Indian Accounting Standard and its Practices – A Study

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Abstract

This paper studies corporate governance standards contributes to the existing literature by using the Ohlson (1995) pricing model as a measure to capture earnings management between related parties in Indian firms, but it has a few limitations. India lacks measures of corporate governance, and this study used corporate governance ratings of the top 500 companies as a proxy for corporate governance practices in Indian firms. A comprehensive measure of governance practices needs to be developed for Indian firms.Companies manipulate earnings (Jian and Wong 2010; Goel 2016). The Enron and WorldCom scandals in the United States, and the collapse of Satyam Computer Services in India, which cost Indian shareholders $1.47 billion, focused the attention of researchers on earnings management practices and raised alarm over the quality of the reported earnings of Indian corporate houses and business groups and the effectiveness of corporate governance mechanisms in India (Ajit et al 2013; Bertrand et al 2002).

Key words International Accounting Standard & Indian Accounting Standard, GAAP

Introduction

Asian economies were rapidly integrating with global markets and undergoing structural change, and their inclination towards value relevance in accounting practices was even stronger. The market settings of Asian economies are unique, and their capital markets are evolving fast, and these offer governance practices and reporting standards new challenges. These changing paradigms make it imperative to pay attention to value relevance, as paying attention to value relevance may reduce informational asymmetry and minimise the adverse selection problem of investors (Lundholm and Van Winkle 2006).

Objective:

This paper intends to explore Corporate Governance, accounting practices its harmonization issue, its current status, challenges with special reference to Indian perspective.

In emerging economies, earnings management practices pose a severe challenge. Good governance reduces the practice of earnings management (Buniamin et al 2012), and legal and regulatory reforms are needed to curb insider abuse and safeguard the minority interest (Jiang et al 2010; Rajagopalan and Zhang 2009).

One of the distinguishing characteristics of a modern corporation is the dichotomy of ownership and control (Berle and Means 1932); owners rarely participate in day-to-day activities. Agents may act in their interests against the owners' and lead a firm to practise earnings management—the "agency problem." Enforceable contracts protect owners from such conflicts of interest, but these give rise to "agency cost" (Jensen and Meckling 1976). Such conflicts

of interest motivate many corporate governance studies that analyse how corporate governance can mitigate the agency problem and agency cost (Shleifer and Vishny 1997). Some of these studies corroborate that better corporate governance mechanisms reduce the practice of earnings management in companies (Sarkar et al 2008; Shan 2015). It is hypothesised that, ceteris paribus, good corporate governance mechanisms are negatively associated with earnings management (Hypothesis 2).

In attempting to understand the domino effect in terms of value relevance, earnings management, and corporate governance in India, this paper addresses two key research questions: Does the practice of earnings management affect value relevance? Do corporate governance practices limit the earnings management practice of Indian firms? In this study, earnings management is operationalised through related party transactions, which may be both normal and abnormal. Lo and Wong (2011) report incentives for using abnormal related party transactions (ARPT) for managing earnings, following the Jian and Wong (2010) model, and this study uses ARPT as a proxy for earnings management.

After adjusting for heterogeneity and removing outliers using the standard deviation method (3σ), the results of the random effect models are estimated for the value relevance and earnings management models (Table 4). Panel A reports the estimated results of Model 1 of the value relevance equation: the book value per share (coefficient value = 2.48, $p < 0.00$) and EPS (coefficient value = 6.41, $p < 0.01$) are positively and significantly related to the stock price of the firm. Table 4 presents the results of Hypothesis 1—whether ARPT as a proxy for earnings management reduces the level of value relevance. Panel A in Table 4 reports that ARPT is negatively associated with the stock price, a proxy for value relevance (coefficient value = -0.34). The relationship is also statistically significant at $p<0.001$, thus supporting Hypothesis 1. The interaction between EPS and ARPT is found to be statistically significant (coefficient value = -0.12, $p<0.001$). These results are inconsistent with previous studies (Chen et al 2001; Ge et al 2010). The model fit reports R^2 and adjusted R^2 of 0.289 (0.286) for the value relevance equation, and the F-statistics are found statistically significant at an appropriate level ($p<0.00$).

Panel B in Table 4 reports the estimated results of regression Model 2 of the earnings management equation. It tests whether a good governance mechanism operationalised by corporate governance ratings is related to earnings management as measured by ARPT in Indian firms (Hypothesis 2). The results show that corporate governance ratings are negatively and significantly related to earnings management (coefficient value = −1.62, $p<0.01$), thus supporting Hypothesis 2. These results are consistent with the related empirical study of Shan (2015), which finds that an improvement in governance mechanisms moderates Chinese firms' practice of earnings management. Firm size and risk are positively related at an appropriate significant level of $p < 0.00$ and $p < 0.001$. The model fit reports R^2 and adjusted R^2 at 0.503(0.497), and the F statistics are statistically significant ($p <0.00$).

Conclusion

earnings management through related party transactions reduces the value relevance of accounting information and good governance mechanisms are likely to restrain earnings management in Indian firms. The study employs a random effects regression model to test the hypotheses, and the results support both hypotheses. These findings have important implications. Accounting information is relevant to the stock prices of listed companies in India, and improving the reporting standards of accounting information would raise investor confidence in the authenticity of the reported and

published financial statements. Good corporate governance practices can limit earnings management in Indian firms. Policymakers and regulators can use these findings as signals to undertake reforms or policy initiatives in governance practices, and they can promulgate improved standards of codes and guidelines on governance practices concerning related party transactions to moderate the earnings management practices of Indian firms.

Auditors play a role in cases of earnings management; they are legally obligated to reporting wrongdoings. However, corporate scandals like Satyam Computer Services were a result of the collusion of promoters and auditors. The SEBI levied a penalty on PricewaterhouseCoopers, the auditors, and banned them from their audit practice for two years, but such cases point towards the systemic problem in the audit process. Are we waiting for a second Satyam in the making? However, SEBI seems to be sending the message that governance practices need to be time-variant to accommodate the changing dynamism in the corporate sector strongly.

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