Financial Reporting In India

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1. **Executive Summary:** Financial reporting and fiscal discipline go hand in hand. From the few page compilation of profit and loss account and balance sheet to today'scomprehensive annual reports, reporting by corporates has indeed come a long way. So have MIS reports undergone considerable change over the years. This article looks at financial reporting in India and the change that has come about in both internal reporting and external reporting and its effects and role in transforming Corporate India.

2. Key Words:

Financial Reporting in India, MIS Reports, Internal and External Reporting, Annual Report, Disclosures, Corporate Governance, Directors Responsibility, Changing World order, XBRL, Risk based approach, The way forward.

3. Introduction: -

The major quantitative information in any organisation is accounting information. This is an universal truth. Every company has to publish its annual report under the requirements of corporate law in the countries in which they are incorporated. Financial reporting is thus of two types, one external and the other internal reporting

a) External Reporting: - Information, published in annual reports, is essentially external reporting or shareholder reporting or custodial accounting. Such information is based on 'ex post facto' events. Hence these are known as historic costs or actual costs. They are accurate. However the effectiveness and efficiency of such information depends upon the speed, accuracy and integrity of data apart from the transparency and uniformity in standards-national and international. Thus, external reporting requires actual revenues and actual costs presented in accordance with the prescription of laws and the generally accepted accounting principles, once again, national and international.

b) Internal Reporting: - Internal reporting refers to internal information tailor made to suit the needs of management at different echelons of management in the organizational structure. The main purpose of internal reporting is to guide and assist management in product costing, planning, control and decision-making. In other words, these are the broad traditional areas, which include: score keeping, attention direction and problems solving. While external reporting addresses mainly score keeping and very little of the remaining two aspects just described, internal reporting has a different purpose. The focus in internal reporting is on attention direction, problem solving and score keeping in that order. The purpose of this paper is to outline, chart and address the issues of financial reporting in India.

4. <u>The Context:</u>

In the words of Prime Minister Manmohan Singh “These are good times for Indian business… The Indian economy has experienced unprecedented change and growth…Economic reforms have created a new world…If we have to realize our full potential…. we have to create a more open and efficient financial system, a system capable of generating the necessary financial resources needed for the rapid growth of our economy”.

Creating an open and efficient financial system requires an efficient and effective financial reporting system. Financial reporting that is based on transparency, integrity, speed and efficiency is the corner stone of true corporate governance, which will in turn make the financial system open and efficient.

In the last decade with the adoption of newer accounting standards, changes in auditing standards and emergence of corporate governance, corporate communication and financial reporting have undergone a sea change.

Financial reporting is of two types. Internal reporting primarily to internal stakeholders in the form of MIS reports for management decision making and External reporting to all the stakeholders both external and internal for communication, compliance and investment decisions. Internal financial reporting was traditionally based on MIS reports that relied heavily on cost sheets, cost per unit calculations, standard costing, variance analysis and marginal costing for decision making. These reports were mostly manual and in later years computer assisted. Today’s MIS is totally transformed being based more on Strategic Cost Management that encompasses activity based costing, value chain analysis, zero base budgeting, BPR, Balanced Score card, Unit cost analysis, Kaizen and so on…

Financial reporting is generally achieved though the medium of the annual report by listed companies, although other periodic reporting in the form of quarterly reports, disclosure statements, press notes, advertisements and public announcements do exist. The article is aimed primarily at tracing the changes, the quantum shift, the radical transformation that has came about in the annual report and financial reporting by corporates therein. These changes, it is felt will help improve fiscal discipline, transparency and reliability leading to an efficient financial system that will help in transforming India.

5. <u>The Annual Report:</u>

Financial reporting and fiscal discipline go hand in hand. From the few page compilation of profit and loss account and balance sheet, to today’s comprehensive annual reports reporting by corporates has indeed come a long way. This article looks at the change that has come about its effects and role in transforming corporate India.

(Space intentionally left blank to adjust the figures – not to be kept blank in printed text)

The bulk and size of annual reports is reflective of the growing disclosure and details that annual reports convey e.g. the Infosys annual report of 1995-1996 contained 96 pages. The Annual report for the 2004-2005 contains 170 pages. But even now the degree and extent of disclosure continues to vary as can be seen from a look at the Annual Report of Indusind Bank for 2005-2006, which has 55 pages.
Looked at on a Company to Company basis, by and large in physical / quantum terms the disclosure has probably on an average doubled over the last ten years. The annual reports generally contained a small directors report, the auditors report, the financial statements – Balance sheet, profit and loss account and schedules alongwith certain additional information required by the companies Act like statement of particulars of employees, quantitative data regarding production turnover and studio, statement regarding energy conservation measures, and so on.

Compare that with today's disclosures both statutory and voluntary and we find a major shift – a change for the better.

The primary reasons for this change are

i) the growing number of stakeholders that are now interested in using the annual report (see Fig 1.)
ii) the changing / growing expectations of users – stakeholders, and
iii) the requirements of newer legislation that is being put in place by government and regulatory bodies (see fig 2.)

(A) Past

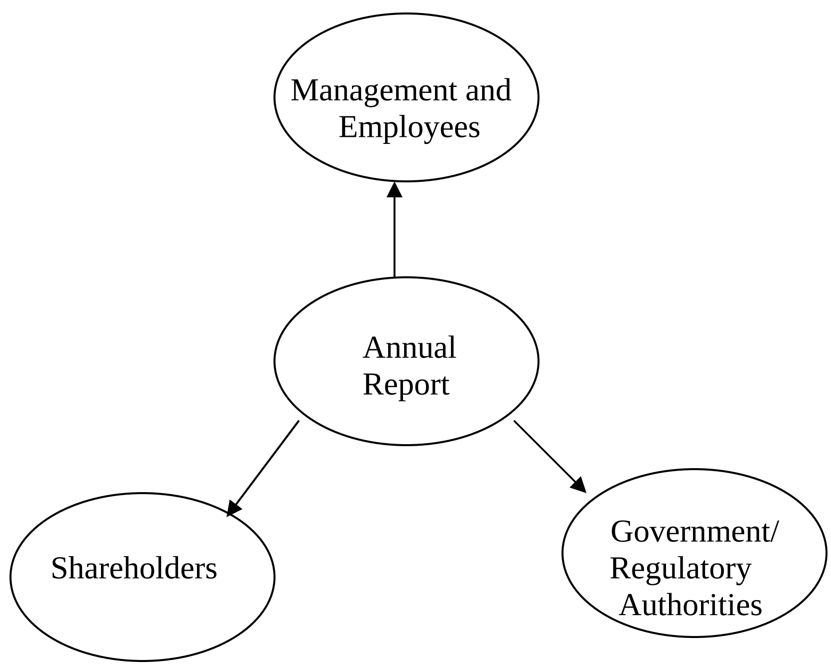


Fig 1: Growing Stakeholders Interest in the Annual Report

(B) Present

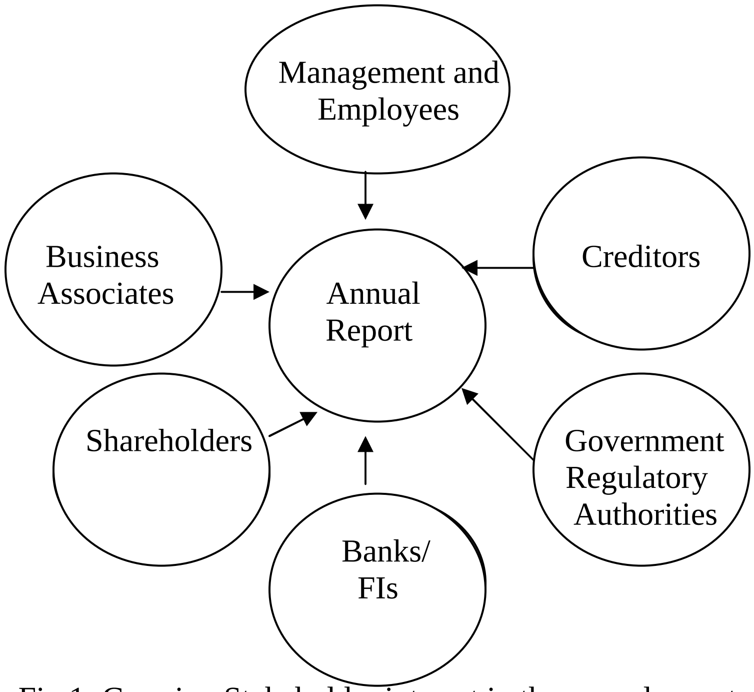


Fig 1: Growing Stakeholder interest in the annual report

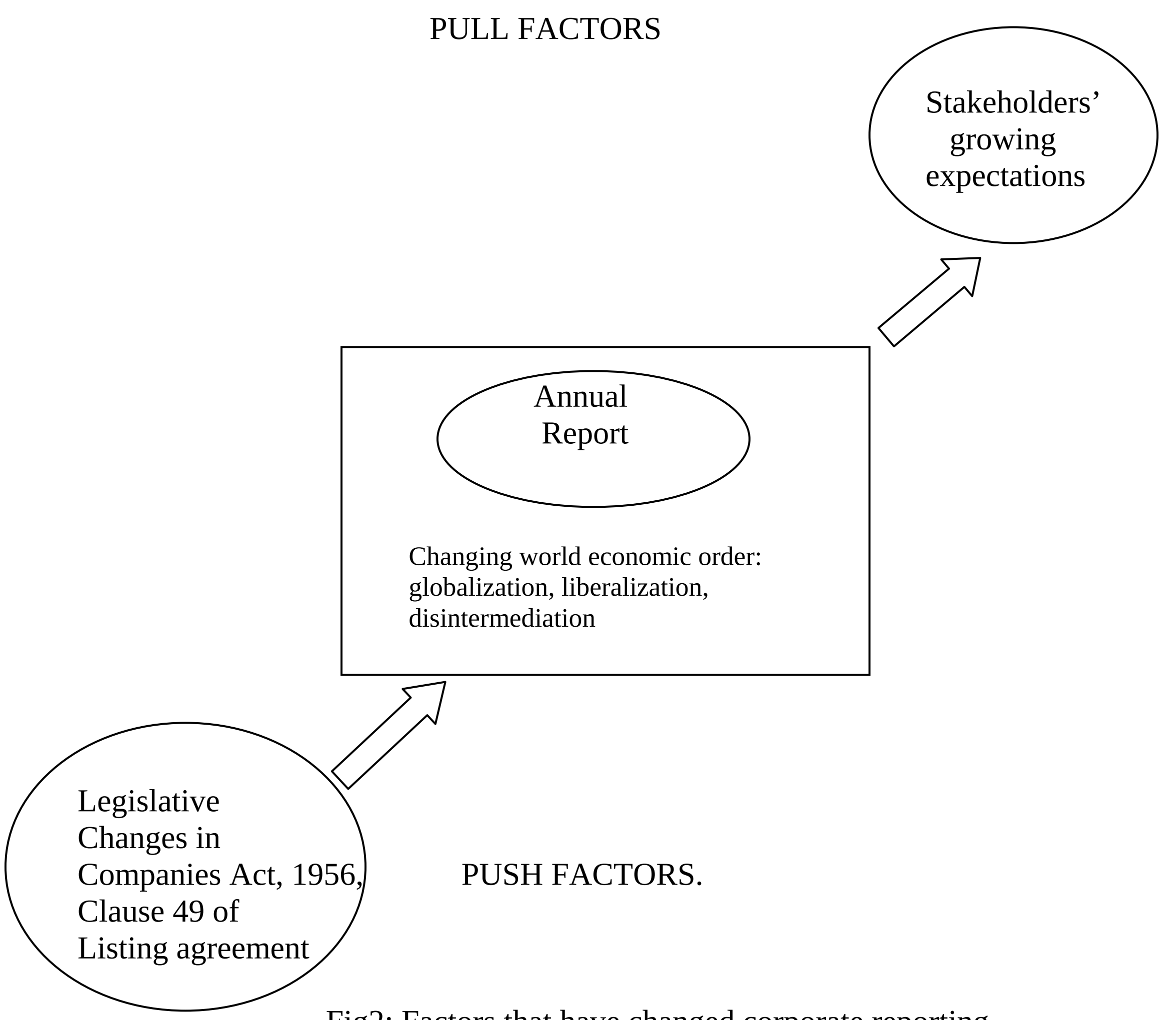


Fig2: Factors that have changed corporate reporting.

Apart from this, Companies now want to communicate their vision, mission and goals and how the year has gone by in meeting them. It communicates to the stakeholders the ethos, the mindset of the organizations and its team.

It tries to give insight into its people, its brand, it strategy, its linkages, its strength and weaknesses, the opportunities that exist and the threats it needs to ward off, the environment in which it works. It also convey to the stakeholders the environment in which it operates, offer an insight into its team – its employees and business associates, gives them an idea of its working and processes, its organization structure, how it manages its risk and how it governs itself.

It thus communicates to the stakeholders a lot of what cannot be precisely measured, reflected, quantified or captured, but needs to be conveyed, appreciated understood by them in order to get the true import of the financial results. It has made financial reporting more meaningful, relevant and useful to the stakeholders, and has come of age and become an art today.

The details of disclosure and contents of a standard annual report of a progressive company are given in the box below. (See fig. 3).

Contents of an Annual Report

Theme **–** This part covers a new idea which communicates the ethos, vision and setting of the company, its team and its associates and shares this in text and pictures bringing the company and its image live in the minds of the readers.

The year at a glance

Letter to the shareholder

Awards for Excellence

CEO and CFO certification

Directors' report **– D**irectors responsibility statement

Particulars and Information pursuant to Companies
Act, 1956 – on conservation of energy, R & D,
Foreign Exchange, particulars of employees, etc.

Auditors' certificate on corporate governance

Financial statements – Indian Generally
Accepted Accounting Principles
(**I**ndian GAAP)

Management's discussion and
analysis of financial condition and
results of operations

Auditors’ reports

Balance sheet

Profit and loss account

Cash flow statement

Schedules

Balance sheet abstract and
company’s general business profile

Section 212 of Companies Act (report on the same.)

Consolidated financial statements- Indian GAAP

Risk management report

Corporate governance report

Additional information

Shareholder information

Share price chart

Frequently asked questions

Selective data

Ratio analysis

Statutory obligations

Human resources accounting

Brand valuation

Balance sheet (including intangible assets)

Current- cost-adjusted financial statements

Intangible assets score sheet

Economic Value-Added (EVA) statement

Value Reporting™

Management structure

Charitable initiatives

Reports on environment, health and safety

Financial statements (unedited) prepared in substantial compliance with GAAP requirements of Foreign Countries and reports of compliance with respective corporate governance standards

Annual General Meeting (AGM) notice
Explanatory statement u/s 173(2) of the Companies Act, 1956

Ballot Form for the AGM

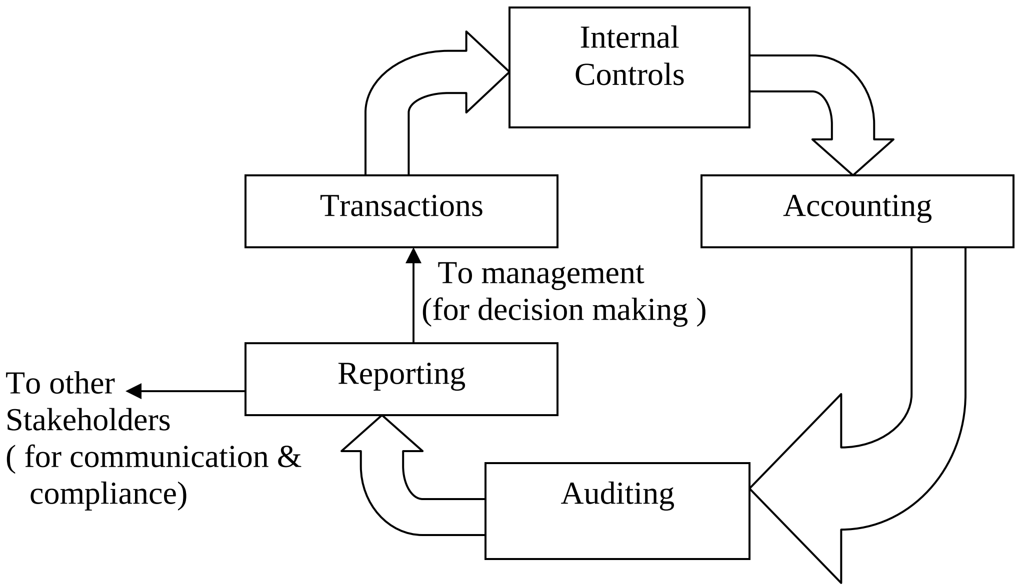
Proxy Form for the AGM

Attendance Slip for the AGM

Fig3: Contents of a standard annual report of a progressive company.

6. Financial Reporting Cycle:

The financial reporting cycle covers all the steps from incurring of the transaction which could be an income or expense or acquisition or disposal of an asset or the incurring or repayment of a liability, to the control over such transactions, its measurement and recording, its accounting, its audit – internal and external, and finally communicating it to stakeholders, the internal stakeholder for decision making the external stakeholders for compliance and governance. A perusal of the diagram below shows that, accounting and auditing are two of the key components of the financial reporting cycle and are very crucial to maintain its quality and timeliness. (See Fig 4).



Let us now look at the changes in accounting and auditing which are major components of the reporting cycle and have been instrumental and have substantially influenced financial reporting and determine its quality to a great extent.

7. <u>Accounting Standards:</u>

Accountants by their very nature and training are known for their conservatism and are averse to change. These qualities are important because they ensure that transactions and accounts remain comparable over different time periods. But given the changing economic scenario and increasing complexity of transactions in the modern commercial world, accounting standards need to evolve and cannot remain static and rooted to the past.

A quick look at the Accounting Standards in India shows that right upto 1994 there were only a handful of standards, less that ten in number. The years 1993, 1994 and 1995 saw a spurt in standards which reached upto 15 in number. Thereafter from 2000 – 2001 onwards came another slew of standards which saw them going past 30 by 2005-2006. For a profession which has seen hardly any changes, this was a quantum change – a paradigm shift. They still fall short of the 41 International Standards and 25 Interpretations issued and followed internationally, but the gap has narrowed considerably. The shift is truly remarkable because the newer standards, covering - Accounting for investments, Amalgamations, Retirement benefits, Governments grants, Borrowing costs, Segment reporting, Related party disclosures, Leases, Earnings per share, Consolidated financial statements, Accounting for taxes on income, Interim financial reporting, Intangible assets, Joint ventures, Impairments of assets, Contingent liabilities and provisions and so on, all make for a more balanced, transparent, uniform and meaningful reporting that helps investors and stakeholders get a better insight into the financials of the organizations and enable a better comparison of performance across board.

Over the past few years there has been a sea change in the accounting profession. The factors that have caused it are many. The movement that begun due to the external forces of globalization and disintermediation became stronger when the need for better and more meaningful accounting and the reporting role of accountants was internalized and understood by the accountants in the after math of the huge scams and financial irregularities of the recent past, when their very integrity, need and existence was questioned the world over. This happened due to two primary drivers. The first was the realization that the post mortem accounts at historical costs seldom reflect the true picture for any sort of decision making, be it strategic or operational decisions by the management, or investment decisions by the shareholders, investors and the stock market.

The other was the realization that the exiting standards and formats were not able to cope with the complexities of commercial transactions involving mergers and acquisitions, joint ventures and emergence of the importance of intangible assets. Business became more complex with transactions and activities covering multiple segments and multiple currencies across the seven continents. Accounting standards therefore had to keep pace with global investors and stockholders demanding international standards in India.

Having seen the drivers on the accounting side for the changes in financial reporting, let us now look at the auditing aspect.

8. <u>Auditing:</u>

Auditing too has changed from the post mortem, check box, tick box, check list – based approach to a proactive discipline that encompasses such emerging disciplines / areas like forensic audit and auditing in a digital environment. Auditing today is not only a continuous process but also a proactive one where it has become predictive and preventive in dealing with financial irregularities and frauds by focusing on auditing and improving controls.

Auditing today also needs to be fast and quick enough to provide comfort to financial reports that are now issued every quarter and even at the end of the year in a matter of days and not weeks and months after the year end. These changes is auditing have had a substantial impact on financial reporting today. There was a time when auditors restricted themselves to the books of accounts and financial statements drawn out therefrom. The emphasis was on “true and correct” which later shifted to “true and fair”. Today the accounting process itself is more transparent with the auditor clearly stating in his report the scope, role and nature of audit activities and what management’s responsibility is and what the auditors does.

Today apart from financial statements, which now cover cash flows and other statements too, auditors also audit quarterly accounts, conduct a limited review of reports, even audit projections containing prospective statements, and audit compliance to corporate governance

The role of the auditors which according to them (the auditors) was perceived as that of a watch dog, has also changed with stakeholders expecting them to be more proactive in actively looking for frauds, irregularities and errors at least like a more aggressive and alert watch dog, if not an outright bloodhound. .

Another very important change that has come over the profession and has a direct impact on financial reporting is the quality of the audit profession. Mechanisms have been put in place to ensure that independence norms are followed and the quality of audits is maintained through capacity building measures like continuing professional education (CPE) and peer review of audit firms. With standards improving, auditing, getting e-enabled and the quality of auditors getting better financial reporting is bound to improve.

9. <u>Risk based approach:</u>

Risk management is becoming a way of life in today's world. Risk is ever present – you have business risk, commercial risk, financial risk, exchange risk, inherent risk, risk of disaster, political risk, the list is endless. The financial reporting process and all its components are no exception to this. You have risks in accounting by way of incorrect capturing of financial information pertaining to transactions, audit risk being control risk (risk of failure of controls) and detection risk (risk of failure to detect errors and misstatements) risks in communication of financial results – reporting risk and eventually the ever present risk of fraud, errors and misrepresentation / mistakes inherent in the business itself. Risk based approach is being adopted in internal accounting of business operations, in auditing the results and in financial reporting so as to make reporting efficient and effective.

10. <u>Emergence of XBRL – Financial Reporting Standard:</u>

Reporting in the present day is not limited to the financial statements alone but carries a lot of other information which has numerous details. The normal reporting formats and presentation techniques used in the annual report differ from company to company and Country to Country making it non – comparable. Despite the advances in computing and information technology this information is not always searchable. The use of hypermedia, especially XBRL that is fast emerging as the global standard makes this information more meaningful and searchable.

11. <u>XBRL: (Extended Business Reporting Language):</u>

Extensible Business Language is based on XML (Extendable markup language) – based format. It was developed to cover electronic communication and analysis of data. XBRL tags each data cell and each line of content and therefore enables fast query and analysis. XBRL if introduced and accepted world over as the reporting standard will enable more than good governance, as standards based analysis will let corporate strategists quickly review internal results and performance comparison of likes with likes Vis – a – vis competitors. Corporate reporting will also improve as more and more countries are preparing to adopt it as the reporting standard of choice.

12. Scams and Reporting:

Corporate reporting in the wake of mega scams across the world – be it WorldCom and Enron in the US, or our very own GTB, the message was clear and the writing was up on the wall. Reporting had to improve if the financial system was to survive and flourish. Quickly sensing this the stakeholders, the government and the key players have moved to rectify the situation.

Frauds and scams are of two types. one financial the other accounting. Financial frauds involve swindling , defalcation and misappropriation of funds. Accounting frauds entail window dressing and are almost always management frauds. A look at the frauds that have happened the world over show that the frauds in India are more the financial type (CRB, Corporative banks ….)as against the US & Abroad …
(World Com & Enron), though now accounting frauds seem to be coming up in India too (GTB) .

The Indian Accounting profession has moved with alacrity to adopt new standards, to stem the tide of frauds and scams. A lot has been accomplished in the area of harmonizing accounting standards. The accounting standards in India are aligned more closely to international accounting standards providing a base for comparable, prudential assessment of results.

They are aimed at providing a "true and fair" view of the financial condition keeping sight of prudence, transparency, relevant information and comparability. Scams have thus had a salutary effect on financial reporting, bringing about a change for the better.

13. Responsibility for Financial Reporting:

With the emergence of corporate governance as the key word in the business world and in the wake of legislation in the US like SOX and in India, the Naresh Chandra Committee Report and clause 49 of the listing agreement, we have greater responsibility placed on the Board of Directors, the CEOs and CFOs for maintaining fiscal discipline, financial accuracy and transparency. Top management is charged with protection, preservation and oversight of assets, income and expenses and need to ensure that proper accounting standards are followed, organizations remain relatively free from fraud and if frauds happen they are reported to stakeholders. Timely and adequate financial information has to be provided to the stakeholders. In fact till a few years back the annual report and the financial statements were almost exclusively signed by the directors and countersigned by the auditors. If a company desired that its CEO or CFO sign such statements an opinion had to be obtained whether such statements would be legally acceptable and valid if signed by these employees. Today the picture is the opposite. Law requires that the CFO and CEO who actually operate the business of the company and are in charge of the finance and the accounting function also sign and authenticate these statements apart from the Board of Directors and the auditors.

14. Financial Accounting, Management and Reporting in Government, Semi – Government and Public Bodies:

The Government system of accounting has all along been based on a single entry system with its drawbacks, such as lack of information on income due for collection, outstanding liabilities in respect of expenses, and the value of assets created and held.

Over the last two to three years, a number of municipal and public bodies have started the process for adopting the double entry system used by corporates, which is widely used by government bodies in the developed world as a measure of self – sustenance of institutions/ organizations. This is a sea change and reflects a quantum jump over the past.

15. Paradigram shift in

	From	To
Year:	1994	2007
1. Accounting standards	10	40
2. Auditing	Mechanical, check list & tick box approach	proactive, continuous risk based audit approach
3. Reporting medium	Hard copy	excel, word, pdf , XBRL,
Standard	MAOCARO	CARO,
Requirements	-	Clause 49 compliance
Signatories	Directors & Auditors	CEO, CFO, directors, auditors
Accounting system	Single entry in public accounting.	Double entry in public accounting municipal, , govt & Public bodies
Contents of annual report	Annual report contains director report , auditors report,& financial statement	Comprehensive, transparent annual report containg adequate disclosures .

16. The way forward:

Thus, over the last ten years we have seen a total change in the way accounts are kept, the way financial position is compiled audited and reported.

This change has been brought about by changes in accounting, changes in auditing, changes in the legal framework, changes in technology, changes in management responsibility, changes in the expectation of the stakeholders and above all a complete change of outlook on the part of all concerned.

In the US the Sarbannes Oxley Act and related changes in accounting and auditing standards have been introduced to combat fraud and financial misreporting. In India the Naresh Chandra committee report ushered in clause 49 of the listing agreement and other ongoing changes in accounting and accounting standards . These have led to better corporate governance and more transparent reporting which will ensure better Compliance and good governance.

The accounting and reporting world including financial analysts and stock market pundits the world over have now recognized the importance of green accounting and ecologically sustainable ROI.

In the long run companies that are socio-ecologically progressive do better than those that are solely motivated by profits, Goldman Sachs has been reported to say – "we believe that Companies' management of environmental and related social risks and opportunities may affect corporate performance. This trend is bound to bring about a quantum change in financial reporting as ecological parameters are incorporated in accounts.

It is indeed a beginning of a new era in accounting and financial reporting that will make annual reports more meaningful in the years to come.

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