The role of in-house governance mechanism on convergence of IFRS: Evidence from Sri Lanka

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Abstract- The convergence of International Accounting Standards (IAS) with International Financial Reporting Standards (IFRS) is an important debate among standards setters, policy makers, regulators, professional bodies and companies worldwide. The objective of this research is to examine the impact of internal corporate governance on convergence of International Financial Reporting Standards (IFRS) and to measure the impact of individual corporate governance factors to the convergence of IFRS.

Changes of equity during the year was used as the dependent variable of the model and no of financial and non-financial variables were used as independent variables. Financial and non-financial data were collected from annual reports published by the listed manufacturing companies in Colombo Stock Exchange (CSE) during the period of 2009 to 2015. This six (6) year period was divided into two categories as before and after convergence of IFRS. All the manufacturing sector companies were selected as the sample of the research. Due to the unavailability of data, there were 29 companies used for the final analysis. Panel data regression was used to analyse data using E-views software.

The results of the study revealed that, effective internal corporate governance mechanism helps companies more aligned with convergence of local accounting standards to IFRS and thereby provide high quality financial information to users of the information.

Index Terms- Convergence of IFRS, Corporate Governance, Manufacturing sector

I. Introduction

According to IFRS foundation Accounting standards are set of principles and guidelines which should be followed by companies in preparing and publishing their financial information periodically. Accounting standards will provide a consistent way of presenting the monetary performance of the company. Listed entities are legally bound to prepare and publish their financial information according to a given set of accounting standards (IFRS Foundation, 2017). With the globalization of accounting and finance sector with the technology, stakeholders are not limited to geographical location or area, they have become global reach (Angeloni, 2016). Therefore, world-wide investors are expecting transparency and proper comparability between financial information with competitors. Board of directors of the organization is responsible for communicate accurate financial information to investors to take economic decision. Proper corporate communication can mitigate the selection problems arise from the financial information taken by the stakeholders (Goodman & Hirsch, 2015). Accounting standards identified as key role for corporate communication with less transaction cost for various stakeholders. It allows them to make more accurate and efficient decision within and outside the organization (Uzma, 2016).

The convergence of International Financial Reporting Standards (IFRS) means one set of accounting standards helps to enhancing international comparability between financial information (Lin & Wang, 2014). The International Accounting Standards Board (IASB) has responsible for developing accounting standards which are used internationally. Therefore, worldwide investors are demanding additional needs for corporate governance and compliance requirements for new IFRS adoption for the respective organization. Board of directors of the organization around the worldwide users face to understanding, adopting and managing cost-benefit associated with new IFRS changes for obtaining an opportunity to gather global investors into the business. IFRS are claimed to significant improvement in quality of the financial information and financial statements and other benefit such as transparency and comparability of the financial statements worldwide (Goodman & Hirsch, 2015), giving a better cost of capital for the investment opportunities (Kim & Ryu, 2016), financial and non-financial benefits (Uzma, 2016; Zéghal, Chtourou, & Sellami, 2011; Luthan & Satria, 2015) and best corporate governance practice (Chen & Rezaee, 2013) and IFRS have been adopted by more than 100 countries without limited to develop or emerging countries. Sri Lanka improved to the internationally develop IFRS as new set of accounting standards call Sri Lanka Financial Reporting Standards (SLFRS) as a fully inline to IFRS with effect of 1st January 2012 with a retrospective adjustment to financial statement (CIMA, 2011). Timely IASB expanded to non-public listed companies that are mostly small and medium sized enterprise (Sellami & Gafsi, 2018).

Convergence of IFRS improving and going beyond the financial statements (O'Rourke, 2008). As a result of IFRS convergence, new regulatory requirement designed to protect investors, ensure transparency of the financial information and comparability between worldwide competitors. Internal control of the organization, corporate governance has been demanding by investors and other stakeholders. Unless improper IFRS adoption generating short term cost like initial establishment and long term cost like adverse assurance from auditors for financial statements (Uzma, 2016). This convergence of IFRS represents good news for investors. Because, financial reporting standards make world-wide comparison and asses the investment opportunities. However, these changes should make more difficult to governance mechanism of the organization. Because, board of directors need to know aware about new IFRS adoption, the impact of financial performance on these changes and competitor's objectives for new IFRS adoption and impact of non-compliance of new IFRS to organization. Nijam (2016) argue IFRS convergence is more effective to advance economics such as developed countries. However, emergent economics increasingly applied IFRS than whole set of accounting standards potentially concerning whether IFRS are relevant and appropriate for the economy (Nijam, 2016; Uzma, 2016). Emergent countries more focus on earning management for stability of the economy. Convergence of IFRS object on investor protection, corporate communication, transference of the financial information than earning management of the organization.

Corporate governance means process of direction and control companies by the board of directors. Any decision taken by the board of directors on behalf of the company or stakeholders, they are responsible for their decision (ICAEW, 2018). Adoption of new IFRS was mandatory for the companies in Sri Lanka (Nijam, 2016). Quality of the financial information and economic decision are depend on correct accounting standards apply by company to financial events (Duarte, Saur-Amaral, & Azevedo, 2015). Good corporate governance provide better solutions and judgments for all financial matters arise in the organization. Example of Fair value measurement, SLFRS 13 provide three inputs to measure fair value of the assets or liabilities. Section 76 of SLFRS 13 provide quoted prices in active market for respective assets or liability at considered date and it is more reliable information. Section 81 provide second input as quoted prices other than active market, similar asset or liability is more reliable sources for fair value measurement. Unavailability of above two inputs to fair value measurement, section 86 of SLFRS 13 explain management can decide fair value of the identified assets or liability based on their knowledge and judgments. According to this example, corporate governance of the organization need to aware and support to IFRS convergence to provide quality financial information to stakeholders.

According to the agency theory, proper understanding among principal and agent create a governance and control mechanism of the organization (Teeboom, 2018). Well defined internal corporate governance of the organization should minimize the conflict between stakeholder's expected and actual performance of the organization (Todorovic, 2013). Therefore, corporate governance is what about board of directors does and how these changes are sets value of the organization. All the companies need to be complied with mandatory adoption of IFRS from locally developed accounting standards (Kim & Ryu, 2016). According to the research study done by Nijam (2016) Sri Lankan companies also need to adopt IFRS for financial reporting. IASB mainly responsible for developed IFRS with proper comparability and transferences of the financial information. Economic decision of the stakeholders were depend on the correct adoption of IFRS and application to the financial events of the company (Duarte, Saur-Amaral, & Azevedo, 2015; Dayanandan, Donker, Ivanof, & Karahan, 2016). Proper corporate governance of the organization with a best professionals were reduce incorrect application of IFRS. Because of that, governance parties are provide better support to IFRS implementation to the company with their knowledge, experience and judgments. IFRS is principle based accounting approach than rule based accounting. That was helps to used suitable application based on professional judgment rather than common accounting rules (Thomason, 2017). Main problem of this research study is unavailability of proper internal corporate governance or consultancy service to new IFRS convergence, company applied accounting standards or judgments with an incorrect manner, which will affect to financial information and economic decision taken by stakeholders. And also more possibility to received adverse opinion or assurance from audit due unawareness of correct IFRS application. Therefore, individual organization need to ensure good corporate governance mechanism for convergence of IFRS process and time to time adjust updated matters to financial statement properly.

Most of the research studies were conducted to examine organization performance on convergence of IFRS (Hastuti, Ghozali, & Yuyetta, 2016; Zéghal, Chtourou, & Sellami, 2011), how IFRS convergence affect to investors perception (Wardhani, The role of investor protection in corporate governance and accounting harmonization: Cross-country analysis in Asia, 2015), and value relevance of the organization (Kim & Ryu, 2016). There are prior research on corporate governance and its impact to the convergence of IFRS (Chen & Rezaee, 2013; Chen & Cheng, 2007; Yadav & Sharma, 2012). However, there is no any research study undertake on the impact of internal corporate governance on convergence of IFRS in Sri Lankan context.

The main objective of this research is to examine the impact of internal corporate governance on Convergence of International Financial Reporting Standards (IFRS) of Sri Lankan manufacturing companies.

II. Literature Review

The convergence of accounting standard or one set of accounting standards across countries is most dynamic are of the today world. The researcher of (Angeloni, 2016) did their empirical research to examine how convergence of IFRS implement individual countries worldwide and what are effort done by the regulators. Mainly author used example of theoretical and empirical literature for and against IFRS implementation. Because, research need to express updated picture of the convergence process and evaluating related benefit and issues of convergence of IFRS process. The author concludes, if successful IFRS convergence gain better corporate communication and transparency. However, main limitation of IFRS convergence are different accounting practices and GAAP.

Goodman & Hirsch (2015) conclude corporate communication is all the economic information such as Total Corporation's effect communicates to stakeholders and better corporate communication success due to one set of accounting standard in worldwide. Because, it provides easy comparability and transparency of financial information for productive economic decisions. Investors are try to absorb maximum benefit from the investment portfolio.

Corporate governance is control mechanism of the agent or managers work to reduce conflict of agency theory or stewardship theory (L'Huillier, 2014). According to that research study, if an agent of manager work with their own wish, overall stakeholder's objectives are not achieved. Therefore, well defined corporate governance help to control their actions to well-being of the all stakeholders. An examination of academic publication's related theories and prior research papers are help to do that research paper. Because, author's perception is what is a framework meaning of the corporate governance. Better corporate governance mechanism system gains financial and non-financial benefit longer period than high initial establishment cost (Mulcahy & Donnelly, 2015). Further research paper mention, initial loss of establishment is not a longer failure, because, unless better corporate governance, business failure more affected to stakeholders than initial governance mechanism establishment. The researcher used loss makes companies from 2004 to 2006 in UK Stock Exchange. In this research paper, evaluate the independent factors such as firm size, structure of the Board of directors, whether Chairman and MD are some person, percentage of director's salaries and management fees and who is the audit firm did by the final audit, how affect to the firm performance.

Chen & Rezaee (2013) examine the important of corporate governance on International Financial Reporting Standard (IFRS) convergence. For their sample, they collect data from all Chinese listed companies under B shares. They try to get what kind of relationship had degree of convergence and corporate governance of the company. They mentioned there are two (2) type of governance had to company such as internal governance and external governance. Researcher get that factors as an independent variables and degree of IFRS convergence as a dependent variable. Researcher conclude that effective internal governance helps to be aligned with IFRS. And also they mentioned external governance provide mediate service for relationship between corporate governance and IFRS convergence. In addition to they mention their sample size is coved only one selected area and time series or panel data more reliable than cross sectional data. Chen & Cheng (2007) examined harmonization of accounting practices with IFRS practices through corporate governance on Chinese context. They used more affected variables to their empirical research such as audit committee, institutional shareholder impact, etc. than previous research. In this research used chinsed B share listed companies for their sample and secondary data collected from selected company's annual reports. Dependent variable is Effect of the accounting practice to financial statement. They obtain net profit differences after based on GAAP and IFRS at same year. Researcher finally conclude that, corporate governance has not a significant contribution towards accounting harmonization. Because of that researcher mention, regression analysis shows negative co-efficient of independent directors of the company, institutional shareholders and big 4 audit firms with dependent variable.

The empirical research of Wardhani (2010) conclude their analysis, inter-relation between convergence of IFRS, investor protection, and corporate governance are positively affect to the organization earning. The author mention, the effect of the convergence of IFRS from local accounting practice gain more earnings if country with weak investor protections. Further, Wardhani (2010) conclude, the company with weak corporate governance, convergence of IFRS will increased the earning of the organization. Wardhani (2010) used company, which are more than 10 years operate in market and collect data from survey and focus group discussions. And also, research examines impact of investor protection, degree of convergence, audit quality, sales growth and level of debt to dependent variable of value of discretionary accrual.

The south Asian research of Yadav & Sharma (2012) examine for convergence of IFRS, what are the things to done by the corporate. With the globalization concept, all the areas are change with the technology including Indian all industries. Multi-national companies are coming to country with open economy and they need to better comparison actual performance with worldwide competitors. In this research, analysing most of the theories and concepts such as globalization of finance, competitive advantage, professionalism, statutory obligations, economic growth, management compensation on plan and awareness of the international practice, Yadav & Sharma (2012) conclude that, better governance procedure and correct application are need to take for higher benefit from convergence of IFRS from local accounting standards. Because, researcher mention, IFRS is a more principle based approach with limited implementation and application guidance. Decision makers are use their judgment to solve different circumstance of the organization. Sometime it's may be conflict of interest between agent and principal. Therefore, more insider and outsider governance process are help to better IFRS convergence to all Indian companies.

Literature reviews facilitate to determine what are the findings and conclusion that the prior researchers are made through-out their studies relating to the impact of internal corporate governance on convergence of IFRS. Based on their experimental future researchers can used most appropriate method to obtain innovates. The role of corporate governance on convergence of IFRS is most dynamic subject of the today contest. Most of the researchers are did their research studies to explain what is the importance of that and how to effect to organization or whole economy. However, most of the researchers are examine what is the impact to earing management of the organization (Zéghal, Chtourou, & Sellami, 2011; Chee & Phua , 2016), investor perception (Wardhani, The role of investor protection in corporate governance and accounting harmonization: Cross-country analysis in Asia, 2015) or value relevant of the organization. The limited no of studies are examined success of IFRS convergence with effect on corporate governance. Sri Lanka also adopt IFRS to financial statement since 2012. However, due to available research studies, no any researcher examined examine the internal corporate governance of the organization is impact to converging local financial reporting standards to International Financial Reporting Standards (IFRS) in Sri Lanka. Better corporate governance of the organization helps gaining better outcome from any decision taken from the company (L'Huillier, 2014). If, organization is adopting or apply incorrect financial reporting standards in their transactions, company will provide incorrect financial information. Ultimately it will affect to economic decision of the stakeholders. Well established internal corporate governance system helps to avoid improper standard application to company transactions. According to the literature reviews, the main research gap identified is involvement of internal corporate governance of the organization on convergence of IFRS in Sri Lanka context.

III. Methodology

Research methodology design mainly based on the previous research of Chen & Rezaee, (2013). This study employ the following regression model to evaluate the main research objective of the study.

Convergence = β + β1 (Leverage) + β2 (AT) + β3 (Intangible) + β4 (A.Str) + β5 (Size) + β6 (Separate) + β7 (Ind.Dir) + β8 (Int.Aud) + β9 (Adoption) + e

Equation 3. 1. Main model of the research

In the above equation, Shareholder equity was used as a measure of the degree of IFRS *convergence*. Organization's equity value shows changes in total asset and liabilities (Chen & Rezaee, 2013). This research study use both financial and non-financial factors as determinacies of good corporate governance of the organization. *Leverage* measure through total liability divided by total equity. *Intangible asset* ratio indicate symbol of the organization. Internally generate goodwill, trademark, copy write and brand image of the company achieve through best performance of the organization and who are the governance parties of particular organization. *Asset turnover* of the organization indicate utilization during the period. Higher the ratio higher the turnover. *Asset structure* indicate how organization's funds invested in the market. Whether it's long term or short term. Better structure shows both profitability and liquidity of the organization. *Size* of the organization shows the stabilization to longer period. *Separate function of Chairman and CEO* is more likely to be better decision taken to organization than decision taken by individual person's interest. *Board of directors consist of more independent* non-executive directors out of total directors of the organization more likely to be taken possible common decision represent stakeholders. In addition, *availability of internal audit function* of the organization helps to identify, asses, control and mitigate fraudulent activities and errors of the organization. All aforesaid variables were used to measure the level of corporate governance of the organization and to further measure the impact of corporate governance to convergence of IFRS. Out of the selected variables, separate function of chairman & CEO, availability of internal audit function and IFRS adoption period were used as dummy variables.

3.1 Sample and Data Collection

All the Financial and non-financial corporate governance and convergence of IFRS data were collected from the annual reports in the Colombo Stock Exchange (CSE) since 2009/10 period to 2014/15. This six (6) year information were divided into two categories as before and after convergence of IFRS.

All the listed manufacturing sector companies were selected as the sample of this study. Due to the data unavailability, 29 manufacturing sector companies were selected as the sample.

IV. Results

This chapter discusses the data analysis section of the study. Data were analysed using suitable statistics tests and using computerized statistical packages such as E-views 8. Descriptive analysis was performed at first which gives detailed information about the behaviour of each variable. Correlation analysis was performed as the next step and finally, a panel regression analysis was carried out.

Equity_change = 39.2239 - 6.3064 (Leverage) - 0.2479 (AT) - 57.5732 (Intangible) - 0.1047 (A.Str) + 6.4908 (Size) + 0.7638 (Separate) - 0.5267 (Ind.Dir) + 0.4595 (Int.Aud) - 0.8653 (Adoption) + e

As per the empirical results on regression analysis, identified internal corporate governance statically significant at 5 per cent. Also, there is a positive impact of internal corporate governance on convergence of IFRS in Sri Lanka. Because of that, constant coefficient is positive amount of 39.2239. Leverage statistically significant at 5 per cent level. Higher level of leverage negatively affect to the organization (Badar & Saeed, 2013). Also, result of this study shows that negative coefficient value of (6.3064) for changes in equity of the organization. In case of asset turnover, Hua, et al., (2012) provide positive relationship between equity changes. In this study shows negative relationship between asset turnover and financial performance of the study by coefficient value of (0.2479). Negative coefficient value of (7.5732) of intangible ratio on equity change of the organization. It implied that, higher intangible ratio will lead to lower financial performance of the organization. However, previous researchers are concluded positive impact of intangible assets on equity changes of the organization (Haji & Ghazali, 2015). Because of that, goodwill, copy rights or patents are provide cost free advertising of the business. In Sri Lanka, internally generated goodwill are cannot be recognized as an asset to organization. Negative relationship was crated on Sri Lankan based on this limited asset reorganization in financial statements. Kutigi & Yahaya (2015) concluded working capital management of the organization positively affect to performance of the organization. As per the result, negative relationship between asset structure and financial performance of the organization based on negative coefficient value (0.1047). Size of the organization was positivist affect to the profitability of firm (Doğan, 2013). Larger organizations are have more opportunity to expand their business on variety of business opportunities. Coefficient of the firm size also shows positive amount 6.4908. In addition size of the organization is impact to the convergence of IFRS due to significant at 5 per cent level.

In case of non-financial corporate governance determination variables of separate function of chairman and CEO, board independence and availability of internal audit function in an organization are statistically insignificant of this study. Chen & Rezaee, (2013) examine same idea of this research study and concluded these variable are statistically significant impact to IFRS convergence in China. However, in Sri Lankan contest, these variable are not involving or no any support to the IFRS convergence in Sri Lanka. Previous research of Ajina, et al., (2013) concluded CEO duality and non-availability of internal audit function was negative impact to the performance of the organization in post IFRS adoption period. According to this study, separate role module perform for Chairman and CEO of the organization and internal audit activities are positively affect to changes in equity of the organization which is reflected in positive coefficients value of 0.7638 and 0.4595 respectively. In case of higher level of independent directors consist in board, profitability of the organization declining (Nuraini, 2015). In Sri Lankan contest, this also reflected in the analysis. Coefficient value of the independent directors is negative (0.5267). In this research concluded convergence of IFRS is negatively affect to the performance of the organization in Sri Lanka. IFRS adoption coefficient is (0.8653) for equity change in selected sample period.

V. Discussion and Conclusion

5.1 Conclusion

The convergence of IFRS means one set of accounting standards helps to enhancing international comparability and transparency financial information (Lin & Wang, 2014). The International Accounting Standards Board (IASB) has responsible for developing accounting standards which are used internationally. Therefore, worldwide investors are demanding additional needs for corporate governance and compliance requirements for new IFRS adoption for the respective organization. Because, as an example of world financial crisis, major pollutions, etc. investors need to proper transparency among available information and actual information. And also, information are available in common platform, it’s easy to compare with possible alternatives for evaluate best option. Therefore, board of directors of the organization around the worldwide users face to understanding, adopting and managing cost-benefit associated with new IFRS changes for obtaining an opportunity to gather global investors into the business. Around 100 countries adopt new IFRS from locally develop financial reporting standards including Sri Lanka. In this research concluded that, individual organization’s corporate governance is impact to the convergence of IFRS in Sri Lanka.

The main objective of the research study was to measure, the impact of internal corporate governance on convergence of IFRS in Sri Lanka. Regression and correlation analysis showed that the impact of internal corporate governance to convergence of IFRS in Sri Lankan listed manufacturing companies during the period of 2010 to 2016. When considering the individual variables, leverage, intangible ratio, size of the organization and pre-post IFRS adoption period were statistically significant at 5 per cent level. Other explanatory variables such as asset turnover, asset structure, separate function of chairman and CEO, board independence and availability of internal audit function were statistically insignificant at the level of 5 per cent. So as per the results of the study, it is concluded that, there is a positive impact of internal corporate governance on convergence of IFRS in Sri Lanka.

5.2 Suggestions

Based on the information gathered from this study some recommendations can be put forward to retain the quality of accounting information and investors decisions in Sri Lanka in a superior level. Regulatory institutions such as CA Sri Lanka should time to time review the existing accounting standards, Code of best practice used in Sri Lanka with international changes. Top management of companies should make revision of these changes for better outcome from the financial information. In order to maintain the quality of proper IFRS adoption, the accounting information reported through annual reports should be reviewed by regulatory bodies thoroughly. Currently the annual reports of the companies in Sri Lanka are audited by independent audit firms as external corporate governance. Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) is the legal entity in Sri Lanka to monitor the compliance with Sri Lankan Accounting and Auditing Standards of the economically significant business enterprises.

As per the findings of this study some corporate governance mechanisms do not support the convergence of IFRS in Sri Lanka, such as board independence of the organization, internal audit function activeness, separate role model for Chairman and CEO of the organization. Government and non-government responsible regulator bodies should address these matters and provide guidance to top management of organizations.

5.3 Limitations

The first limitation of the study was, the examination of convergence of IFRS was limited to listed manufacturing companies in Sri Lanka. The result may not be generalized to whole companies in Sri Lanka. Second, the immediate effect of the IFRS convergence also should have measured, without considering an average of few years. Finally, the researcher only used internal corporate governance in the current study. The External corporate governance such as audit quality was not considered in this study. Future researchers could focus on these matters when measuring the impact of corporate governance on convergence of IFRS.

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