Impact of IFRS on the Capital Market

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A capital market is a market for long-term securities in the nature of debt or equity, where business enterprises and government can raise long-term funds. It is an institutional system where lenders and borrowers interact with a view to transacting or trading. In the capital market money is provided for periods longer than a year as the raising of short-term funds takes place in other markets (e.g., the money market). The capital market includes the stock market (equity securities) and the bond market (debt). Capital markets may be classified as primary markets and secondary markets. In primary markets, new stock or bond issues are sold to investors via a mechanism known as underwriting. In the secondary markets, existing securities are sold and bought among investors or traders, usually on a securities exchange, over-the-counter, or elsewhere.

Capital market is vested largely in stock exchanges and in India, stock exchanges are regulated by the Securities and Exchange Board of India.

As the investors are providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them whether they should buy, hold or sell the investment. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends. Financial statements of the business enterprise provides the required information to the investors, as it provides the information about the entity's financial position, performance and changes in financial position. The investors make use of financial statements to take investment decisions.

Globalisation of capital markets has created a need for a financial reporting system which can help in preparing comparable and globally understandable financial statements. For this purpose, singe set of high quality globally accepted Accounting Standards are being adopted around the world, which have the ability of enhancing comparability and transparency of financial statements for investors, resulting in greater willingness of investor to invest across borders, a lower cost of capital, more efficient allocation of resources and higher economic growth. International Financial Reporting Standards are increasingly accepted as global Accounting Standards. Realising the benefits of implementing IFRS, it has been decided that in India IFRS-converged Accounting Standards will be implemented in a phased manner.

Roadmap to convergence for Banking, Insurance, NBFCs and other companies has been laid down by the Ministry of Corporate Affairs. As per the roadmap for Companies other than Banking Companies, Insurance Companies and NBFCs, converged Accounting Standards will be applied to specified class of companies in three phases. Companies forming a part of NSE-Nifty 50, BSE – Sensex 30, whose shares or other securities are listed on stock exchanges outside India, and listed or unlisted companies having a net worth in excess of Rs.1,000 crores will implement IFRS-converged Standards from accounting periods commencing on or after 1st April 2011. Listed or unlisted companies having a net worth exceeding Rs. 500 crores but not exceeding Rs. 1,000 crores will implement IFRS-converged Standards from accounting periods commencing on or after 1st April 2013. Listed companies having a net worth of Rs. 500 crores or less will implement IFRS-converged Standards from accounting periods commencing on or after 1st April 2014. All insurance companies will implement IFRS-converged Standards from accounting periods commencing on or after 1st April 2012. Banking companies will implement IFRS-converged Standards in two phases, i.e., from accounting periods commencing on or after 1st April 2013 and 1st April 2014. Similarly, NBFCs will implement IFRS-converged Standards in two phases, i.e., from accounting periods commencing on or after 1st April 2013 and 1st April 2014. Implementation of IFRS- converged Accounting Standards in India would definitely have impact on reporting of financial position and performance of the entities, which in turn would impact the capital markets.

IFRS-converged Standards, like the corresponding IFRSs, would be based on the premise that the financial statements should be more and more transparent and should faithfully represent the actual financial position and performance of the entity. In order to present a fair picture of the entity's financial position, there standards would require more than 3000 disclosures. Such disclosures would assist investors in making more informed financial decisions and predicting the future financial performance of the entities. Moreover, financial statements prepared using IFRS-converged standards would give a signal of higher quality accounting and transparency. Imposing the disclosure requirements of these standards would improve the information disclosure quality of companies also.

In order to fairly present the financial position and performance of an entity, IFRS-converged standards would require greater use of fair valuation approach. One of the advantages of use of fair valuation approach would be that the book earnings would be closer to financial earnings and would represent the actual valuation of entities. This would be a positive outcome for the efficient functioning of the market as investors would be able to know the actual performance and worth of the entity. Investors could better distinguish between the good and bad investments. Furthermore, in many cases, fair value represents the market's expectations about expected future cash flows for a financial instrument, which makes it of considerable significance for users of financial statements when making decisions about them. One of the basic doubt in this regard is about the reliability of estimates of the fair value. To overcome this limitation, these standards would require the disclosures of all the relevant information and assumptions used. This would help the investors in better understanding the risks and rewards involved.

Another factor which would have impact on capital market would be more importance to concept of substance over form. IFRS-converged standards would require to look into the economic reality of a transaction. For example, the substance of a financial instrument would have to be looked into, rather that its legal form to determine its classification in the balance sheet. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. For example, a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, would be a financial liability. As per Schedule VI to the Companies Act today it is classified as a part of equity. This would result into change in debt-equity ratio, which is an important factor for investors for making investment.

Another example of faithful representation of transactions is, accounting treatment prescribed for operators working under service concession arrangements. Operators working under service concession arrangements would be required to recognise their right to use the asset as intangible asset and the amount due from or at the direction of the grantor shall be accounted for as financial asset. At present, operators may be recognising the assets constructed under such an arrangement as their fixed assets. It would also have impact on their income statements, as amortisation of assets would decrease as a result of reclassification of some tangible assets as financial assets or intangible assets and revenues on financial assets would increase. This accounting treatment would result into increased clarity, as well as enhanced comparability and distinction between different types of contracts based on clear criteria. Financial information prepared as per this treatment will assist both the management of companies and users of financial statements to better assess the performance and risk exposures related to these service concession arrangements. Investors would clearly benefit from the harmonised accounting in this regard and will be able to take more informed decisions.

In order to faithfully represent the transactions, accounting standard on business combinations may require that where fair value of assets on acquisition date is more than consideration paid, such gain should be recognized as bargain purchase in profit or loss. At present, such difference is treated as capital reserve. This treatment is prescribed in accordance with the definition of income given in the Framework that any enhancements of assets that result in increases in equity shall be recognized as income.

All the above examples show that reporting under IFRS-converged standards would be more transparent. It would help in providing valuable information and would reveal new information which is not being provided at present. This will help the investors to better understand the risks and rewards associated with the investment in an entity and, therefore, it would be easier to draw conclusions.

In this regard, it could also be noted that converged AS 1, *Presentation of Financial Statements,* is being formulated to improve users' ability to analyse and compare the information given in financial statements. It would require presentation of statement of changes in equity. This will enable investors to analyse changes in a company's equity resulting from transactions with owners in their capacity as owners (such as dividends and share repurchases) separately from 'non-owner' changes (such as transactions with third parties).

The implementation of IFRS-converged standards would reduce information asymmetry and would subsequently smoothen the communication between managers, shareholders, lenders and other interested parties, resulting in lower agency costs. Lower information asymmetry would also lead to lower costs of equity and debt financing. By reducing information asymmetry, investors would be able to monitor managerial performance better and therefore would demand a lower risk premium. Therefore, this would tend to enhance stock market efficiency, and would have positive impact on the company's stock returns and stock related financial performance measures.

Implementation of IFRS-converged standards would result into integration of capital market. Now industry would be able to raise capital from foreign markets at lower cost because financial statements complying with globally accepted accounting standards would create confidence in the minds of foreign investors. With the diversity in accounting standards from country to country, enterprises which operate in different countries face a multitude of accounting requirements prevailing in the countries. The burden of financial reporting would be lessened with convergence of accounting standards because it would simplify the process of preparing the individual and group financial statements and thereby would reduce the costs of preparing the financial statements using different sets of accounting standards.

Use of IFRS–converged accounting standards would open market for foreign investors also, i.e., those who wish to invest outside their own country. Investors want the information that is more relevant, reliable, timely and comparable across the jurisdictions. Financial statements prepared using a common set of accounting standards would help investors to better understand investment opportunities as opposed to financial statements prepared using a different set of national accounting standards. For better understanding of financial statements, global investors have to incur more cost in terms of the time and efforts to convert the financial statements so that they can confidently compare opportunities. Investors' confidence would become strong if accounting standards used are globally accepted. Convergence with IFRSs is expected to contribute to investors' understanding and confidence in high quality financial statements.

To understand the reaction of capital market on adoption of IFRS, experience of European firms on mandatory adoption of IFRS could also be considered. All publicly traded companies in European Union are required to prepare their consolidated financial statements in accordance with IFRS from 2005. A research study undertaken on 'Capital Market Consequences of European firms' Mandatory Adoption of IFRS' has concluded that investors perceived net benefits from adoption of IFRS. Cost of capital decreased significantly and there was an increase in value relevance and information content of earnings announcement. More positive reaction has been observed for European firms with lower pre-adoption information quality and higher pre-adoption information asymmetry because IFRS have improved the information environment for such firms. Market consequences were different for firms in code law legal origin countries than in common law legal origin countries in 2006, after implementing IFRS. Firms applying code law-based domestic accounting standards had a more significant reaction to IFRS adoption than do those applying common law-based domestic standards. The value relevance of earnings and book value of equity for firms domiciled in common law countries did not significantly change between 2004 and 2006. Common law-based domestic standards were more comparable to IFRS while code law-based accounting standards deviated more from IFRS and, consequently, firms domiciled in code law countries had to make more significant changes in financial reporting with the adoption of IFRS. Also, the institutional infrastructure required to support high-quality financial reporting is more developed in common-law countries such as the UK. Therefore, adopting IFRS resulted in more significant market consequences to firms domiciled in code law rather than common law countries.

The abovementioned research study in Europe has concluded that market participants find the announcement of earnings determined in accordance with IFRS as useful information. The adoption of IFRS improved the transparency of financial reporting in European countries, as well as the reliability and the relevance of the reported numbers, resulting in higher value relevance of accounting information and increased information content, ultimately leading to a lower cost of equity capital.

Keeping in view the above and the experience of European Union, various benefits are expected for investors from implementation of IFRS-converged standards, such as, better information quality, improved transparency, decreased information asymmetry, management information, together with consistency of reporting between jurisdictions etc. It is expected that these benefits would enhance capital market efficiency.

To facilitate the achievement of above mentioned benefits by the capital markets, it is imperative that these standards are implemented in the same spirit in which they have been formulated. To ensure proper implementation of IFRS-converged accounting standards, necessary initiatives are being undertaken by the ICAI to educate and train the concerned stakeholders. In this regard, 100 hours IFRS certificate course has been started by the ICAI, whereby more than 1600 members of the ICAI have already undergone the course. In addition to the Certification Course, IFRSs e-learning Course has been started. Workshops, seminars on IFRSs are being organised all over the country. To familarise the members, corporates and other stakeholders with IFRS converged Accounting Standards, allIndia chain workshops on Indian Accounting Standards converged with IFRS have been started in collaboration with the MCA.

Regulators, such as, MCA, RBI, SEBI, IRDA, etc. have a very significant role to play in implementation of IFRS-converged standards. They need to amend various laws and regulations so as to make them consistent with the requirements of IFRS-converged standards. Moreover, to ensure that IFRS-converged standards are implemented in the manner that certain inherent dangers of using IFRS–converged accounting standards, e.g. fair valuation approach, are addressed effectively, regulators may consider imposing restrictions to ensure that unreasilsed gains are not distributed as dividends.

In nutshell it may be said that implementation of IFRS-converged standards with appropriate safeguards would help in attainment of expected benefits for capital market.