

# Globalisation and Indian Accounting Standards

Indian accounting regulation has evolved in two major phases so far. Since accounting regulation is affected by the development of economic and political institutions and policies in a country, these phases largely mirror the economic development model that was followed. The first phase was from the 1950s

are particularly significant in the context of reforms in accounting standards.

## Financial Reporting in the Context of Economic Reforms and Globalisation

The system of financial reporting is a function of the economic, legal and political institutions in a country. There

stitutions that came into existence in the 1950s and 1960s and continued to play a major role until the mid-1990s.

- § The government controlled the issuance and pricing of shares and debentures.
- § The stock markets themselves were plagued with extensive insider trading, besides other serious deficiencies in their trading and settlement procedures. As a result, there were inadequate mechanisms for price discovery.

As a result, prior to 1991, companies depended on state-owned and state-controlled banks and financial institutions for their capital requirements. However, since 1991 Indian companies have depended to a greater extent on the capital market for raising resources. Financial reporting has been influenced by foreign institutional investment, foreign direct investment, disinvestment and privatisation, and listing in overseas stock exchanges, as explained below.

- § Foreign institutional investors hold a significant portion of equity in major listed firms. These investors make international comparisons of financial reporting standards and corporate governance systems in various countries. Foreign institutional investors have been net buyers over the last four years. In 2004, out of the total institutional

This article explains the frequent issuance of many Accounting Standards in recent years and recommends complementary institutional mechanisms needed to strengthen the quality of financial reporting and corporate governance in India.



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to the early 1990s and the second phase was from the mid-1990s onwards. During the first phase (1950 to 1991), India's economy remained isolated from events in the rest of the world. The state assumed a major role in determining the economic life of the country and even involved itself in firm-level decisions on plant location, products, prices, raising capital and pricing capital issues.

Its serious balance of payments crisis in 1991 forced India to radically reform its economic policies. Besides structural reforms in foreign trade, taxation and industrial policy, many of the controls on firm-level economic decision-making were dismantled. Free floatation of the Indian rupee within limits, permission to Indian companies to raise capital abroad, liberalisation of the rules for foreign direct investment, and permission for portfolio investment by foreign financial institutions

have been major changes in financial reporting in India since the economic reforms and globalisation began in the early 1990s. Among others, the following forces are important:

- § Capital, product and labour market pressures;
- § Company law and securities law changes in India; and
- § International accounting and securities regulations.

## Market Pressures

### Capital Market Pressures

Though stock exchanges have existed in India for more than a century, the capital market could not play an effective role in channelling savings into investments due to several reasons:

- § The importance of stock exchanges in financing corporate investments was greatly reduced by the expanding operations of government financial in-

turnover of Rs 5,475 billion, foreign institutional investors accounted for about 92 per cent.

§ Foreign direct investment has also been increasing over the years. Much of the foreign direct investment is in the form of setting up wholly-owned subsidiaries or joint ventures with Indian companies. Presenting the financial statements of Indian operations in accordance with the accounting system that the overseas parent company uses is important for performance evaluation and preparation of consolidated financial statements.

§ Partial privatisation (or disinvestment) and privatisation of state-owned enterprises create demand for high quality financial reporting from these firms as a means of monitoring

and rewarding managerial performance.

§ Investor confidence in companies is bound to increase if they comply with internationally accepted standards. This view is the same argument that has been applied around the world, particularly in countries whose accounting standards might be considered less developed, or less likely to ensure the provision of high quality financial information to investors.

§ Consistent with the trend towards privatisation and internationalisation, several Indian firms have listed on overseas stock exchanges. They are subject to detailed disclosure requirements, as specified by the relevant exchanges. Annual reporting of financial statements based on accounting

standards adopted and/or trusted in the country of listing reduces investors' costs of monitoring the listing company, and should, therefore, reduce the companies' cost of capital.<sup>1</sup>

### *Product Market Pressures*

Since the commencement of the economic reforms, Indian firms have enjoyed greater interactions with overseas markets in the form of exports and imports of goods and services. These interactions have impacted financial reporting.

§ Overseas customers, dealing with Indian firms are concerned with the firms' financial performance, especially when long-term relationships are involved. Increasingly, they demand high quality financial reports to monitor the firms' performance. To a slightly lesser extent, the



Lamiya Lokhandwala

<sup>1</sup>The then Governor of the Reserve Bank of India, Bimal Jalan stated that adoption of global accounting practices would help Indian companies gain by about 20-30 basis points in cost of funds when they borrow from abroad.

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same comment applies to suppliers.

§ High quality financial reporting contributes to the reputation of a firm in its product market as a dependable organization to transact business with. Using the case of Infosys Technologies, Narayanaswamy (1996) illustrates how a company modifies its financial reporting in response to the needs of its product market. In 1994-1995, the company voluntarily provided unaudited US GAAP financial statements. At the time, 73 per cent of the company's revenue came from the United States. As of 31 March 2005, the company provides consolidated income statement and consolidated balance sheet prepared in accordance with the national accounting requirements in Australia, Canada, France, Germany, Japan and the United Kingdom. The company has operations in all of these countries. A major objective for overseas listing is to create brand equity in the company's international product markets.

§ Similar considerations apply to domestic listing. For example, India's largest software services firm, TCS has long been privately held by the Tata group but in 2004, the company's shares were offered for sale to the public. Clearly, the motivation for going public was not any immediate need for additional capital, as the company is cash rich. Being a listed company carries greater prestige when it comes to dealing with present and potential

customers. We would expect TCS to seek overseas listing in course of time, given its significant exposure to the U.S software market. Again, financial reporting under accounting standards recognised internationally will assist that transition.

The rapid globalisation of the services sector of India explains why technology and software services firms are at the forefront of adopting international financial reporting standards. The evidence from Infosys and other IT firms persuades us to conclude that potential benefits in product markets provide significant incentives to Indian firms to accept high quality accounting and disclosure systems.

*Labour Market Pressures*

Indian firms need talent to stay ahead of the competition in their product and capital markets. The labour market influences financial reporting standards and quality in several ways.

§ Superior financial reporting could be useful in convincing a firm's present and potential employees of its financial soundness, so that as key users of a firm's accounting information they can trust the firm as a dependable employer offering good long-term prospects of growth.

§ Some firms (mainly, but not only, in the technology sector) have employee stock ownership plans. Employees in these firms demand financial information in order to have a liquid market for their claims.

§ Sunder (2002) states that strong pay-performance links in US managerial

contracts make demands on US accounting systems that are largely absent in seniority-based systems elsewhere. In India, prior to the 1990s the government regulated and approved remuneration of top management. However, since the 1990s Indian companies have been moving in the direction of relating management compensation to financial performance.

§ Since professional employees have worldwide mobility, they are likely to benefit from making investments that have cross-border mobility that results from international listing of their companies' stocks.

§ Firms with large overseas operations employ foreigners who are generally more comfortable with financial reporting and disclosure standards that are followed around the world.

These arguments build on the point in Desai (2004) that firms with employees abroad might be interested in listing their stock in these foreign markets as an employee incentive program.

**National Regulations**

In the last decade there have been significant changes to Indian laws and regulatory requirements relating to accounting and governance. The major developments are briefly as follows:

§ *National Advisory Committee on Accounting Standards:* In 1999, the Companies Act, 1956 was amended to provide for setting up a National Advisory Committee on Accounting Standards (NACAS) to advise the Government on the formulation

of accounting standards. This amendment was largely in response to an international groundswell of interest in the globalisation of accounting standards, and as part of India's economic reforms to facilitate international trade and capital movements. Significantly, the press release issued by the Government stated that "the Committee shall advise the Central Government on the accounting standards to be followed, evolved and practised in the country ... to meet the challenges of emerging globalisation of Indian economy."

**§ Securities Legislation and the Stock Exchange Listing Agreement:** The Securities and Exchange Board of India (SEBI) has over the years, and more so since the late 1990s, played an active role in requiring compliance with accounting standards and provision of additional disclosures. It mandated half-yearly reporting of financial results and later required quarterly reporting. In 1995, SEBI amended the listing agreement to require annual report publication of the statement of cash flows by listed companies, although the Companies Act did not (and even now does not) require the statement. In 2001, SEBI amended the listing agreement to require segment performance reporting in listed companies' quarterly results.

**§ Corporate Governance Reforms:** Over the years, a number of initiatives have been taken by the government, regulators and the private sector on reforming corporate governance in India. The recommendations made by the various committees have had an impact on financial reporting in India. These include the following:

- **The Narayana Murthy Committee on Corporate Governance:** The major recommendation concerning financial reporting is that in case a company has followed an accounting treatment different from that prescribed in an accounting standard, management should justify why they believe such alternative treatment is more representative of the underlying business transaction. Management should also clearly explain the alternative accounting treatment in the footnotes to the financial statements. These changes have been incorporated in the new clause 49 in the Listing Agreement. SEBI also requires a certificate from the company's external auditor on compliance with this clause.
- **The Naresh Chandra Committee on Corporate**

**Audit and Governance:** It was appointed in 2002 in the wake of the series of corporate scandals that shook the U.S. in 2001 and 2002 and the enactment of the Sarbanes-Oxley Act (SOX) in July 2002. The Committee made several recommendations on strengthening the mechanism of corporate audit as an effective tool for monitoring the quality of financial statements.

- **The Kumar Mangalam Birla Committee on Corporate Governance:** This was the first official committee to examine corporate governance in India. It was motivated, among others, by "the financial crisis in emerging markets", a reference to the 1997 East Asian Crisis. The Committee emphasised the effect of globalisation of accounting standards by saying that India



has “to move speedily towards the adoption of international standards. This is particularly important from the angle of corporate governance” (para. 12.1). The Committee recommended presentation of consolidated financial statements, segment reporting and disclosure of related party transactions. In 2000, the recommendations of the Committee resulted in a major change in the Listing Agreement.

### International Accounting and Securities Regulations

The restructuring of the International Accounting Standards Board (IASB) and the International Organization of Securities Commissions (IOSCO) acceptance of the IASB’s “core set of standards” for the purpose of cross-border listing have improved the acceptability of IAS/IFRS within India. SEBI is a member of IOSCO and is on several of its key committees. As such, it would be difficult for SEBI to defend Indian accounting practices that are not in accordance with international standards and practices. The changes in Indian accounting described in this paper are, to a great extent, the result of pressure felt by SEBI because of being a part of a body of international securities regulators. In turn, SEBI required major changes in Indian accounting.

Even though SEBI and the Department of Company Affairs could be said to be broadly interested in disclosure and accounting respectively, the lines of distinction have been blurred, at least by SEBI. For example, it was SEBI that first set up an Accounting Standards Committee in 1998-

1999 as a Standing Committee with the following objectives:

- To review the continuous disclosure requirements under listing agreements;
- To provide input to the ICAI for introducing new accounting standards in India; and
- To review existing accounting standards, where required and to harmonise these accounting standards and financial disclosures on par with international practices.

In 2001, the DCA entered the scene with the idea of the National Advisory Committee on Accounting Standards.

Despite the DCA’s activism, necessary amendments to the Companies Act have not been made on many of the matters on which recommendations were made by the Naresh Chandra Committee. SEBI’s competitive advantage is that it is less politicised, it deals with listed companies via stock exchanges and it has to worry less about implementation problems. On the other hand, the DCA has to work with several ministries and departments in the Government of India and any changes it wants to bring about require the approval of Parliament. Therefore, the process is slow and sometimes politicised.

It is significant that international developments produce ripples quicker in India than was the case earlier. For example, the 1987 stock market crash in the rest of the world left India relatively unaffected. Even more to the point was the securities scam in 1992 in India that wiped out a large part of investors’ wealth in many companies. The response to the scandal was considered slow and half-hearted. Contrast this with the developments in the late

1990s and later when major events such as the bursting of the dotcom bubble, corporate accounting scandals, corporate governance reforms in the U.S. and elsewhere, and SOX, were followed up more quickly in India. This, more than any other measure, captures the effect of globalisation of the Indian economy on standards of accounting and corporate governance.

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### Impact of Economic Reforms and Globalisation on Accounting and Governance

A recent study on corporate governance in ten countries in Asia indicates that in conformity to the IASB’s standards, India is ranked fourth in the region; Singapore, Hong Kong and Malaysia are ahead of India; South Korea, Taiwan, Thailand, Philippines, China and Indonesia are behind. In enforcement, only Hong Kong and Singapore are ahead of India. Indian investors are willing to pay a governance premium of 23 per cent, conceivably for lower agency costs. (Barton et al. 2003).

### NEW INDIAN ACCOUNTING STANDARDS

#### Issuance of Accounting Standards Gathering Pace

Accounting standards issued since 2000 are frequently referred to as the “new accounting standards.” The ICAI issued 13 accounting standards between 2000 and 2004, as compared to 16 standards issued from 1977 (when it was established) to 1999. The new accounting standards cover several complex recognition as well as disclosure issues, such as segment reporting, leases, deferred taxes, consolidated financial statements, intangible

assets, and impairment of assets. These standards cover matters for which there were mostly no prior pronouncements. As a result, they have tended to follow the IASB promulgations more closely than the previous generation of standards. Nevertheless, there are substantial differences between the new accounting standards and the corresponding IASB standards.

Some of the new accounting standards came to be issued in view of the need felt by SEBI. The ICAI did the rest. In fact, SEBI was under pressure from IOSCO to improve Indian accounting standards and bring them in line with the IASB. SEBI also tightened the stock exchange Listing Agreement. Some of the matters that SEBI required were not then reporting requirements under the Companies Act 1956.

As such, the accounting standards globalisation movement in which IOSCO was a key player led to SEBI's influence to hasten India's involvement in the globalisation process. For example, an amendment to the Listing Agree-

ment required companies to present consolidated financial statements even though such a requirement did not exist then in Indian law, and does not exist even now. Also, companies were required to publish quarterly segment financial results although the Companies Act has no requirement for segment reporting.

### Greater Convergence with International Accounting Standards

Increasingly, Indian accounting standards are getting closer to IAS/IFRS than was the case until the 1990s. To begin with,

the Accounting Standards Board (ASB) sticks faithfully to the language of standards with few exceptions. This contrasts sharply with the earlier ASB practice of making sometimes mere verbal changes. Also, in the past Indian accounting standards were tacitly influenced by tax considerations. The ASB was implicitly concerned with the effect of standards on reporting for income tax, despite the

fact that shareholder reporting and tax reporting are different in India, as in other British Commonwealth jurisdictions. In recent times, there is a recognition that financial reporting should not be coloured by tax considerations. An enabling factor for this development is the steady drop in income tax rates resulting in taxation being less important now than it was.

Another trend in India's movement towards accepting the globalisation of accounting standards is the adoption in some cases of the benchmark treatment rather than the allowed alternative treatment in the relevant IFRS. For example, when AS 11 dealing with the effects of foreign exchange rates was revised in 2003, the ASB decided to adopt the international benchmark treatment that requires recognition in the current period of all exchange differences arising from transactions. The alternative treatment that allows carrying the additional liability arising from a severe devaluation as part of the cost of the related fixed asset was not accepted. This was despite the fact that the Companies Act requires adjusting the cost of fixed assets for exchange differences arising from foreign exchange liabilities related to acquisition of fixed assets.



## Moving towards International Accounting Standards

The differences between Indian accounting standards and IAS/IFRS have been narrowing, especially in the case of standards issued since the late 1990s. Some of the differences are attributable to the need for conformity with the Companies Act. Some others exist because there is no corresponding Indian standard on the subject (e.g., financial instruments and business combinations). A general perception is that financial reporting practices have improved over the past 5 years; however, significantly strengthened enforcement mechanisms are needed to further improve the quality of corporate financial reporting (World Bank 2004).

Some of the new accounting standards are far reaching in their impact on firms' balance sheets and income statements and are therefore expected to have significant economic consequences. These provide opportunities for research. Mizuno (2004) provides evidence that Japanese companies' adoption of new accounting standards produced significant economic impacts on decision-making by corporate management. It is possible that India, too, will experience some effects. The following are illustrations of possible economic consequences that may arise from implementing the accounting standards.

**Consolidated Financial Statements:** In the past, when companies were required to attach the financial statements of subsidiaries to the parent's financial statements, they could keep a loss-making business as a subsidiary rather than as a division of the parent and not recognise the subsidiary's losses in the (par-

ent) company's financial statements. With the advent of consolidation, companies have incentives to divest unprofitable subsidiaries and associates. Changes in the structure of corporate holdings since the initiation of consolidated financial statements in 2001-2002 can be studied. Another issue is whether consolidation has led to companies changing their criteria for performance evaluation. Given the major role of family-controlled corporate groups in India, the requirement for consolidated financial statements may lead to significant improvement in transparency and considerable restructuring activity.

**Deferred Tax Accounting:** The effect of deferred tax accounting is to capture the tax effect of differences between accounting profit and taxable income. The creation of deferred tax liabilities for temporary differences will result in lower net profit. This could impact firms' tax planning strategies. According to some commentators, deferred tax accounting is a major change with far-reaching consequences.

**Foreign Exchange Transactions:** In the past, companies were allowed to adjust their foreign exchange gains and losses arising from change in foreign exchange liabilities related to acquisition of fixed assets to the cost of the fixed assets concerned. AS 11 (revised) provides for recognition in the profit and loss account of such differences in the period in which they arise. Management would likely reduce the resulting volatility in reported profit by entering into suitable hedging arrangements.

## Institutional Mechanisms for Global Accounting Standards

As argued in this paper,

**The effect of deferred tax accounting is to capture the tax effect of differences between accounting profit and taxable income.**

Indian accounting standards are gradually moving towards IAS/IFRS under the forces of globalisation of Indian business. Some commentators have stated that India should adopt IAS/IFRS completely in order to convey to the outside world that the country's accounting standards are in line with the best international practices. Will the adoption of IAS/IFRS be effective in improving the quality of Indian financial reporting and disclosure?

Let us remember that IAS/IFRS are drawn from common-law countries, such as the UK and Australia and to a certain extent the US, all of which are economically developed. The economic, legal and political institutions in these countries provide the framework for the effective working of high quality accounting standards. Ray Ball (2002), a well-known professor of accounting at the University of Chicago, identifies a number of institutional features in these countries that are important in determining the quality of accounting:

- § These countries have a long history of free markets that are regulated to varying degrees, but the capital market rather than the state decides on resource allocation in the economy.
- § The capital market is efficient and is able to price securities efficiently.
- § The primary focus of the corporate governance systems is on shareholders, rather than other stakeholders such as lenders and employees. Public markets for equity and debt funds, rather than banks, are the major sources of finance.
- § There is a clear separation of ownership and



management of the firm. Shareholders engage managers to run the firm's operations.

- § These features give rise to demand for public financial reporting and disclosure and independent auditing of financial statement information.
- § Since the incentives of managers and auditors are not the same as those of the shareholders, agency problems arise. Shareholders have access to private litigation to get compensation for loss caused by the actions of managers and auditors. Individual shareholders can sue managers and auditors, and groups of shareholders can initiate class action suits.
- § The private litigation process is facilitated by efficient court systems and speedy action on judicial decisions and orders. This explains why potential litigation in the US is a powerful deterrent against manager and auditor failures. The litigation process is further facilitated by the system

of contingent fees prevalent in the United States for a long time, and the system of conditional fees allowed in the United Kingdom in recent years.

- § Independent auditors undergo high quality training and testing of knowledge and skills.
- § Financial reporting and tax reporting are separate and covered by different sets of rules.

Ball notes that these features do not exist to the same extent in developing countries. He provides evidence from the East Asian group of countries (Hong Kong, Malaysia, Singapore, and Thailand) and China to show that although these countries follow IFRS/IAS, the accounting quality in these countries is greatly inferior to the common-law group (Australia, Canada, United Kingdom, United States). Ball's comments are also valid in the case of India. There is no clear separation of ownership and management in family-owned and government-owned Indian enterprises. Since the owners of these enterprises are on the boards of the companies,

they have access to private information for monitoring the performance of the enterprises. To that extent, there will be less demand for public financial reporting. Furthermore, even now, the stock market in India does not account for a large portion of the investment. The legal provisions for private securities litigation are cumbersome and are not helpful to individual shareholders or groups of shareholders for filing class action suits. Also, agreements for payment of contingent fees are not legally enforceable in India. In sum, merely transplanting accounting standards from an advanced jurisdiction to India without the complementary institutional framework will be ineffective.

**Indian accounting standards and corporate governance requirements are now more in line with international practices.**

#### Conclusion

Indian accounting standards and corporate governance requirements are now more in line with international practices. The recent developments can be attributed to the operation of economic forces arising from capital, product market and labour market pressures and to regulatory initiatives in response to overseas developments, such as the East Asian Crisis and SOX. Foreign financial institutions and listing in international stock exchanges are playing a major role in speeding the pace of raising Indian standards to international levels. India is still in the early stages of its involvement in the globalisation of accounting standards. Mere adoption of superior accounting and disclosure standards will not raise the quality of Indian financial reporting. Creating a complementary institutional framework that, among others, facilitates cost-effective private litigation by shareholders is critical. □