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Corporate Financial Reporting

1. Introduction

An understanding of the conceptual bases of the corporate financing reporting system and preparation of financial statements are essential prerequisites to be a good accountant or a financial analyst. This Chapter intends to explain the corporate financial reporting system and issues involved. Regulatory framework of corporate financial reporting in India and practices of Indian Companies are also covered. In the last section reporting issues relating to matters that are reported outside the general purpose financial statements are considered.

2. Corporate Financial Reporting System

This chapter discusses the conceptual issues of corporate financial reporting.

2.1 Concept of Corporate Financial Reporting

Financial reporting is the communication of financial information of an enterprise to the external world. Bedford conceptualizes the financial reporting process as consisting of four procedural steps:

1. Perception of the significant activity of the accounting entity or in the environment in which the entity performs. Implicit in the traditional perception is the belief that financial transactions represent the significant activities.
2. Symbolizing the perceived activities in such fashion that a database of the activities is available that can then be analyzed to grasp an understanding of the interrelationship of the mass of perceived activities. Conventionally, this symbolization has taken the form of recordings in accounts, journals, and ledgers using well-established bookkeeping and measurement procedures.
3. Analysis of the model of activities in order to summarize the interrelationships among activities and to provide a status picture or map of the entity. Traditionally, this analysis process has been viewed as one of developing accounting reports to provide insights into the nature or entity activities.
4. Communication (transmission) of the analysis to users of the accounting products to guide decision makers in directing future activities of the entity or in changing their relationship with the entity.

First two steps constitute the process of accounting **measurement**, the quantification of an entity's past, and present, or future economic phenomena on the basis of observations and

rules. Implicit in this conception are the requirements that (a) there exist some attribute or feature of a business-related objects or event (e.g.; the value of an asset) worthy of measurement and (b) there exist a means of making the measurements (e.g., the use of exchange prices to value enterprise assets). Step 3 and 4 of the financial reporting process constitute **disclosure**. Hence, measurement and disclosure are two dimensions of reporting process and these two aspects are interrelated. Together, they give corporate reporting its substance.

Corporate financial reporting is a series of activities that allows companies to record operating data and report accurate accounting statements at the end of each month, quarter and year. Bookkeepers record operating data by debiting and crediting financial accounts. Accountants prepare financial statements in accordance with corporate policies, industry practices and regulatory guidelines.

As per Section 2(40) of the Companies Act, 2013, the Financial statements of the company include:

1. a balance sheet at the end of the financial year;
2. a profit and Loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;
3. cash flow statement for the financial year;
4. a statement of change in equity, if applicable; and
5. any explanatory note annexed to, or forming part of, any document referred to in sub-clause(i) to sub-clause (iv).

Provided that the financial statements, with respect to One Person Company, small company or dormant company, may not include the cash flow statement.

The financial statements, augmented by footnotes and supplementary data (often referred to as 'Notes to the Accounts') are intended to provide relevant, reliable and timely information essential for making investment, credit and similar decision. Such financial statements are called *general purpose financial statements*.

It may be mentioned that the term financial reporting is not restricted to information communicated through financial statements. Financial reporting includes other means of communicating information that relates, directly or indirectly to the information generated through accounting process. Information provided by means of financial reporting other than financial statements may take various forms and relate to various matters. Communication by means of financial reporting other than a formal financial statement is made due to regulatory requirements or customs. In a few occasions, management may communicate any matter voluntarily when it considers such communication is useful to the stakeholders outside the enterprise. Publication of unaudited financial results, news releases, management forecasts and description of future plans are examples of reports that are provided outside the general purpose financial statements.

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2.2 Users of Financial Statements

Different classes of users use financial information for different purposes. Identification of the users and their classes is necessary in order to determine the purposes for which they use information. Identification of users helps in defining user group characteristics which influence both the specific type of information to be presented and the manner of presentation.

According to the Framework for the Preparation and Presentation of Financial Statements issued by the ICAI in 2000 (hereinafter referred to as 'ICAI Conceptual Framework') the users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public.

The common characteristic of external users is their general lack of authority to prescribe the information they want from a company. It is also observed that some users have more resource and influence than others so that they can obtain more information about an enterprise than is generally available to others. These privileged users include managers, large scale equity investors etc. These different user groups have different objectives and diverse information needs. But, general purpose financial statements are prepared to meet the common needs of all types of users. However, all of the information needs of these users cannot be met by such a report. Multiplicity and conflicts of objectives of a wide variety of potential users for general purpose reports make it difficult to design a single set of published statements that can simultaneously provide all necessary information to all possible users.

Traditionally, investors (both existing and potential) are singled out as the dominant user-group of published financial statements. As providers of risk capital to the enterprise, investors need more comprehensive information than other users. The ICAI Conceptual Framework states that the provision of financial statements, which meet the investors' needs, will also meet most of the needs of other users. Also in practice, top priority is given to the information needs of the investors while deciding what items of information should be disclosed in general purpose financial statements.

2.3 Objectives of Corporate Financial Reporting

Corporate financing reporting is not an end in itself but is a means to certain objectives. There are debates regarding objective of financial reporting. However, some consensus has been developed on the objectives of financial reporting through the issuance of the conceptual framework. The conceptual framework provides the conceptual basis for generally accepted accounting principles (GAAP). It outlines the characteristics accounting information must possess to be useful in investment and other economic decisions. Like other standard setting bodies, paragraph 22 of the Framework states that the objective of financial statements is to provide information about financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions. The Framework specifies present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public as the users of financial statements.

In USA, the FASB has identified the following major objectives of financial reporting:

- (i) Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.
- (ii) Financial reporting should provide information to help investors, creditors, and others to assess the amount, timing and uncertainty of prospective net cash inflows to the related enterprise.
- (iii) Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events and circumstances that change resources and claims to those resources.
- (iv) Financial reporting should provide information about an enterprise's financial performance during a period.
- (v) The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components.
- (vi) Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise's resources to owners, and about other factors that may affect an enterprise's liquidity or solvency.
- (vii) Financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it.
- (viii) Financial reporting should provide information that is useful to managers and directors in making decisions in the interest of owners.

Apart from investment decision making another objective of financial reporting is to provide information on management accountability. Management accountability is a broad concept that encompasses stewardship. The accountability relationship may be created by a constitution, a law, a contract an organization make, a custom or even by informal moral obligation. It is considered that management of an enterprise is periodically accountable to the owners not only for safekeeping of resources but also for their efficient and profitable use. Management accountability objective mainly emphasizes reliability aspect of accounting information. Accordingly, compared to relevance, verifiability through adequate documents, records and system is considered dominant consideration for inclusion of any piece of information in the financial statement.

Corporate financial reporting being user oriented and users' need of information being not same, the role of accounting and financial reporting may vary from country to country. But, financial reporting is central to the process of allocating financial resources in capital markets. Hence, primary purpose of providing useful information to all users, which help them in decision making, is common in all countries.

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2.4 Capital Market and Non-Financial Influences on Corporate Financial Reporting

Till the quarter of the twentieth century, financial reporting was confined to the stewardship reporting, i.e., reporting of the wealth and income earned by the owners. With the growth in size, companies need large sums of money to finance extensive productions and distribution activities. Due to internal financial constraints, companies depend heavily on external capital markets to finance the capital needs. However, investors are seldom in a position to observe on a day-to-day basis, whether saving entrusted to the companies are utilized efficiently and effectively. Hence, investors expect and are provided with an accounting for the stewardship of monies entrusted to the company. Stewardship traditionally refers to the safe keeping of resources and the execution of plans for conserving and utilizing them. Modern concept of accountability of management extends beyond the element of stewardship and covers performance based issues. The managers of the companies accept the accountability phase of their stewardship, or at least recognize in self-interest that disclosure through financial reporting process delegates part of the responsibility for assessing the financial status of the company and its performance to the users of financial reporting but, with the growth of the capital market, the central focus of financial reporting has been shifted from stewardship reporting to decision-oriented financial reporting.

Further, the competition among the companies to obtain external financing at a relatively cheaper rate has impact on corporate disclosure. Companies are now making expanded disclosure to attract capital in domestic capital market and/or in international market and to reduce the firm's cost of capital. There are various research studies that establish that increased firm disclosure has definite impact a firm's overall cost of capital. Such reduction of cost of capital through expanded disclosure has linkage with the theory of behaviour of investors who take investment decision under uncertainty. Increased disclosure in financial reports improves the subjective probability distributions of a security's expected returns in the mind of an investor by reducing the uncertainty associated with that return stream.

Thus, capital market influences are having a major role in shaping the nature of corporate financing reporting that is now driven by the consideration of decision usefulness. The objective of decisional usefulness has formally been incorporated into the conceptual frameworks for the preparation and presentation of financial statements set out by the standard setting bodies of different countries as well as by the International Accounting Standards Committee.

Apart from accountability to shareholders, there is a growing worldwide trend of holding companies accountable to the public at large. Such a trend is responsible for changing the disclosure practice of companies to a considerable extent. Such a movement is creating companies aware about the disclosure needs of "non-financial shareholders" such as trade unions (interested in terms of employment), government (interested in the macroeconomic impact of operations of corporate sector) and general public (interested in social and environmental impact of corporate actions). Voluntary reporting of employee information, environmental information and other corporate social responsibility reports (e.g. social balance sheet) are examples of disclosure arising from non-financial influences. Corporate response to

such expanded disclosure requirements are mixed. However, it is desirable that financial reporting should cater needs of all type of users.

2.5 Qualitative Characteristics of Information in Financial Report

Qualitative characteristics are the attributes that make the information provided in the financial statement useful to the users. ICAI Conceptual Framework earmarks four principal qualitative characteristics viz., understandability, relevance, reliability and comparability. According to the ICAI Conceptual Framework, materiality is not a principal qualitative characteristic. A piece of information is considered to be material when its disclosure or non-disclosure would affect decision or would make a difference in the valuation of the firm. But, in the ICAI Conceptual Framework, materiality is considered as a threshold limit, which needs to be judged before referring to any other qualities of any information provided in financial statements. If any piece of information does not fulfill the threshold criteria, it need not be considered further.

2.5.1 Understandability

Information in annual reports should be presented in such a way that it is readily understandable by users. ICAI Conceptual Framework states that the criterion of understandability requires that the users have a reasonable knowledge of business and economic activities, accounting, and a willingness to study the information with reasonable diligence. It has also suggested that information, which is relevant to the economic decision-making needs of some of the users should not be excluded merely on the ground that it may be difficult to understand by others.

2.5.2 Relevance

The concept of relevance is directly related to the decision making needs of users. Information is said to be relevant if it can influence 'the economic decisions of users by helping them evaluate past, present or future events or confirming or correcting, their past evaluation. It is suggested that all those items of information, which may aid the users in making predictions or decisions, should be reported. Information, which does not assist users in making decisions is irrelevant and hence, should be omitted. Thus, relevance is the dominant criterion of taking decisions regarding information disclosure. *Timeliness* is an important aspect of relevance. Information loses value rapidly in the financial world. As time passes and the future becomes the present, past information became increasingly irrelevant.

2.5.3 Reliability

Information is reliable if it is free from material error and bias, and faithfully represents what it purports to represent. Information is reliable to the extent a user can depend upon it to represent the economic conditions or events that it aims to represent. Being free from bias implies impartial measurement and reporting by enterprise of its events and transactions.

2.5.4 Comparability

The ICAI Conceptual Framework emphasizes that users must be able to compare financial statements, of an enterprise through time in order to identify trends in its financial position, performance and cash flows, and of different enterprises in order to evaluate their relative

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financial position, performance and cash flows. For this purpose, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way. The Framework indicates that the important implication of comparability is that users should be informed of the accounting policies employed in the preparation of financial statements, any changes of those policies and the effects of such changes. For achieving comparability, the Framework (paragraph 40) suggests compliance with relevant accounting standards including the disclosure of accounting policies used by the enterprise.

2.6 Theories of Disclosure

2.6.1 Concept of Disclosure

The concept of disclosure is of great significance to the accomplishment of the objectives of financial reporting. Financial reporting is the communication of financial information of an enterprise to the external world.

The theory is that a fully informed consumer would more likely make better choices. Knowing the true cost of everything would force consumers to be better educated and more informed.

Available disclosure literature suggests that disclosure is not only fundamental to financial reporting but is, at the same time, its most qualitative aspect and the nature and extent of disclosure needed in individual reporting situations is determinable only by expert professional judgment. Disclosure standards and practices are influenced by legal systems, source of finance, political and economic environments, education level and culture.

2.6.2 Motives behind Disclosure

It is argued that competition for capital is the major motivating force to disclose decision-oriented information to different user groups. Hence, market forces would ultimately shape the nature of corporate disclosure. Corporations not only compete among each other in the capital markets but also attempt to obtain capital at a lower cost. It is indicated by many researchers that there is relationship between a firm's capital cost and its level of disclosure in its annual report. Due to such linkage and decision usefulness of published financial statement, corporate financial reporting is perceived as a pre-requisite for the growth of capital markets. Apart from stock market considerations, there are varieties of considerations that may motivate management of a company to disclose information voluntarily and not wait for mandatory requirements. Some of these important considerations are:

- ◆ Political costs consideration
- ◆ Users' needs consideration, and
- ◆ Ideological goal consideration.

Political costs consideration: Fines, penalties, potential public hostility toward the company are the examples of political costs. It is now recognized that political costs may play an important role in decisions relating to additional disclosure in the form of social and environmental information. Disclosure of environmental information can be considered to reassure the public or the regulating agencies that companies were concerned about the environment and were doing everything possible to reduce the negative impact of their

activities on the environment.

Users' needs consideration: Guthrie and Parker have argued that companies may disclose social information to meet the stakeholders' demand for such information. The argument is based on Users' Utility Model. Disclosure of additional information on a voluntary basis depends on the users' needs, and how these needs are perceived by management of companies.

Ideological goal consideration: It has been argued that companies would be motivated to disclose voluntarily additional information to serve their own political and ideological goals. Such disclosure would be guided by companies' agenda, ideologies and goals which are likely to be different for different companies even within the same industry. Consequently, disclosure of such information will vary from company to company.

2.6.3 Basic Problems of Disclosure

In disclosing information, business enterprises, particularly corporate entities, are confronted with certain basic problems, the solutions of which need answers to the following questions:

- (i) Who are the users of information or for whom information should be disclosed?
- (ii) What information should be disclosed?
- (iii) How much information should be disclosed?
- (iv) How should information be disclosed?
- (v) When should information be disclosed?

The first question requires identification of users of information. The second question needs the identification of the purposes for which information will be used. The third question relates to the problem of determining quantum of information. The fourth and fifth questions concern the problems of deciding about the mode and timing of disclosure respectively.

Disclosure being the transmission of accounting measurement to the users group, corporate entities views it as a major policy issue. As the disclosure of accounting information is not costless, preparers of financial statement have to make judgments on the allocation of accounting information among various user groups.

From regulator's standpoints, leaving the decision about disclosure in the hand corporate management or market forces, has not been viewed favourably. It is possible for management to disclose information that is considered helpful to facilitate its external relations programmes and still withhold certain pieces of vital information that is useful for decision making by the users. Hence, greater control over corporate reporting is imposed whenever it is perceived that there is failure to adequately respond to express information needs of different stakeholders.

Thus, the scope of negative sanctions of regulatory controls over corporate disclosure increases when user groups perceive that there are deficiencies on the part of companies in providing adequate disclosure.

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2.7 Role of Auditors

The audit of financial statements is a legal requirement. The audit provides an external and objective check on the measurement and disclosure aspects of corporate financial reporting. An auditor is appointed by the shareholders, but effectually his appointment is subject to will of management or promoter group. Nevertheless, the auditor is supposed to be independent of management and to serve the shareholders and other users of financial statements. Although, Management is responsible for the preparation of financial statement including the notes, the auditor through the auditor's report states whether financial statements presents fairly, in all material respects the financial position, the results of operations and the cash flows for the accounting period. The auditor is responsible for seeing that the financial statements issued conform with generally accepted accounting principles. Thus, the auditor must agree that accounting policies adopted by the management is appropriate and all estimates are reasonable. Any departure from generally accepted accounting principles (including non-compliance with the measurement and disclosure requirements of the accounting standards) would result in a qualified opinion. Auditor's report is an important accompaniment of financial statements. Because of boilerplate nature (ie. standard language) of these reports, there is tendency to skip over them while analyzing financial statements. However, such failure to give attention to the auditor's report may cause the user to miss significant information.

2.8 Quality of Financial Reporting

Ideally, financial statements should reflect an accurate picture of a company, its financial condition and performance. If the financial statements distort economic reality, capital will be deployed sub-optimally; resources will be misallocated; investors will pay a huge opportunity cost by investing in companies with unrealistic, inflated values and better investment opportunities may get bypassed. Regulations on financial reporting generally provides for penalties and other measures to deter accounting frauds. However, it may be pointed out that management has considerable discretion within the overall framework of generally accepted accounting principles. As results, there are scopes for management to "manipulate" the accounts. Such manipulations mainly relate to management of bottom line (profit or loss) and commonly referred to as earnings management. For an investor or a security analyst it is important to recognize that many opportunities exist for management to affect the quality of financial statements. Hence, reported earnings may not best represent economic reality or the future operating potential of a firm.

2.9 Mode of Financial Reporting

A number of documents and avenues of communication are available through which companies provide information about its state of affairs to the external users of such information, for example, annual report, interim report, employee report, environmental report, communications with analysts, letters to shareholders and debt holders, question and answer sessions held at annual general meeting, telephone conversations, speeches made by company officials at stock exchanges and so on.

Despite the existence of different sources of information, the annual report is regarded as the

most important source of information about a company's affairs.

A typical corporate annual report usually contains a balance sheet, profit and loss account, cash flow and / funds flow statement, and directors' report. Besides, the details of information and additional information are provided in the schedules and notes on accounts, which form parts of financial statements. Annual reports often contain useful supplementary financial and statistical data as well as management comments. Many companies in India now include Management Discussion and Analysis (MD & A) report, corporate governance report, chairman's statement, historical summary, operating positions, highlights of important data etc.

3. Indian Financial Reporting System

India is a federal state with unitary bias. This is perhaps why, unlike in the USA, there is no separate company law for any state in India. Apart from professional regulation, corporate financial reporting in India is governed primarily by the Companies Act, 2013. Another body that has a major influence in reshaping Indian financial reporting is the Securities and Exchange Board of India (SEBI). The Companies Act, 2013 prescribes the financial reporting requirements for all the companies registered under it. The reporting requirements that are imposed by the SEBI through its Guidelines and through the Listing Agreement are in addition to those prescribed under the Companies Act. SEBI requirements are to be followed by the companies listed on the Indian stock exchanges. The Companies Act and the SEBI requirements together provide the legal framework of corporate reporting in India.

Role of the SEBI: The Securities and Exchange Board of India (SEBI) is the regulatory authority in India established under Section 3 of SEBI Act, 1992. SEBI Act, 1992 provides for establishment of Securities and Exchange Board of India (SEBI) with statutory powers for

- (a) protecting the interests of investors in securities
- (b) promoting the development of the securities market and
- (c) regulating the securities market.

Its regulatory jurisdiction extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. SEBI has been obligated to perform the aforesaid functions by such measures as it thinks fit. In particular, it has powers for

- Regulating the business in stock exchanges and any other securities markets
- Registering and regulating the working of stock brokers, sub-brokers etc.
- Promoting and regulating self-regulatory organizations
- Prohibiting fraudulent and unfair trade practices

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- Calling for information, undertaking inspection, conducting inquiries and audits of the stock exchanges, intermediaries, self - regulatory organizations, mutual funds and other persons associated with the securities market.

SEBI has used its power to order changes in listing agreement and such changes are instrumental to bring about improvement in disclosure practices of listed companies in their annual reports. Listing agreement is the standard agreement between a company seeking listing of its securities and the stock exchange where listing is sought. Any stock exchange has power to alter the clauses of listing agreement unilaterally, and companies listed with that exchange are bound to accept such changes to enjoy the facility of listing. Thus, whenever the SEBI suggests any change, it is incumbent on the listed companies to follow such a change. In effect, the SEBI has power to direct the listed companies to follow any changed disclosure requirements.

SEBI has imposed a number of disclosures and other requirements through this route. Some important requirements are as follows:

- ◆ Dispatch of a copy of the complete & full annual report to the shareholders.
- ◆ Disclosure on the Y2K preparedness level.
- ◆ Disclosure of Cash Flow Statement.
- ◆ Disclosure of material developments and price sensitive information.
- ◆ Compliance with Takeover Code.
- ◆ Disclosure of interim unaudited financial result
- ◆ Disclosure regarding listing fee payment status and the name and address of each stock exchange where the company's securities are listed.
- ◆ Corporate governance report.
- ◆ Compliance with Accounting Standards issued by the ICAI.

The initiative to introduce the Cash Flow Statements (as a principal financial statement) in India was taken by the SEBI and it has used its power under section 11 of the SEBI Act, 1992 to direct all recognized stock exchange for a requirement of appending an audited Cash Flow Statement (CFS) (prepared only as per Indirect method as prescribed in AS 3 or Ind AS 7) as a part of annual accounts. As per the SEBI mandate, the requirement of providing a CFS is mandatory for listed companies from the financial year 1994-95 i.e., year ended 31st March 1995. When the SEBI mandate was issued, there was no accounting standard issued by the ICAI as regard preparation and presentation of a CFS. The ICAI issued a revised accounting standard (AS 3) on the subject by replacing its standard on Fund Flow Statement in March 1997. After introduction of ICAI standard the SEBI has directed a change in the Listing Agreement to provide that CFS shall be prepared in accordance with the ICAI standard. Earlier in the Companies Act, 1956, there was no requirement for preparing the cash flow statement. However, the new Companies Act, 2013 has mandated the Level I entities to

prepare the Cash flow statement as one of the main part of its Financial Statements.

The process of the SEBI has resulted in a changed regime for imposition of financial disclosure requirements that is quick and does not require lengthy process of legislative changes. By virtue of the provisions contained in the Listing Agreement, listed companies are now under legal compulsion to comply with all the accounting standards issued by the ICAI.

The Companies Act, 2013: The Companies Act, 2013 lays down the detailed provisions regarding the maintenance of books of accounts and the preparation and presentation of annual accounts. The Act also prescribes the mechanism for issuance of accounting standards by National Financial Reporting Authority (NFRA)**. It specifies the roles and responsibilities of directors and also the matters to be reported upon by them in the annual reports of the companies. Under the provisions of the Act, audit of annual accounts is compulsory for all companies registered under it. The Act extensively deals with the qualification, appointment, removal, rights, duties and liabilities of auditors and provides contents of auditors' report. In case of delinquency/ default by the management or auditor, penal provisions are prescribed. However, despite providing for detailed requirements in respect of maintenance of books of account, preparation and presentation of financial statements and audit of annual accounts, the main thrust under the Companies Act is upon the presentation of a 'true and fair view' of the state of affairs and operating results of the reporting companies.

As the preparation of financial statements contained in annual reports presupposes the existence of a recording procedure of transactions of the reporting entities, the requirements as to the maintenance of books of accounts are also mentioned. As per Section 129 of the Companies Act, 2013, at the annual general meeting of a company, the Board of Directors of the company shall lay financial statements before the company:

Financial Statements as per Section 2(40) of the Companies Act, 2013, inter-alia include -

- (i) a balance sheet as at the end of the financial year;
- (ii) a profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;
- (iii) cash flow statement for the financial year;
- (iv) a statement of changes in equity, if applicable; and
- (v) any explanatory note annexed to, or forming part of, any document referred to in sub-clause (i) to sub-clause (iv):

Provided that the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement.

*** Constitution of NFRA is prescribed under Section 132 of the Companies Act, 2013. However, this section has not been notified till 30th November, 2016.*

3.13 Financial Reporting

Requisites of Financial Statements

It shall give a true and fair view of the state of affairs of the company as at the end of the financial year.

Provisions Applicable

(1) Specific Act is Applicable

For instance any

- (a) insurance company
- (b) banking company or
- (c) any company engaged in generation or supply of electricity* or
- (d) any other class of company for which a Form of balance sheet or Profit and loss account has been prescribed under the Act governing such class of company

(2) In case of all other companies

Balance Sheet as per Form set out in Part I of Schedule III and Statement of Profit and Loss as per Part II of Schedule III.

Points to be kept in mind while preparing financial statements:

- ◆ Requirements of Schedule III to the Companies Act;
- ◆ Other statutory requirements;
- ◆ Accounting Standards issued by the Institute of Chartered Accountants of India on different accounting matters and notified by the Central Government (AS 1 to AS 32);
- ◆ Statements and Guidance Notes issued by the Institute of Chartered Accountants of India; which are necessary for understanding the accounting treatment / valuation / disclosure suggested by the ICAI.

Compliance with Accounting Standards

As per section 133 of the Companies Act, it is mandatory to comply with accounting standards notified by the Central Government from time to time.

Schedule III to the Companies Act, 2013

As per section 129 of the Companies Act, 2013, financial statements shall give a true and fair view of the state of affairs of the company or companies and comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III under the Act.

The MCA on 6th April 2016, amended Schedule III to include general instructions for preparation of financial statements of a company whose financial statements are required to comply with Ind AS. The amendment divides Schedule III into two parts i.e. Division I and II:

* The Electricity Act, 2003 does not specify any format for presentation of Financial Statements. Therefore, Schedule III of the Companies Act, 2013 is followed by Electricity Companies in preparation of their financial statements.

- Division I is applicable to a company whose financial statements are required to comply with the current accounting standards.
- Division II is applicable to a company whose financial statements are drawn up in compliance with Ind AS.

Schedule III to the Companies Act, 2013 has been given as Appendix at the end of the Module I of the Study Material. For full details, students are advised to refer the same.

The Financial Statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 of the companies Act, 2013 and shall be in the form of or forms as may be prescribed for different class or classes of companies in Schedule III. As per Section 133 of the Companies Act, 2013, the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

Section 135 of the Companies Act, 2013 deals with Corporate Social Responsibility obligations for the companies. As per provisions of this section, every company having net worth of rupees five hundred crore or more, or turnover of rupees one thousand crore or more or a net profit of rupees five crore or more during any financial year shall constitute a Corporate Social Responsibility Committee of the Board consisting of three or more directors, out of which at least one director shall be an independent director. The Board of every company shall ensure that the company spends, in every financial year, at least two per cent of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its Corporate Social Responsibility Policy:

Provided that the company shall give preference to the local area and areas around it where it operates, for spending the amount earmarked for Corporate Social Responsibility activities:

The Corporate Social Responsibility Committee shall,

- (a) formulate and recommend to the Board, a Corporate Social Responsibility Policy which shall indicate the activities to be undertaken by the company as specified in Schedule VII;
- (b) recommend the amount of expenditure to be incurred on the activities referred to in clause (a); and
- (c) monitor the Corporate Social Responsibility Policy of the company from time to time.

Provided further that if the company fails to spend such amount, the Board shall, in its report, specify the reasons for not spending the amount.

All companies covered u/s 135 of the Companies Act, 2013 are required to disclose amount of expenditure incurred on corporate social responsibility activities as note under heading 5 (k) in statement of profit and loss as per requirements of Schedule III.

3.15 Financial Reporting

Balance Sheet: The Companies Act requires that every Balance Sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year. It shall be in the form set out in Part I of the Schedule III under the Companies Act, 2013). In preparing the Balance Sheet, the preparers should follow the general instruction for preparations of Balance Sheet under the heading 'Notes' at the end of the aforesaid Part of the Schedule.

Statement of Profit and Loss: Like Balance Sheet, every Profit and Loss Account of a company is required to exhibit a true and fair view of the profit or loss of the company for the financial year. The Profit and Loss Account is required to be prepared as per the requirements of Part II of the Schedule III under the Companies Act, 2013). Like Balance Sheet, Profit or loss is also prepared in the vertical form (in which items of income are shown first and items of expenses are reported as a deduction from their form) as prescribed in Part II of the Schedule III. The main advantage of the vertical form of presentation is that it makes the Balance Sheet and Profit and Loss Account easily understandable to the users who may not have a basic knowledge of accounts.

The Profit and Loss Account has to disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature. Accounting Standard 5 on *Net Profit or Loss for the Period, Prior Period Items and changes in Accounting Policies* states that when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Schedule III also requires earnings per share to be given at the end of the Statement of Profit and Loss.

NOTE: For details, students are advised to refer Schedule III to the Companies Act, 2013 given at the end of Module I of the Study Material.

Narrative Disclosures: The narrative disclosures that are contained in published company accounts embrace both qualitative and quantitative information. In most cases narrative disclosures are presented in textual form wherein more emphasis is laid on words than on figures. Although most of the narratives disclosed in published company accounts relate to the items of basic financial statements, there are certain narrative disclosures, which focus on things that are not related to financial statement items.

In India requirements as to narrative disclosures stem from the provisions of the Companies Act and that of the accounting standards. These requirements are discussed under the following two broad heads:

- A. Accounting Policies
- B. Notes on Accounts

A. Accounting Policies: Accounting policies often contain a large volume of narratives that have a significant bearing on the financial health and performance of the company. Accounting Standard 1 on *Disclosure of Accounting Policies* issued by the ICAI deals with the disclosure

of significant accounting policies followed in the preparation and presentation of financial statements. The purpose of this standard is to promote better understanding of financial statements by ensuring the disclosure of significant accounting policies in the financial statements in an orderly manner. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

B. Notes on Accounts: The section titled "Notes to the Accounts" or "Notes on Accounts" contains sizeable data. Notes on Accounts are integral part of the financial statements. Some of the disclosures made under Notes on Accounts are in fact the extensions of the items of the basic financial statements; while other notes may provide additional information. Disclosure through notes is done either to comply with statutory requirements or the company may voluntarily choose to provide details on certain items. Such notes provide information about the accounting methods, assumptions and estimates used by management to develop the data reported in the financial statement.

Cash Flow Statement: In a cash flow statement, cash flows are required to be classified in terms of the activities generating them. AS 3 prescribes three types of activities that generate cash flows for an enterprise. These are:

- (i) cash flows generated by operating activities;
- (ii) cash flows generated by investing activities; and
- (iii) cash flows generated by financing activities.

Disclosure by Listed Companies

1. Balance Sheet, Profit and Loss Account and Directors' Report: Please, refer para given above.

2. Cash Flow Statement: Cash flow statements are prepared as per AS 3. Students are advised to refer AS 3 for details.

3. Related Party Disclosure: Transactions between related parties may not be at arm's length. Hence, companies are required to make appropriate disclosures in respect of such transactions so that users of financial statements can make their own assessment. Such disclosures have to be made in annual reports in compliance with the accounting standard on Related Party Disclosure (AS 18) issued by the ICAI.

4. Disclosure to be made by Holding Companies and Subsidiary Companies in respect of Loans, Advances and Investments: Disclosures are required as per section 129(3) of the Companies Act, 2013.

5. Management Discussion and Analysis Report: Management Discussion and Analysis (MD & A) report is a very important document through which management of a company can express its views and opinions on various aspects of a company like performance, success or failure, future plan of the company, forward looking information, etc.

The MD&A complements and supplements the financial statements, but does not form part of the financial statements. The objective in preparing the MD&A should be to improve the

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reporting company's overall financial disclosure by providing a balanced discussion of the results of operations and financial conditions. Although originally devised as a regulatory document to supplement financial statements, the MD&A report has the potential to be a foundational and integrative business reporting document that provides 'forward-looking information'.

The MD&A serves the laudable purpose of giving investors important disclosures about a company's operations. Although this section contains useful information, investors must heed caution, as the section is unaudited.

By virtue of the provisions contained in the Listing Agreement, the company has to provide a MD & A report to the shareholders. This report may be presented *as part of the directors' report or as an addition thereto*. It should include discussion on the following matters within the limits set by the company's competitive position:

- (i) Industry structure and developments.
- (ii) Opportunities and threats.
- (iii) Segment-wise or product-wise performance.
- (iv) Outlook.
- (v) Risks and concerns.
- (vi) Internal control systems and their adequacy.
- (vii) Discussion on financial performance with respect to operational performance.
- (viii) Material developments in Human Resources/ Industrial Relations front, including number of people employed.

6. Corporate Governance: In India the first attempt was made by the Confederation of Indian Industries (CII) to codify Corporate Governance. But the genesis of the provisions on Corporate Governance contained in the Listing Agreement is the Report of Kumar Mangalam Birla Committee. On 7th May 1999, the SEBI had set up a committee under the chairmanship of Sri Kumar Mangalam Birla to formulate the code of Corporate Governance. The SEBI in its meeting held on 25th January, 2000 accepted the recommendations made by the committee and suggested incorporation of certain matters in the Listing Agreement.

The following disclosures shall be made in the section on the corporate governance of the annual report.

- (1) A brief statement on listed entity's philosophy on code of governance.
- (2) Board of directors:
- (3) Audit committee:
- (4) Nomination and Remuneration Committee:
- (5) Remuneration of Directors:
- (6) Stakeholders' grievance committee:

- (7) General body meetings
- (8) Means of communication
- (9) General shareholder information
- (10) Other Disclosures:

4. Corporate Reporting Practices in India

There are few studies that deal with Indian practices of corporate financial reporting. The Institute of Chartered Accountants of India has made survey of corporate reporting practices in India from time to time. Other notable studies on financial reporting in India are Dasgupta Lal, Chakraborty and Banerjee. An analysis of the findings of these studies reveals that Indian corporate reporting practices are coping with changing needs of the economy and the society. Furthermore, the compliance with statutory disclosure requirement is a general phenomenon. However, in a recent study by Das reveals that there are cases of non-compliance with mandatory disclosure requirements. Thus, there is scope of improvement in the area of reporting of even mandatory disclosure items and role of management is important since the ultimate responsibility of providing information to the user rests on management. It may also be noted that there is a great amount of diversity in corporate reporting. The quality of information provided by the big companies has improved considerably and reports of some Indian companies are internationally competitive. With this brief introduction, we discuss in the following section the current reporting practices of Indian companies.

4.1 Published Financial Statements

Annual report is major vehicle through which Indian companies are publishing their financial statements. Like companies of any developed countries, Indian annual reports now include much more than the legal minimum requirements. Regarding elements of annual reports, the following are most common:

- ◆ Notice of annual general meeting
- ◆ Director's report
- ◆ Management discussion & analysis
- ◆ Risk Management Report
- ◆ Audited Standalone financial statements
- ◆ Audited Consolidated financial statements
- ◆ Corporate governance report
- ◆ Shareholders Information
- ◆ Auditor's report on financial statements
- ◆ C & AG's Comments on Accounts (in case of Government Companies)
- ◆ Business Responsibility Report*

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- ◆ Information on human resources*
- ◆ Value added statement*
- ◆ Corporate social responsibility policy/report
- ◆ Environmental report*
- ◆ Information on Brand/ Intangibles*
- ◆ EVA report*

The marked elements are provided voluntarily. Regarding last few items disclosure is limited to large companies only. However, financial statements with respect to One Person Company, Small Company and Dormant Company may not include the cash flow statement.

4.2 Business Responsibility Report

SEBI recently mandated that the top 100 listed entities based on market capitalization of BSE and NSE should include 'business responsibility' reports in their annual report. Other listed entities may voluntarily disclose business responsibility reports. According to a SEBI circular, an entity's business responsibility performance will be assessed based on nine principles, business responsibility reporting is a step in the right direction, as it is expected to align Indian reporting requirements with global standards. Business responsibility reports can help entities demonstrate to key stakeholders – including investors, employees, the government and consumers – that their businesses are not detrimental to the environment, society or employees. This will positively impact brand reputation, attract, motivate and retain employees, provide access to global markets and attract foreign capital. To comply with the new reporting requirements, entities would need appropriate systems, mechanism and processes.

4.3 Corporate Social Responsibility Reporting

Every company having net worth of rupees five hundred crore or more, or turnover of rupees one thousand crore or more or a net profit of rupees five crore or more during any financial year shall constitute a Corporate Social Responsibility Committee of the Board. The Board's report under sub-section (3) of section 134 shall disclose the composition of the Corporate Social Responsibility Committee and disclose contents of such Policy in its report and also place it on the company's website, if any, in such manner as may be prescribed; and ensure that the activities as are included in Corporate Social Responsibility Policy of the company are undertaken by the company. If the company fails to spend the prescribed amount, the Board shall, in its report made under clause (o) of sub-section (3) of section 134, specify the reasons for not spending the amount.

5. Other Reports

Disclosure of Financial Information in Prospectus: Prospectus is an important offer document that is issued by a company for making public issue of securities. SEBI (Disclosure & Investor Protection) Guidelines provide contents of the prospectus. There are requirements to disclosure certain important pieces of financial information relating to the issuer company and group companies. The major aspect of disclosure of financial information relates to reporting of audited profits and losses and assets and liabilities of the issuer company for each of the five financial year immediately preceding the issue of the prospectus. The requirements of the SEBI Guidelines on audited financial statements are similar to that of Section 26 of the Companies Act, 2013. Requirements of Indian Companies Act are elaborated separately. Other financial information that is to be provided in the prospectus includes.

1. Capital structure of the company
2. Utilization of Issue Proceeds
3. Financial Information of group companies
4. Promise vis-à-vis performance
5. Accounting and other ratios to justify the basis of issue price. (Such ratios shall be based on the financial statements prepared on the basis of Indian Accounting Standards)

It may be noted that abovementioned items are disclosed without any audit / review by independent accountant.

SEBI Guidelines, now allow an issuer company, if it so desires, to include in the offer document, the financial statements prepared on the basis of more than one set of accounting standards (e.g. Indian standards and US GAAPs) subject to disclosure of the material differences arising because of differences in the accounting policies of two different accounting standards.

Requirements of the Indian Companies Act regarding disclosure of financial information in prospectus are discussed under two heads: Auditor's report in prospectus and Accountant's report in prospectus.

Unaudited Quarterly Results: All listed companies are now required to furnish unaudited quarterly results in the prescribed proforma within one month from the end of the quarter to the stock exchanges on which it is listed and publish the same within 48 hours of the conclusion of the board meeting in atleast one national newspaper and one regional language newspaper. The quarterly results are to be prepared on the basis of accrual accounting policy and in accordance with uniform accounting practices for all periods on quarterly basis. It incorporates a statement of segmentwise revenue; results and capital employed prepared as per AS 17 on Segment Reporting and also comply with AS 22 on Accounting for Taxes on Income as regards measurement of the requirements of deferred taxes.

6. Best Presented Accounts

For many years the ICAI has been awarding shields and plaques for best presented accounts. The aim is to encourage companies in presenting accounting information in the financial statements convincingly to serve the information needs of the users in the best possible manner.

6.1 Conditions for Entry to the Annual Competition for the Best Presented Accounts

I. From 2004-2005 onwards, ICAI started presenting the awards for Excellence in Financial Reporting in following seven categories:

Category I: Manufacturing and Trading enterprises (including processing, mining, plantation, oil and gas enterprises).

Category II: Finance sector (including NBFCs, mutual funds, investment bankers, HFCs etc.).

Category III: Service sector (including hotels consultancy, transport, stock exchanges, R & D, private hospitals).

Category IV: Banking, Insurance and Financial Institutions.

Category V: Information Technology, Communication and Entertainment enterprises.

Category VI: Infrastructure and Construction sector (including power generation and supply, port trusts, roads).

Category VII: Others (Section 8 companies, educational institutions, NGOs, charitable hospitals and other organisations).

Gold Shields and Silver Shields are presented, in all the seven categories, to the award winners for 'Excellence in Financial Reporting'.

II The accounts for entry to the competition should relate to the financial year ending on any day between 1st April and 31st March of next year.

III Six copies of the following documents (or such other similar documents as are prepared by the Organisation concerned) should be sent to the Secretary, Research Committee, the Institute of Chartered Accountants of India, Indraprastha Marg, New Delhi-110002, so as to reach him before the specified date.

- (a) Balance Sheet
- (b) Profit and Loss Account
- (c) Directors' Report
- (d) Chairman's statement or speech at the Annual General Meeting.

IV. No form has to be filled up and no fee is payable.

V. Cyclostyled copies of the Annual Report and Accounts are not accepted. This condition,

however, does not apply to entities covered by Category IV.

VI In all matters concerning the competition, the decision of the panel of judges appointed by the Institute will be final.

6.2 Some Important Factors Generally Considered for the Award of Gold/Silver Shields and Plaques for the Best Presented Accounts

1. Compliance with the legal requirements in the preparation and presentation of financial statements as specified by the relevant statute, e.g., the Companies Act, 2013, in case of companies.
2. Basic quality of accounts as judged from the qualifications in the auditor's report, notes to the accounts and compliance with the generally accepted accounting principles such as those enunciated in the Accounting Standards, Statements, Guidance Notes, etc., issued by the Council of the Institute of Chartered Accountants of India and its various Committees.
3. The nature and quality of information presented in the accounts to make the disclosure meaningful. For example:
 - (i) Sufficient details of revenues/expenses for financial analysis, e.g., distinction between manufacturing cost, selling cost, administrative cost.
 - (ii) Use of vertical form as against the conventional "T" form; judicious use of schedules; use of sub-totals; manner of showing comparative figures; ease of getting at figures.
 - (iii) Extent to which additional financial information is provided to the readers through charts and graphs.
 - (iv) Extent of clarity, lucidity and comprehensiveness of the information contained in the financial statements, in the context of a layman.
 - (v) Financial highlights and ratios.
 - (vi) Inclusion of one or more of the information like value added statement, break-up of operations, organisation chart, location of factories/branches, human resource accounting, inflation adjusted accounts, social accounts, etc.
4. The extent to which the (i) Reports of the Governing Body such as Board of Directors Report and/or (ii) Chairman's Statement, if any, are informative. The following aspects are generally considered relevant in this regard:
 - (i) Availability of information regarding different segments and units of the entity, i.e., whether details about each product/service and units, and whether located in the same area or spread in different geographical locations, are given.
 - (ii) Information regarding financial operations, capital raised during the year, financial requirements, borrowings, etc. In respect of multi-product/multi-unit organisations, whether details as per (i) above have been given for financial operations.
 - (iii) Employee relations.

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- (iv) Industry problems and problems peculiar to the enterprise.
 - (v) Information regarding social concerns (e.g., contribution to conservation and development of environment and ecology).
 - (vi) Information on contribution to community development projects, (e.g., medical institutions, educational institutions, provision of sanitary and drinking water, etc.), particularly in areas around location of entity.
 - (vii) Post-balance sheet events not requiring adjustment in accounts but material enough to warrant disclosure and future plans, programmes, market conditions, profitability forecast, environment friendliness, etc.
 - (viii) Manner of review of performance, plans and prospects by the company.
 - (ix) Compliance report on the Corporate Governance, clearly indicating non-compliance with any of the mandatory requirements with the reasons therefor.
 - (x) Directors' Responsibility Statement required under section 134 of the Companies Act, 2013.
5. Layout of contents, general appearance, presentation and quality of printing.
 6. Timeliness in presenting accounts based on the date of the notice of the Annual General Meeting in respect of which the Annual Report is circulated to the shareholders.