Financial Reporting
CONTENTS

Worldwide Financial Reporting: Charting for Future
Lingisetti Venu ................................................................. 9

The international disparities against global accounting uniformity is an interesting study. This article demonstrates various inherent factors such as diverse country practices for such differences and how emphasis on quality disclosure could be helpful in this scenario.

Financial Reporting in India
Vishnu Kanhere and Guruprasad Murthy ................. 13

Quality Financial Reporting: Using Truth to Achieve Market Efficiency and Greater Prosperity
Paul BW Miller and Paul R Bahnson ......................... 24

Ethics in Financial Reporting
Swapan Kumar Bakshi ............................................ 35

Directors’ Report: The Nucleus of Corporate Reporting
Dharminder Singh Ubha ........................................ 42

Segmental Disclosures and Corporate Governance: The Road Ahead
Neeti Sanan ................................................................. 49

Corporate Environmental Accounting and Reporting: A Green Framework
P Malarvizhi ................................................................. 54

Fair Value: A Tool for Financial Reporting
S Vijayalakshmi ......................................................... 60

Role of Voluntary Disclosure and Transparency in Financial Reporting
Pankaj Madhani ............................................................. 63

Accounting for Globalization and its Impact on Corporate Reporting
A Vinayagamoorthy ..................................................... 67

Converging Accounting Standards: The New Buzz in Financial Reporting
B Sujatha ................................................................. 71

Financial Reporting of Banking Companies in India
Kashmir Singh ............................................................... 76

Features

Top Line ................................................................. 5
Financial Reporting
News Roundup ............................................................. 6
Financial Reporting

For companies in the European Union, International Financial Reporting Standards (IFRS) have become mandatory from the current year. Accounting standards constitute the basis for the preparation of financial statements and provide essential information to carry out the audit, in almost all the countries of the world. These are concerned with system of measurement and disclosure rules for the preparation of financial statements. The rationale of the accounting standards is to improve the quality of Financial Reporting. Because of the globalization, awareness of capital markets and the size of the investment by the public are increasing. As the foreign institutional investors are investing in a big way, the reporting system is gaining importance. There is a greater need for the legislation to bring transparency, uniformity and rationalization in accounting standards. International Accounting Standards Committee (IASC) was established in 1973 to formulate accounting standards. 41 standards have been accepted in all countries except Canada and Japan. On May 25, 2000, the US Securities and Exchange Commission (SEC) admitted the acceptance of International Accounting Standards (IAS) for use in cross-border listings in the US. In 2001, the international fraternity of accountants constituted the International Accounting Standards Board (IASB) to evaluate and prescribe norms for treatment of several items. Financial Accounting Standards Board (FASB) and IASB are in the process of eliminating the differences in some of the standards.

Most of the users and their auditors are finding the international accounting standards too complex and, some contend, too theoretical. Even companies in the UK, which are the supporters of IFRS, are now finding the costs and complexities too onerous. Banks and corporate entities in Europe are suffering from “regulatory fatigue”. Basel-II and the so-called Markets in Financial Instruments Directive (MiFID) also add to the complexity with little discernible benefits.

Adopting a common Financial Reporting language is a big move towards improving the efficiency of international capital markets. Adoption of IFRS will reduce barriers to both trade and the flow of capital. The aim is to set uniform accounting standards that can be applied globally. Audit firms will be able to maintain quality of audits and regulators will benefit from consistency and quality of information. Reshaping of internal Financial Reporting system, enhancing the communication of financial results to investors, stakeholders and analysts reduce the costs of capital. As more and more companies are becoming global entities, cross-border accounting compliance will remain a key element of doing business. The American subsidiaries of foreign entities must follow the same accounting standards as their corporate parents, and for many, that means IFRS. Australia has become one of the first countries to implement the international accounting rules that were supposed to attract foreign investment and encourage local companies to compete offshore. Largest European multinationals like Novartis, Nestle SA, and Allianz group have completed transition to IFRS. Nokia, the Finland-based mobile communication provider, also shifted to IFRS.

S Vijayalakshmi
Financial reporting and fiscal discipline go hand in hand. From a 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. The Management Information Systems (MIS) reports have undergone considerable change over the years. This article looks at financial reporting in India and the change that has come in both internal reporting and external reporting and its role in transforming corporate India.

The major quantitative information in any organization is accounting information. Every company has to publish its annual report obeying the guidelines of corporate law of countries in which they are incorporated. Financial reporting is thus of two types, external and internal reporting.

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 i.e., national and international. Thus, external reporting requires actual revenues and costs presented in accordance with the prescription of laws and the Generally Accepted Accounting Principles (GAAP), once again, national and international.

Internal Reporting
Internal reporting refers to internal information tailor-made to suit the needs of management at different echelons in the organization. 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 problem-solving. While external reporting addresses mainly score-keeping and very little about the other two aspects, 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 article is to outline, chart and address the issues of financial reporting in India.
The Context
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”.

To create an open and efficient financial system, an effective financial reporting system is required. The financial reporting that is based on transparency, integrity, speed and efficiency is the cornerstone of true corporate governance. This in turn will 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 in the form of MIS reports to internal stakeholders for management decision-making and external reporting to all the stakeholders for communication, compliance and investment decisions. Internal financial reporting was traditionally based on MIS reports that relied more 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 (SCM) that encompasses activity-based Costing, Value Chain Analysis, Zero-base Budgeting, Business Process Reengineering (BPR), Balanced Scorecard, 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 come in the annual and financial reporting by corporates therein. It is felt that these changes will help to improve fiscal discipline, transparency and reliability leading to an efficient financial system in India.

The Annual Report
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.

The bulk size of annual reports is reflecting the growing disclosure and details that annual reports convey, e.g., the Infosys annual report of 1995-96 contained 96 pages and the one for the 2004-05 had 170 pages. But even now, the degree and extent of disclosure continue to vary as it can be seen from a look at the annual report of IndusInd Bank for 2005-06, which has 55 pages. If we look in 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 along with certain additional information required by the Companies Act like statement of particulars of employees, quantitative data regarding production, turnover and statement regarding energy conservation measures, and so on.

If we compare that with today’s disclosures, both statutory and voluntary, we find a major shift—a change for the better.

The primary reasons for this change are:
- The growing number of stakeholders are now interested in using the annual report (Figure 1).
- The changing/growing expectations of users—stakeholders, and
- The requirements of newer legislation that is being put in place by government and regulatory bodies (Figure 2).

**Figure 1: Growing Stakeholder Interest in the Annual Report**

(A) Past

Management and Employees

Annual Report

Shareholders

Government/Regulatory Authorities

(B) Present

Management and Employees

Business Associates

Annual Report

Creditors

Shareholders

Government/Regulatory Authorities

Banks/FIs
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 organization and its team.

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

It thus communicates to the stakeholders a lot of what cannot be precisely measured, reflected, quantified or captured, but needs to be conveyed, appreciated and 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-1.

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, accounting, audit—internal and external, and finally communicating it to stakeholders—to the internal stakeholder for decision-making and to the external stakeholders for compliance and governance. A perusal of the diagram below shows...
### Box 1: Contents of a Standard Annual Report of a Progressive Company

**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 — Directors' 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 (Indian 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

Contd...
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 (Figure 3).

Let us look at the changes in accounting and auditing which are the major components of the reporting cycle and have been instrumental in substantively influencing financial reporting and determining its quality to a great extent.
Accounting Standards

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 increased complexity of transactions in the modern commercial world, accounting standards need to evolve, as they cannot remain static and rooted to the past.

A quick look at the Accounting Standards in India shows that till 1994 there were only a handful of standards, less than ten in number. The years 1993, 1994 and 1995 saw a spurt in standards which reached upto 15 in number. Thereafter between 2000-01 came another slew of standards which saw them going past 30 by 2005-06. 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, Government grants, Borrowing costs, Segment reporting, Related party disclosures, Leases, Earnings Per Share (EPS), 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 for a more balanced, transparent, uniform and meaningful reporting that helps investors and stakeholders to 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 began 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 aftermath of the huge scams and financial irregularities of the recent past, when their very integrity, need and existence was questioned by the world. 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 the transactions and activities covering multiple segments and multiple currencies across the seven continents. Therefore, accounting standards had to keep pace with global investors and stock-holders demanding international standards in India.

Having seen the drivers on the accounting side for the changes in the financial reporting, let us now look at the auditing aspect.
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 should be quick enough to provide comfort to the 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 in 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 the responsibility of management as well as the auditors.

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 watchdog, has also changed with stakeholders expecting them to be more proactive in looking for frauds, irregularities and errors like a more aggressive and alert watchdog, 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 independent 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 improved standards auditing is getting e-enabled and the quality of financial reporting by auditors is bound to improve.

Risk-based Approach
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, disaster risk, 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 also in financial reporting, so as to make reporting efficient and effective.

**Emergence of XBRL – Financial Reporting Standard**

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 uncomparable. Despite the advances in computing and information technology, this information is not always searchable. The use of hypermedia, especially Extensible Business Reporting Language (XBRL), is fast emerging as the global standard making this information more meaningful and searchable.

**XBRL**

Extensible Business Reporting Language is based on Extensible Markup Language (XML). 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 the world over, 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 dislikes vis-à-vis competitors. Corporate reporting will also improve as more and more countries are preparing to adopt it as the reporting standard of choice.

**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 Global Trust Bank (GTB), the message was clear and the writing was up on the wall. Reporting has to improve, if the financial system is 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 is financial and the other is 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 happened the world over shows that the frauds in India are more the financial type (CRB, Cooperative banks, etc.), as against those abroad.

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.

**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 Sarbanes-Oxley Act (SOX), 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 Chief Executive Officers (CEOs) and Chief Financial Officers (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 authorities. Today the picture is in the other way. Law requires that the CFO and CEO, who actually operate the business of the company and are in charge of the finance and also the accounting function, should sign and authenticate these statements apart from the Board of Directors and the auditors.

**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.

**The Way Forward**

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

<table>
<thead>
<tr>
<th>Year</th>
<th>From</th>
<th>To</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>10</td>
<td>40</td>
</tr>
<tr>
<td>2. Auditing</td>
<td>Mechanical, check list and tick box approach</td>
<td>proactive, continuous risk-based audit approach</td>
</tr>
<tr>
<td>3. Reporting medium</td>
<td>Hard copy</td>
<td>Excel, Word, Pdf, XBRL,</td>
</tr>
<tr>
<td>Standard</td>
<td>MAOCARO</td>
<td>CARO,</td>
</tr>
<tr>
<td>Requirements</td>
<td>-</td>
<td>Clause 49 compliance</td>
</tr>
<tr>
<td>Signatories</td>
<td>Directors and Auditors</td>
<td>CEO, CFO, Directors, Auditors</td>
</tr>
<tr>
<td>Accounting system</td>
<td>Single-entry in public accounting</td>
<td>Double-entry in public accounting municipal, government and Public bodies</td>
</tr>
<tr>
<td>Contents of annual report</td>
<td>Annual report contains director report, auditors report and financial statement</td>
<td>Comprehensive, transparent annual report containing adequate disclosures</td>
</tr>
</tbody>
</table>

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

In the US the SOX 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, in turn leading to better compliance and good governance.

The accounting and reporting world, including financial analysts and stock market pundits, has now recognized the importance of green accounting and ecologically-sustainable Return On Investment (ROI).

In the long run, companies that are socio-ecologically progressive do better than those that are solely motivated by profits. Goldman Sachs has reported that, “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.

Reference # 09M-2007-06-03-01