

**THE CHALLENGE OF ACCOUNTING STANDARDS  
A CRITICAL PERSPECTIVE**

by

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# THE CHALLENGE OF ACCOUNTING STANDARDS

## A CRITICAL PERSPECTIVE

### Abstract

This paper identifies a number of serious deficiencies in the current constitutional arrangements as well as processes for setting accounting standards in India.

The author examines the recent move by the Institute of Chartered Accountants of India to enforce some accounting standards. This is an important move towards disciplining corporate financial reporting but the standards are not tight enough and they have been formulated by a process not open to public scrutiny, argues the author. Besides, the Institute has no powers for enforcing the standards on preparers of financial statements.

The author proposes a private sector solution: the establishment of preparers users and auditors of financial statements for formulating standards. The decisions and processes of the proposed body should be open to public scrutiny says the author.

Recently, the Institute of Chartered Accountants of India (ICAI) announced that eight of the eleven accounting standards issued by it so far will come into force from April 1, 1991. The announcement, which is of great significance to the business and financial community in India, has gone virtually unreported in the business press. The essence of ICAI's declaration is that from now on chartered accountants functioning as company auditors will be obliged to report to the shareholders any deviations in the financial statements audited by them, failing which, they would invite disciplinary action from the premier accountancy body under the Chartered Accountants Act, 1949, the law regulating the profession of chartered accountants.

It is widely known that financial statements are prepared using numerous accounting practices. From time to time there are allegations that companies manipulate reported results by using arcane accounting methods. In 1977, ICAI constituted the Accounting Standards Board with a view to harmonising accounting policies. The standardising of accounting practices will result in companies applying similar accounting methods in similar circumstances, thus making their financial statements more comparable. Clearly, the needs of the users of financial statements are better served if accounting data are comparable at least across companies in similar businesses. Under the Companies Act, 1956, companies are required to prepare financial statements that give a "true and fair view" of their profit and financial position. It is claimed that the application of accounting standards will result in producing financial statements that give a "true and fair view". Preparers, users and auditors should take notice of ICAI's standards since they seek to define the notion of true and fair view. The standards have significant implications for a number of parties who are keenly concerned with financial reporting rules such as shareholders banks, financial institutions, investment advisers, stockbrokers and security analysts, managers, employees and unions, tax authorities and regulatory agencies. Certainly, accounting information is of interest to a whole lot of people besides those who are involved in producing and certifying financial statements. It is necessary to examine carefully whether the present system of establishing accounting standards is designed

to best serve the interests of all those having a stake in financial reporting.

## **WHY ARE ACCOUNTING STANDARDS NECESSARY**

### **Nature of Accounting Diversity**

To a large extent, the diversity of accounting practices is inherent in the legal framework for financial reporting. The Companies Act requires that financial statements give a "true and fair view" of profit and financial position. Schedule VI to the Act specifies the form and content of financial statements. These are in the nature of a legal minimum. The test of "true and fair view" is the touchstone of what constitutes proper financial reporting in a given set of circumstances. In practice, companies choose their accounting policies from among alternatives that are considered to be in accordance with generally accepted accounting principles (GAAP). Thus, it is lawful for two companies that have identical operations in a year to follow different accounting practices for inventory valuation, depreciation, revenue recognition, amortisation of goodwill, foreign currency translation etc. so long as those practices are in accordance with GAAP, and the financial statements of both companies will be attested by their respective auditors as giving a true and fair view. The auditors of the two companies (even where they happen to be the same firm) cannot be accused of compromising on accounting rigour in such a situation.

## **Accounting Diversity Distorts Comparisons**

It can be argued that financial statement information becomes virtually non-comparable, if not irrelevant, when there is a wide variation in the rules for measuring profit, assets and liabilities. Investors and analysts value companies by reference to the price-earnings ratio, that is the share price divided by forecast earnings per share. When earnings from different companies in the same business are computed using different accounting methods, the calculation of share prices becomes a spurious exercise. Sophisticated users like financial institutions and security analysts may be able to recompute the accounting numbers and express them in a common language of accounting, but ordinary investors are unlikely to be aware of the intricacies of depreciation accounting and inventory valuation, the nuances of revenue recognition or the mysteries of off-balance sheet financing. In a well-documented report published recently Richard Hannah and Terry Smith of the London firm of stockbrokers UBS Phillips & Drew, indicate that even sophisticated analysts may not have been adjusting for certain complex accounting treatments.

## **The Efficient Market Hypothesis**

Not everyone is equally persuaded by the above case for accounting standards, though. Some believe in the efficient market hypothesis (EMH) which states that security prices fully reflect all publicly available information - so it does not matter what accounting policies are followed so long as these are

disclosed by companies. This view of market efficiency, known as the semi-strong form, is based on the assumption that in a competitive market analysts constantly search for imperfections and mis-priced securities, hence potential pricing inefficiencies such as the ones arising from accounting method differences are eliminated.

While EMH has a considerable following among academics, accountants and security analysts are sceptical about its validity. Anecdotal evidence too does not support EMH; for example, the scrip of Polly Peck, a British company that collapsed recently, could not have been rated so well if analysts had carefully considered the effect of the notes on accounts covering interest receivable and foreign currency losses, among others.

Apart from the question of the validity of EMH, the stock market is just one of the many users of financial statements. Banks pore over financial statements before granting loans, employees and trade unions study them for pitching their wage and bonus claims, suppliers look at them to decide whether a customer is credit-worthy, governments and regulatory agencies scrutinise them for determining taxes, prices, incentives and wages, and even make use of accounting information for formulating economic and social policy. Further, a large part of the Indian economy is still in the State sector which is virtually unaffected by the goings-on in the stock market. These reasons are presumably weighty enough to justify accounting standards in India.

## **Auditors and Preparers Benefit from Standards**

While the users of financial statements clearly benefit from accounting standards, interestingly accountancy profession itself may be the biggest beneficiary. After all the credibility of auditing will be enhanced by the application of accounting standards since it is assured that similar accounting matters are treated similarly by companies. Auditors also will find it easier to enforce accounting rules on clients by taking umbrage under the standards. Companies would like to comply with the standards to convince shareholders that their profits are real and not the result of creative accounting. So accounting standards would seem to be the financial market's equivalent of the medical world's wonder drugs like the polio vaccine and the anti-TB drug that will alleviate the misery of investors, accountants and corporations, that is if all goes well. More of that later.

## **Standards Are Not A Panacea for all Reporting Problems**

It should be noted that there is considerable scope for the management's judgment in matters like estimating fixed asset lives, determining inventory values, deciding on the length of the future period which would benefit from current expenditure and so on. Also, there may be room for interpreting the standards in more ways than one. Accounting standards cannot, and should not, completely take away the company management's responsibility

for exercising judgment in financial reporting. It is for the auditors to review whether the assumptions made by the management in making these judgments are reasonable and "blow the whistle" if they are not satisfied. Of late it is realised in Britain that despite a fair number of standards covering all the important areas of accounting, financial statements do not inspire much confidence in the public because the auditors are not perceived to be acting independently. This is what auditors euphemistically refer to as the "expectations gap". It is unlikely that accounting standards can remedy audit failures.

### **SETTING ACCOUNTING STANDARDS**

Agreeing that accounting standards are necessary in India, we need to look at a number of aspects of setting standards: how standards should be set, who should set them, how they should be enforced and how the standards programme should be financed.

### **HOW THE STANDARDS SHOULD BE SET**

Perhaps, the most important question is how accounting standards should be set (i.e.the process) rather than who should set them (i.e.the producer) or what the standards should be (i.e. the product). The worth of a standard to the public is as much a function of the process followed for establishing it as of the technical features of the standard or the reputation of the standard-setter. Accounting standards are expected to satisfy the



information needs of the financial community, and therefore have to be highly user-oriented. They aim at reducing the number of accounting alternatives in circulation. This involves choosing from alternative methods hitherto acceptable to accountants. the constraining of accounting choice is bound to result in reported revenues, expenses, profits, liabilities and asset values that are materially different from the ones computed using other methods (if the new and old figures do not differ materially, no standard should have been issued in the first place).The changes in reported profits, etc. would probably have serious implications for the financial well-being of a company's shareholders creditors, employees and managers apart from a number of other parties relying on financial statements. The larger social and economic implications of standards require that they should be, and seen to be, issued in the public interest rather than in any sectional interest if they are to be generally regarded as fair and reasonable. The standards' body has a duty to convince the public that it operates free from undue political pressure in the discharge of its role. This can be done by following "due process" procedures.

### **Due Process**

Due process requires that the standard-setters

- (1) operate in the open
- (2) invite public debates on proposed standards
- (3) listen to various views
- (4) publish the comments received on proposals

- (5) explain the reasons for adopting or not adopting a proposed standard or accounting alternative
- (6) publish their agenda and working papers in advance, and
- (7) hold public hearings.

These procedures are not as radical as some accountants may think. The standard-setters in the USA and UK have been following them for years. The respect commanded by the US and the UK standards bodies is in no small measure due to their open and consultative style of functioning. Of course, the early standard-setters in these two countries had followed less open styles of functioning but having realised that transparency in standard-setting was by far the best assurance that they functioned in the public interest, they have adopted the open process outlined above.

### **Due Process and ICAI**

Let us examine the process of standard-setting in India. ICAI publishes the exposure drafts and definitive standards. Nothing else is shared with the public. The criteria for deciding on the standards agenda is not disclosed. The basis for selecting standards for enforcement is also not apparent. For example, the standard on inventory valuation (it is nothing more than a collection of the methods of inventory valuation currently in use plus even some methods not in use in India such as the LIFO method) has not been enforced, in spite of persistent allegations

that companies tinker with inventory values for dressing up their results. Again the exposure draft on deferred tax liability was issued a couple of years ago but a standard on deferred tax has apparently been shelved for the time being (due to pressure from industry?). Recently, a guidance note on the subject has been issued suggesting that a standard is unlikely to be issued in the near future. There is no information on where the matter stands now. Deferred tax accounting is necessary to tone down the exaggerated profits reported in the early years of an asset's life owing to the lower rates of depreciation used in financial statements than the now-liberalised depreciation allowance for tax purposes. To take another example, the standard on as important a topic as depreciation accounting does not bother to specify the acceptable methods of depreciation but is instead couched in generalities and platitudes, with the result that it can be interpreted as permitting every method of depreciation known to the mankind! It is doubtful if it can be described as a standard at all. In a similar vein the standard on prior-period and extraordinary items, in effect, merely restates the position in Companies Act by permitting extraordinary items to be shown as a part of current period results if explained in a footnote. Many companies manipulate the earnings per share by including extraordinary gains and footnote disclosure is not a remedy. Perhaps the ICAI thinks that it owes no voluntary explanation for its choice of the standards agenda or for the content of individual standards. It would be in the interests of everyone connected with financial reporting (including ICAI) to follow the due process requirements outlined earlier.

## **WHO SHOULD SET THE STANDARDS**

### **Preparers And Users Should Be Involved**

Practical accounting standards can only be issued by persons involved in the preparation, certification, analysis and interpretation of financial statements. Preparers of financial statements, namely corporate accountants should have a role in standard-setting since being the persons responsible for implementing the standards they would be the main "victims" of this regulatory process. In the end standards will not succeed if they are rejected by the preparers. Corporate accountants' views on the information production costs resulting from new standards on the problems that particular standards can cause in terms of conflicting with management information needs, taxation and investments and on the competitive disadvantages of additional disclosures have to be carefully considered by standard-setters. Preparers would demand standards that leave them sufficient flexibility for handling complex transactions not envisaged in the standards. Users, however, may be expected to favour highly prescriptive standards, i.e. those that specify the accounting method to be followed if a set of conditions is fulfilled, so

that accounting data of different companies can be compared with the minimum of recomputations.

### **The Politics of Setting Accounting Standards**

Inevitably, standard-setters have to arbitrate between the conflicting pulls of preparers and users. Many a time the standard that eventually comes out is likely to be the product of a process which is more political than technical. But the "sunshine" requirements outlined earlier will ensure that the whole process is open to public scrutiny which should have a sobering effect on those trying to bring undue pressure to influence standard-setting. Leading academics, practitioners, and policy makers all over the world have come to accept that accounting policy making like any other policy making is after all a process of social choice, though accountants like to believe that it is a purely technical exercise.

The present system of setting standards in India reflects almost wholly the point of view of auditors. While the accountancy profession should continue to provide leadership and guidance in standard-setting, it should be recognised that those outside the auditing community have vital stakes in accounting standards. Preparers and users should also have a formal place in the standard-setting agency. Incidentally, the Chartered Accountants Act under which ICAI is allowed "to regulate the profession of chartered accountants" does not explicitly empower it to issue and enforce regulations on those outside the accountancy profession, that is business and

industrial corporations. Providing advice and guidance of a non-binding nature is of course a different matter.

### **Advantages Of Involving Preparers And Users**

The proposed structure is also advantageous to accountants. Accountants will continue to play an important role in terms of providing the technical skills vital in standard-setting. At the same time, the standards will reflect the collective judgment of preparers, users and auditors on the costs and benefits of adopting various accounting alternatives. A more tangible gain is that the standards are likely to be better received by the financial community which would force companies into compliance. In the beginning accounting standard-setters in the USA and UK tried to set standards without involving "outsiders", but have been forced to admit preparers and users in the face of failure of 'accountants-only' bodies to bring about acceptable standards. If international experience is any guide, accountants can only hope for keeping outsiders out of the standards board for a few years.

Standards set by a body comprising users, preparers and accountants following an open and consultative process should have relatively high acceptability. The model followed in the USA is that the Financial Accounting Standards Board (FASB), an independent private-sector body, sets standards and these are accepted by AICPA whose members as auditors are bound to report deviations from FASB's standards. Despite political pressures,

FASB enjoys a good record of objectivity and independence. The FASB model may also be the best guarantee against governmental intervention in accounting standard-setting. In the early stages it may be easier to work with a board consisting of part-time members in view of the high cost a full-time body would entail as well as the difficulty in locating suitable talent willing to serve as full-time members. There should be a well-staffed secretariat that can handle the additional work load resulting from having to follow extensive due process.

### **HOW STANDARDS SHOULD BE ENFORCED**

Compliance by preparers is the acid test of success of standard-setting. How should the standards be enforced? There are a number of options for enforcement.

#### **Enforcement Through Stock Exchanges**

One option is that the Stock Exchanges (SEs) can require listed companies to comply with accounting standards as a condition of listing. This option suffers from a number of shortcomings as a tool of enforcement. Large unlisted companies will be outside the pale of accounting standards. The highest penalty for non-compliance can be the delisting of defaulting companies' securities which would hurt the innocent investors of these companies rather than their delinquent managements. Stock exchanges have had difficulty in delisting companies that did not pay the listing fee because to delist them was considered to be

not in investors' interest. Since the mechanism for dealing with non-compliance has to be operated by the SEs, the accountancy profession would become a helpless spectator of the financial reporting scene. Moreover, since the SEs are under the overall control of the Ministry of Finance and the Securities and Exchange Board of India it amounts to inviting governmental intervention in standards and is thus not really a private-sector solution.

### **Enforcement Through Auditors**

Another option for the accountancy profession is to "go it alone". This may take the form of asking the auditors to ensure compliance with the standards and to report cases of deviations from the standards to the shareholders of the company concerned. This option is likely to be appealing to the accountancy profession since it does not have to look to non-accountants like SEs and the government to secure compliance with the standards, which are after all an accounting matter. In fact, ICAI has recently settled for this option.

### **Auditors and Financial Statements**

Unfortunately the odds are heavily against the accountancy profession, and without a miracle in its favour the profession is unlikely to meet with much success. This prediction is based on the legal position of auditors in relation to financial statements. The Board of Directors of a company prepares the



financial statements and the Company's auditors only report on them. As functionaries appointed under the Companies Act, auditors have to report on matters specified in the Companies Act. They may be tempted to qualify their opinion on whether the financial statements show a true and fair view of profit and financial position on the ground that they do not comply with the ICAI's accounting standards. "True and fair view " is a legal concept and only the courts can decide the question whether financial statements give a true and fair view. Compliance with accounting standards is not in law a prerequisite for giving a true and fair view. It is recognised that the notion of "true and fair view" is a question of fact. The courts may look to accountants (as experts) on what may be regarded as GAAP, though they are not bound to accept GAAP as conclusively resulting in a true and fair view. The question then is whether accounting standards are a part of GAAP. The authority of GAAP is persuasive rather than legal. It is based on the general acceptance by accountants of certain accounting practices for preparing financial statements. If accounting standards have to be accepted as a part of GAAP, they should enjoy general acceptance. But unless they are a part of GAAP, accountants are not bound to comply with them. This is a chicken-and-egg problem:accounting standards need to be widely followed so as to form part of GAAP but unless they are a part of GAAP they need not be followed.

### **Auditor's dilemma**

In such a situation the position of company auditors vis-a-vis their clients is going to be difficult. As members of ICAI they are obliged to comply with its directive asking them to ensure that the financial statements audited by them comply with ICAI's standards. However, companies would point out that since audit reports are issued under the Companies act they cannot report on matters not specified in the Act. They may not, in many instances, mind a qualified audit report if that can buy peace for them and their auditors. After all, few take auditors qualifications seriously and company directors are not believed to be among those few! In most instances directors do not even care to reply to auditors' qualifications, though the Companies Act requires that they answer them in the Board's report to the shareholders. Most of the shareholders do not understand the phrases used in auditors' reports and those who understand such matters know that they cannot do much in company meetings. Those who attend shareholders' meetings will agree with this assessment. The Department of Company Affairs has not displayed any great enthusiasm in bringing delinquent companies to book. Put simply, qualifications in auditors' reports do not seem to matter really, except in extreme cases. Therefore, it seems that recalcitrant companies will go on as merrily as ever.

### **Audit Qualification Has Not Been A Deterrent**

There are at least three widely known recent examples to show that many companies care pretty little about qualified reports. In the early eighties ICAI pronounced that the

capitalisation of interest expense relating to the period after an asset is commissioned was not a good accounting practice. But many companies went on with the practice in the face of audit qualifications repeated year after year. Companies resorted to this practice to strengthen their claim for investment allowance under the income-tax law on not only the asset cost but also the entire interest expense incurred to finance the asset. The tax savings they would get by interest capitalisation were presumably more important to them than the urge to follow ICAI's advice and accounting rules were bent. The practice could only be ended when the government realised that companies would be getting an unintended tax bonanza and amended the tax law in 1986 so as to exclude the post-commissioning-date interest from the definition of asset cost. Note that the **government was motivated by revenue considerations rather than true and fair financial reporting**. The second example relates to ICAI's directive in the mid-eighties requiring companies to apply multiple-shift rates under the straight-line method of depreciation when they actually worked multiple shifts. The directive was ignored by some companies despite audit qualifications; the list of companies included some household names. But all those companies fell in line once the Companies Act was amended in 1988 requiring the provision of multiple-shift depreciation. The third example concerns ICAI's pronouncement asking companies to provide gratuity on accrual basis rather than cash basis, which was also ignored by a number of companies despite audit qualifications, but they were spurred into following the accrual basis (using actuarial estimates) when

the Companies Act banned the use of cash basis accounting.

### **Earnings Come Before Respect For ICAI**

Personally, most finance directors, themselves CAs, would like to see their companies follow ICAI's directives and guidance notes but they often give in to the management's pressure to show a flattering bottom line in difficult times. It may after all be that quite a few companies do not care to follow the accountancy profession's advice if it clashes with their own accounting objectives, and the fear of audit qualifications is probably not high enough to force them into compliance. And those companies that comply might have done so purely on their own.

### **Standards Are No Different**

The widespread non-compliance may well be due to the lack of legal force in ICAI's directives. Of course, accountants may pride themselves on the fact that the government supports their efforts in regulating accounting practices (as shown by statutory intervention in the cases discussed earlier), but it also exposes their inability to do much without the support. Obviously, ICAI is optimistic that accounting standards are different and would be automatically complied with unlike some earlier directives, but the basis for such optimism is unclear.

## **Enforcement Through Law**

Considering all the problems in private-sector initiatives, accountants may be tempted to ask for legislative support for standards formulated by them. After all standards would then have automatic legal backing and compliance is assured. One way is to get the standards included in the Companies act or the rules. For example, the cost accounting requirements for companies are currently laid down by rules issued by the government. But the difficulty with this route is that the standards cannot be amended swiftly to deal with new situations calling for revision in the standards because the amendments have to be cleared by the government every time.

## **Why Not Legalise ICAI's Standards?**

A simpler way is to amend the Companies Act to provide that financial statements not prepared in accordance with ICAI's standards shall not be deemed to be giving a true and fair view of a company's profit and financial position. It would also take care of problems of interpretation by the courts discussed earlier. But such a legal requirement would be extraordinary for several reasons. For one thing it would be an open admission by accountants that they have failed to forge a professional initiative on a largely technical matter, with adverse consequences for their reputation. More importantly, it would amount to the government abdicating its responsibility for protecting the public interest. ICAI's job is after all to

regulate the profession of chartered accountants according to the Chartered Accountants Act, 1949. In substance, it is a closed club of CAs (though there are a few government nominees on its Council). Its affairs are not open to public scrutiny, perhaps for valid reasons. But it would be wrong to invest such a body with the legal power to make rules which will affect the lives of a large number of persons outside the profession who use accounting information, for example, shareholders, banks, stock brokers, employees and unions, tax authorities and regulatory agencies. Such a step would be clearly unprecedented in India.

### **Governments Everywhere Intervene in Accounting**

If anything, all over the world governments have been encroaching upon the authority of accountants to set accounting standards. This is the result of a poor record of compliance with the accountancy profession's standards as well as a public perception that accounting and audit failures underlie the collapse of several large companies in recent times in these countries. Since 1990 the UK has moved towards what in effect is a government controlled Accounting Standards Board, replacing the profession's two decade-old Accounting Standards Committee (interestingly, the UK profession's Auditing Practices Committee has been recently replaced by an Auditing Practices Board with non-accountant members.) In Australia accounting standards are now set by a government-appointed board in place of the earlier system of governmental review of accountants' standards. In the

US the private-sector Financial Accounting Standards Board functions under the watchful eyes of the Securities and Exchange Commission and the Congress, which do not hesitate to pull the rug when they feel like. While India may decide to go the way of UK, Australia or USA in course of time, for the present an independent standards board in the private-sector is considered appropriate. Tacit support of the Securities and Exchange Board of India, the stock market watchdog body and the Department of Company Affairs may be forthcoming if the standards programme is seen to be operating reasonably well.

#### **HOW TO FINANCE STANDARD-SETTING**

The question of financing the standards programme is one of extreme importance, but not seriously addressed as yet. If accounting standards are needed by users and preparers of financial statements they should contribute the funds necessary for developing them. At present the cost of setting standards is borne wholly by the chartered accountancy profession. Funds should come from auditors, banks, financial institutions, stock brokers and SEs, companies and others who need standards. The sharing of financial burden by all these persons would also ensure their active involvement in all aspects of the standards programme including monitoring compliance. The cost of standard-setting would go up significantly with increase in the number of standards increased emphasis on due process closer supervision of compliance serious follow-up of non-compliance cases, periodic

review of existing standards and obtaining independent research inputs for guiding policy formulation. The costs incurred by ICAI at present on standard setting cannot be taken as guide to the future level of expenses since until now ICAI's standards have been largely reproductions of international accounting standards with insubstantive modifications, and ICAI has spent very little on monitoring and research relating to standards.