Accounting standards and the globalisation of Indian businesses

Firms are increasingly raising capital and attracting major investors from outside their home countries. A handful of firms in India are participating in this trend, raising capital in North American and European markets and attracting foreign institutional investors to India. But India has by no means realised its full potential with respect to attracting foreign capital. The country's low-cost, high-quality human resources afford Indian companies a unique competitive advantage. But to fully leverage this advantage they need to attract more foreign capital from the global financial markets.

Accounting standards are crucial to effective participation in the global market. Academic research has shown that foreign investors are attracted to firms that use accounting standards with which the investor is familiar. Foreign investors evaluating Indian companies as investment choices are thus likely to exhibit a strong preference in this direction. A broader investor base attracted by familiarity with indigenous firms' accounting information will lower the cost of capital for Indian firms, even more so when these firms adopt an entire set of accounting standards. This is consistent with recent research that suggests the cost of capital is lowered for firms that adopt international accounting standards (IAS)*.

Accounting standards around the world are converging. This had been occurring slowly, but the process has speeded up dramatically over the last few years in response to the European Union's decision to require IAS for all firms in its jurisdiction. This decision also seems to have placed IAS firmly in the driver's seat as the eventual global standard. Canada, Australia, and a number of other countries have announced intentions to adopt IAS. Even the United States, which has long shown a preference for maintaining its independent standards setting body, is evidencing interest in recognising a set of international standards. The International Accounting Standards Board and U.S. Financial Accounting Standards Board are working together to harmonise the IAS and US GAAP.

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That globalisation is a crucial force in the world economy today is evident in firms' operations. Companies are outsourcing their back office operations and software development to India, setting up large manufacturing facilities in East Asia, recruiting talented managers from a global human resource pool, and marketing their products the world over. This change in operations is mirrored by an equally dramatic globalisation of financial markets.


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*The International Accounting Standards Board has created a set of standards to provide international guidance. Originally known as International Accounting Standards (IAS), more recently created standards are referred to as International Financial Reporting Standards (IFRS). Throughout this discussion we use IAS to refer to the body of standards that includes both IAS and IFRS.

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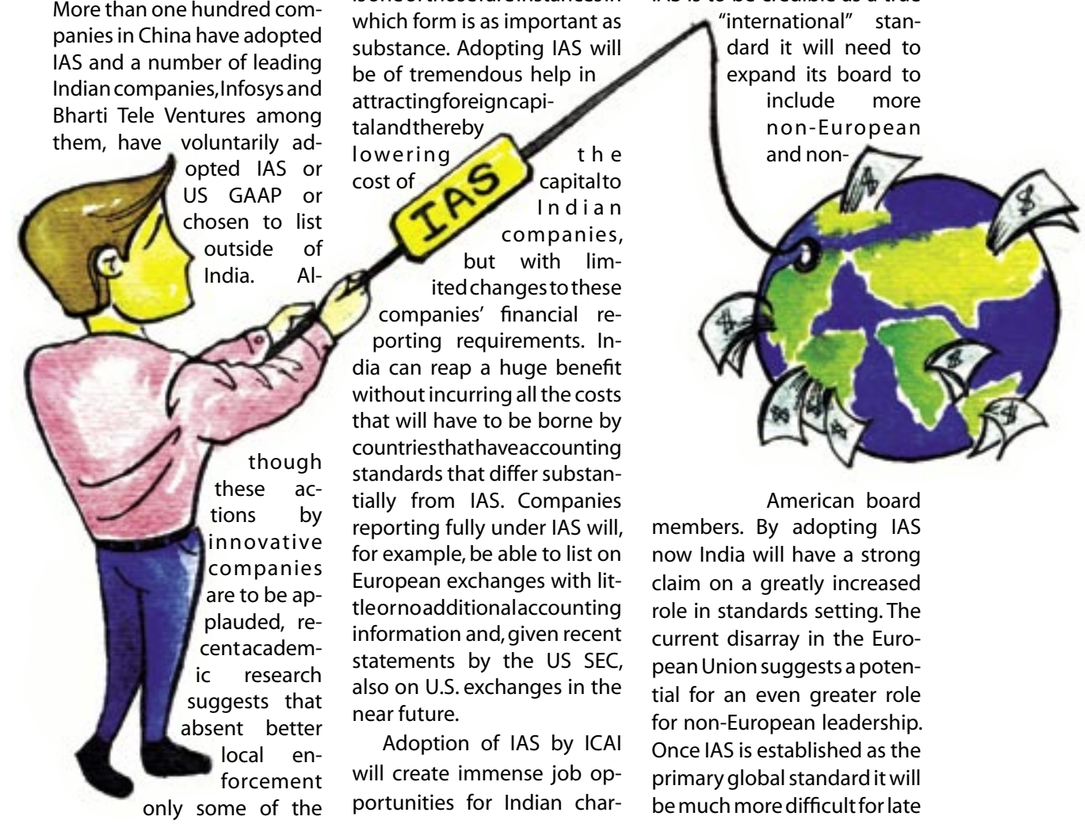
The US SEC also recently indicated that it will likely relax accounting reconciliation standards for firms reporting under IAS.

IAS is also receiving support from individual companies in countries that have not yet adopted the standard. More than one hundred companies in China have adopted IAS and a number of leading Indian companies, Infosys and Bharti Tele Ventures among them, have voluntarily adopted IAS or US GAAP or chosen to list outside of India. Although these actions by innovative companies are to be applauded, recent academic research suggests that absent better local enforcement only some of the benefits of adopting IAS or US GAAP are likely to be realized. Part of this enforcement involves having auditors and oversight agencies that are familiar with IAS, a goal most effectively reached if IAS is the standard for a country.



The case for ICAI adopting IAS

Current Indian accounting standards are of good quality, in most instances, in fact, are practically the same as IAS. A switch to IAS would be a switch more in form than substance. Yet many foreign investors are not aware that Indian accounting standards and IAS are practically the same. This is one of those rare instances in which form is as important as substance. Adopting IAS will be of tremendous help in attracting foreign capital and thereby lowering the cost of capital to Indian companies, but with limited changes to these companies' financial reporting requirements. India can reap a huge benefit without incurring all the costs that will have to be borne by countries that have accounting standards that differ substantially from IAS. Companies reporting fully under IAS will, for example, be able to list on European exchanges with little or no additional accounting information and, given recent statements by the US SEC, also on U.S. exchanges in the near future.

Adoption of IAS by ICAI will create immense job opportunities for Indian chartered accountants the world over. Already reputed to be well trained, Indian chartered accountants well versed with IAS are more likely to be hired by employers and businesses worldwide and more accounting work be readily outsourced to Indian chartered accounting firms.

ICAI's adoption of IAS now will enable India to shape the standard in the future. Already there is a proposal that Europe, by virtue of having adopted IAS first, should have more say in setting future IAS. If India, too, is an early adopter it will have a more legitimate claim to shape future IAS. In fact, many experts argue that if IAS is to be credible as a true "international" standard it will need to expand its board to include more non-European and non-American board members. By adopting IAS now India will have a strong claim on a greatly increased role in standards setting. The current disarray in the European Union suggests a potential for an even greater role for non-European leadership. Once IAS is established as the primary global standard it will be much more difficult for late

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adopting countries to influence the standards setting process. ICAI needs to take advantage of the window of opportunity that exists today.

The ICAI is in a unique position as it is in charge of setting accounting standards, training chartered accountants who will prepare the statements according to those standards, and enforcing the adoption of accounting standards as part of the attesting function of external auditors. In many countries these functions are split over several different entities, often with incentives and institutions that make coordination difficult. Academic research having documented the importance of the enforcement of accounting standards, immense benefits might accrue to India from ICAI's adoption of IAS that other countries might find difficult to replicate.

India's adoption of IAS is inevitable. When the whole world is adopting one language it will not be possible to hold out for too long. The case is clear: India needs foreign capital; foreign capital providers demand IAS. Sooner, voluntary adoption by ICAI is better than later, mandated adoption. Far better that ICAI voluntarily adopt IAS than be mandated to do so by the Ministry of Finance or SEBI. Voluntary adoption will afford ICAI more flexibility. An analogy might be made to the adoption of pollution standards by the automobile industry in India. If they had voluntarily adopted emission standards Indian automobile manufacturers could have pre-empted the imposition of Euro norms by India's judiciary.

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The ICAI might also use the flexibility afforded by voluntary adoption to manage the transition to IAS in a smooth manner. ICAI could mandate, for instance, that only companies that exceed a specified size need adopt IAS initially and provide smaller companies more time to make the switch.

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Conclusion

The ICAI finds itself with a rare opportunity to shape the financial destiny of India. It does not need governmental approval and can act expeditiously on its own to adopt IAS. Such adoption could have a huge positive impact on the Indian economy by affording more Indian companies access to foreign capital and lowering the cost of capital to Indian companies generally. It will also create vast opportunities for Indian chartered accountants all over the world. Finally, it could enable India to play a crucial role in creating future IAS.

Will the ICAI rise to this challenge? ❐