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China, Japan and South Africa)**

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A Justification For the Role of Audits?: Adoption of International Financial Reporting Standards (IFRS) and Jurisdictional Analyses (Brazil, China, Japan and South Africa)

Marianne Ojo

As well as consolidating on the existing literature on fair value accounting, by way of reference to jurisdictional analyses which include a focus on China, Japan, Brazil, and South Africa, this paper not only highlights why there is need for a re-think of the use of fair values as the primary basis for the implementation of IFRS, but also accentuates the links between systemic risk and information asymmetries – hence the justification for greater focus on information channels as well as disclosure and financial reporting requirements.

Audits, which serve as vital signalling mechanisms in capital markets, have limited roles in many emerging economies than is the case with industrial nations. In contributing to the extant literature on the topic, this paper also aims to address the vital and crucial question relating to whether certain emerging economies are justified in their reluctance to fully embrace audits – based on cost- benefit considerations, as well as other inadequacies relating to fair value measurements. Furthermore, it will be highlighted that whilst audits may appear to have more limited roles in certain jurisdictions, there appears to be greater willingness to embrace Basel III requirements – and in particular, the Basel III leverage ratios in jurisdictions such as China.

Ultimately the paper also aims to investigate whether there are any justifications or rationales for a jurisdiction's willingness and pace to adopt IFRS, Basel III requirements, in relation to the existing role assumed by audits in such jurisdictions.

Key Words: fair value accounting, Finance Theory, information asymmetries, risk, corporate governance, ownership structures, auditor, disclosure, principal, agent, regulation, moral hazard, IFRS, China, Japan, Brazil, and South Africa

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A Justification For the Role of Audits?: Adoption of International Financial Reporting Standards (IFRS) and Jurisdictional Analyses (Brazil, China, Japan and South Africa)

A Introduction

Based on the IFRS, Analysis of the G20 IFRS Profiles¹:

The G20 brings together finance ministers and central bank governors from the following 19 countries plus the European Union: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States of America.

Further observations include:²

1. **Commitment to a single set of global accounting standards.** All of the G20 jurisdictions have made a public commitment supporting a single set of high quality global accounting standards.
2. **Commitment to IFRSs.** The relevant authority in all of the G20 jurisdictions has made a public commitment to IFRSs as the single set of global accounting standards.
3. **Adoption of IFRSs.** 14 of the G20 jurisdictions have adopted IFRSs for all or most companies in their public capital markets. Of the remaining 6 G20 jurisdictions:
 - a. three permit IFRSs on a limited voluntary basis for domestic and/or foreign issuers (India, Japan, United States);
 - b. one (Saudi Arabia) requires IFRSs on a limited basis (banks and insurance companies only);
 - c. one (China) has substantially converged its national standards to IFRSs; and
 - d. one (Indonesia) has adopted some IASs/IFRSs but has not announced a plan or timetable for full adoption.
4. **Scope of use of IFRSs.** Of the 14 G20 jurisdictions that have adopted IFRS for all or most publicly traded companies, 11 require IFRSs for all; 2 (Mexico and Argentina) require IFRSs for all other than financial institutions; and 1 (Canada) allows US GAAP for some and has deferred IFRSs for some others. 13 of the 14 G20 jurisdictions that have adopted IFRSs for all or most publicly traded companies also permit IFRSs for all or most non-publicly traded companies.
5. **Few modifications.** The G20 jurisdictions made very few modifications to IFRSs, and the few that were made are generally regarded as temporary steps in the jurisdiction's plans to adopt IFRSs. There are 5 EU jurisdictions in the G20. While the EU did make an optional 'carve-out' from IAS 39 that the EU itself describes as 'temporary', the 'carve-out' has been applied by fewer than two dozen banks out of the 8,000 IFRS companies whose securities trade on a regulated market in Europe. 2 jurisdictions in the G20 require use of the equity method to account for subsidiaries in separate company financial statements;

¹ See IFRS, "Analysis of the G20 IFRS Profiles"

<http://www.ifrs.org/Use-around-the-world/Pages/Analysis-of-the-G20-IFRS-profiles.aspx>

² see *ibid*

this issue is now under consideration by the IASB. And the EU deferred the effective dates IFRSs 10, 11 and 12 for one year to 2014, though early application is permitted.

A comparative approach will be implemented in analysing and evaluating the progress made within the selected jurisdictions in their adoption of IFRS. A selection of questions from those presented by the IFRS foundation - as well as responses, will be incorporated into section B of this publication and the questions are as follows:³

- 1) Has the jurisdiction made a public commitment in support of moving towards a single set of high quality global accounting standards?
- 2) What is the jurisdiction's status of adoption?
- 3) What additional comments are provided on the adoption status?
- 4) Which IFRSs are required or permitted for domestic companies?
- 5) Does the auditor's report and/or the basis of preparation footnote allow for 'dual reporting' (conformity with both IFRSs and the jurisdiction's GAAP)?
- 6) Are IFRSs incorporated into law or regulations? If yes, how does that process work?
- 7) Does the jurisdiction have a formal process for the 'endorsement' or 'adoption' of new or amended IFRSs (including Interpretations) in place.

Rationale for selecting these jurisdictions is based on many factors, namely:

They constitute part of the G20 member nations and jurisdictions

They are all emerging economies

Countries selected provide an optimal mix in terms of diversity and comparative variations. Countries have been selected from different continents: Africa, Asia and South America. Two countries have been selected from Asia to contrast their approaches to the adoption of IFRS.

It is hoped that the analyses provided will help enlighten the interest demonstrated globally in the adoption of IFRS - as well as the importance of such adoption.

³ See IFRS, "IFRS Application Around the World: Jurisdiction Profiles"
<http://www.ifrs.org/use-around-the-world/Pages/Jurisdiction-profiles.aspx>

B IFRS Adoption in Selected Jurisdictions

B I) IFRS Adoption in Brazil

Based on a response from two Brazilian organisations,⁴ the IFRS foundation was able to provide some feedbacks to the several questions relating to jurisdictional adoption of IFRS. In response to whether Brazil has made a public commitment in embracing the move towards a single set of high quality global accounting standards, to which the response was “Yes”, information provided by both organisations in relation to the jurisdiction’s status of adoption highlighted that “Brazil has already adopted IFRSs for all companies whose securities are publicly traded and for most financial institutions whose securities are not publicly traded, for both consolidated and separate (individual) company financial statements.”

In relation to additional comments on the adoption status some notable observations are as follows:

- For listed entities, IFRSs have been mandatory for the consolidated financial statements of companies whose debt or equity securities trade in a public market for financial years ending 31 December 2010.
- For unlisted entities, changes were introduced in Corporate Law 11.638/07 on the 1st January 2008, paving the way to a process of accelerated convergence of BR GAAP to IFRSs. Full convergence with IFRSs was reached for financial reporting years ending at 31 December 2010 and onwards
- As regards financial institutions, financial institutions regulated by the Brazilian Central Bank (BACEN) that are (a) listed or (b) unlisted but required to have an audit committee have been required to present consolidated financial statements prepared in accordance with IFRSs as supplemental information since 2010. An audit committee is required for all financial institutions that have regulatory capital or manage resources of third parties in an amount equal or above R\$1 billion (approximately US\$ 500 million) or hold deposits and manage resources of third parties in an amount equal or above R\$5 billion (approximately US\$ 2.5 billion).

⁴ The organisations are: Comitê de Pronunciamentos Contábeis (CPC) [The Brazilian Accounting Pronouncements Committee] and Comissão de Valores Mobiliários (CVM) [Securities and Exchange Commission of Brazil]. See IFRS, IFRS Application Around the World: Jurisdiction Profiles
<http://www.ifrs.org/use-around-the-world/Pages/Jurisdiction-profiles.aspx>
<http://www.ifrs.org/Use-around-the-world/Documents/Jurisdiction-profiles/Brazil-IFRS-Profile.pdf>

IFRS Permitted For Use By Domestic Companies in Brazil

According to the response obtained, IFRSs permitted for use are those issued by the IASB, but some options have been eliminated, for example, the revaluation of property, plant and equipment under IAS 16 Property, Plant and Equipment and revaluation of intangible assets under IAS 38 Intangible Assets. Nevertheless, it is added, the resulting consolidated financial statements can still be in full compliance with IFRSs as issued by the IASB.

Does the auditor's report and/or the basis of preparation footnote allow for 'dual reporting' (conformity with both IFRSs and the jurisdiction's GAAP)?

The answer to this was in the affirmative - with the qualification that it applied to separate company financial statements.

In also providing an affirmative response, to the question on **whether IFRSs are incorporated into law or regulations**, it is indicated that the CPC⁵ approves standards that are identical to IFRSs as issued by the IASB (Bound Volume Blue Book).

Existence of formal process for the 'endorsement' or 'adoption' of new or amended IFRSs

It was also confirmed that Brazil has a formal process for the 'endorsement' or 'adoption' of new or amended IFRSs (including Interpretations)

B II) IFRS Adoption in China

The responses obtained to the questions⁶ presented by the IFRS foundation were provided by the Accounting Regulatory Department, Ministry of Finance, People's Republic of China.

In response to the first question which was selected for the purposes of this comparative based study, namely, whether China has made a public commitment in support of moving towards a single set of high quality global accounting standards, the response was in the affirmative.

⁵ "The CPC is the Brazilian standard-setting body that approves all IFRSs for application in Brazil as they are issued by the IASB following the terms of a Memorandum of Understanding among CPC, IASB, and CFC (the Brazilian Accountants Body). See *ibid*

⁶ IFRS APPLICATION AROUND THE WORLD JURISDICTIONAL PROFILE: People's Republic of China
<http://www.ifrs.org/Use-around-the-world/Documents/Jurisdiction-profiles/China-IFRS-Profile.pdf>

As regards the jurisdictions status of adoption it was also highlighted that “China has adopted national accounting standards that are substantially converged with IFRSs.”

Additional Comments Provided on the IFRS Adoption Status in China

According to the IFRS Report,⁷ the Chinese Accounting Standards for Business Enterprises (ASBEs) issued in February 2006 were substantially converged with IFRSs, which was recognised in the Joint Statement of CASC Secretary-General and IASB Chairman signed in November 2005.

IFRS Permitted For Use By Domestic Companies

In contrast to Brazil, however, the use of IFRSs is not permitted for domestic companies.

IFRSs incorporated into law or regulations

In response to the above related statement, it was indicated that Chinese Accounting Standards for Business Enterprises (ASBEs) are a part of law and regulations in China.

B III) IFRS Adoption in Japan

The respondent to the questions presented by the IFRS foundation was the Accounting Standards Board of Japan (ASBJ), a “private-sector” Japanese accounting standard-setting body.

As is the case with Brazil and China, it was confirmed that the jurisdiction has made a public commitment in support of moving towards a single set of high quality global accounting standards.

In relation to Japan’s status of adoption, it was indicated that “voluntary application of IFRS for consolidated financial statements by companies that meet certain criteria has been permitted since March 2010.”⁸

⁷ see *ibid*

⁸ IFRS APPLICATION AROUND THE WORLD JURISDICTIONAL PROFILE: Japan

<http://www.ifrs.org/Use-around-the-world/Documents/Jurisdiction-profiles/Japan-IFRS-Profile.pdf>

Additional comments provided on the adoption status

It was highlighted that “as of February 2014, 34 companies have either started to use IFRS or have publicly announced their intention to use IFRS as a basis for preparing consolidated financial statements as required by the Financial Instruments and Exchange Act (FIEA).”

In responding affirmatively to the question on whether all or some domestic companies whose securities trade in a public market are either required or permitted to use IFRS in their consolidated financial statements, it was also highlighted that IFRS are permitted for companies that meet certain criteria.

IFRS Required or Permitted for Domestic Companies

These were highlighted to be “designated IFRS”.⁹

Existence of formal process for the 'endorsement' or 'adoption' of new or amended IFRSs

It was also confirmed that Japan has a formal process for the 'endorsement' or 'adoption' of new or amended IFRSs (including Interpretations)

B IV) IFRS Adoption in South Africa

The responses to the IFRS Foundation’s questions were provided by the South African Institute of Chartered Accountants (SAICA).

⁹ “Designated IFRS’ are IFRS that have been designated by the Commissioner of the Financial Services Agency. To date, all standards of IFRS have been so designated prior to their effective dates. Reconciliation between the consolidated financial statements prepared in accordance with Designated IFRS and those prepared in accordance with Japanese GAAP is not required.”

Public commitment towards IFRSs as that single set of high quality global accounting standards

As is the case with Brazil, China and Japan, the response to the above statement was in the affirmative with South Africa's status of adoption being that it "requires some companies to use IFRSs, with the remaining companies being allowed to use IFRSs or the IFRS for SMEs."¹⁰

Furthermore, it was confirmed that all domestic companies whose securities trade in a public market are either required or permitted to use IFRSs in their consolidated financial statements. It was also highlighted that IFRS are required by the Companies Act Regulations and JSE Listings Requirements.

IFRS Required or Permitted for Domestic Companies

These include IFRS issued by the IASB, "ie standards and amendments are immediately effective as and when issued by the IASB."

As well as confirming the auditor's report and/or the basis of presentation footnotes stipulation that financial statements have been prepared in conformity with IFRS, it is also highlighted in the response that IFRS are incorporated into law or regulations.

The global importance of the adoption of IFRS and the seriousness of the response to its adoption is thus reflected from the IFRS Foundation responses which have been analysed - in relation to the selected G20 jurisdictions. In view of such global adoption and response, the subsequent section will therefore consider the importance and significance of re-considering the use of fair values as the primary basis for IFRS implementation.

¹⁰ See IFRS, "IFRS APPLICATION AROUND THE WORLD JURISDICTIONAL PROFILE: South Africa" <http://www.ifrs.org/Use-around-the-world/Documents/Jurisdiction-profiles/South-Africa-IFRS-Profile.pdf> "In 1995, the APB decided to harmonise SA GAAP with IFRSs. Since 2003, after due process, the APB has issued IFRSs as SA GAAP without amendment. From 2003 SA GAAP was used by all companies in South Africa; listed, unlisted, and private companies."

C Re-thinking the Use of Fair values As the Primary Basis for the Implementation of IFRS

i) Contribution of Fair Value Measurements to Pro cyclicality and Systemic Risks

As highlighted in a previous paper,¹¹ accounting standards' contribution to procyclicality and particularly, the pro cyclical nature of accounting, is attributed to two principal elements:

- Fair value measurements
- The treatment of impairments.

Whilst results of a certain sample generated by Khan¹² illustrate and support the evidence that „a more fair value-oriented accounting regime is associated with an increase in bank contagion above and beyond that which exists as a result of trade and financial linkages in the banking industry“, Laux and Leuz argue in contrast (and based on their analysis), that fair value accounting (frequently also referred to as mark-to-market accounting), is unlikely to have contributed to the severity of the 2008 Financial Crisis in a major way.¹³ Furthermore, they add that „while there may have been downward spirals or asset fire sales in certain markets, little evidence supports the fact that such effects are the result of fair value accounting.“

ii) Advantages and Disadvantages of Fair Value Measurements

The principal advantage attributed to fair value measurements has already been highlighted – namely, the value of information they incorporate in the financial statements – such value being more complete and accurate than that provided by historical cost accounting.

Problems identified with fair value accounting, as highlighted by Ball, include:¹⁴

¹¹ M Ojo, „The Role of the IASB and Auditing Standards in the Aftermath of the 2008/2009 Financial Crisis“ European Law Journal, Vol. 16, No. 5, September 2010, pp. 604–623 at page 612; Also see M Grande, Accounting and Procyclicality, Conference on Financial Reporting in a Changing World at page 2

¹² U Khan, „Does Fair Value Accounting Contribute to Systemic Risks in the Banking Industry?“ at page 4 <http://papers.ssm.com/sol3/papers.cfm?abstract_id=1327596>

¹³ See C Laux and C Leuz, „Did Fair Value Accounting Contribute to the Financial Crisis?“ ECGI Working Paper Series in Finance, Working Paper No 266 October 2009 at page 3. <http://papers.ssm.com/sol3/papers.cfm?abstract_id=1487905>

¹⁴ R Ball, „International Financial Reporting Standards (IFRS): Pros and Cons for Investors“ at pages 21 and 22 <http://papers.ssm.com/sol3/papers.cfm?abstract_id=929561>

- Market liquidity is a potentially important issue in practice and spreads could be large enough to cause substantial uncertainty about fair values.
- In illiquid markets, trading by managers could influence traded – as well as quoted prices hence allowing them to manipulate fair value estimates.
- The potential for fair value accounting to become „mark to model“ accounting when liquid market prices are not available
 - Tendency for fair value accounting to increase opportunities for manipulation when „mark to model“ accounting is employed to simulate market prices (since managers are able to influence both the choice of models and the parameter estimates).

In line with measures aimed at mitigating procyclicality and its facilitation of forward-looking provisioning, the Basel Committee is supporting a move towards an expected loss approach in accounting standards - this being in line with risk management considerations that suggest that „loan-loss provisions should be forward looking.“¹⁵ This approach is contrasted¹⁶ to accounting standards, and particularly IAS 39, which traditionally require banks to provision based on specific “incurred loss” not expected loss. Further, it is added that „whilst the adoption of international accounting standards contributes to financial stability by limiting the scope for arbitrary earnings manipulation, in a number of cases it has implied lower loan-loss provisioning than many supervisors would have considered prudent during the expansion phase of the cycle.“¹⁷

D The Need for Audits and External Audits in An Increasingly Risk Based Regulatory Environment

Risks have become not only increasingly significant in the modern regulatory environment, but also serve as vital regulatory tools. Auditors and audits, furthermore, serve as fundamental and crucial tools of quantifying risks. As highlighted several times, in the literature relating to risk, „in order for risks to be quantifiable, they must be auditable“. Coupled with the inherent uncertain nature of risks is also the quantifiable, as well as unquantifiable aspect and characteristic of risk. In this regard, it is important to distinguish between risk and uncertainty. Whilst risk is traditionally associated with probability calculations – which suggests that an event can be predicted and controlled, „uncertainty is not capable of measurement and deals with possibilities incapable of calculation which are based on guesswork and

¹⁵ „That is, take into account expected credit losses over the medium term „ See R Moreno, Policymaking from a macro prudential perspective BIS Working Paper No 336, January 2011 at page 13 of 24

¹⁶ *ibid*

¹⁷ *ibid*

judgement“.¹⁸

In assessing whether the current regulatory framework appropriately and adequately balances the objectives, as set out in paragraph 29 of the Discussion Paper, „The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability,“¹⁹ consideration is to be had to trade-offs required to find the right balance: Trade offs between costs in improving framework in a bid to improve complexity, risk sensitivity – at the possible expense of simplicity and comparability.

The need for consistency in the implementation of Basel requirements and regulations is all the more vital and necessary if practices relating to regulatory capital arbitrage are to be minimised and controlled. Differences in the implementation of Basel requirements and rules across various jurisdictions are evident from the very stringent application of rules in certain jurisdictions to those jurisdictions where more lax approaches have been adopted.

Evidence which highlights the fact that different countries could be inconsistently implementing parts of the Basel rules and regulations – either by consolidating or weakening the original requirements, is illustrated through the following:²⁰

- In the EU, in relation to the Capital Requirements Directive/Regulation IV (CRD/RIV) - where based on evidence from latest proposals and negotiations, EU member states will assume greater independence in their ability to increase capital requirements.
- In China, where the implementation framework for Basel III is considered to be more stringent than the international standard (with a requirement of a higher core tier 1 capital adequacy ratio – 5% as opposed to 4.5%, as well as a higher leverage ratio requirement of 4% as opposed to 3%).
- In the U.S, through recent proposals relating to standard and supplementary leverage ratios.

Having highlighted the above, it is also worth mentioning that “over compliance” with rules (and particularly where it appears that such rules or ratios appear to be insufficient) – as indicated by the supplementary ratios in the U.S, is certainly much better than under compliance. Furthermore, what may be regarded as overcompliance for a particular jurisdiction may not necessarily be the case for another. Conversely what may be required for minimal compliance purposes in certain jurisdictions may prove inadequate for certain major economies.

¹⁸ See J Gray and J Hamilton, *Implementing Financial Regulation : Theory and Practice* (2006) at page 20

¹⁹ July 2013

²⁰ See JP Morgan, 'Basel III Implementation: Is the Industry Running Out of Time?'

http://www.jpmorgan.com/tss/General/Basel_III_implementation_Is_the_industry_running_out_of_time_/1320504512062

E Conclusion

It has been argued in many studies, that bank capital ratios and several other financial indicators do not serve as effectively in emerging market economies as is the case with industrial nations. According to Rojas-Suarez (2002), the capital-to-asset ratio, has under-performed as an indicator of banking crisis related problems in Latin America and Asia.²¹ Two reasons which have been put forward as explanations for this are:²²

- Severe deficiencies in the accounting and regulatory framework in these jurisdictions;
- Lack of liquid markets for bank shares, subordinated debt and other bank liabilities and assets which are required to confirm and justify the actual worth of a bank – rather than merely its accounting value.

To which it will also be added that audits, which serve as vital signalling mechanisms in capital markets, have limited roles in many emerging economies than is the case with industrial nations.

Auditors' significance in the supervisory process in identifying areas of potential risks have also been acknowledged in various sections of the literature.²³ If audits are performed as effectively, in the manner in which they are expected to be undertaken, then information provided by such audits should be credible and reliable. Whilst the informational issue with credit agencies appears to be the timely processing and transmission of information (a feature which depends on effective exchange, coordination and communication between those agencies and authorities involved), with audits, the crucial issue appears to be the credibility of information.

A liquidity crisis is considered to be „the classic type of banking crisis whereby a bank for some reason, cannot meet all its payment obligations.“²⁴ The role played by imperfect knowledge in triggering such a crisis is further elaborated. In this sense, bank runs are triggered as a result of such „imperfect

²¹ L Rojas-Suarez, „Rating Banks in Emerging Markets: What Credit Agencies Should Learn From Financial Indicators (2002) http://papers.ssm.com/sol3/papers.cfm?abstract_id=300891

²² see *ibid*

²³ See M Ojo, „Audits, Audit Quality and Signalling Mechanisms: Concentrated Ownership Structures“ http://papers.ssm.com/sol3/papers.cfm?abstract_id=2372511 and Basel Committee for Banking Supervision, paragraph 6 page 31, Core Principles for Effective Banking Supervision September 2012 <http://www.bis.org/publ/bcbs230.pdf>

²⁴ See RM Lastra and G Wood, „The Crisis of 2007 – 09: Nature, Causes and Reactions“ *Journal of International Economic Law* 13(3) at pages 531 and 532

knowledge which customers have of their banks, and the links through the interbank market and payment system.²⁵ Such role played by imperfect knowledge or information asymmetries in triggering such crises could also be extended to enterprises, firms and organisations - and not just banking organisations.

²⁵ *ibid*

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