International Journal of Multidisciplinary Research and Development

Volume: 2, Issue: 6, 8-14
June 2015
www.allsubjectjournal.com
e-ISSN: 2349-4182
p-ISSN: 2349-5979
Impact Factor: 3.762

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Conservatism analysis on Indian Generally accepted accounting principles (GAAP) and International Financial Reporting (IFRS)

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Abstract
The quality of accounting information is the basic objective every accounting standards aims to achieve. It is therefore essential to found out the level of conservative and prudence between AS and Ind.AS (IFRS)
This study has measured the accounting information quality between AS and Ind.AS (IFRS) by using Gray's Index of Conservatism (GIC) on 5 years consolidated financial statement. F-test and T-test were used to test the hypothesis.
It was found that IFRS provides current and quality information on liquidity ratios than AS reporting. However there was a mix results on the quality of accounting information on leverage.
In general all the profitability ratios GIC signify that, the computed ratios of AS are higher than IFRS ratio in both companies inferring that IFRS is conservative and prudent in profitability reporting, hence accounting information on profitability ratio per IFRS is quality than AS ratios. The hypothesis testing results indicates that averagely the impact of IFRS adoption have similar impact on accounting ratio of both companies but at different timings
The study therefore concludes that Ind.AS will provide current and quality accounting information on accounting ratios but the quality level will not be same over the years.

Keywords: AS CIP, Ind.AS and IFRS

Introduction
The announcement of the long waited MCA notification on the implementation of converged IFRS standard in India has not only set grounds for research but it has also tasked researchers and professionals to provide insight projections on the new standard.
While various articles including government publications have explain the difference between Indian version of IFRS and the global IFRS, they do not address the impact on accounting values. It is very obvious that, there is much difference between IFRS and Local GAAP as well as the converged Ind.AS. In fact this first sight impression has been supported by various articles by global auditing firms such as PWC, KPMG, Deloitte and EY.
Unfortunately majority of these studies are geared towards a simple theoretical comparison between IFRS and Local GAAP, without any empirical interpretation. But the big question which is let unanswered is what changes do these differences bring to quality and relevance of on financial statements and accounting ratios information? Are these differences in value same over the years? Is the impact IFRS same for all companies? What inference should investors makes for future projections?
To find answers to these questions this study has measured accounting information quality between the standards with the aid of Gray's Index of Conservatism on Infosys Technologies Limited and Tata Motors Limited that are reporting under IFRS. These two companies represent the two important industries of Indian economy; IT and Automobile respectively

1.2. The Concept of Conservatism
The US financial Reporting Standard Board defines conservatism as a prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered. Bliss 1924 also defines accounting conservatism as the anticipation of all losses but no profit whereas Basu 1997 explains accounting conservatism as capturing accountants' tendency to require higher degree of verification for recognising good news than bad news. This asymmetry in recognition leads to systematic difference between bad news and good news periods in the timeliness and persistence of earnings.

Ball et al (2007) classifies accounting conservatism from prior research into balance sheet conservatism and earnings conservatism. Balance sheet conservatism as defined by Feltham and Ohilson (1995) is the persistent undervaluation of shareholders equity book value. Earning conservatism on the other hand is resulting in earnings reflecting bad news more quickly than good new Accounting conservatism is recognising more current value relevant news in earnings and leaving less current value in future earnings (Basu1997).

2.0 Literature Review

Due to the wide spread use of IFRS across the world, both academicians and professionals are continuously study is global accounting standard waves across country level and national boundaries. Whiles some are looking at the challenges and issues of implementing, others are empirically testing of impact of IFRS to account information quality and accounting valuation especially on domestic firms.

Jain Zhang (2011) used Basu's model to measure the impact of IFRS adoption on accounting conservatism in New Zealand. He found the existence of conditional conservatism for both pre and post adoption of IFRS. IFRS increase the accounting conservatism in New Zealand. But the improvement of accounting conservatism was experience by mandatory adopters but not for voluntary adopters after the IFRS adoption. It was therefore concluded that the adoption of IFRS in New Zealand has positive impact on earnings quality

In a study on companies in 15 member states of European Union (EU) before and after the full adoption of IFRS in 2005, Chen et al (2010) found that IFRS improve majority of Accounting Quality indicators. The research also showed that there is less of managing earnings towards a target, a lower magnitude of absolute discretionary accruals and higher accruals quality. Further, they found, that the improved accounting quality is attributable to IFRS, rather than changes in managerial incentives, institutional features of capital markets and general business environment.

A study by Barth et al (2008) on 1,896 firms in 23, countries supports the fact that IFRS increase the accounting quality than the previously used local GAAP. They found that IFRS users are exposed to less earnings management, more timely recognition of losses, and more value relevance of accounting amounts than those entities using only domestic GAAP.

Tendeloo and Vanstraelen (2005) argue against the reporting quality of IFRS. They indicated diverse earnings management performance under IFRS reporting compared to German GAAP reporting.

Paananen and Li 2009 also agree with the low quality reporting of IFRS by saying that, IFRS does not decrease net income smoothing. Moreover, IFRS does not show significant improvement in value relevance (Gjerde et al 2008). Hung and Subranmanyam (2007) also did not find any consequence of IFRS adoption on value relevance of book value and net income.

3.0 Methodology

Since IFRS consolidated financial statement is a variable in this study, the sampling is limited to only companies that have presented consolidated financial statement under IFRS. Therefore a purposive sampling was used to select two companies, one representing the Automobile and Information Technology industries each; Tata Motors Limited and Infosys Technologies Limited respectively. These two industries are the dominating sectors within the Indian industries with many companies in them; hence an analysis on them will have a meaningful use within Indian context.

Although, more than two companies could have been used for analysis as done by Rahul and Ruchir (2013) it may not reflect the impact that this study seek to achieve. Combining more companies from different industries will yield average which is not the true reflection of the impact. Because, accounting standards is not use in equal manner among all industries, an average from different industries will be affected by extreme values. Again an item that will be operational revenue in one industry may be revenue from extra-ordinary items for another. To eradicate these problems, the study has taken only two companies for separate analysis. Each company was analysed separately to determine the possible impact on its respective industry.

Five (5) years consolidated financial statements of 2009/2010 to 2013/2014 prepared under both AS and IFRS were collected from on each company.

The financial statements for analysis are the profit and loss account and balance sheet. The AS financial statements are taken from the annual reports of the companies whiles the IFRS financial statements are taken from the Form 20F company fillings with the Security Exchange Commission of USA.

Unlike other researches such as Ibiamke and Ateboh (2014) and Callo and Lanez (2007) that take two financial statements under different standards from two different years, this study takes all set of financial statements from same accounting year. This ensures that the figures are comparable and the real impact is shown.

Since there is no Ind.AS financial statement, IFRS financial statements are used as proxy for Ind.AS on the following assumptions;

- From the second year onwards of the adoption of Ind.AS, because most of IFRS 1 and Ind.AS 101 difference is likely to eliminated afterwards.
- The textual difference is ignored
- The entity chooses the option which is same as IFRS where such choice is given by Ind.AS. For instances an entity recognise unrealised exchange difference (Ind.AS 21) on long term items in profit and loss rather than equity.

3.1 Accounting ratio analysis

Accounting ratios are computed to explain the proportionality between two accounting values. It is widely use accounting comparison tools. It usually forms the basis for any accounting valuation because of its simplicity and understandability. In consistent with literature; Ibiakme and Ateboh (2014), Callo and Lainez (2007), Bhargava and Shikla (2013), Rahul and Ruchir (2014) three main categories of ratios namely, liquidity, profitability and leverage are calculated from the financial statements. Details of each category of ratio are explained in table 4.1 below. The ratios are calculated individually for each set company. The calculated ratios are mapped against each other under between the different set of standard's financial statement to determine the impact.

The difference will be interpreted Gray's Index of Conservatism GIC) and the hypothesis is tested with the aid of F-test and T-test. As discussed early, India is moving from Local GAAP (AS) to Ind. AS (converge IFRS) in the next accounting years, hence stakeholders are curious about the impact of the new standard.

Table 4.1: Description of accounting ratios.

	Ratios	Definition	Interpretation
A	**Liquidity ratios**	Ratios to measure the ability of a company to generate or convert non cash assets to cash and cash equivalent to pay out debt and expense	
1	Current ratio	$\frac{Current\ assets}{Current\ liability}$	The number of times existing current assets can be used to pay existing current liabilities The higher the better.
2	Acid test	$\frac{Current\ assets - Inventory}{\text{Current liability}}$	The number of times, cash + bank + debtors can be used to pay current liabilities The higher the better.
3	Cash ratio	$\frac{Cash + cash\ equivalents}{Current\ liabilities}$	This is the true liquidity of a company. It shows how many times the company can generate cash flow to pay short term liabilities. The higher the better.
B	**Profitability Ratios**	Ratios constructed to measure the performance of a company based on the profit and earnings	
1	Return on asset ROA (Operating income approach	$\frac{Net\ income}{Total\ assets}\ X\ 100$	The percentage returns generated as operating for investing in assets
2	Net profit margin	$\frac{Net\ income\ after\ tax}{Total\ revenue}\ X\ 100$	It represent the percentage of revenue which is earn as net income after tax
3	Return on Equity ROE (Return on Equity)	$\frac{Net\ income}{Total\ equity}\ X\ 100$	The percentage of net profit from operating activities to total equity. It indicates the percentage equity gets from investment
C	**Leverage ratios**	These are set of ratios used to estimate the impact liabilities on the company's activities and performance.	
1	Debt-equity ratio	$\frac{Total\ long\ term\ liabilities}{Total\ equity}$	It shows the leverage of the company. The lower the better and less risky of the business
2	Debt security ratio	$\frac{Total\ Assets}{Total\ liabilities}$	The ability of a company to use its total assets as surety for its liabilities. The higher the better

3.2 Gray's Index of conservation

This is an index which was proposed by Gray in 1980 to find out whether some countries are more prudent than others as concerns accounting practices (Gray, S. (1980) was the first to quantify the impact of different national accounting practices on profit measurement by means of a „conservatism index": 1 - [(RA – RD) / |RA|], Where RA = adjusted profits and RD disclosed profits. Measuring the disclosed profit in French, German and UK against the profits adjusted for international financial analysis, Gray found that French and German companies" results were more conservative than the results of the UK companies.

Formula

$$1 - [\frac{(New\ GAAPnumbers - Previous\ GAAP\ numbers)}{New\ GAAPnumbers}]$$

The index expresses the normalised process of the distance between values of different accounting practice. The result of Gray Index (GI) is interpreted as follows.

GI = 1 means both accounting standards gives the same value. That is prudence is equal and conservatism is equal among the standards.

GI > 1 means the previous standard values are more than values pertaining to the new standard. Implying that, the new standard is more conservative and prudent than previous standards. From the qualitative perspective, the new standard provides quality and current information.

GI < 1 the new standard numbers are greater than the previous standard values. Implying that, the new standard is less prudent and conservative than the previous standard.

Gray went further to set a conservatism degree scale for various entities depending on the index value.

GI < 0.95 there is conservatism; the previous standard is more prudent than the new standards. There are also three sub divisions. That is below 0.5, between 0.5 and 0.74, 0.75 to 0.95.

0.95 < GI < 1.05 this is called neutrality region: that is the level of prudence or the values between the two standards are nearly equal or equal. (Sub divisions; 0.96 to 0.99, 1 and 1.01 to 1.05)

GI > 1.05 the optimism region (less conservative). The previous standard is less prudent and cautions than the new standard values. (Subdivisions 1.06 to 1.25, 1.26 to 1.50 and above 1.50)

Gray, S. (1980) work has been widely replicated and extended by several subsequent studies using company's form 20-F reconciliations to US GAAP (Cooke, T. (1993), Hellman, N. (1993), Weetman, P., & Gray, S.J. (1990)] among others.

Adams, et al (1993), applied the Gray's Index in comparing Finish national GAAP with IAS. Based on their Index results it was argued that Finnish shareholder's equity is more conservative than IAS adjusted shareholder's equity even though it was insignificant.

Gray's Index of Conservatism is used to determine which of the standard is conservative and prudent is reporting. The

index is also used to interpret the information quality level of the values provided by standard with reference to each other.

Formula $1 - [\frac{(IFRS\ values - AS\ values)}{IFRS\ values}]$

The index expresses the normalised process of the distance between values of different accounting practice. The result of Gray Index (GI) is interpreted as follows.

GIC = 1 means both accounting standards gives the same value. That is prudence is equal and conservatism is equal among the standards.

GIC > 1 means the previous standard values are more than values pertaining to the new standard. Implying that, the IFRS value is more conservative and prudent than AS standards.

GIC < 1 the new standard numbers are greater than the previous standard values. Implying that, the IFRS value is less prudent and conservative than the AS standards.

Following from Watt (2003) arguments that, higher accounting information quality would be accompanied by higher conservatism and less information asymmetry, this study interpret GIC from information quality perspective as follows;

GIC = 1 means both IFRS and AS accounting standards have same level of information qualities and both and includes current values in reporting. That is prudence is equal and conservatism is equal among the standards.

GIC > 1 means IFRS provides high quality information and current relevant values than AS. Implying that, the IFRS value is more conservative and prudent than AS standards.

GIC < 1 means IFRS provides less quality information and current relevant values than AS. Implying that, the IFRS value is less prudent and conservative than the AS standards.

There are arguments on which standard to be designated as the denominator or the base. Some scholars such as (Fifiled 2011, Hellam 2011) argue that the previous standard (Local GAAP) should be the denominator on the basis that it has been tested and proven. Istrate (2013) support this argument because the previous standards form the start of the analysis.

Although the original formula by Gray (1980) which uses new standard values as the denominator has been supported by early users such as Weetman, Adams etc, the vibrant of previous standards is currently dominating in literature.

This study follows the original Gray's Index by using the new standard (IFRS) standards as denominator. IFRS is designated as the denominator in parallel with previous studies like Ibiamke and Ateboh (2014) and Tsalraouts and Evans (2010). It is assumed that IFRS is of high quality than the AS.

Notwithstanding, the widely use of the Gray's Index, there are some constraints on its use. Firstly the index gives absolute figures which can be extreme (Ibiamke and Ateboh (2014). For example if ratio under AS approaches zero and that of the Ind.AS is higher, the index will be very extreme. Secondly the index does not measure the level of significance of the difference between the two accounting standards. To overcome these problems the Sample T–test and the F-test are employed to test the hypothesis.

4.0 Development of Hypothesis

4.1 Hypothesis to test consistency among the years.

Since the difference in the standards has existed till date, it is assumed that the difference in their level of information quality will be same or consistent over the period. It is therefore expected that there will be no variations in the GIC among the years.

H_0: There is no variation in GCI among the years (Standard Deviation = 0) of both companies.

H_1 There is variation in GCI among the years (Standard Deviation > 0) of both companies

4.2 Hypothesis to test the impact between the companies

All companies in every industry apply the same set of standards within a country in reporting financial statements. It is therefore expected that all companies will experience same level of impact on its accounting information quality when there is new set of standards or change in the existing standards. On this assumption it is hypothesis that;

H_0: There is no difference in the GIC of Infosys Technologies Limited and Tata Motors Limited over the 5 years financial statements.

H_1: There is difference in the GIC of Infosys Technologies Limited and Tata Motors Limited over the 5 years financial statements.

Analysis and Discussion

5.0 Infosys Technologies Limited.

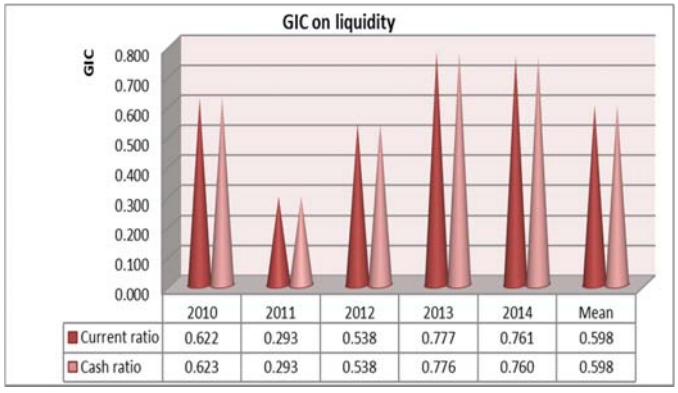
5.1 Gray's Index of Conservatism on liquidity (GIC)

The GIC confirms the higher values of IFRS calculate ratios because the GIC of all the liquidity items are less than 1.00. That is the ratio constructed from IFRS values are less conservative and prudent than ratio constructed as per AS.

Liquidity GIC < 1.00 also means that, IFRS shows higher liquidity position for Infosys Limited than AS. That is the ability for the company to pay out its debt and generate more cash and cash equivalent is higher according to IFRS statement than AS statement.

Here also, the GIC of current ratio and cash ratio are almost, same across the years. With the mean of 0.598 (which is less than 1.00), over the years, it can be said that, the IFRS constructed liquidity ratio has been higher and less conservative to constructed liquidity ratios, per AS throughout the 5 years period.

Further, IFRS provides current and quality information on liquidity of the company than AS reporting. *Figure 5.1* depicts that the GIC of both current ratio and cash ratio for 2013 and 2014 are similar, suggesting that, in recent times the conservative level between AS and IFRS have be constant.



	2010	2011	2012	2013	2014	Mean
Current ratio	0.622	0.293	0.538	0.777	0.761	0.598
Cash ratio	0.623	0.293	0.538	0.776	0.760	0.598

Fig 5.1: Gray's Index of Conservatism on liquidity (GIC)

5.2 Gray's Index of Conservatism on Leverage ratios (GIC)

Apart from 2012 and 2014 financial years, the GIC on debt/equity was less than 1.00 suggesting that, the IFRS computed ratios where higher than debt/equity ratios of AS financial statements. But the average of the 5 years GIC shows that AS computed ratio were higher and less

conservative as compared with the ratios from IFRS financial statements. This is due to the high GIC in 2012 making it an outliner year.

Excluding 2012 will bring the average to less than 1.00 making IFRS less conservative. Asset to liability ratio analysis resulted in GIC less than 1.00 implying that the ratio between total assets and total liability is less conservative as per IFRS. The ratios calculated from IFRS financial statement were higher than AS ratio.

The mean of 0.686 signals that, over the 5 years period, IFRS asset/liability ratio was less prudent and conservative than AS. IFRS estimate high leverage on Infosys Limited. The *figure 5.2* below gives a picture that, GIC on asset/liability in 2011 and 2012 were closer but that of 2013 and 2014 were almost same.

In general, it can be suggested that over the years the leverage ratios of IFRS were higher than AS, meaning that AS was more conservative and prudent on the computation of leverage ratio.

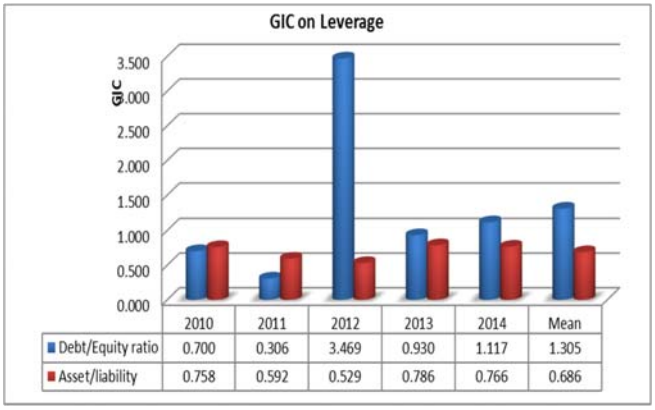


Fig 5.2: Gray's Index of Conservatism on Leverage ratios (GIC)

5.3 Index of Conservatism on profitability ratios (GIC)

Both the net profit margin and return on asset average are close to 1.00 suggesting that the level of conservative and prudence on AS and IFRS are similar. That is there no much difference in ratios between AS and IFRS. The return on equity on the other hand has quiet higher GIC as compared with the other profitability ratios. In general all the profitability ratios GIC signify that, the computed ratios of AS are higher than IFRS ratio except for return on assets in 2012. This implies that IFRS is conservative and prudent in profitability reporting. The standard deviation of the profitability index demonstrates that the variation of GIC across is very less. This means that, GIC from one year to another can be predicted to some extent.

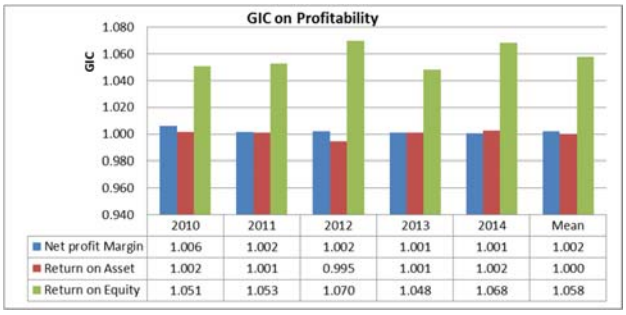


Fig 5.3: Gray's Index of Conservatism on profitability ratios (GIC)

6.0 Tata Motors Limited

6.1 Gray's Index of Conservatism (GIC) on liquidity

The high reported cash and cash equivalent by AS financial statement is also reflected in the GIC on cash ratio (GIC is greater than 1.00) throughout the study period. Unlike the decreasing pattern of CIP the GIC is depicting an increasing trend, implying that the level of conservatism between AS and IFRS has been improving from 2012 – 2014.

On a whole, the computed liquidity ratios of AS financial statement are higher than IFRS computed ratio, however, the ratios from IFRS financial statement are more conservative and prudent in reporting. From the qualitative of accounting information, the IFRS liquidity ratios reflect current value hence is of more quality because is conservative and prudent.

The difference between current ratio and acid test ratio across the yeas suggest that inventory measurement and recognition variation between AS and IFRS have impact on the liquidity ratios, of the company especially for manufacturing firms like TATA MOTORS

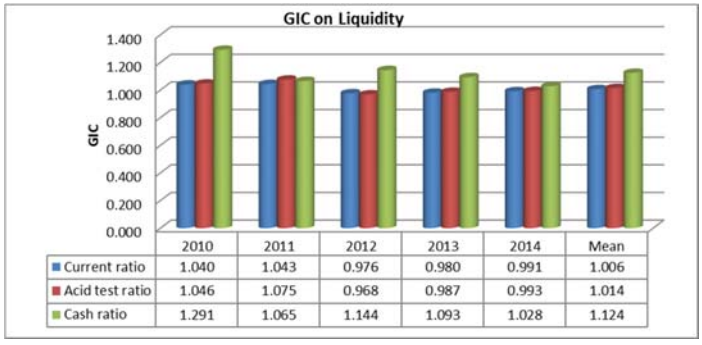


Fig 6.1: Gray's Index of Conservatism on liquidity (GIC)

6.2 Gray's Index of Conservatism on Leverage ratios (GIC)

The liability/equity ratio of IFRS was conservative and prudent than as ratio on 2010 and 2012 because the GIC in both years over less than 1.00. In the same way, the average of all the years shows that the calculated ratio of IFRS financial statement is higher than that of AS liability/equity ratio.

Meaning that the IFRS is conservative and prudent on of liabilities/equity ratio and IFRS ratio represent quality information. The GIC asset/liabilities ratio on the other hand suggest that the IFRS ratio where higher from 2010 to 2013, hence it was less conservative and less in quality in current values.

This pattern reflected an average GIC of 0.973. It can be said that, the level of conservatism between AS and IFRS on leverage ratio are very close to 1.00 implying that their level of conservatism on average are similar and the information quality level are close, therefore their ratios can be compared.

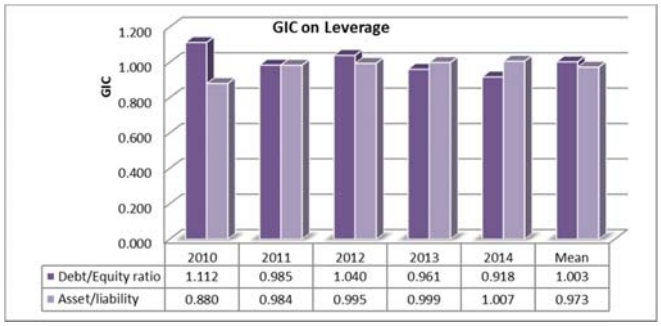


Fig 6.2: Gray's Index of Conservatism on Leverage ratios (GIC)

6.3 Gray's Index of Conservatism on profitability ratios (GIC)

GIC of the profitability ratio have been getting closer to 1.00 over from 2011-2014. Thus the level of conservatism and prudent between AS and IFRS profitability ratio are coming together because the GIC between the two set of standard's ratio's has decreasing from 1.250 in 2011 to 1.078 in 2014. With the exception of 2010 financial year, the profitability ratios of AS in the following years are higher than in value and less than in conservatism as compared with the computed IFRS profitability ratio.

This means that, the accounting information on profitability ratio per IFRS is quality than AS ratios. The average of the three selected profitability ratio indicates that, for the five (5) years period the AS ratio has be higher than the ratios constructed from the IFRS financial statement.

This suggests that IFRS has been conservative and prudent in the profitability ratio than AS computed ratios. However as depicted on the graph, there is no consistency in the GIC of any profitability ratio. This is also supported by the non-zero standard deviation (STD > 0). Therefore it can be said the GIC of the profitability ratio varies from year to year.

7.0 Hypothesis Testing Results

Sample T-test is also used to find out if the 5 years average CIP of the Infosys Technologies and Tata Motors limited are same or otherwise at 5% significant level. Since both companies apply same accounting standards, it is expected that on average both companies will experience same impact.

The results are presented in the last column of table 7.1. The T-test results shows that the 5 years average on, current ratio, debt/equity and profitability of both companies are similar and significant at 5% level. This implies that, averagely the impact of IFRS adoption have similar impact on those items for both companies

The F- test statistical tool is used to test the hypothesis that, the variation of IFRS impact on Infosys financial statement and that of Tata Motors over the years are the same at 5% significant level.

The results presented on table 7.1 below shows that there are variations between the years of Infosys and Tata motors information quality level on ratio are significantly other than, cash ratio and Asset/liability ratio.

This implies that the impact of IFRS adoption and convergence in a country affects companies differently and at different financial year.

	Mean		Standard Deviation		F-Test	T-Test
Items	**Infosys**	**Tata**	**Infosys**	**Tata**		
Current ratio	0.598	1.006	0.197	0.033	0.004	0.004
Cash ratio	0.598	1.124	0.197	0.102	0.233	0.233
Debt/Equity ratio	1.305	1.003	1.247	0.075	0.000	0.000
Asset/liability	0.686	0.973	0.117	0.052	0.148	0.148
Net profit Margin	1.002	1.046	0.002	0.238	0.000	0.000
Return on Asset	1.000	1.054	0.003	0.214	0.000	0.000
Return on Equity	1.058	1.091	0.010	0.200	0.000	0.000

Table 7.1: Results on Hypothesis Testing

8.0 Conclusion

This study has measured accounting information quality between the AS and Ind.AS (IFRS) with the aid of Gray's Index of Conservatism by using Infosys Technologies Limited and Tata Motors Limited as sample companies. The analysis reveals the following results;

IFRS provides current and quality information on liquidity than AS reporting in both Infosys and Tata Motors

For Infosys Technologies limited, the leverage ratios of IFRS were higher than AS, meaning that AS was more conservative and prudent on the computation of leverage ratio.

However the IFRS conservative and prudent on of liabilities/equity ratio and IFRS ratio represent quality information in Tata Motors. But the level of conservatism on average are similar and the information quality level between the two standards are close, therefore their ratios can be compared

In general all the profitability ratios GIC signify that, the computed ratios of AS are higher than IFRS ratio in both companies inferring that IFRS is conservative and prudent in profitability reporting, hence accounting information on profitability ratio per IFRS is quality than AS ratios.

The hypothesis testing results indicates that averagely the impact of IFRS adoption have similar impact on accounting ratio of both companies but at different timings

The study therefore concludes that Ind.AS will provide current and quality accounting information on accounting ratios but the quality level will not be same over the years

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