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**AN INVESTIGATION INTO RECENT CHANGES TO
ACCOUNTING REGULATION IN INDIA**

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ABSTRACT

In April 1977 the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) was formed to harmonise the diverse accounting policies and practices of various enterprises at that time. The ASB undertook the task of considering the International Accounting Standards (IASs) and/or International Financial Reporting Standards (IFRSs) and integrating them into the laws, customs, usages and business environment present in India.

The current study investigates the rationale of the step of adapting the IFRSs to the Indian context focussing on the formulation of accounting standards in India, by examining the accounting environment of India, describing the approach taken by India while adapting IFRSs, identifying the response of Indian companies to IFRSs and the factors that influenced the Indian Government and hence the profession, to take this step.

This study contributes to the existing body of literature through explaining the rationale behind the adaptation of IFRSs in India by exploring the culture of the country and relating that to the accounting values of the country. This project examines the issue by taking-up an in-depth study of the rationale behind the adaptation of IFRSs to the Indian context, whereas most of the available literature regarding India explains only a part of the issue and is brief in nature. This study also contributes to the literature by exploring the influencing factors in a systematic manner.

Key Words: IFRSs, India, ICAI.

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CHAPTER ONE

INTRODUCTION

1.0 Background

The regulation of accounting by government through its agents was necessitated in India during the 1960s when the financial reporting system was criticised on some strong grounds. Firstly, comparing different companies was difficult due to the lack of uniformity in accounting practices and secondly, the existence of multiple accounting practices allowed company managers to select alternative presentations of financial results, which made it possible for them to manipulate earnings and conceal economic realities (Banerjee, 2002a). On the other hand, changes took place internationally in the accounting environment, due to initiatives by the International Organisation of Securities Commission (IOSCO) towards propagating International Accounting Standards (IASs), issued by the International Accounting Standards Committee (IASC), as the uniform language of business to protect the interests of international investors. The Institute of Chartered Accountants of India (ICAI) took the leadership role by establishing the Accounting Standards Board (ASB), to fall in line with national and international expectations (www.icaai.org).

The ICAI formed the ASB in April 1977 to harmonise the diverse accounting policies and practices in India (www.icaai.org). The main function of the ASB is to formulate accounting standards. The ASB gives due consideration to the International Financial Reporting Standards (IFRSs)¹ and tries to integrate them into the laws, customs,

¹ Since 2001, International Accounting Standards (IASs) are known as International Financial Reporting Standards (IFRSs). For the purpose of this study, the term IFRS is used to mean both IFRSs and IASs.

usages and business environment prevailing in India (www.icai.org). The ICAI issued its first standard in 1979 and then 26 other standards between 1981 and 2002, making all but one mandatory in different phases (Banerjee, 2002a).

The adoption of the IASs by developing countries has been observed by various authors (Chand, 2001; Hove, 1989; Perera, 1989). These studies raise considerable issues such as administrative difficulties and technical problems in preparing financial reports (Chand, 2001) and the inappropriateness of the IASs to developing countries (Hove, 1989; Perera, 1989). On the other hand, some studies examine the relation between the adoption of IASs by a specific country and an influencing factor, such as the development of the equity market (Larson and Kenny, 1995). While stressing the importance of regional harmonisation, others have raised the issue of non-representation of the Association of South East Asian Nations (ASEAN) countries in the international accounting standard setting process (Saudagaran and Diga, 1997). Regional accounting harmonisation views harmonisation as occurring among neighbouring countries.

Some researchers questioned the lack of any locally developed accounting standards in developing countries (Ali, Ahmed and Henry, 2003). Ali, Ahmed and Henry (2003) investigate the reporting practices in the annual reports of a sample of Indian companies listed on the Bombay stock exchange by taking 15 IASs as the basis, that have been adopted by India. The authors conclude that disclosure compliance is higher for standards regarding depreciation; inventories; property, plant and equipment. The higher compliance is due to detailed disclosure requirements under the Companies Act. On the other hand, the authors have shown concern as the level of

compliance with standards regarding accounting for leases and accounting for business combinations is low.

There does not, however, seem to be any study explaining the rationale behind the change in accounting regulation in India.

Accounting regulation refers to *"the act of making accounting process regular, and/or the act of controlling, governing, correcting and adjusting it by rule or provision of law"* (Banerjee, 2002a, pp.2-3).

Accounting regulation in India comprises of Companies legislation (Companies Act 1956) presently known as Companies (Amendment)/(Second Amendment) Act 2002, the stock exchange listing requirements, that is, Securities and Exchange Board of India (Amendment) Act 2002 and Indian Accounting Standards. Most of the available literature regarding India observes only the differences between the Indian Accounting Standards (ASs) with IASs and/or US Generally Accepted Accounting Principles (GAAP) (Iyer, 2001; Iyer, 2002; Narayanswamy, 1997).

A recent study by Banerjee (2002a) examines the compliance of a sample of Indian companies with the ASs. The author concludes that the level of compliance of Indian companies with these accounting standards seems to be good. The study does not provide a detailed explanation of the rationale behind the change in accounting regulation in India that involves the adaptation of IFRSs.

The current study proposes to explain the rationale behind the change in accounting regulation in India, focussing on the formulation of accounting standards. To achieve this aim, it considers both the similarities and dissimilarities between ASs and the corresponding IFRSs, and the voluntary compliance of Indian companies with IFRSs. Testing the level of voluntary compliance by Indian companies with IFRSs seems relevant, as this will give us an indication of the extent to

which IFRSs are embraced by Indian companies. The present study also considers the culture of India in order to explain the rationale behind the change in accounting regulation in India. Various aspects of the accounting ecology of India has been considered for the current research due to the concerns shown by various authors in regard to the adoption of the IASs by developing countries (Chand, 2001; Hove, 1989).

1.1 Aim and objectives of the research

The aim of the present study is to explain the rationale behind the change in accounting regulation in India, focussing on the formulation of accounting standards.

In order to achieve the aim, the current research will have the following objectives:

First, to identify the concerns shown by various authors in regard to international harmonisation of accounting standards with special reference to developing countries.

Second, to explain the country profile of India and its relation to the accounting environment of the country.

Third, to describe the approach taken by India while changing its accounting regulation.

Fourth, to identify the response of Indian companies to IFRSs.

Fifth, to discuss the factors that influenced the decision to adapt the IFRSs.

1.2 Research methodology

According to Burrell and Morgan (1979) there are several assumptions about the nature of social science, in regard to its ontological, epistemological, human and methodological nature. The

nature of science can be thought of in terms of a subjective-objective dimension, and assumptions about the nature of society in terms of a regulation-radical change dimension. The subjective view of the nature of science tries to understand the way individuals create, modify and interpret the world in which they find themselves. On the other hand, the objective view treats the social world as hard and external. The researcher subscribing to this second view focuses upon an analysis of relationships and regularities between different elements, which it comprises (Burrell and Morgan, 1979).

The "*sociology of regulation*" (Burrell and Morgan, 1979, p.17) refers to the writings of theorists who are mainly concerned with providing explanations of society in terms that stress its underlying unity and cohesiveness. On the other hand, "*sociology of radical change*" (Burrell and Morgan, 1979, p.17) is mainly concerned with finding a rationalisation for radical change, inherent structural conflict, modes of domination and structural contradiction, which its theorists see as characterising modern society.

On the basis of assumptions about the nature of social science, Burrell and Morgan (1979) suggest four distinct sociological paradigms, i.e., radical humanist, radical structuralist, interpretive and functionalist. These four paradigms represent principally different perspectives for the analysis of social phenomena. They are based on different meta-theoretical assumptions regarding the nature of science and of society.

The radical humanist paradigm has much commonality with the interpretive paradigm, since it views the social world from a nominalist, anti-positivist, voluntarist and ideographic viewpoint. The radical humanist approach emphasises radical change, modes of domination, emancipation, deprivation and potentiality. The idea of

structural conflict and contradiction do not however figure in most parts within this perspective, since they are features of more objectivist views of the social world (Burrell and Morgan, 1979).

The radical structuralist paradigm is dedicated to radical change, emancipation and potentiality, in an analysis that stresses structural conflict, modes of domination, contradiction and deprivation. It focuses these general concerns from a realist, positivist, determinist and nomothetic standpoint (Burrell and Morgan, 1979).

The functionalist paradigm addresses general sociological concerns from realist, positivist, deterministic and nomothetic standpoints (Burrell and Morgan, 1979).

The interpretive paradigm includes a broad range of philosophical and sociological thought which shares the common feature of attempting to understand and explain the social world mainly from the perspective of the actors directly involved in the social process (Burrell and Morgan, 1979).

The use of the interpretive paradigm has been advocated by a large number of researchers (Jonsson and McIntosh, 1997; Morgan, 1988). Morgan (1988) suggests that the knowledge of human beings can only create a weak and rather uni-dimensional representation of the world. Accountants are involved in interpreting a complex reality, in a way that is heavily weighted in favour of what is possible to be measured by them and which they choose to measure, through the particular schemes of accounting to be adopted. In real life, many people know that the accountant's work is based on some arbitrary assumptions and conventions. They believe that the accountant tries to persuade others that his or her concepts have superior insight; while in reality these concepts are partial as any other.

Rahim, Rahman and Goddard (1998) followed interpretive methodology to study accounting practices embedded in two religious organisations in Malaysia. The authors propose that interpretive methodology using ethnographic methods of inquiry helps in properly understanding the culture and value systems of these religious organisations together with the accounting technology used in these organisations. They also advise that the interpretive schema is a useful conceptual framework to theorise the relationship between culture and accounting practice. It establishes a significant link between the system of notions that direct the actions of individuals and the actual behaviour of individuals whilst recognising the complex interrelationship between these two modes.

The interpretive paradigm has been adopted by Scheytt, Soin and Metz (2003), while exploring the characteristics of control with regard to different regional cultures. These authors opine that control as an everyday life experience has various interrelated social, political, cultural and moral implications, which should not be taken as "*biases*" to an "*objective definition*" or "*correct*" practice of control (p.530). These authors argue that a narrative approach such as that used in their study, enables one to take a different view of the complexity and embedded nature of the concept of control.

In line with the explorative studies conducted by Rahim, Rahman and Goddard (1998) and Scheytt, Soin and Metz (2003), this study will adopt the interpretive paradigm. The present study will adopt the interpretive paradigm as suggested by Burrell and Morgan (1979). This paradigm provides an appropriate basis for the present study to explain the social world, that is, the rationale behind the changes in accounting regulation in India, focussing on the formulation of accounting standards. As an individual researcher, I believe that

reality is the product of one's mind and not that it already exists in the world. I also believe that knowledge should be experienced, not acquired.

Within the interpretive paradigm, 'Institutional Theory' will be used to explain the rationale behind the change in accounting regulation in India. This is due to the strength of this theory in explaining external and internal pressures exerted on organisations to conform to an institutional pattern. The following subsection explains institutional theory that has been employed in this study.

1.3 Institutional Theory

Scott (1987) states that 'institutionalisation' is viewed as "*the social process by which individuals come to accept a shared definition of social reality- a conception whose validity is seen as independent of the actor's own views or actions but taken for granted as defining the ways things are, and/or the ways things are to be done*" (Scott, 1987, p.496). 'Institutionalisation' refers to *the processes "by which the expectations of society of appropriate organisational form and behaviour come to take a rule-like status in social thought and action"* (Covaleski and Dirsmith, 1988, p.562). The word 'institutional' refers to "*(a) a rule-like, social fact quality of an organized pattern of action (exterior), and (b) an embedding in formal structures, such as formal aspects of organisations that are not tied to particular actors or situations (nonpersonal/objective)*" (Zucker, 1987, p.444).

Products, services, techniques, policies, and programmes that are institutionalised function as powerful myths, and many organisations adopt them ceremonially (Meyer and Rowan, 1977). In regard to inter-organisational relationship formation, institutional

theory is valuable in helping to describe the reasons behind firms behaving the way they do (Barringer and Harrison, 2000).

Institutional theory is useful in explaining accounting choice in organisations where self-interest maximising actors cannot exert effective influence over the choice of accounting practices due to their relative power positions in their organisations (Carpenter and Feroz, 2001).

Institutional theory has been adopted in addressing accounting issues by various authors. Carpenter and Feroz (2001) used institutional theory to explore the way institutional pressures exerted on four state governments in the United States (U.S.), namely, New York, Michigan, Ohio and Delaware, influenced the decision of these governments to adopt or resist the use of GAAP for external financial reporting. The study reveals that coercive institutional pressure stems mainly from resource dependence on credit markets that was associated with early adoption of GAAP.

Kenny and Larson (1993) explain the role of lobbying in international accounting standards setting and examine the process followed by the IASC in regard to promulgation of IAS 31- Financial Reporting of Interests in Joint Ventures. The authors incorporate aspects of institutional theory as it relates to strategic choice by organisations. The study reveals that the interaction between respondents and the IASC is consistent with an institutional theory explanation of organisational change and adaptation of environmental pressures. Respondents from the US/United Kingdom (UK) group were less likely to support Exposure Draft 35 on 'Financial reporting of interests in joint ventures' (ED-35) than were respondents from other countries, such as France, South Africa, Japan, Sweden and Switzerland. This led the IASC to modify ED- 35 to allow the equity

method for accounting for jointly controlled entities together with the modification of descriptions and requirements for disclosures in accordance with the comments of respondents. This action is consistent with institutional theory because to be legitimate and survive IASC must remain acceptable to its constituency.

Chalmers and Godfrey (2004) used institutional theory together with legitimacy theory to explain the response of managers to derivative financial instrument disclosure requirements, proposed by the Australian accounting standards setting bodies and the Australian Society of Corporate Treasurers (ASCT). Only 41 firms pre-committed themselves to an ex ante disclosure policy until 1995. After ED 65 was released by the Australian Accounting Standards Board (AASB) and the ASCT Industry Statement (an ex ante effort to coerce enhanced disclosures), 96 firms disclosed the information in 1995 and 105 in 1996. The study reveals that the concerns of managers regarding legitimacy and reputation combined with institutional pressures led them to be responsive to information demands, which are seen to be effective conduits for attaining enhanced disclosures. In this regard, reputation costs of managers have been proxied by the affiliations of firms with professional bodies such as the ASCT and G 100², in addition to the reputation of firms' auditors.

The present study will adopt the concept developed by Di Maggio and Powell (1983) who have theorised about the different processes that might result in an organisation changing its structure in ways that make it conform to or become isomorphic with an institutional pattern (cited in Scott, 1987).

² Group of 100 is an association of senior accounting and finance executives who represent the major public companies and government owned enterprises in Australia.

'Institutional Theory' provides an excellent basis for identifying the factors that have influenced the current situation of transformation of accounting regulation in India that involves the adaptation of IFRSs. This theory has been applied in the current research to understand the pressures arising from various parties on the ICAI, such as the World Trade Organisation (WTO), the World Bank and the International Monetary Fund (IMF) to conform to the IFRSs.

1.4 Research Method

This study uses the following methods:

Firstly, it conducts an extensive survey of the literature that addresses various issues associated with the applicability of international accounting standards in developing countries together with the level of harmonisation achieved by the IASC. Various authors (Chand, 2001; Larson and Kenny, 1995) question the suitability of IFRSs to developing countries. This study investigates the rationale behind the decision to adapt IFRSs by the ICAI in India.

Secondly, the study provides the country profile of India, taking the model suggested by Gernon and Wallace (1995) as the basis.

Thirdly, the study performs an empirical examination of the level of adaptation of IFRSs by the ICAI in formulating the ASs, to describe the approach taken by India while changing its accounting regulation to adapt IFRSs.

Fourthly, annual reports of a sample of Indian companies have been examined to search for their level of voluntary compliance with IFRSs. It provides an indication of the response by Indian companies to IFRSs.

Finally, the study investigates the factors that influenced the decision by the ICAI to adapt IFRSs, taking an Institutional theory approach. It seems that India adapted the IFRSs due to external and internal pressures.

1.5 Chapter outline

The rest of the thesis will be organised in the following manner:

Chapter Two: Prior research

This Chapter explains the wide range of studies available regarding international harmonisation by dividing them into three broad categories, namely, harmonisation issues concerning specific countries with special emphasis on developing countries, measurement of international harmonisation and factors influencing the practice of accounting. This chapter places the current research within the context of available literature and explains its contribution to knowledge.

Chapter Three: From harmonisation to convergence

This chapter explains the shift of emphasis from harmonisation of accounting standards to convergence and its probable impact on developing countries.

Chapter Four: India- country profile

The Chapter explains the accounting ecology of India in terms of the framework suggested by Gernon and Wallace (1995). This chapter provides a background to accounting standards and practices in India. This was thought necessary in understanding the change in accounting regulation in India.

Chapter Five: Comparison of the IFRSs and Indian accounting standards

The chapter compares the IFRSs as in 2002 with the ASs as at July 2002 in detail.

Chapter Six: Survey of annual reports- Practice

The Chapter examines the voluntary compliance of a sample of Indian companies with the IFRSs.

Chapter Seven: The adaptation of IFRSs in India- an Institutional Theory perspective

This chapter explains those pressures that influenced the decision by India to adapt the IFRSs. This chapter discusses the issue by adopting the Institutional theory developed by DiMaggio and Powell (1983).

Chapter Eight: Analysis and Discussion

This chapter discusses the changes made by the ASB to some IFRSs and provides an understanding of the probable reasons behind those changes made by the ASB, by taking the culture of the country into account.

Chapter Nine: Conclusion

This chapter summarises the main findings of the study and explains the contribution to knowledge of the current research. This chapter also identifies the areas where future research is required.