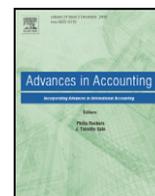




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The evolution of Indian accounting standards: Its history and current status with regard to International Financial Reporting Standards

Shalini E. Perumpral^{a,*}, Mark Evans^{b,1}, Sanjay Agarwal^{c,2}, Felix Amenkhienan^a^a College of Business and Economics, Radford University, Radford, Virginia 24142, USA^b Kelley School of Business, Indiana University, Bloomington, Indiana 47405, USA^c IBM Business Consulting Service, USA

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ABSTRACT

This paper addresses the adoption and applicability of International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS), issued by the International Accounting Standards Board (IASB) to India. Specifically, the paper highlights some major areas where the country lacked harmonization with IAS in 1993 and the rapid congruence with IAS in the decade that followed. The attempt to achieve congruence with IAS appears to be more a by-product of the country's rapid economic growth rather than its catalyst. However, continued growth and the attraction of foreign capital to domestic ventures will depend on the transparency of the financial dealings. The Institute of the Chartered Accountants of India, (ICAI), India's standard setting body, is increasingly attempting to provide this transparency by revisions and additions to accounting standards, and by Exposure Drafts which aim to bring India more in line with International Financial Reporting Standards.

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1. Introduction

Propelled by globalization, world attention today is centered on two emerging market economies, India and China. China's managed liberalization has allowed it to achieve more rapid growth and has attracted a larger portion of direct foreign investment. India, with its messy democracy and nod to individualism in recent times promises a more exciting market environment with greater potential for future growth. The liberalization of the Indian economy since 1991 has exposed Indian firms to foreign competition and foreign investment. As a result, the information needs required by both managers and investors have changed. A first step in this process is the demand for transparency in the financial reporting. This transparency is rapidly occurring in India as the country catapults into becoming a major economic power propelled on by the combined forces of the technological revolution, the opening up of its borders and the privatization of many infrastructure industries such as transportation and communication. This paper addresses the adoption and applicability of International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS), issued by the International Account-

ing Standards Board (IASB) to India.³ Specifically, the paper highlights some major areas where the country lacked harmonization with IAS in 1993 and the rapid congruence with IAS in the decade that followed. The attempt to achieve congruence with IAS appears to be more a by-product of the country's rapid economic growth rather than its catalyst. However, continued growth and the attraction of foreign capital to domestic ventures will depend on the transparency of the financial dealings. The Institute of the Chartered Accountants of India, (ICAI), India's standard setting body, is increasingly attempting to provide this transparency by revisions and additions to accounting standards, and by Exposure Drafts which aim to bring India more in line with International Financial Reporting Standards. The focus of this paper is on the evolution of these Indian Accounting Standards.

2. Literature review

In order to effectively review the literature with regards to harmonization of accounting standards in general, it is deemed appropriate to first examine the International Accounting Standards Board's (IASB) position, reasons for harmonization, and recent efforts towards this goal. Epstein and Mirza (1997) define the IASB's goals as

³ The International Accounting Standards Committee (IASC) was replaced by the International Accounting Standards Board (IASB) in 2001. The IASB inherited the standards issued by the IASC (the IAS), which were revised in most cases, and issued new standards of their own called the International Financial Reporting Standards (IFRS). In this paper, IAS and IFRS are used interchangeably depending on the chronological sequence of events.

* Corresponding author. Tel.: +1 540 831 5233.

E-mail addresses: sperumpr@radford.edu (S.E. Perumpral), mark.evans@duke.edu (M. Evans), sanjay.agarwal@us.ibm.com (S. Agarwal), famenkhi@radford.edu (F. Amenkhienan).

¹ Tel.: +1 919 660 7629.

² Tel.: +1 571 345 5780.

first, to promote the acceptance of proposed accounting standards across the world; and second, to continue improvement in the harmonization of accounting standards, regulations, and procedures. As of 1990, sixteen countries had achieved 100% conformance with the thirty IAS that existed at the time, and seven developing countries such as Pakistan and Malaysia had adopted IAS fully as their own national standards (Gernon, Purvis, & Diamond, 1990). As of October 2007, a total of seventy-three countries have made IFRS a requirement for reporting for domestic listed companies.

Despite this seemingly widespread acceptance, some research suspects the irrelevance or inapplicability of common standards in certain national environments (Larson & Kenny, 1996, 1995; Fechner & Kilgore, 1994). Based on their research, Larson and Kenny (1996) conclude that the adoption of IAS depend on a country's economic development theory, and its proposed level of adoption of the IAS. They also find no support for the hypothesis that there is a positive correlation between adoption of IAS and level of economic growth, and between adoption of IAS and level of equity market development (Larson & Kenny, 1995).

In a panel discussion of policy setters concerning harmonization of accounting standards in 1990, several panel members noted that harmonization of accounting standards may not be appropriate or cost effective. They suggested large, multinational companies around the globe had the abilities and the funds to cope with lack of harmonization. As a result, they perceived a lack of incentive for preparers and users to harmonize accounting standards (Gernon et al., 1990).

The largest obstacle hindering the harmonization of accounting standards is national culture, especially in developing countries. Riahi-Belkaoui (1995) researched the required accounting standards across thirty-three national stock exchanges and found that accounting disclosure is significantly affected by the cultural dimensions of power distance, individualism, and uncertainty avoidance studied by Geert Hofstede. In particular, Riahi-Belkaoui (1995) found that in "societies in which people accept a hierarchical order in which everyone occupies a place that needs no justification..." people are "expected to take care of themselves and their immediate families only..." As a result, these societies are "tolerant of ambiguity and have strong conditions for extended disclosure requirements of stock exchanges" (p. 124). Hence, disclosure requirements of stock exchanges of certain developing nations were more extensive than that nation's general financial reporting standards. This is a major point in the case of India, whose stock exchange, for example, required a statement of cash flows long before its general standard – setting body did in 2000. Also, since 2002, consolidated financial statements have been required by the Securities Exchange Board of India, while the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) only provides some loose guidelines to date (Deloitte, 2007).

Along this same vein, other researchers suggest the influence of many external factors on the development of accounting standards such as cultural factors, the external environment, and the institutional structure (Fechner & Kilgore, 1994; Doupnik & Salter, 1995). According to this research, these varying effects on accounting standard – setting are significant, and along with varying legal systems, are found to be major determinants which cause conflict in setting accounting standards (Doupnik & Salter, 1995). Fechner and Kilgore (1994) have proposed a modified general framework to assess the extent to which economic factors, cultural factors, and the accounting subculture (uniformity, professionalism, conservatism, and secrecy), directly or indirectly affect accounting practice.

In spite of opinions, conflicts and hindrances to the contrary, there is abundant support in favor of international accounting harmonization and for the adoption of IAS in the literature (Epstein & Mirza, 1997; Graham & Wang, 1995; Wyatt, 1992; Gernon et al., 1990). For example, Gernon et al. (1990) point out that the benefits of harmonization range from better decision making within a firm with respect to asset allocation, to improving the efficiency of capital markets, and

increasing competitiveness among firms within and across national boundaries irrespective of a country's stage of development. Complementing this argument, Riahi-Belkaoui (1994), notes that accounting standard harmonization is crucial to a developing country which needs outside capital or foreign loans as potential investors and creditors often rely on these financial statements in making decisions such as allocation of capital. Furthermore, he points out that harmonization is often mistaken for "complete standardization" (1994) whereas harmonization recognizes the specific needs of each country. Therefore, he suggests the first step in harmonization should be to recognize certain country – specific issues, and to reconcile them with the objectives of other countries. The second step should be then to "correct or eliminate some of these barriers in order to achieve an acceptable degree of harmonization."

As a starting point, the evolution of the Indian accounting system is investigated and the various domestic influences, such as economic, political, legal, socio-cultural and academic factors, are considered along with international influences that may have had an impact. Secondly, the bare essentials of the Indian accounting system are juxtaposed with the international standards and a compare and contrast approach is adopted for the purpose of analysis. Thirdly, the major differences with respect to accounting treatment – statutory requirements for certain items and altogether absence of these requirements for other items – are highlighted, along with the degree of disclosure of information in financial reports. Finally, an attempt is made to identify various causes and effects of such differences and variations.

3. The historical development of Indian accounting standards

The evolution of India's present day accounting system can be traced back to as early as the sixteenth century with India's trade links to Europe and central Asia through the historic silk route. The subsequent entry of the East India Company had widespread influence on Indian trade and commerce, and soon the economy was virtually taken over by the company's owners. The British government, realizing immense potential by way of business opportunities, natural resources and manpower, decided to colonize India by taking over the East India Company. The British *Raj* (rule) explains the almost identical pattern of accounting and financial reporting practices between India and England (Marston, 1986). However, since 1947, when India regained independence, some changes have taken place to accommodate the special needs of the Indian economy.

Indian accounting practices reflect its diversity as India has eighteen official languages and scores of dialects spread over twenty – eight states and seven union territories. Each state has its own distinct culture and general trade practices. Furthermore, the accounting practices of the unorganized rural/agricultural sector and the small-scale-urban-industrial sector vary considerably from one region to another. The establishment of a certain uniformity in the accounting and trade practices for these sectors is, therefore, nearly impossible. Moreover, a large number of businesses are controlled by tightly knit conservative families and the management of such businesses is usually very reluctant to disclose any financial information for reasons of privacy and fear of competitors.⁴

A vast majority of the Indian population lives in the rural area, with very low levels of education and economic development. The primary source of income for this majority is through agriculture, although virtually no agricultural accounting system exists. Due to the linguistic and intra-cultural differences, it is also not possible to bring about a standardization in rural accounting practices. Changes to this scenario

⁴ A recent case in point would be the declaration by the international media that Indian industrialist, Mukesh Ambani, had overtaken Bill Gates to become the world's richest man, a claim that was disputed by the company the next day saying that some of the numbers had been erroneously calculated.

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