

# What is indian accounting system

[Business](#), [Accounting](#)



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 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. 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 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 and Kenny, 1996], [Larson and Kenny, 1995, Summer] and [Fechner and 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 and Kilgore, 1994] and [Doupnik and 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 and Mirza, 1997], [Graham and Wang, 1995], [Wyatt, 1992, Spring] and [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 began to occur with the introduction of the Panchayati system or the grass roots level of administration by the late Prime Minister, Rajiv Gandhi.

This program empowers the Village Chief with political and financial administration within the boundaries of the Indian Constitution, and has been fairly successful in that it has made a substantial dent on the existing sluggishness in the underground economy. In sharp contrast, India is one of the world's largest industrial nations in the world, a military superpower in its own right, and a world leader in space research and satellite technology. A jolt to the Indian economy occurred in 1991, when India strained for foreign



reserves and pressure from the International Monetary Fund, (IMF) introduced major changes in economic policy.

The net result was a substantial reduction in government interference and in taxes on the business sector, long favored by then Finance Minister (now Prime Minister) Manmohan Singh. Markets were opened up to foreign collaboration and investment. Segments of the public sector were privatized (Anderson & Lanen, 1999). As a result, India has emerged as a major player in exporting software technology, industrial and consumer goods, and financial services through a large number of multinational corporations.

The presence of such global conglomerates also means increased interaction with international organizations such as the World Bank, International Monetary Fund, United Nations, and the Organization for Economic Cooperation and Development, just to name a few. However, the public sector still continues to play a major role in the Indian economy since all industries that are relevant to national defense and security are owned by the Indian government and account for a major portion of the nation's industrial economy.

The accounting practices of this public sector, along with that of the organized private sector, fall into the realm of The Companies Act, 1956, and are similar in many respects to International Accounting Standards. The involvement of international institutions and businesses in financial matters makes it even more imperative that the Indian accounting system be compatible with its international counterpart. The Indian accounting system, which is based on the Companies Act of 1956, is basically a copy from its

counterpart in the U. K. The Act has been amended several times to suit Indian conditions.

More notable amongst the amendments are the ones in 1965 and 1969, which introduced regulations relating to maintenance of cost accounts and requirements for a cost audit. Also relevant are the two notifications issued in 1971 and 1973, which extended disclosure rules considerably (Marston, 1986). Research efforts at several Indian universities and other organizations have been commendable and have exerted influence on the accounting system in that they have focused on the changing needs of accounting with respect to the rapidly changing economic and technological environment.

Such organizations include: the Indian Council of Social Science Research, which organizes research surveys in the areas of accounting and financial management; the Indian Accounting Association, which has made significant contributions through independent accounting research; and the Institute of the Chartered Accountants of India, (ICAI), which promulgates accounting standards for use by Indian companies. 5 Other international bodies, of which India is an active member, have also contributed towards bringing the Indian accounting system to par with International Accounting Standards.

Examples of such bodies are: the Confederation of Asian and Pacific Accountants; and the Ad hoc Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (Marston, 1986). In addition, the Financial Stability Forum organized by Finance Ministers and Central Bank Governors of the G7 has helped to promote standards for global best practices (Echeverri-Gent, 2001). As a result of all these forces,

an amendment to the Companies Act was enacted in October 1998 which established a new National Advisory Committee on Accounting Standards (Deloitte, 2007).

However, cultural and political dimensions continue to influence India's accounting practices. 4. Comparative analysis of the international accounting standards and the accounting standards and practices of India Our analysis of the differences in International Accounting Standards (IAS) and the accounting standards and practices of India is presented in this section. Gernon et al. (1990) note six ways of evaluating national standards in conjunction with the IAS, which they extracted from an IASC survey entitled Survey of the Use and Application of IAS 1988.

The six categories are as follows: 1. IAS adopted as national standard, 2. IAS used as the basis for a national requirement, 3. National requirements conform ' in all material respects, with IAS', 4. National practice ' generally conforms with IAS', 5. National requirements do ' not conform with IAS', and 6. National practice does ' not generally conform with IAS'. Differences between accounting standards issued in India and accounting standards issued by the IASB fall under items five and six – either national requirements do not conform, or national practice does not conform.

Using these criteria, Gernon et al. (1990) found India's conformity index with IAS to be 56%, in the decade before the 90s. It was the fifth lowest among the countries represented. Since Gernon et al. 's study in 1990, the IASB revised many of its standards, which became effective in 1995 (Epstein & Mirza, 1997). This “ Comparability/Improvements Project” attempted to

narrow the alternatives available to adopting countries. 6 Ten IAS were revised under this project and are included in IAS 1997: Interpretation and Application of IAS 1997.

The standards affected include: inventories; errors and changes; research and development; construction contracts; property, plant and equipment; revenue recognition; retirement benefits; foreign exchange rates; business combinations; and borrowing costs (Epstein & Mirza, 1997). Our research and analysis of IAS includes these revisions. For purposes of our research, accounting standards used in India were extracted from the International Accounting Summaries of 1993 (Coopers & Lybrand (International), 1993) and from the Accounting Standards Updates by Jurisdiction (Deloitte, 2007).

This includes accounting standards and guidance notes issued by the Institute of Chartered Accountants of India (ICAI) and the Companies Act of 1956. The ICAI had issued twelve standards as of 1993, seven of which were mandatory. These 12 standards are contrasted against the IAS. 7 Appearing in descending order of IAS, the major differences in accounting standards are outlined below according to the same format used by Graham and Wang (1995). 4. 1. IAS 2 – Inventories

Based upon the Comparability / Improvements Project, the base stock method for costing of inventories is now prohibited, while the last-in, first-out (LIFO) method, has been reduced to an “ allowed alternative” (Epstein and Mirza, p. 11). The Indian Accounting Standard, AS 2, revised in 1999, is generally in line with the IAS now with FIFO being the popular method among

public limited companies. However, there are many firms still using the LIFO method, which is the allowed alternative under IAS, (Shankaraiah and Rao).

This practice contrasts with the earlier period when under accounting standards issued by the ICAI, the base stock method could be used in “exceptional circumstances”, and the LIFO method was normally accepted (Coopers & Lybrand (International), 1993). Yet the fact that different procedures are still allowed make it difficult to compare performances across firms. 4. 2. IAS 7 – Cash flow statements Epstein and Mirza (1997) note that national and international accounting standard setters view the statement of cash flows as a “ necessary component of complete financial reporting”.

Thus, the statement of cash flows is a required component of a set of financial statements to be prepared under IAS. Under standards issued by the ICAI, AS 3, revised in 1997, either a funds flow statement or a statement of cash flows is acceptable. In practice, the majority of firms provide a funds flow statement with their annual reports. This is a significant change from the earlier period when the statement of changes in financial position (funds flow statement) was recommended but was not common practice (Coopers & Lybrand (International), 1993).

However, under Clause 32 of the listing agreements for stock exchanges, a cash flow statement in similar conformance with the corresponding IAS was required for Indian companies at the time. An example could be found in the 1995-6 Annual Report of Tata Iron & Steel, now Tata Steel (Tata Iron & Steel, 1996). 4. 3. IAS 8 – Net profit or loss for period, fundamental errors and changes in accounting policies Effective in 1995, IAS 8 allows as an

alternative, inclusion the effects of errors in current period income, while the ICAI standards (AS 5) permit this approach as the only accounting treatment.

However, AS 5 requires only the disclosure of prior period items but not its effect on current income (Shankaraiah and Rao). AS 5 was revised in 1997 and an exposure draft was issued in 2001 proposing limited revisions. 4. 4.

IAS 11 - Construction contracts Based upon the IASB's

Comparability/Improvements Project, the percentage-of-completion method for accounting for construction contracts is required, and the completed contract method is no longer allowed.

The ICAI standard, AS 7, revised in 2002, allows for both the percentage-of-completion method and completed contract method but recommends the percentage-of-completion method if a reliable estimate of the outcome is possible. Also, under the umbrella of construction contracts is IAS 23 - Borrowing Costs. Under IAS, interest incurred on a construction contract should be expensed. This is the benchmark treatment. Capitalization of interest costs is an allowed alternative. The ICAI standards, AS 16, allow capitalization of interest if it is incurred during the period of construction. 4. 5.

IAS 12 - Accounting for taxes on income IAS 12 permits the use of the tax deferral method or the tax liability method, in accounting for income taxes. The ICAI permits use of the tax payable method or the tax liability method. Also, the IAS prescribe a three year reversal period before timing differences can be excluded, while under tax laws in India the reversal period is five years. Also, under tax laws in India, a tax loss is permitted to be carried

forward for eight years, while IAS 12 does not specifically prescribe a time period. 4. 6. IAS 14 – Reporting financial information by segment

IAS 14 requires disclosure of segmental information if the firm has public subsidiaries, or if national standards require such treatment. AS 17, issued in 2000, is broadly in line with IAS 14. No such requirement existed earlier, but there were extensive disclosure requirements when reporting by product. As of October 2007, IAS 14 has been superseded by IFRS 8 – Operating segments. 4. 7. IAS 16 – Property, plant and equipment Under the Comparability/Improvements Project, IAS 16 now suggests historical cost as the benchmark in valuing property, plant and equipment. Revaluation is the allowed alternative.

Under the ICAI's standards, AS 10, the appraisal method is preferred, and the most common in practice. 4. 8. IAS 17 – Accounting for leases Accounting standards issued by the ICAI did not include leases in 1993. In practice, no distinction was made between financial and operating leases. Under IAS 17, provisions for accounting for leases include both capital and operating leases. Accounting standards for leases were issued by ICAI in 2001, AS 19. These standards are broadly in line with IAS. 4. 9. IAS 19 – Retirement benefit cost IAS 19 requires actuarial valuations to be allocated to income on a systematic basis.

Also, new under the Comparability / Improvements Project the accrued benefit valuation method is the benchmark in accounting for pensions, and the projected benefit method is the allowed alternative. Standards issued in India, AS 15, had no language concerning valuation methods, and no specific

reference on how to account for actuarial valuations. However, the standards that were revised in 2005 and became effective in 2006, require that enterprises “ actuarially determine and provide for such liability based on the ‘ Projected Unit Credit Method’”(Deloitte, 2007). 4. 10. IAS 21 – The effects of changes in foreign exchange rate

Since accounting standards issued by the ICAI do not require consolidation, the effect of changes in foreign exchange rates are reflected in the financial statements of the foreign branches of the “ parent” company. The benchmark under IAS 21 is to recognize the effect of fluctuations in exchange rates as differences in income or expense in the period incurred. The allowed alternative is to include the difference in the carrying value of the related asset. Under the ICAI's standards, revised in 1994 and 2000, exchange rate differences are accounted for in the carrying value of the asset only for fixed assets.

For all other accounts, differences are recognized as income or expense in the period incurred. For foreign entities not integral to operations, the IAS prescribe accounting for all assets and liabilities at the closing rate.

Assuming foreign branches outside of India to be non-integral, non-monetary items are accounted for at the rate prevalent on the date of transaction under India's accounting standards. Clearly, the issue of accounting for changes in foreign exchange rates is in a state of flux in India, and a hotly debated item, as the rupee continues to strengthen.

It has moved upwards relative to the dollar by 15% since 2004 with most of it occurring in the period 2006–2007. 4. 11. IAS 22 (superseded by IFRS 3) –



Business combinations The Companies Act of India had no requirement for consolidation until April 2001. In turn, there was no requirement to write off goodwill, or to use the equity method. Subsidiaries normally accounted for in consolidation were accounted for as investments. AS 21 requires a parent company preparing financial statements to provide financial information about the economic activities, resources, obligations and results of its group.

It is not mandatory to prepare consolidated financial statements. However, the Securities Exchange Board requires listed companies to prepare consolidated statements as of 2002. 4. 12. IAS 24 – Related party disclosure

Although there was no prescribed accounting treatment by the ICAI or the Companies Act concerning related party transactions or disclosures, the Act did specifically define related parties. AS 18, issued in 2000, is now broadly in line with IAS 24. 4. 13. IAS 31 – Financial reporting of interests in joint ventures Accounting standards issued by ICAI had no standard concerning the different forms of joint ventures until 2002.

Jointly controlled entities were accounted for as long term investments. AS 27, reporting of interests in Joint Ventures lays out principles and procedures for accounting for Joint Ventures for both venture partners and investors. The standards still differ from IAS. In accounting for jointly controlled entities, IAS 31 prescribes proportionate consolidation as the benchmark; and the equity method as the allowed alternative. The above analysis indicates that there are many critical issues that need to be dealt with by India's standard setting body, the ICAI.

An important consideration in analyzing the differences between IAS and standards issued in India is the absence of mandatory requirements for consolidated financial statements. Fischer, Taylor, and Leer (1993) suggest that the presentation of consolidated financial statements is of great importance to the parent company's stockholders. Firms in India account for their subsidiaries as investments under the cost method of accounting for investments. This is perhaps a grave misinterpretation of the parent company's economic substance.

The use of the cost method in accounting for subsidiaries in contrast to consolidation accounting represents the legal form of the companies, but does not represent the more important economic substance. In addition, the lack of consolidated financial statements in a developing country such as India impedes the progress towards comparability of multinational financial statements. Many large Indian companies have numerous subsidiary companies whose selected financial figures are presented separately in the annual reports as opposed to being consolidated with the “parent” companies.

This makes it increasingly difficult for potential investors and financial analysts worldwide to make knowledgeable decisions. As recent as March 2007, the Press Trust of India quoted the ICAI president, Sunil H. Talati, as saying that Indian accountants face problems in accounting for mergers and acquisitions. However, as Indian companies opt to get listed on exchanges at home, the Securities Exchange Board of India requires consolidated financial

statements. 5. Conclusions In recent years, India, one of the fastest growing economies has captured the attention of investors worldwide.

Since the early nineties, following the opening up of the economy with more liberal policies, technical and financial collaborations have increased multifold and so has foreign direct investment and portfolio investment (Anderson & Lanen, 1999). Nevertheless, certain archaic accounting practices still continue. In their study on managerial accounting practices in India, Anderson and Lanen, 1999 S. W. Anderson and W. N. Lanen, Economic transition, strategy and the evolution of management accounting practices: The case of India, *Accounting, Organizations and Society* 24 (1999), pp. 379–412.

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(21)Anderson and Lanen (1999) report little involvement by investors and owners in the development of strategy which still is to a large extent controlled by the government. The Company's Act restricts “ takeovers” and blocks transactions that the government may view as prejudicial to the interests of the company or the public. It is not surprising therefore to find that financial accounting practices mirror this policy by the lack of consolidation of parent and subsidiary financial statements, a major divergence from the IAS.

Fischer et al. (1993) note that “ stockholders are interested in the total financial position of the corporation, regardless of how diversified the operations have become” (p. 64). They also report that unconsolidated subsidiaries are very rare in businesses today. The push for changes in

accounting practices appears to come from the equity markets. Change has come more rapidly to the equity markets because reform in these markets “ have not aroused as much political opposition” (Echeverri-Gent, 2001).

However the banking and business sectors are still steeped in tradition and political agendas of national and state parties affect their evolution. Besides, it is also important to consider the strong cultural element present in India. This could impede the process somewhat even though over the last few years many Indian standards have sought conformance with the International Accounting Standards (Narayanaswamy, 1992). Nevertheless, in March 2007, the Press Trust of India reported that India had adopted only 21 IAS in comparison to the 47 IAS adopted by several developed countries. (Press Trust of India, 2007). In July 2007, the council of the ICAI announced a plan to converge the Indian Accounting Standards with the International Financial Reporting Standards (formerly IAS). However, it retained the stipulation that any modifications will still have to reflect “ Indian conditions. ” (Deloitte, 2007). The new standards will be effective on or after April 1, 2011. Our study of the Indian accounting system in conjunction with the International Accounting Standards indicates the importance of developing comparable financial statements in emerging economies with those of the developed world.

In India, the political and social impediments need to be tackled in order to improve comparability for financial statement users. On the Business Competitiveness Index, India is ranked 48th among industrial countries. By conforming to international standards, India would be taking the necessary

steps to improve its competitive position in world markets. References

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