Accounting for Stock Options
The New Principles
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Accountants
Men with Feet of Clay?

The article is an attempt to explode certain myths about Indian accounting. Given the scams in the Indian environment many questions are being raised about the integrity of internal control mechanisms as well as the effectiveness and adequacy of the controls imposed by law. Yet, the nature and extent of scams in India have been negligible vis-à-vis other countries. The institutional framework affecting corporate governance in terms of transparency, accountability and adequacy of information is intact, and with greater rigor and better understanding, the scope for scams can be reduced further. Ultimately, the scams originate from the human mind. If human genius is perverted, no amount of control can really provide any solution.

Experts have recently tried to define scams as financial or accounting frauds. Looked at in this way, accounting scams will cover those irregularities and frauds (more often perpetrated with the active participation or tacit connivance of top management) that take place due to misstatements in published accounts by using ‘creative’ accounting techniques or even downright window dressing.

Unlike financial scams, which can be perpetrated by either outsiders or insiders at any level, accounting scams will almost always need the blessings of the top management to flourish and succeed. In fact, more often than not these are motivated by the desire of company managements to either show better results and gain personally or to make direct personal gains at the cost of the company.

A look at the scams over the years shows a marked increase in the size and magnitude of the funds misappropriated and swindled. They also show a disturbing trend of scams having evolved into accounting scams from the earlier financial scams. However, this is development from financial to accounting scams is mostly seen in the US and Europe. In India scams till date have mostly been financial, be it Teju Kaya, Harshad Mehta, Ketan Parikh or the ‘Government Securities’ scam involving the cooperative sector. There have been practically no major accounting scams of the scale and magnitude of Europe in India. That does not mean that all is well on the Indian accounting scene. Some Indian balance sheets throw up examples of window dressing, be it by overstating current assets like stock or debtors, or by under provisioning of liabilities, or by using the convenient head of deferred revenue expenditure to carry forward large expenditure payouts.

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However, despite the perception that Indian accounting and auditing is not as advanced as US GAAP in terms of number, quality and depth of accounting and auditing standards and corporate governance legislation or the SEC regulations in the US and the more recent Sarbanes-Oxley Act, the actual number of accounting scams to have surfaced in India is very negligible.

This phenomenon needed to be investigated and hence this effort.

We need to analyze and explode myths of Indian accounting:

1. Indian accounting standards are rudimentary and not as detailed and advanced in numbers and quality as their US and European counterparts.

2. Indian auditing profession is more subjective in its approach and deals less with internal controls and advanced audit techniques, which are quantitative in nature and address risk management through the use of sampling techniques. Indian auditors are also perceived as weak on documentation and weak in carrying out planned procedures.

3. Presentation of annual accounts in India varies from company to company and auditor to auditor and lacks rigorous uniformity and comparability leading to a scope of misstatements and innovative creative accounting. Even the annual report dealing with intangibles is not uniform/common, with each company choosing to highlight only that aspect which shows it in good light. Thus, some companies present the value of their human capital one year and then turn to valuing their brand the next year.

4. Adequate legislative and regulatory framework to ensure good governance, transparency and disclosure does not exist.

The basic/fundamental principles of accounting are based on reliability (faithful representation, substance over form, neutrality, prudence and completeness), going concern basis, matching concept, materiality, prudence and conservatism.

These principles if applied in spirit are sufficient to ensure a true and fair presentation of accounts. In fact, all accounting standards draw their source and inspiration from these basic principles and concepts.

If the standards are applied by their letter rather than by their intent and objective, then the presentation will obviously not be true and fair. Standards should thus not become so rigid or oppressive that they will prevent the auditor from using his discretion to represent a transaction in (substance than in form), a true and fair manner.
In India where no standard existed for intangibles, auditors were following a practice of expensing or amortizing out the entire expenditure on intangibles on a conservative basis to protect the business from over stating the profit.

With the introduction of a standard where there is a rebuttable presumption of life of ten years for an intangible asset, straight-line amortization is now one of the permitted methods entities have started using for capitalizing intangibles which were earlier written off fully as revenue expenses. This maybe fine in cases where the intangibles really have a ten-year life. In cases where the failure risks are substantial compared to the likelihood of success a peculiar situation like the following would arise.

In the case of accounting for intangibles AS 26, AS 38. A company can, under the pretext that the patterns in which the intangible asset’s economic benefits are earned cannot be evaluated, adopt the straight-line method for amortizing the assets on the basis of a life of ten years resulting in overstating the profits of the initial year. The above practice, which is not in the true spirit of the standard gets supported and authenticated by the newly introduced accounting standards. In the past, before the standard was introduced, no company would dare to or dream of adopting such a policy.

The story of Yudisthira the Pandava king of Mahabharata who tricked Dronacharya by saying “Ashwatthama mruto jatah! Naro va Kunjarova” and saw his chariot immediately grounded (Yudisthira’s chariot floated an inch above the ground until then, depicting his honest and benevolent nature) reminds one of an accountant trying to categorize expenditure into capital or revenue and then selecting the softer option of deferred revenue.

Traditional conservatism and answering the call of conscience approach of Indian accountants and auditors have ensured that Indian accounts by and large present a true and fair view of the state of affairs leaving minimal scope for window dressing or misstatements.

Let us look now at some of the legislations, which ensured a true and fair view and promoted good (corporate) governance in India even before the Sarbanes Oxley Act came onto the scene in the US, corporate governance came to the fore in the western world and the Naresh Chandra committee was constituted in India.

A study of these provisions across various acts and regulations will reveal that many mechanisms, now sought to be incorporated by corporate governance legislation worldwide, existed in India much earlier and that the end sought to be achieved now by the newer legislation could be achieved then as well, by applying those provisions in the right spirit.

Financial accounting had its origin in the double entry system of accounting developed by Luca Pacioli in 1775. Financial statements were drawn up for the first time when joint stock companies were formed in the UK in 1875, where there was a divorce of management from ownership for the first time. Statutory financial accounting came into its own in the 1950s with the Companies Act, 1956 and thereafter with the statutory compliances required including cost accounting records and audit from the 1960s to 1980s.
Laws are made by the people and are meant for the people. They are like governments—of the people, for the people and by the people—and therefore, changes in legislation more often than not tend to formalize and sanctify the ground realities.

Traditionally, the management accountant has had a one-to-one relationship with the management (the internal management of the company). The traditional role was reporting financial cost and some non-cost information for product costing, planning and control, and decision-making.

Today the changes have come about not just in this relationship, but in the emergence of a number of new relationships whereby the management accountant has to some extent become the focus of strategic business decisions taken both inside as well as outside the organization.

The management accountant now has a relationship with the management (internal), the owners (shareholders and stakeholders—external), the workers (internal), financial institutions and banks (external), creditors and business associates (external associates), general public, society (external), regulatory authorities—Sebi, stock exchanges, etc., and the government.

Each of these stakeholders expects meaningful information and inputs from the management accountant.

In fact, it is the needs of these diverse entities that have led to statutory changes, which have had an impact on the management accountant’s role. This becomes clear if we map the statutory requirements of the different entities and their expectations from the management accountant.

Thus, the emerging role of the management accountant is to identify, collect, analyze, measure, and report information about critical factors like profitability, new product development and stakeholders’ satisfaction, on which the success of the business depends.

Managers expect accountants to know more about business and making strategic decisions than about accounting finance and costs.

**Provisions of the Companies Act, 1956 and MAOCARO Guidelines**

Apart from the detailed requirements of schedule VI of the Companies Act, 1956 which prescribes the format of the balance sheet and profit and loss account and the details and disclosures required thereunder, the following can be considered as milestones in reporting of management accounting information to external parties as a statutory requirement.

- GSR No. 909 (E); Notification No. 12/5/86-CL-V dated 7/9/1988).
- GSR No. 480 (E); dated 12-6-2003.

**For All Companies**

a. Deals with existence of sound internal controls, periodic, physical verification and checks and proper treatment of discrepancies.

b. Prejudicial financial transactions and business transactions with related parties.

**For Some Companies**

c. Whether the company has a reasonable system of allocating materials consumed and man-hours utilized to relative jobs commensurate with the size and nature of its business. Also, whether adequate internal control with a reasonable system of
authorization at proper levels exists on issue of materials and allocation of materials and labor to jobs.

Additional Information Required to be Given Under Part II of Schedule VI
In the case of manufacturing concerns, itemwise break-up of value and quantity (quantitative information) of all-important basic raw materials consumed. Quantitative and value details of each class of goods produced, opening stocks, production, purchases, sales and closing stocks and similar details to the extent possible for trading companies.

In the case of manufacturing companies detailed quantitative information of the licensed capacity (where applicable), the installed capacity and the actual production, value of imports, value added and exports. These provisions thus promoted transparency, propriety and efficiency which in turn promoted ethical behavior on the part of the management.

Appointment of Auditors and Laws Governing Them
Even in respect of appointment and removal of auditors under the Companies Act, 1956, mechanisms are in place to ensure that independence and professionalism of the auditors is maintained. Thus, auditors (long before their counterparts in the West had to follow it), in India could not and still cannot hold even a single share directly or indirectly in the company they audit for, nor can they earn more than 30% of fee from one client/group of clients and again cannot provide consultancy for fees exceeding the audit fee.

Provisions Relating to Cost Audit and Cost Audit Rules
Section 209 of the Companies Act provides for the maintenance of books of accounts, which include cost records where the government so prescribes and the same are audited by the cost auditor u/s 233B of the Companies Act, 1956.

A look at the Cost Audit Report shows that it is not just a routine audit of cost records but actually propriety, efficiency and a management audit. Cost audit was the first important step in conveying accounting and cost information with a managerial focus to outsiders though these were only the government and the statutory departments like the tax department and not the shareholders or the general public.

Listing Agreements with Stock Exchanges
The statements in lieu of prospectus are Section 60A and 61 of the Companies Act and Sebi guidelines and rules for public issues as well as terms and conditions of Stock Exchange Listing Agreements.

All these statutes require certain business projections to be filed regarding the sources of funds, their proposed deployment and the future projections of income and balance sheets for at least five years. It is expected that the company charts the actual performance vis-à-vis these projections and explains the shortfall/changes adequately and satisfactorily.

Recent Changes in Corporate Governance
The introduction and implementation of the concept of corporate governance through insertion of section 292A in the Companies Act by the Companies Amendment Act,
2000 w.e.f. 13/12/2000 with a view to ensuring the constitution of audit committees is the culmination of the process started in the UK by the Cadbury Committee in 1956 and the Kumar Mangalam Birla Committee in India in 1999.

The provisions of section 292A of the Companies Act, 1956 and clause 49 of the Listing Agreement with Stock Exchanges provide for, among other things:

- Full access to information contained in the records of the company and external professional advice, if any.
- Review of quarterly, half yearly and annual financial statements.
- Such executives (as the audit committee considers appropriate) shall be invited and will have to be present at the meetings (particularly the head of the finance functions this will include the management accountants as well).
- The role of the audit committee shall include, among other things.
  
  a. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
  
  b. Reviewing with management the quarterly, six monthly and annual financial statements before submission to the board, focusing on accounting policies, practices, procedures and standards.
  
  c. Reviewing the company's financial and risk management policies.

With the implementation of good corporate governance leading to more transparent, ethical and fair business practices to be adopted by corporates at large, the management accountant will now have to play a key role in providing inputs to the Audit Committee as part of the statutory requirements prescribed under Section 292A of the Companies Act.

Other Statutes

There are other statutes, which demand a variety of information. Thus, there is the Foreign Exchange Management Act (FEMA) and rules and guidelines which provide for furnishing of projections of five years to set up a Wholly Owned Subsidiary (WOS) company or Branch of an Indian Company outside India and vice versa and thereafter yearly reporting with an analysis of variances with explanations thereof. Quite simply put a management accountant's job.

Banks and financial institutions also require quarterly projections and future projections, estimates and budgets failing which penal interest is charged and credit facilities denied. Again a domain of the management accountant.

Government authorities continue to collect cost data and other relevant internal information from certain manufacturing industries for

- Cost plus contracts.
- Issuing drug price control orders.
- Granting protection to industry against unfair dumping by foreign countries.

Excise and Customs Authorities

Require the filing of data to set all industry rates of duty drawback to protect the Indian industry from unfair competition and to promote exports.
Income Tax Act, 1961

Sections 209 to 211 of Income Tax Act (1961) provide for payment of advance tax on the basis of estimates of income, which involves making accurate reasonable estimation.

Transfer Pricing Provisions

Sections 92 to 92F of the IT Act, 1961 (Budget—2001-2002) involve determination of arms-length price for an international transaction, again requiring the services of expert management accountant.

Payment of Bonus Act

The managerial accountant has to provide profitability information especially economic value added statements to determine bonus payable and remuneration incentives to workers and employees according to the provisions of the said Act.

Expectations of Stakeholders and Others

Shareholders progressively expect and companies want to provide external transparency, greater information and valuable content in their annual report. The annual report is now looked upon more as a communication of the annual accounts of the company for the limited purpose of compliance.

In this context the management accountant has a crucial role to play.

Thus, the emerging expectations and tools give an indication of the emerging future.

Management Accounting will move towards Social Accounting, Environmental Reporting, Inflation Adjustment and Net Present Value, Economic Value Added Statements, Human Resource Accounting, Business Valuation, Know-how Valuation and Brand Valuation.

The emerging expectations and the role of the management accountant thus seems to have a clear strategic emphasis. What is expected of today’s management accountants is to connect the basic accounting methods, tools and techniques and the overall needs of the organization.

A management accountant today needs to focus on:

• The competitive strategy of the firm.
• Identification and measurement of critical success factors.
• Use of cost management tools and techniques to achieve success.
• Understanding and application of cost management methods to:
  – Strategic management
  – Planning and decision-making
  – Financial reporting and
  – Control.

Today the management accountant has to come out of the organization and look at

• The contemporary business environment.
• New technologies of manufacture and distribution.
• The IT Revolution.
• Customer focus.
• Newer forms of organization.
• Social, political, cultural and above all considerations of ethics and fair play to protect organizational values.
Contemporary tools like total quality management, benchmarking, continuous improvement, activity-based costing/management, re-engineering, constraints, mass customization, target costing, life cycle costing, balanced score card, and so on.

Today, accountants the worldover are being questioned about the usefulness and relevance of their figures and statements for decision-making and understanding the value, worth and state of business.

Vested pressure groups have off and on dismissed reported profit figures of financial statements as a dubious product of creative accounting, thus reaffirming the perception that financial statements conceal more than they reveal.

In this scenario the management accountants equipped with the emerging tools and not shackled by (free from) obsolete standards, concepts and practices like historical cost and going concern, have their role/work cut out for them.

They can step in, bridge the information gap and claim their rightful place.

To reiterate, emerging management accountant is a—progressive, forward and future looking proactive business partner of the line/top management.

To sum up the approach of Indian accountants and auditors appears to be driven by the spirit rather than by professional attitude and or systematic approach. Indian accountants are seen to be ad hoc with less emphasis on documentation and regulation than their western counterparts. They also appear to use less of statistical techniques and rely more on gut feeling and hunch. In our opinion all of us have our foibles and shortcomings and lack of professionalism cannot be used to bracket them as 'men with feet of clay'. It is the spirit, which is important, and as long as the spirit of fair play and independence exists and is fostered, Indian accountants can equip themselves with newer tools and technologies and stand up with the best in the world.

As Charles Handy once said:

"Success goes to people who invent the world and not to those who respond to it. Life is best understood backward, but has to be lived forward."

Select References


Reference # 09M-2005-12-03-01