe, but also between Europe and the rest of the world.<sup>2</sup> Currently in the USA, there is a slow shifting movement from the US GAAP (Generally Accepted Accounting Principles) to IFRS. IFRS has an impressive success compared to other accounting standard sets since it has been adopted over 100 countries, despite of the limited theoretic work and evidence on what are the advantages of uniform standards. The biggest risk that it created is whether there will be substantial differences among countries concerning the implementation of the IFRS which may lead to different regulatory applications.<sup>3</sup>

Is IFRS really applicable for all the countries? What are the forces behind the institutions responsible for setting these standards? Are the countries that had a voting power on the formation of these standards are the ones that benefit from this application most?

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<sup>2</sup> Armstrong, Chris S., Barth, Mary E., Jagolinzer, Alan D. and Riedl, Edward J., Market Reaction to the Adoption of IFRS in Europe 2009 Accounting Review, Forthcoming. SSRN: <http://ssrn.com/abstract=903429>

<sup>3</sup> Ball, Ray, International Financial Reporting Standards (IFRS): Pros and Cons for Investors. Accounting and Business Research, Forthcoming. Available at SSRN: <http://ssrn.com/abstract=929561>

## **2. Cost-Benefit Analysis regarding Developing Countries**

There are two groups of economies in the world, industrial economies and developing economies and each group is highly affected by the economic stability of the other group. This is why economic policies of advanced countries are influenced by the situation in the developing countries. Hence, the use of IFRS in developing countries is highly encouraged by the industrialized countries. However, the convergence to IFRS is highly costly and might cause many small and midsize enterprises from developing countries to shut-down. The one important positive long-term effect of the IFRS for the developing countries is that, it lets more transparency in balance sheets and this is a warranty for the foreign investor. IFRS promotes fair-value accounting, hence detects the current real values of the companies' assets. This transparency, compared to historical cost accounting, was demanded by the investors in order to judge the actual financial states of companies more accurately.<sup>4</sup> So it can be said that converging to IFRS increases the amount of the foreign investments for a developing country. Here the question to discuss is whether converging to IFRS or trying to convince foreign investors that the local accounting system is safe is more costly. The foreign investors want to see the IFRS based reports to balance the information asymmetry. IFRS increases efficiency in an obvious way, but the cost of the convergence of a whole domestic system to IFRS is ambiguous, since it includes many variables forming a significant transaction cost; such as the disappearance of small and mid-size companies, price of the convergence training, cost of the adoptive change in certain economic regulations etc.

The main idea behind forming a uniform accounting regulation was to help the creation of globalized capital markets. If IFRS succeeds to fulfill this mission, it can be foreseen that developing countries will benefit from this in the long-run. Converging to IFRS in a developing country signals<sup>5</sup> that fair-value accounting is used in that country, therefore it encourages foreign investments. The key issues that foreign investors look for are reliability and comparability of the financial information from the market of a developing country. Even if there are differences in

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<sup>4</sup> Morley, IFRS simplified, Nixon-Carre Ltd.

<sup>5</sup> Signaling is needed as prevention from the information asymmetries. Through signaling, the agent enlightens the principal about the unknown status of itself. In the accounting reports context, the investors are the principals to whom the current financial status of the firm is transmitted through the accounting reports prepared due to IFRS. On the other hand, the relevant agent can be named as the firm, the auditor, or the IASB since each had significant role on the reports by different means.

the accounting standards between countries, investors and financial analysts need to be clear about the nature and magnitude of the differences. International investors would need uniform accounting standards to facilitate the comparison of the performance of the borrower countries.<sup>6</sup>

From a social welfare perspective, it is beneficial for the shareholders of the companies in the developing countries while it is also beneficial for the States of the developing countries since attracting foreign investments has prospective positive effects on the industrial development. IFRS Foundation created a guideline which is called IFRS for Small and Midsize Enterprises and it holds several training programs in the developing countries to facilitate the process. However, even having a training on IFRS for a small size is highly costly<sup>7</sup> for the firm's shareholders and might lead to the disappearance of the firm before or shortly (most probably maximum 2 years) after the convergence.

Given the information above, a potential cost-benefit analysis is possible as the following; Costs: C, Benefits<sup>8</sup>: b, duration of adjustment n periods of switching costs: C<sub>s</sub>, transaction costs :C<sub>p</sub>,

$$C = C_s + C_p$$

interest rate: r, period: t

Regarding a long-term cost-benefit analysis, the State incurs costs C in each period until the convergence has finished. The costs consist of the actual switching costs C<sub>s</sub> from the national accounting rules to IFRS. The State also needs to deal with defaults or disappearance of the Small and Midsize companies that result from the new accounting standards. Those costs can be summed up as transaction costs C<sub>p</sub>. Hence, the State has an incentive to change its national accounting rules in favor of IFRS, if

$$c_s + \sum_{t=1}^n \frac{c_p}{(1+r)^t} < \sum_{t=1}^n \frac{b_t}{(1+r)^t}$$

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<sup>6</sup>Antwi Kofi Gyasi, Adoption of International Financial Reporting Standards in Developing Countries - The Case of Ghana, Vaasa Ammatikorkeakoulu University Of Applied Sciences, p. 72

<sup>8</sup> Benefits = earnings based on the foreign investments that would not occur without the convergence to IFRS

Note, however, that  $C_P$  for  $t > 2$  is very likely to be only marginal, since most companies that cannot cope with IFRS rules should be out of business by then. On the other hand the equation shows that the prospective foreign investments increasing over time can guarantee a positive impact over the economy of the developing countries in the long-run even the transaction costs are high since this variable is not related to time.

### **3. Representational Structure of the IASB**

IFRS are the set of rules that creates the basis for the financial globalization.<sup>9</sup> However one serious risk of adopting IFRS, which is not only the quality of the standards, but the accountability and independence of the International Accounting Standards Board (hereinafter referred as IASB). The IASC (International Accounting Standards Committee) Foundation Trustees who name the IASB members, have proposed amendments to create a Monitoring group composed of the securities authorities. IASB is in charge since 2001 and formerly the responsibility for decision taking for International Standards belonged to the IASC who had about 140 member bodies from 104 countries. The IFRS Foundation raises funds for the operation of the IASB. Most contributors are banks and other companies which use or have an interest in promoting international standards. Which is self-explanatory why the IFRS expects from the developing countries to go through a lot of disadvantages while offering many advantages to the industrialized countries<sup>10</sup>.

Maybe the former version of the board was more democratic but the former accounting rules was not efficient enough and never became as widespread as IFRS. IFRS foundation declare their mission on their official website to form “enforceable” set of rules, and maybe less democratic structure of IASB is the key to make more enforceable rules since the voices from the developing countries who would not enforce the rules due to the mistakes in the local applications will not be heard in the board anymore.

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<sup>9</sup> B. Eichengreen, International Financial Regulation After the Crisis, Daedalus, 109

<sup>10</sup> The argument which declares that “the contribution of signaling theory is the prediction that higher quality firms will choose accounting policies which allow their superior quality to be revealed, while lower quality firms will choose accounting methods which attempt to hide their poor quality”(Morris, Signaling, Agency Theory and Accounting Policy Choice, Accounting and Business Review, Vol 18, 1987, p.54) matches with the idea that industrialized countries choose the uniform set of accounting standards which allow them attract even more investments than the developing countries.

In order to understand the institutional background of the IFRS, a public choice perspective can be applied. “Public choice can be defined as the application of economics to political science. The subject matter of public choice is the same as that of political science: the theory of the state, voting rules, voter behavior, party politics, the bureaucracy, and so on. The basic behavioral postulate of public choice, as for economics, is that man is an egoistic, rational, utility maximizer.”<sup>11</sup> IASB members are chosen by the Trustees of the IFRS Foundation. Trustees are appointed for a renewable term of three years. Six of the Trustees must be selected from the Asia/Oceania region, six from Europe, six from North America, one from Africa, one from South America and two from the rest of the world, North America is represented by four members from USA and one member from Canada, Europe is represented by Germany, France, UK, Netherlands and Spain. Asia is represented by Republic of China, Republic of Korea, Australia, India, Japan, South America is represented by Brazil and Africa is represented by South Africa. The IASB members are the representatives of the following countries;

Number of Members	Country
4	US
2	Japan
2	UK
1	Australia
1	Brazil
1	France
1	Germany
1	India
1	New Zealand
1	Republic of China
1	South Africa
1	Sweden
1	The Netherlands
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It is hard to see whether an international accounting model be could strong enough to fend off political pressure from governments around the world.<sup>12</sup> The IASB and the Trustees do not represent developing countries, therefore it gives a strong opinion that the developing countries

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<sup>11</sup> Mueller, *Public Choice II*, Cambridge, Cambridge University Press. 1989, pp. 1-2

<sup>12</sup> <http://blog.ifrs.com/2009/01/iasb-accountability-and-independence.html>

had no right to vote on the IFRS however in order to attract foreign investors they have to adopt the standards. Is it possible that the countries that formed IFRS actively, took into consideration the effects on the developing countries or did they just protect their own interests?

#### **4.Examples from Developing Countries**

After the 1960`s, the developing countries started to differ more from each other when it comes to economic policies for growth. East Asian countries abandoned import-substituting industrialization and turn to a successful development strategy on export. While Latin American countries reduced trade barriers trying to rein in the governmental effects in their economy and to reduce inflation.<sup>13</sup> A recent case study in India points out the fact that even currency differences can cause an unexpected IFRS convergence cost for the firms in the developing countries<sup>14</sup>. This shows that each country might need a different economic regulation for development, and which also brings up the discussion whether developing countries can benefit from a uniform financial regulation as much as more industrialized economies that has similar economic growth strategies can do.

Two main problems in the developing countries are lack of capital and skilled labor. Political instability in these countries usually ends with misguided economic policies and it discourages investment in capital while also reducing overall economic efficiency<sup>15</sup>. Even if adoption of IFRS increases the capital inflow it will not be enough for faster growth by itself<sup>16</sup>.

Following Global Credit Crisis of 2008-2009, it is clear that global financial instability can affect even the strongest national economies. Many countries took measures to become more immune for a new possible crisis; however these measures were not uniform. For example, United States put effort in strengthening mortgage, while United Kingdom has emphasized the perverse incentives created by bonus-based compensation of financial executives. France and Germany focused on the risks created by the soft regulation of hedge funds and private equity firms<sup>17</sup>. Each country had an opinion and solution for their weakest financial regulation, which

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<sup>13</sup> P.Krugman, M. Obstfeld, M. Melitz, International Economics Theory & Policy, Pearson, 653

<sup>14</sup> Ramanna, The international politics of IFRS harmonization, Working Paper, Harvard Business School, August 2011, p.24

<sup>15</sup> P.Krugman, M. Obstfeld, M. Melitz, International Economics Theory & Policy, Pearson, 650

<sup>16</sup> E. Prasad et al., Effects of Financial Globalization on Developing Countries, Occasional Paper 220, IMF, 2003, 3

<sup>17</sup> B. Eichengreen, International Financial Regulation After the Crisis, Daedalus, 107

can also show that a uniform accounting standard may not be the solution for a global financial stability since it assumes that each country can deal with the same type of financial regulation.

The disagreement among national regulators over priorities and strategies is a source of conflict but it also makes it harder that their efforts will provide financial stability for the whole world. It is a known fact that many regulatory restrictions are inefficient if they are applied solely at the national level this is why a significant international cooperation is needed when it comes to applying a regulatory policy such as taxation policies<sup>18</sup> or control in bank activities.

To see the effects of the IFRS convergence in a developing country, Ghana can be used as an example. A recent study on the IFRS compliance in Ghana lists some benefits and disadvantages after discussing with several multinational companies and audit companies in the country. The benefits are mostly theoretical such as aiming more transparency and attracting more foreign investments, consolidation of group accounts which emphasize that with IFRS the whole accounts of subsidiaries can be consolidated with much ease and less time. While the disadvantages are more practical; such as many trainings has to be given to the local staff, and some standards do not meet the accounting and financial requirements of the country. In any case there would be some gap between these standards and the real accounting and financial reporting needs of these developing countries. For example; Zimbabwe has converged to IFRS but the Financial Reporting in Hyper-Inflationary Economies for instance were not adopted in Zimbabwe in that it was considered to be inapplicable at the time of adoption.<sup>19</sup>

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<sup>18</sup> “political factors are a fundamental determinant of the tax policymaking” (Poterba, Public Finance and Public Choice, National Tax Journal, Vol 51, 1998, p.391)

<sup>19</sup> Antwi Kofi Gyasi, Adoption of International Financial Reporting Standards in Developing Countries - The Case of Ghana, Vaasa Ammatikorkeakoulu University Of Applied Sciences, 73

## **Conclusion**

The examples show that the costs of convergence to IFRS can only be substituted with increasing foreign investments in the developing countries over time. It is assumable that the developing countries need customized solutions to their economic problems and therefore, there is a possibility that even if they adopt the uniform IFRS on paper, the convergence will remain as a shadow and the accounting will be done just as before. For the developing countries, the convergence can only be a beneficial investment in the long-run, assuming that the foreign investors will rely on the transparency of the financial reports. But if the investors suspect that IFRS cannot become enforceable in the developing countries due to the relevant reasons on Section 4, the convergence risk to be only a waste of resources. A possible solution could be asking developing countries to use IFRS as a benchmark and create their own IFRS-like system , so that they could decrease the transaction costs that might occur from a strict shift to IFRS. The institutional process behind IFRS and the effective forces on the Board also shows the probability that the votes of the developing countries are not taken into account. Maybe a more democratic standard setting system, where more countries are represented and have chance to declare their ideas about which system fits best to their proper economic structure could grow a more efficient international set of standards. However further statistical data on several countries' CBA is necessary to clarify whether this solution would be applicable.

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