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IFRS: THE IMPACT ON INDIAN CORPORATE

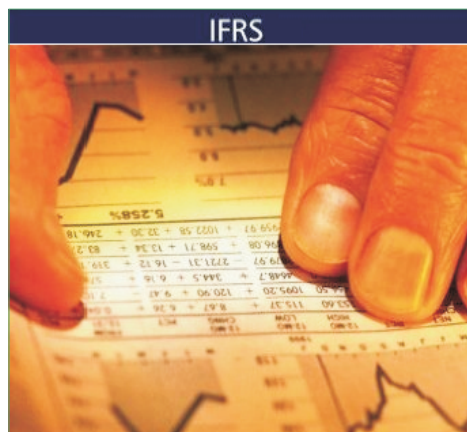
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ABSTRACT

Improvement in comparability of financial information and financial performance with global peers and industry standards. This will result in more transparent financial reporting of a company's activities which will benefit investors, customers and other key stakeholders in



India and overseas; The adoption of IFRS is expected to result in better quality of financial reporting due to consistent application of accounting principles and improvement in reliability of financial statements. This, in turn, will lead to increased trust and reliance placed by investors, analysts and other

stakeholders in a company's financial statements; and Better access to and reduction in the cost of capital raised from global capital markets since IFRS are now accepted as a financial reporting framework for companies seeking to raise funds from most capital markets across the globe. A recent decision by the US Securities and Exchange Commission (SEC) permits foreign companies listed in the US to present financial statements in accordance with IFRS. This means that such companies will not be required to prepare separate financial statements under .

KEYWORDS : global peers and industry standards, Securities and Exchange Commission (SEC)

INTRODUCTION

However, the perceived benefits from IFRS adoption are based on the experience of IFRS compliant countries in a period of mild economic conditions. The current decline in market confidence in India and overseas coupled with tougher economic conditions may present significant challenges to Indian companies.

IFRS requires application of fair value principles in certain situations and this would result in significant differences from financial information currently presented, especially relating to financial instruments and business combinations. Given the current economic scenario, this could result in significant volatility in reported earnings and key performance measures like EPS and P/E ratios. Indian companies will have to build awareness amongst investors and analysts to explain the reasons for this volatility in order to improve understanding, and increase transparency and reliability of their financial statements.

This situation is worsened by the lack of availability of professionals with adequate valuation skills, to assist Indian corporates in arriving at reliable fair value estimates. This is a significant resource constraint that could impact comparability of financial statements and render some of the benefits of IFRS adoption ineffective.

The key to economic development is a sound financial reporting system sustained by good governance, clearly defined quality standards and established regulatory framework. In India, the Institute of Chartered Accountants of India (ICAI), as the accounting standards formulating body in our country, has always formulated accounting standards that have withstood the test of time. As we globalise, the significance of convergence with International Financial Reporting Standards (IFRS) increases. In today's scenario of global business village India cannot afford to insulate itself from the developments and modifications taking place worldwide.

IFRS can be explained in a narrow as well as a broad sense. In the narrow sense IFRS are the new numbered series of pronouncements that IASB has issued. In the broad sense IFRS includes standards and interpretations approved by the IASB, IASB & SIC. These new set of accounting standards are more principles based as compared to the earlier standards that were basically principle based. In India, the accounting standards board set up an IFRS task force with the objective to explore:

- 1) The approach for achieving convergence with IFRS.
- 2) Laying down a road map for achieving convergence with IFRS with a view to make India IFRS compliant.

In Feb, 2011, IFRS converged Indian Accounting Standards (Ind AS) came into existence. The implementation was postponed until April 2012 due to the practical challenges faced by Indian Regulators as well as corporates. Irrespective of the varying opinions convergence of IFRS with local standards is now not just a forum of discussion but a reality.

COST & BENEFITS:

The transition to IFRS may cause short term hindrances, but in the long run, the benefits of investments and consistency will definitely outweigh the costs and other challenges. The beneficiaries of IFRS implementation comprise of the economy, investors, industry, accounting professionals and all the stake holders at large. Large numbers of Indian entities are expanding their functioning in the global arena. Migration to IFRS will enable them to access international capital markets without the risk premium involved in Indian GAAP financial statements. This migration will also help lowering the cost of raising funds, as it will eliminate the need for preparing dual set of Financial Statements. IFRS statements will enable entities to recognise their relative standing looking beyond country and regional milestones. This will facilitate companies to set targets and milestones based on global business environment, rather than merely local ones. IFRS adoption by all group entities will enable company managements to have a common reporting platform thus escaping multiple reporting. IFRS will overcome the flaw of not recording business combinations at fair value. (Purchase Consideration paid for intangible assets not recorded in acquiree's book is usually not reflected separately in financial

statements; instead the amount gets added to goodwill. Hence, true value of business combination is not communicated through Financial Statements.) [Ernest & Young]

IFRS adoption will not only open up a bundle of benefits to Indian Corporates but it will also open up a host of opportunities for accounting professionals. As IFRS is principle based, it will provide cross border activities to professionals including accountants, valuers, auditors & actuaries, which will boost the growth prospects for BPO/KPO segments in India. The mobility of accounting professionals in industry also increases in all parts of the world. The benefits and costs associated with IFRS implementation are broadly discussed for three important aspects of accounting, i.e. corporate accounting, public accounting and academia.

CORPORATE ACCOUNTING:

Accounting in corporate is the most affected by transition to IFRS. The Financial Reporting of corporations would undergo a thorough restructuring which in turn would also affect investor decisions. The accounting and auditing costs would definitely inflate due to the learning curve. The fact that IFRS is more judgement oriented would require skills of expert auditors thus enhancing the audit costs. Transactions will be harder to account for and the reasons provided for this are that there will be an initial struggle for companies to learn and apply the new standards along with the fact that companies will now be able to manipulate the standards to up sell themselves to investors over their competitors. This is due to the principles-based standards of IFRS that do not provide strict reporting rules for companies to follow. In the long run, companies expect costs to fall as employees in the accounting department become more familiar with the regulations of IFRS.

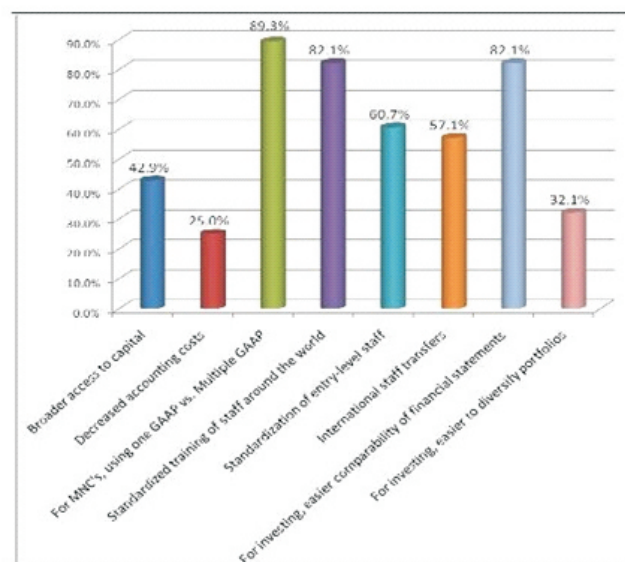


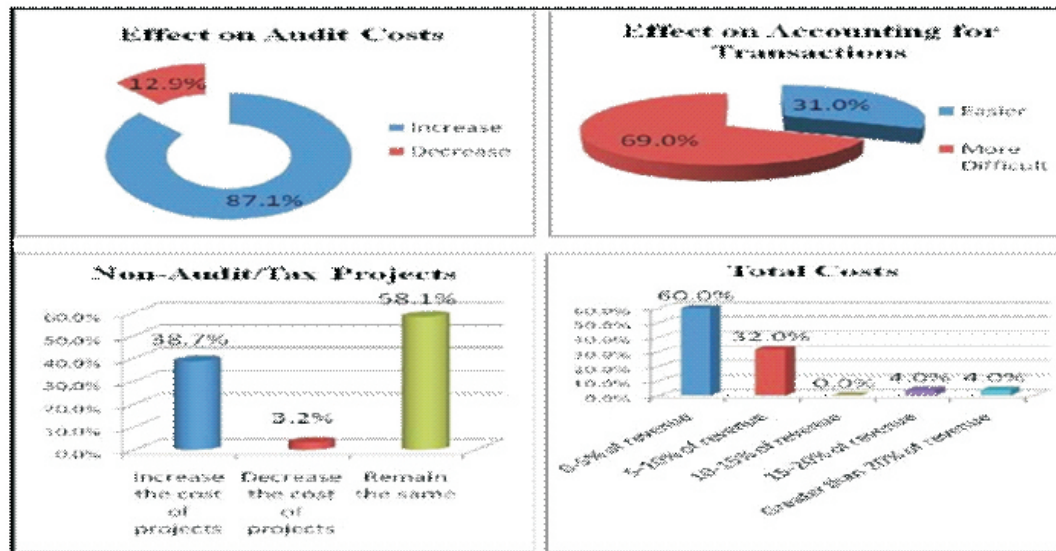
Figure 1

Source: Senior Capstone Project for Kenneth Smith

Similarly, there would be a change in the technology used to record accounting transactions. This would include change in hardware and software re-training of employees and paper work etc. As judgements will be involved more, the use for accounting purposes shall decrease. The major benefits for corporates:

- ✦ Standardised/ Global training of staff

- ✦ International Staff transfers
- ✦ Comparability of entry level staff across the globe
- ✦ Comparability of financial statements enhancing investor spectrum
- ✦ Accounting work can be done off-shore to avail best quality work at best prices.



PUBLIC ACCOUNTING:

The transition to IFRS will affect public accounting in terms of the rate being charged by accountants, the billable hours, tax planning etc. The accounting and auditing firms would raise the fees as the new standards would require larger amount of time to be spent with clients due to the new set of rules being more principle based. Also, the time spent would be more due to the unfamiliarity with new standards and their interpretations and judgements. The knowledge of accountant or auditor has to be more analytical. The corporates shall have to hire experienced or trained consultants to initiate the process and also to train the existing staff/ accountants. But definitely, the escalation cost due to the above mentioned reasons is quite less as compared to the benefits that the organisation would gain by being in line with the corporates across the globe in term of financial statements.

EDUCATION:

It has been seen generally that the students enrolling for courses in accounting/ commerce/ business has increased while teachers in the field have not increased in the same proportions. This has lead to a greater responsibility on teachers/ professors to pick and choose which information is desired the most to prepare students to meet the challenges of the real world. There is a dire need to update our courseware. Either we need to integrate newer concepts gradually into the education system so that the teacher and the taught both can incorporate them well in teaching and learning or IFRS can be introduced as an elective at different levels. KPMG has begun a program to help educate professors on IFRS. KPMG's "Faculty Forum Webcasts" and seminars helps professors to gain knowledge about IFRS and transition issues to be taken care of in making modifications in the current curriculum. Deloitte similarly, participates in an "Annual Deloitte National Student Case Study Competition" where they bring real life cases into the classroom to help give students a real exposure. As per an article on

globalnewswire.com, Price Waterhouse Coopers (PWC) awarded \$7,00,000 in grants to educational institutions in US to help prepare for IFRS (Globe newswire, 2009)

Another issue related to academia is training of faculty and availability of text books that have incorporated IFRS. The fact that IFRS is more principle based will make the teaching a little tedious and harder for students to understand & apply. As far as the faculty are concerned, the inclusion of IFRS in curriculum would give them newer opportunities for research & learning and they would develop ability to teach in any part of the world. (courseware being the same).

Hence, here again, it seems that the benefits of IFRS inclusion in courseware definitely outweighs the cost involved (which seems to be quite negligible as faculties can go for self training).

MAJOR DIFFERENCES BETWEEN INDIAN GAAP AND IFRS:

The international financial reporting standards are quite different from the IAS that we have been following. The switch over from GAAP to IFRS is not just a technical exercise of shift from one set of accounting policies to another but much more. This would not only have significant accounting consequences but very far reaching business implication too. The organisations can challenge the way in which they are assessed by investors, stake holders, competitors etc. The impact assessment of transition from IAS to IFRS is related to various faces of business because the differences between the two are quite substantial. These differences are mainly related to:

- Business Combinations
- Financial instruments
- Group accounts
- Fixed Assets and investments
- Presentation of Financial Statements
- Share based payments and Employee Benefits
- Revenue Recognition
- Impairment of Assets
- Segment reporting

Under Indian GAAP, there is no extensive standard related to all business combinations. IFRS3 accounts for all business combinations as per the purchase method and prohibits merger accounting i.e. IFRS Accounting of business combinations will have a negative impact on the future P&L Account of Indian Companies because Accounting for assets including intangibles is done at fair value, so amortisation of these will reduce future year profits. Under IFRS preparation of group accounts is mandatory whereas preparation of CFS is required only for listed entities under Indian GAAP. The definition of control is also different under IFRS and GAAP. IFRS allows a three month gap between financial statements of parent or investor and subsidiary, associate or jointly controlled entity. Indian GAAP allows a six month time gap.

Under IFRS Special Purpose Entities¹ (SPE) may have to be consolidated as they are in substance controlled through an auto pilot mechanism or through legal provisions determined at inception. Such is not the case with Indian GAAP because SPE"s do not need the definition of subsidiary under companies act. The consolidation of SPE"s under IFRS may have a substantial impact on P&L Account, Net Asset and gearing position, and also certain key ratios such as debt equity.

Under IFRS Employee Stock Ownership Plans (ESOP"s) are accounted using the fair value method, whereas the Indian GAAP permits ESOP"s to be accounted for using either Intrinsic value

method or the fair value method and most entities use Intrinsic method. So, IFRS will result in lower profits that use ESOP's for remunerating employees. Shares are recorded as equity and preference dividend as dividend under GAAP whereas IFRS classifies financial instruments as a liability or equity. For example, Redeemable Preference Shares are considered to be a liability and Preference Dividend as Interest cost. Hence, IFRS will show the firm as more geared and profits would be lower as a result of Preference Dividends being treated as Interest.

Under IFRS, Foreign Currency Convertible Bonds (FCCB's) are split into two components – the loan liability and the convergence option. The Loan liability creates interest at market rate after foreign exchange rate adjustment. Thus, the charge to profits under IFRS is higher. The conversion option is marked to market and the impact is recognised in P&L Account. This will have a significant impact on the volatility of profits.

Under Indian GAAP sales made on deferred payment is valued at nominal value. Under IFRS they are recognised as a combination of financing and operating activity. The fair value of revenue is accounted in the period of sale whereas imputed interest is treated to be interest income over the credit term. Hence, revenue under IFRS will be low, EBIT will also be lower as the financing component will be recognised as interest income.

IMPACT OF IFRS ON FINANCIAL STATEMENTS:

Large number of studies in various parts of the world analysed the impact of IFRS on corporates. They all found that the adoption of IFRS has had a positive impact on entities, financial reporting and wider economic settings. Daske et al. (2008) and Li (2010) examined the impact of IFRS adoption on international capital markets. Daske et al. (2008) found that firms adopting IFRS in the year of mandatory adoption experience large increases in market liquidity but mixed results for the cost of capital. However, Li (2010) examined the effect of IFRS on the cost of equity in the European Union and found that mandatory adopters of IFRS experience significant reductions in the cost of capital in the years of mandatory adoption, but only in countries with strong legal enforcement.

Other studies have examined the effects of IFRS adoption on accounting quality. Goodwin and Ahmed (2006) studied the impact of IFRS in Australia in relation to the size of entities. Smaller firms had fewer adjustments upon IFRS adoption and experienced increases in net income and equity. In contrast, larger firms had many adjustments, negligible increases to net income, as well as a decrease in equity. Their conclusion is that the adoption of IFRS has been found to have little impact on the accounting quality of smaller firms, and a larger impact on the accounting quality of larger firms. In a similar study, Goodwin, Ahmed and Heaney (2007) found, that on an average, IFRS caused increases in liabilities and leverage ratio and decreases in equity and earnings. These findings are consistent with the results of Hung and Subramanyam (2007), who focused on the detailed financial statement effects of adopting IFRS by using a direct comparison of financial statements prepared under IFRS and German GAAP.

Barth, Landsman and Lang (2008) examined an increase in accounting quality resulting from the adoption of IFRS in 21 countries that previously used domestic GAAP. They concluded that entities that prepare their financial statements under IFRS are exposed to less earnings management, more timely recognition of losses, and more value relevance of accounting amounts than those entities using only domestic GAAP. They also concluded that the quality of accounting information is higher for firms that apply IFRS than for those that do not. Additional information about the impact of IFRS adoption on financial statements comes from studies that extended the analysis to common financial ratios (Stent, Bradbury and Hooks 2010). Stent et al. (2010) found that adoption of IFRS in New Zealand led to a

significant increase in liabilities and a decrease in equity for private sector entities. Adjustments to income taxes, employee benefits and financial instruments were the main reasons for increases in liabilities and decreases in equity.

This paper tends to discuss the impact of IFRS on financial statements and some significant ratios with the help of a case study on Wipro. Wipro Limited (Wipro or the parent company) together with its subsidiaries is a leading India based organisation that offers products and services in IT business, consumer care and lighting and also infrastructure engineering. The IT business includes IT services and products. It comprises of software services, BPO services and products. The company has its geographical presence in America, Europe, India, Japan, Middle East, South East Asia and Asia Pacific.

The consolidated financial statements as per GAAP are compared with the consolidated financial statements under IFRS. Some selected ratios have been analysed to indicate the differences between two sets of statements. The figures in the Balance Sheet and the Profit and Loss statements have been completely drawn from the annual report of the company. All figures are related to the period ending 31st march 2012.

Comparative Consolidated Balance Sheet of Wipro under GAAP and IFRS:

Shareholders' funds	As IAS	As IFRS	% Diff
Share capital	4,915	4917	0.04%
Reserves and surplus	2,65,258	281246	6.03%
	2,70,173	286163	5.92%
Minority interest	849		-100.00%
Non-current liabilities			
Long term borrowings	22,510	22817	1.36%
Deferred tax liabilities	275	353	28.36%
Other long term liabilities	778	8922	1046.79%
Long term provisions	3,107	61	-98.04%
	26,670	32153	20.56%
Current Liabilities			
Short term borrowings	35,480	36448	2.73%
Trade payables	47,736	47258	-1.00%
Other current liabilities	23,305	32858	40.99%
Short term provisions	28,368	1121	-96.05%
	1,34,889	117685	-12.75%
Total Equity and Liabilities	4,32,581	4,36,001	0.79%
Non-current assets	As IAS	As IFRS	% Diff
Goodwill	67,961	67937	-0.04%
Fixed assets			
Tangible assets	54,627	58988	7.98%
Intangible assets	1,767	4229	139.33%
Capital work-in-progress	3,466	3462	-0.12%
Non-current investments	3,232	3232	0.00%
Deferred tax assets	440	2597	490.23%
Long term loans and advances	22,893	10287	-55.06%
Other non-current assets	9,168	11781	28.50%
	1,63,554	162513	-0.64%

Current assets			
Current investments	41,483	41961	1.15%
Inventories	10,662	10662	0.00%
Trade receivables	80,387	80328	-0.07%
Cash and bank balances	77,666	77666	0.00%
Short term loans and advances	23,263	37128	59.60%
Other current assets	35,566	25743	-27.62%
	2,69,027	273488	1.66%
Total Assets	4,32,581	4,36,001	0.79%

Table 1**Amt. In Rs. Million except share and per share for the year ended 31st march 2012****Comparative Consolidated P&L Account of Wipro under Indian GAAP and IFRS:**

REVENUE	As IAS	As IFRS	% Diff
Revenue from operations (gross)	3,73,083	371971	-0.30%
Less: Excise duty	1,205	0	-100.00%
Revenue from operations (net)	3,71,878	3,71,971	0.03%
Other income	12,685	12506	-1.41%
Total Revenue	3,84,563	3,84,477	-0.02%
EXPENSES			
Cost of materials consumed	20,158	60270	4.15%
Purchases of stock-in-trade	37,595		
Changes in inventories of finished goods, work in progress and stock-in-trade	118		
Employee benefits expense	1,54,074	154066	-0.01%
Finance costs	3,439	3491	1.51%
Depreciation expense	9,592	10129	3.84%
Amortisation expense	162		
Other expenses	89,611	86771	-3.17%
Total Expenses	3,14,749	314727	-0.01%
Profit before tax	69,814	69,750	-0.09%
Tax expense			
Current Tax	13,933	13763	-1.22%
Deferred Tax	88		-100.00%
	13,845	13,763	-0.59%
Profit before minority interest/share in earnings of associates	55,969	55,987	0.03%
Minority interest	(257)	(257)	0.00%
Share in earnings of associates	333		-100.00%
	56,045	55,730	-0.56%

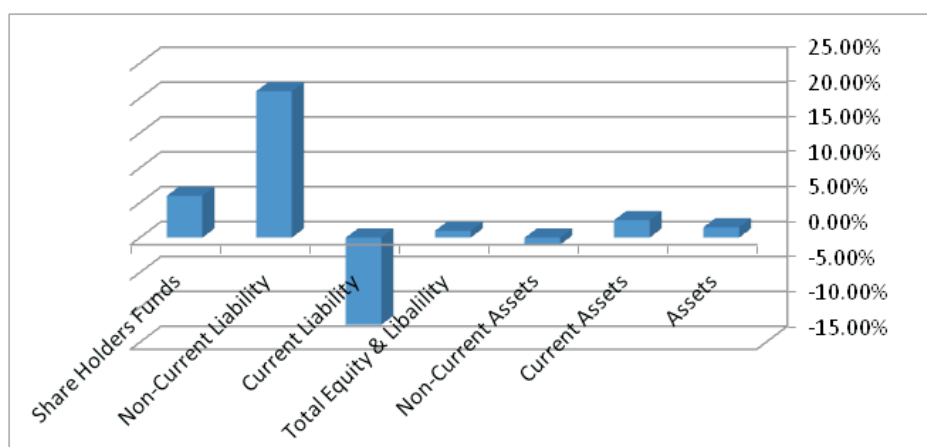
Table 2 Amt. In Rs. Million except share and per share for the year ended 31st march 2012

Ratios	As IAS	As IFRS	% Diff
Liquidity Ratios			
Current Ratio	1.994	2.324	16.52%
Acid Test Ratio	1.915	2.233	16.60%
Profitability Ratios			
Return on Capital Employed	0.235	0.219	-6.83%
Return on Shareholders Equity	0.207	0.196	-5.56%
Earning Per Share Basic	22.88	22.76	-0.52%
Earning Per Share Diluted	22.83	22.69	-0.61%
Book Value Per Share	110.317	116.846	5.92%

Table 3: Comparison of ratios as per values under IAS and IFRS

Liquidity:

The amount of current assets and current liabilities in the two sets is quite different. The amounts of short term loans and advances and that of other current assets vary. This is probably due to the variations in recognition of certain items of loans and trade receivables. Under IFRS loans as well as trade receivables are treated quite differently. (IAS 18) The total of the current assets is 1.66% more in case of IFRS which shows that IAS are more conservative. The reason probably is, under IFRS the fair value measurement difference in recognition of certain current assets like deferred contract costs, balance with excise and customs and non convertible debentures that are not included in current assets in IAS. Similarly short term loans and advances, prepaid expenses, advance to suppliers are accounted for differently in both sets of accounts. The total of current liability varies by 12.75% which is quite substantial. Other current liabilities includes employee benefits, statutory liabilities, advances from customers, derivative liabilities and accrued interest, varies by about 50%. The reason being that cost of leases and interest expenses are treated on fair values in IFRS (IFRS3) which is not the case in IAS. The inclusions of items along with their values are treated differently under IFRS. Similarly short term provisions too differ by 96 %. Under IFRS the total current liabilities are quite less as compared to IAS. These are the various reasons why the current ratio is 16.52% higher in case of IFRS. So the liquidity of the firm is well depicted in IFRS statements.



Profitability:

The Return on Capital Employed, Return on Shareholders Fund and Earning per Share are good indicators of profitability. The return on capital employed and return on share holders fund depends upon share capital and profits. The share capital under IFRS is higher because shares issued to controlled trust do not form a part of share capital in IAS which is not the case in IFRS. The premium on shares issued to controlled trust (Rs 542 m) is treated differently in both sets of accounts. Again as regards Employee Stock Options (ESOPs) outstanding and hedging reserves are a part of share holder funds in IAS but not under IFRS (IAS19, IAS39, IAS 32). In IAS the surplus from P&L (Rs. 65365m) is a part of reserves and surplus which is not included under IFRS (IAS 19). The difference in non controlling interest is because IFRS permits its measurement as a proportionate share of identifiable net assets at fair value. (IFRS3). This explains the variation of 6.8% in the ratio of return on capital employed and a difference of 5.56% in return on shareholder's equity. The EPS basic varies by 0.52% and diluted by 0.61%. The outstanding shares considered for the purpose of calculation under IAS and IFRS are different due to ESOPs being accounted using fair value method under IFRS whereas IAS permits their valuation on intrinsic value method. (IAS19)

CONCLUSION:

As India is striving ahead on the path of financial and economic progress, Indian corporates need to unify and compete with global peers. The financial reporting thus has to be competitive and based on global accounting standards. This transition will create a win-win situation for all sections of the economy, the public accounting, the corporate accounting as well as the academia. The paper discusses the impact of transition on various items of the financial statements and their impact on some powerful ratios. The variation in total assets and liabilities is because of the reclassification among equity and liability and also because of the difference in the concept of revenue recognition. The valuation and depreciation of property plant and equipment is also a big cause of difference. All the above observations emphasise the fact that IFRS is a fair value principles based accounting which will improve quality of disclosures and enhance international comparability and understanding of financial statements. This in turn will boost investment from across the globe that will ensure enhanced performance for Indian corporate.

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