

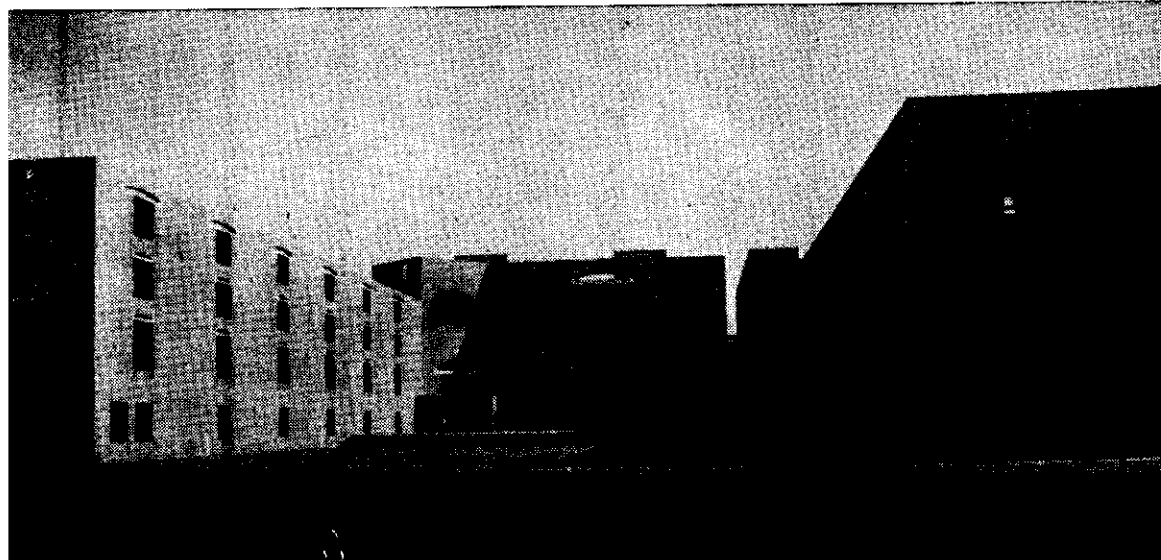


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# Working Paper



ACCOUNTING POLICY CHOICES:  
SOME EMPIRICAL EVIDENCE

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INDIAN INSTITUTE OF MANAGEMENT  
AHMEDABAD

# ACCOUNTING POLICY CHOICES: SOME EMPIRICAL EVIDENCE\*

by  
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We can broadly classify the users of accounting information into two categories—internal and external. Among the external users we can identify tax authorities as a distinct class. Theoretically there is a substantial difference in the objectives, the principles and basis underlying the information required for these uses (Figure 1).

Figure 1: Framework of Accounting Policy Choice

<u>Purpose of Accounting Data</u>	<u>Basis</u>	<u>Principles</u>	<u>Objectives</u>
1. For external reporting	Financial Accounting	<ul style="list-style-type: none"><li>- Legal requirements under the Companies Act</li><li>- Generally accepted/reported accounting principles</li></ul>	Maximization of the externally reported EPS, DPS, and hence market price of the shares
2. For internal reporting	Management Accounting	<ul style="list-style-type: none"><li>- Policies of individual managements</li><li>- Guidelines for 'cost audit'</li></ul>	Motivation and evaluation tool so that corporate objectives are achieved. Information for decision making
3. For tax reporting	Tax Accounting	<ul style="list-style-type: none"><li>- Legal requirements of the income-tax act</li><li>- Court judgements</li><li>- Generally accepted/reported accounting principles</li></ul>	Minimisation of tax burden Maximization of tax avoidance; Easing the firm's cash flows

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This implies that corporations do use different reporting practice for different users. The difference in reporting emanates from the difference in the treatment of certain items. We have identified a few areas where there is scope for treating these items differently for external, internal and tax reporting. The objective of the study is to look into how for companies choose different accounting policies for different users. For example in the case of depreciation only declining balance method is allowed for tax purposes. Companies may prefer straight line method to reduce the fluctuations in reported income. And for internal purposes perhaps annuity method may be more useful.

Given the basis for different accounting policies for different statements we wanted to empirically find out whether corporations use different accounting policies for different reporting. There are a number of areas wherein alternate accounting policies are used. We identified the following major areas:

1. Inventory valuation
2. Depreciation on fixed assets
3. Amortisation of Research and development expenditure
4. Gratuity
5. Expenditure on training and development of employees
6. Amortisation of other intangible assets
7. Recognition of income from shipping/contracts etc.

A questionnaire was prepared (Exhibit 1) incorporating the above aspects and were sent to the top 101 private corporations. But the response was not very good. Twenty five companies returned the questionnaire duly filled and one company intimated their inability to fill the questionnaire due to their pre-occupation with new projects. Even though the sample size is not very high it contains a good variety of companies. A list of companies who responded to the questionnaire is given in Exhibit 2.

From the responses we analysed the accounting policy choices under various heads.

1. Inventory Valuation: Twenty four out of the twenty five respondents had answered to the questions relating to inventory valuation. Out of them 20 companies used the same method for internal, external and tax purposes, eventhough there was a wide difference in the method used by each company. The methods used included FIFO, weighted average cost, average cost and a combination of these. Surprisingly none of the above 20 companies used LIFO method. This may partly because of the fact that LIFO's acceptability for tax purpose is not certain.<sup>1</sup> Only four companies had

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<sup>1</sup> Minister of National Revenue Vs. Anaconda American Brass Ltd., 30 ITR 84 (PC)

some deviation for internal reporting purposes though the external and tax reporting was same. For internal purposes LIFO, standard costs and replacement value were used by four companies whereas weighted average or average cost were used for external and tax purposes. From the above it is clear that as far as inventory valuation is concerned there is no difference in the accounting policy choice for external and tax purposes. Further the absence of LIFO strengthens the hypothesis that tax accounting is the major guiding factor in choosing external accounting policy. Another major inference that one can draw is that the function of managerial accounting has not taken a deep route in the organisations. The relevant policies for control and decision making like standard cost and replacement value basis were used by only five companies. The summary results are given in Table 1.

Table 1: Inventory Valuation  
(Number Responded: 24)

Table 1.a: Summary of Responses

Method Purpose	FIFO	Weigh- ted Average Cost	Average Cost	Combi- nation of 1,2 and 3	Stand- ard Cost	Cost (Un- defi- ned)	LIFO	Repla- cement Value	Total
Internal	7	2	7	4	1	1	1	1	24
External	7	4	7	4	-	2	-	-	24
Tax	7	4	7	4	-	2	-	-	24

Table 1.b: Differences across use

Method	Inter- nal only	Exter- nal only	Tax only	Internal External and Tax	Internal and External only	External and Tax only	Tax and Internal only
FIFO				7		2	
Weighted Average Cost				2		2	
Average Cost	1			6		1	
Combination of above				4			
Standard Cost	1						
LIFO	1						
Cost (Un- defined)				1		1	
Replacement Value	1						
	4	-	-	20	-	4	-

Depreciation: In the area of depreciation the picture was different from that of inventory valuation. Out of the 25 companies only 3 companies used the same method for internal, external and tax reporting. As far as tax reporting is concerned there was no choice as only the declining balance method is allowed. This however did not inhibit companies from choosing alternate methods for internal and external

reporting. Only seven companies followed the same method for tax and external reporting out of which four companies had different method for the internal reporting. There were two companies which followed different policies for internal, external and tax reporting. Four companies used a policy for internal reporting which was different from their external and tax reporting policy. Three companies have used inflation adjusted depreciation for their internal purposes. The summary results are given in Table 2.

Table 2: Depreciation

(Number Responded:25)

Table 2.a: Summary of Responses

Method Purpose	WDV	Straight line	Combina- tion of WDV and Straight line	Inflation Adjusted	Total
Internal	3	17	2	3	25
External	7	16	2	-	25
Tax	25	-	-	-	25



Table 2.b: Differences Across Use

Method	Inter- nal only	Exter- nal only	Tax only	Internal External and Tax	Internal and External only	External and Tax only	Tax and Internal only
WDV			18	3		4	
Straight Line	3	2			14		
Inflation adjusted	3						
Combination of WDV Straight Line					2		
	6	2	18	3	16	4	-

Research and Development Expenditures: Twenty three companies have responded to the questions relating accounting treatment of Research and Development expenditures. All but one company used the policy of writing off in the same year for tax purposes. However eleven of them were using different policy for their external and internal reporting. Nine companies were using common policy for internal and external reporting. Only two companies used different policies for each of the different reporting purposes. They were using inflation adjusted method for internal reporting. For

external reporting they have adopted straightline and WDV method whereas for tax purposes the expenditure was written off in the same years. The summary results are given in Table 3.

Table 3: Research and Development Expenditure  
(Number Responded: 23)

Table 3a: Summary of Responses

Method Purpose	Written off in same year	WDV	Straight Line	Combina- tions of 1,2and3	Infla- tion adjusted	Total
Internal	11	3	6	1	2	23
External	11	5	6	1	-	23
Tax	21	2	-	-	-	23

Table 3.b: Differences across Uses

Method	Inter- nal only	Exter- nal only	Tax only	Internal External and Tax	Internal and External only	External and Tax only	Tax and Internal only
Writing off in same year			10	11			
WDV		1	1		3	1	
Straight- line	1	1			5		
Inflation adjusted methods	2						
Combina- tion of methods 1,2&3					1		
	3	2	11	11	9	1	-

The summary result of accounting policy choices in case of Gratuity, training and development expenses and intangible assets like huge expenditure on advertisement and sales promotion etc., are given in tables 4, 5 and 6 respectively.

Table 4: Gratuity

(Number responded: 25)

Table 4.a: Summary of Responses

Method Purpose	Cash basis	Actuarial basis	Standards	Total
Internal	6	18	1	25
External	8	17	-	25
Tax	10	15	-	25

Table 4.b: Differences across Use

Method	Inter- nal only	Exter- nal only	Tax only	Internal External and Tax	Internal and External only	External and Tax only	Tax and Internal only
Cash basis			3	5	1	2	
Actuarial basis	2		1	13	3	1	
Standards	1						
	3		4	18	4	3	-

Table 5: Training and Development Expenditure

(Number Responded: 25)

Method	Internal only	External only	Tax only	Internal External and Tax and Tax	Internal and External only	External and Tax only	Tax and Internal only
Same year write off				24			
Capitalised Amortisa- tion method				1			
Unspeci fied							
				25			

Table 6: Other Intangible Assets

(Number Responded: 25)

Table 6.a: Summary of Responses

Method Purpose	Write off in same year	Straight line	WDV	Total
Internal	20	5	-	25
External	19	6	-	25
Tax	21	3	1	25

Table 6.b: Differences across use

Method	Internal only	External only	Tax only	Internal External and Tax	Internal and External only	External and Tax only	Tax and Internal only.
Same year			2	18	1		1
Straight-line		1		3	2		
WDV			1				
	-	1	3	21	3		1

From the tables we see that as far as training and development expenditure is concerned all companies were following the same method for internal, external and tax reporting. Only one company has indicated that they capitalised if the training is not of a regular nature and of enduring benefit. However, the method of amortisation was not given. In the other two items also eventhough there were different accounting policies practised, many companies followed uniform policy for their internal, external and tax reporting.

Of the twenty five companies, only four companies had income from long term contracts. All the companies used uniform method for their internal, external and tax reporting.

### CONCLUSION

From the above analysis certain broad generalisations can be made:

1. If the tax authorities stipulate only one type of policy for tax purposes then companies do use different accounting policies for internal and external reporting. But if for tax purposes alternate policies are allowed then companies tend to follow uniform accounting policies for tax, external and internal reporting.
2. Internal reporting as a distinct function catering to informational needs for decision making and control is not yet prevalent among companies.
3. An examination of the balance sheet of many of the companies which follow different policy for tax and external reporting revealed that they do not account for deferred tax durability. This results in distortion of tax across years. As companies start using different accounting policies for tax and external reporting the Accounting Bodies should make mandatory the creations of deferred tax liability.

## EXHIBIT I (Questionnaire)

## ACCOUNTING POLICY CHOICES - AN EMPIRICAL STUDY

General

We have identified certain important items where the accounting policy used for internal, external and tax reporting may be different. We here under define the scope of internal, external and tax reporting.

Internal reporting: Financial statement generated for internal purposes like performance evaluation, planning, control etc.

External reporting: Financial statement presented to shareholders

Tax reporting : Financial statement **for the purpose** of **corporate** income tax.

Kindly state the accounting policy currently being used for different purposes with respect to the following items.

1. Inventory valuation (LIFO, FIFO, Standard Cost, Average Cost etc.)
  - a. Internal reporting
  - b. External reporting

c. Tax reporting

2. Depreciation on fixed assets (Straight Line, WDV, Sum of digits etc)

a. Internal reporting

b. External reporting

c. Tax reporting

3. Research and Development Expenditure (Writing off in the same year. Straight Line, WDV etc.)

a. Internal reporting



b. External Reporting

c. Tax reporting

4. Gratuity (Accrual basis, cash basis)

a. Internal reporting

b. External reporting

c. Tax reporting

5. Expenditure on Training & Development of Employees  
(Writing off in same year, straight line, WDV etc.)

a. Internal reporting

b. External reporting

c. Tax reporting

6. Other intangible assets (Writing off in same year,  
Straight line, WDV etc.)

(High sales promotion  
Expenses, Preliminary  
expenses etc.)

a. Internal reporting

b. External reporting

c. Tax reporting

7. Do you have in your income any receipts from shipping/longterm contracts/instalment sales? (Yes/No)
  
8. If your answer to the above is 'Yes' then please state the nature of income (from shipping/contracts/instalment sales) and the income recognition method (completed voyage, completed contracts, realised sale etc.) used for internal, external and tax reporting.

6

Kindly provide the name and designation of the person best informed about your company's accounting policies whom we can contact for further information.

Name

Designation

I thank you very much for your cooperation. Please mail the questionnaire to

Prof. G. Srinivasan  
Indian Institute of Management  
Vastrapur  
Ahmedabad 380 015  
GUJARAT

## LIST OF COMPANY'S RESPONDED

1. Ashok Leyland Limited
2. Brook Bond India Limited
3. Ceat Tyres of India Limited
4. Ciba-Geigy of India Limited
5. Colour Chem Limited
6. Crompton Greaves Limited
7. Goodyear India Limited
8. Gujarat State Fertilizer Company Limited
9. Hindustan Lever Limited
10. Hyderabad Asbestos Cement Products Limited
11. Madura Coats Limited
12. National Rayon Corporation Limited
13. Peico Electronics and Electricals Limited
14. Rallis India Limited
15. Seshasayee Paper and Boards Limited
16. Shaw Wallace and Company Limited
17. Siemens India Limited
18. The Ahmedabad Electricity Company Limited
19. The Alkali and Chemical Corporation of India Limited
20. The Associated Cement Companies Limited
21. The Tata Hydro-Electric Power Supply Limited
22. The Tata Oil Mills Limited
23. Union Carbide India Limited
24. Walchandnagar Industries Limited
25. Zuari Agro Chemicals Limited

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