

## Chapter 3

# Reporting Standards

### 3.1 Introduction

In the last few years there has been a global phenomenon of an integrated and interdependent world economy, with free flow of goods, services, and capital. The emergence of a global market has given rise to changes in the financial environment within a country. A feature of the international financial environment is the increasing trend towards an integration of the world capital markets. Capital market integration has many advantages to both the issuers and the investors, as there will be optimal use of investment funds and allocation of consumption.<sup>139</sup> Investors may derive many benefits from international securities trading. They have opportunity for increased risk-adjusted returns and diversification that allows investors to reduce the systemic risk associated with domestic securities because of the low returns.<sup>140</sup> Investing globally also provides investors with opportunities to outperform domestic markets. For this, investors need an efficient disclosure system that can supply them, at a low cost, the information needed for the accurate pricing of the stocks. From the issuer's perspective, offering securities globally will reduce the cost of capital for the companies.

Capital market integration has certain impediments. Amongst them, an important problem faced by the investor relates to interpreting financial statements based on the diverse set of accounting and reporting rules across different countries. Companies prepare financial reports for the stakeholders who use them for decision-making. These statements are prepared based on certain accounting principles. In order to compare a company's results across countries, the investors need to understand the accounting practices of different countries that are prepared based on different measurement and accounting standards. Measurement differences such as asset valuation basis, adherence

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<sup>139</sup> T. Bayoumi and R. MacDonald, "Consumption, Income and International Capital Market Integration", 42 (3) *IMF Staff Papers* 552- 576 (1995)

to historical cost in the primary accounts, the use of discretionary reserves to smooth income, income tax, accounting for research development, depreciation, leases and pensions. Differences also exist in the reporting formats, differences in consolidation, foreign currency translation differences, goodwill, equity accounting and reporting segment information and non- financial information.<sup>141</sup> The scope of financial statements may also differ, for instance, in India individual financial statements and consolidated statements are prepared, while in the US only consolidated financial statements is required.

In a study by Choi and Levich the institutional investors, corporate issuers, underwriters and market regulators of five countries (Germany, Japan, United Kingdom, United States and Switzerland) were asked to identify accounting items that were important for making foreign investments. They found that in addition to those items described above, treatment of long-term contracts and provisions, frequency of interim information, and description of capital expenditures were stated as factors having an impact on foreign investment decisions. The study also found that forty eight percent of those interviewed felt that their decisions were affected by the diversity in accounting standards. Majority of the investors and underwriters who made investment decisions directly felt that accounting diversity was a problem.<sup>142</sup>

In any system, application of different accounting principles will result in differences in reported numbers in the financial statements. Accounting diversity hinders the measurement of decision variables and ultimately affects their decisions regarding the geographic location of market activity, the types of company invested in, information processing costs, as well as the pricing of international securities. The impact of accounting differences will reflect in the unwillingness of investors to invest in countries where the accounting standards are considerably different from those in their home countries.<sup>143</sup> Variation in accounting therefore becomes an informational barrier that impedes capital flow

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<sup>140</sup> C.W. Smith Jr., "On Trading Foreign Securities in US Markets", *Modernizing U.S. Securities Regulation: Economic and Legal Perspectives* 77-82 (K. Lehn and R. Kampuis eds.,Pittsburg: Pittsburgh Center for Research on Contracts and the Structure of Enterprise, 1992)

<sup>141</sup>G.K. Meek and S.M. Saudagaran, "A Survey of Research on Financial Reporting in a Transnational Context", 9(1) *Journal of Accounting Literature* 145-182 (1990)

<sup>142</sup> F.D.S Choi and R.M. Levich, "International Accounting Diversity: Does it Affect the Market Participants?", 47(4) *Financial Analysts Journal* 73,73-82, (1991)

<sup>143</sup> *ibid* at 78

across countries and it will be a potential loss for such countries. Hence there is a need for comparison of the disclosure standards.

The comparison of international accounting is viewed from four perspectives: this could be due to historical reasons, multinational reasons, comparative reasons and harmonisation reasons.<sup>144</sup> A country based comparison of the development of accounting helps in understanding the evolution of current practices, against the cultural background of each country. The comparative study of historical developments helps in identifying the institutions that have been instrumental in the development of accounting and other regulations. The United Kingdom was the pioneer followed by the United States and others in the development of accounting. The Institute of Chartered Accountants in England and Wales was established as early as 1880 and the UK was the first to export the concept of "true and fair view". Because of the colonial rule the accounting practices spread to many other countries including India. The American Institute of Certified Public Accountants (AICPA) was set up as early as in 1887, which initiated various developments in accounting. As discussed by Schipper, the investigation of disclosures made by firms in other countries can provide useful information to the US standard setters.<sup>145</sup> Quoting Easton et al., in her work "Easton provide descriptive information to the use of discretionary asset write-ups of non monetary assets in Australia. Their findings could be an input to policy discussion of feasibility and possible consequences of US standard permitting such write-ups." A study of historical developments in accounting will help in understanding how the accounting system evolved and the consequences of certain regulations, which in turn will aid the standard setting authorities of other countries.

There has been an increase in the activities of multinational companies all over the world. These companies purchase and sell goods from different countries and have set up operations in more than one country either in the form

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<sup>144</sup>R.H. Parker, "Some International Aspects of Accounting", *International Accounting and Transnational Decisions* (S.J Gray ed., London: Butterworth, 1983) as cited in C. Nobes and R. Parker, *Comparative International Accounting* (India: Pearson Education Ltd, 2002) at 4

<sup>145</sup> K. Schipper, "Commentary: Academic Accounting Research and the Standard Setting Process", 8(4) *Accounting Horizon* (1994) at 66 Quoting P. Easton and T. Harris, "An Investigation of Revaluations of Tangible Long Lived Assets", 31(3) *Journal of Accounting Research* 1-45 (1993)

of subsidiaries or through branches or joint ventures. Multinational strategies are not restricted to operations but also involve financing and investment activities. Accounting information plays a crucial role for investments and operations of these companies in other countries. Financial reports are key means of communication between managers and others from different national backgrounds. Even though the core concepts of accounting are not very different internationally, differences in rules and the application of those rules hamper communication and become an impediment while functioning in different countries. Understanding the differences in the accounting and reporting practices of the countries is therefore very essential. If there were uniform measurement and reporting, the internal controls and audits would also be simplified. Many companies raise capital in international markets and consequently follow reporting practices that meet the international standards; to this extent the problems arising out of accounting differences are mitigated. When companies invest and trade across different countries for the capital, and the exchange of goods and services, there should be a common yardstick known to everyone by which its operations can be judged.

Harmonisation of accounting rules and regulations has become an important agenda for many organisations.<sup>146</sup> The International Organisation of Securities Commissions (IOSCO) is encouraging internationalisation or standardisation of prospectus information. IOSCO has issued 'International Disclosure Standards' for cross-border offerings and initial listings by foreign issuers. These include, recommended disclosure standards, operating and financial review and discussion of future prospects in the offer document. These non-financial disclosures are intended to enhance both comparability of information and investor protection. Similarly, they have approved certain core accounting standards based on the International Accounting Standards Board (IASB) pronouncements. Certain national standard setting bodies like the FASB in the United States have designed strategies to have their accounting rules applied beyond their respective jurisdictions and also to become the global standard setting body. Harmonisation of accounting standards affects the global equity market performance. Harmonisation would reduce both the cost of capital

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<sup>146</sup> Supra note 141 at 154

and market risk for the participants. This would result in a more efficient competition among markets and firms.<sup>147</sup> Other benefits of harmonisation include: Comparison of reports between companies in different countries, enhancing accuracy by reducing any arbitrary adjustments in the reporting, reduction in book keeping costs for multinational companies, easier consolidations and facilitating an efficient allocation of resources.<sup>148</sup> Harmonisation of domestic accounting standards with the foreign accounting standards may also affects the market performance and the trading volumes in a way, which may or may not be beneficial.<sup>149</sup> A comparative study of accounting and reporting regulations of countries helps policy makers in getting the best practices to their own country and adopt the same to their own environment.

### 3.2 Factors Affecting the International Differences in Accounting

A considerable amount of research in international accounting is devoted to investigating the relationship between accounting and its environment<sup>150</sup>. Accounting literature suggests that as the business environment changes, the demand and use of financial information also changes leading to the establishment and development of accounting. Accounting does not develop in a vacuum but reflects the particular environment in which it is developed, which explains why accounting systems, practices, and disclosure differ from one country to another.<sup>151</sup> Literature suggests that accounting is a social construct and is affected by and may be explained by a number of environmental factors such as a country's particular colonial history or stage of development, economic, political, legal, and cultural diversity.<sup>152</sup> A factor that affects

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<sup>147</sup> U. Geiger, "The Case for Harmonisation of Securities Disclosure Rules in the Global Market", <http://ssrn.com/abstract=57963>(Nov 12, 2002)

<sup>148</sup> C.W. Nobes, "Harmonisation of Financial Reporting", *Comparative International Accounting* 3-21 (C.Nobes and R.Parker, eds., New York: Prentice Hall Inc, 1991)

<sup>149</sup> M.E. Barth, G. Clinch, and T. Shibano, "International Accounting Harmonization and Global Equity Markets", 26 (1-3) *Journal of Accounting and Economics* 201, 202-235 (1999)

<sup>150</sup> This section draws information from various books referred in the bibliography.

<sup>151</sup> For a detailed discussion on these see: A. Adhikari, and R. H. Tondkar, "Environmental Factors Influencing Accounting Disclosure Requirements of Global Stock Exchanges", 4(2) *Journal of International Financial Management and Accounting* 75, 78-90 (1992) also see, L.H.Radebaugh, "Environmental Factors Influencing the Development of Accounting Objectives, Standards and Practices in Peru", 11(1) *International Journal of Accounting*, 39-56, (1975)

<sup>152</sup> Environmental factors are discussed in detail in by: S.J. Gray, "Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally" 24(1) *Abacus* 1-15 (1988)

accounting and reporting is the culture of the country. Culture includes a set of societal values that drive institutional form and practice.<sup>153</sup> Further these societal values have consequences in the form of legal system, political system, the capital markets and patterns of ownership etc.<sup>154</sup> Several environmental factors have an effect on accounting development such as the legal system the political system, the nature of business ownership (public ownership as against family holding and cross holding), differences in size and complexity of the business firm, social climate, the level of sophistication of business management (including low speed of business innovation like mergers and acquisition, equipment leasing etc.) and level of sophistication of financial instrument.<sup>155</sup> Tax accounting may also influence the corporate accounting practices to a certain extent. Some early studies provide results suggesting that accounting could be linked to economic systems and development among other variables, however the results were mixed and inconclusive.<sup>156</sup> Financial reporting and accounting practices in India and other countries reflect the influences of these factors.

Factors that influence the accounting system are depicted in Figure 3.1 Sources of finance, legal system of a country, the taxation system and the accounting profession are some of the main factors that affect the accounting and reporting system of a country and are discussed next.

### 3.2.1 Sources of Financing

Literature shows that the way in which the business is financed has a great influence on the accounting and reporting practices of a country. These could be the bank based financing system and the equity based financing system, which may affect the accounting system of a country.<sup>157</sup> In the United States, the capital market system and traditional separation of banking and industry resulted in a diffused ownership structure. In the United Kingdom too,

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and T.S. Douplik and S.B. Salter. "External Environment and Accounting Practice: A Preliminary Test of a General Model of International Accounting Development", 30(2) *The International Journal of Accounting, Education and Research* 189-207 (1995)

<sup>153</sup> G. Hofstede, *Culture's Consequences: International Differences in Work Related Values*. (California: Sage Publications, 1980)

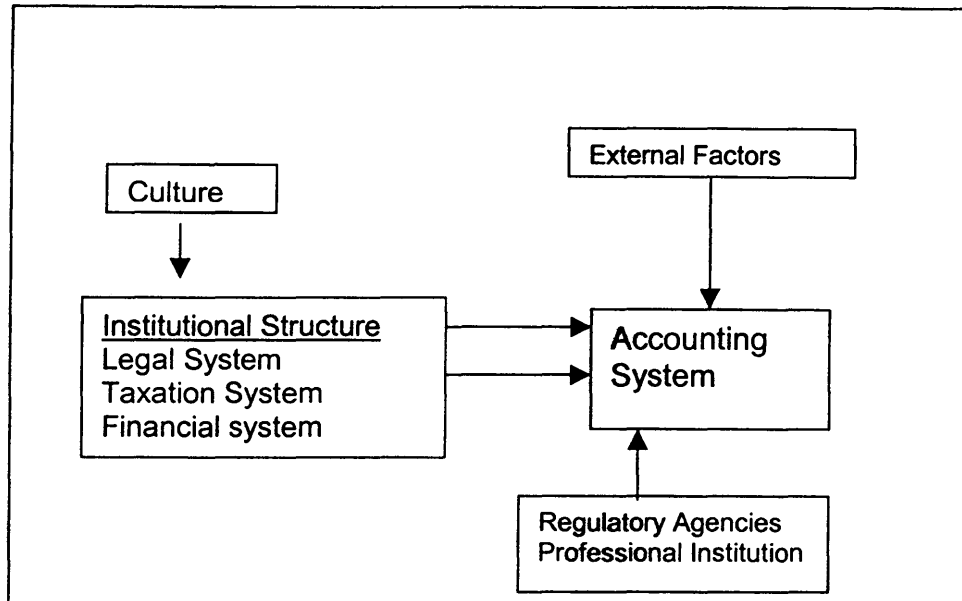
<sup>154</sup> S.J. Gray, "Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally", 24(1) *Abacus* 1, 9-10, (1988) where the culture is linked to accounting

<sup>155</sup> F.D.S. Choi and G.G. Mueller, *International Accounting* (New Jersey: Prentice Hall Inc, 1986)

<sup>156</sup> R.D. Nair and W.G. Frank, "The Impact of Disclosure and Measurement Practices in International Accounting Classifications" LV(3) *The Accounting Review* 426-450 (1980)

equity is the main source of finance. The Japanese system does not separate banking and industry; and as a result banks are important owners, monitors and suppliers of capital. In Germany, France and Italy capital provided by banks are very significant.

**Figure 3.1 Factors influencing the accounting system**



Source: Adapted from Douplik and Salter (1995)<sup>158</sup>

Many European countries have been influenced by family owned companies, which were mostly financed by banks. Banks play a major role as that of the shareholder as well as the creditor in financing these companies. The need for disclosures therefore is not very strong as major lenders and finance providers they have direct access to information. Hence, the objective of reporting in such countries is not transparency. In the USA and the UK shareholders are widely dispersed, and do not have access to internal information. This puts a pressure on companies to make fair presentation, or as in the UK a true and fair view of financial information to help investors in decision-making. The reporting practices in these countries are therefore very different.

<sup>157</sup> C. W. Nobes, "Towards a General Model of the Reasons for International Differences in Financial Reporting", 34(2) *Abacus* 162-187 (1998)

<sup>158</sup> T. S. Douplik and S.B.Salter, "External environment, Culture, and Accounting Practice: A Preliminary Test of a General Model of International Accounting Development", 30(4) *International Journal of Accounting* 189-207(1995)

### 3.2.2 Legal Systems in Different Countries

Literature broadly classifies the legal system into two types, the common law system and the code law system. The common law system gives a limited amount of laws or statutes and leaves the major part of interpretations to the courts. Common law is so called because it arises from common accepted practice of the market and when the practices become prevalent, courts will use the same for the judgements and subsequently it becomes a rule. The law has its origins in the UK. This has influenced laws of many countries like India. For example the Companies Act in the UK did not give the rules for preparation of accounting or disclosures for a long time. Instead accountants established their own rules and practices called as accounting standards. Accounting standards originated from commonly accepted principles of practice. These are enforced privately through civil litigation. Common-law systems typically place greater emphasis on public information systems.

The laws are developed on a case-by-case basis and the system encourages and permits the exercise of judgement.<sup>159</sup> The arms length principle in transactions, supported by the legal system ensures active capital markets. In a code-law system, the government enacts and enforces the accounting code, with violations carrying criminal penalties. Codified law system is based on the Roman law, which was developed in European Universities. Here the statutes are 'codified' i.e., rules are linked to morality and justice which then becomes a law. For example in Germany the accounting rules are part of the Company law. Countries like Germany, France, Italy, and The Netherlands and to some extent Japan are considered as codified law countries. Investors in such countries rely more on private rather than public information. The promulgation of laws relies on the government ministers having deep knowledge of the subject and contemporary business practices and working. The accounting system is characterised by less timely incorporation of economic losses in the books of accounts.<sup>160</sup> In comparison, the main strengths of common-law systems are that losses are quickly included in published financial statements. An example is the

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<sup>159</sup> I. Antl, "The Case Against International Uniformity", 5(1) *Management Accounting* 12,12-16 (1971)

well-cited Daimler–Benz case. Daimler recorded a profit of US\$ 733 million under German accounting and a US\$ 589 million loss in the US-GAAP accounting when it listed in the New York Stock Exchange indicating the income smoothing effect showing up in different GAAP.<sup>161</sup> When losses are recognised as soon as they are incurred, then managers will become aware of decreases in expected future cash flows from long-term investments and will include the information as speedily into the profitability as one-time losses. This system ensures that managers take action for improving the investments and strategies that are loss making, thereby making the company more efficient. Guiding the enforcement of timely loss recognition is also the threat of shareholder litigation.<sup>162</sup>

### 3.2.3 Taxation System

A country's tax system also influences the accounting system. Although taxation does not affect the reporting part of accounting, it may affect the measurement of accounting transactions. In countries like Germany and France tax rules and accounting rules seem to coincide. Tax accounts are the same as financial accounts and companies must record revenues and expenses to claims tax benefits. In Japan, for example, tax depreciation and accounting depreciation have to be the same to claim deduction in tax assessments. In the UK, depreciation does not depend on the tax rules. They are charged on the basis of Financial Reporting Standards and calculated based on established practices of accounting. Thus, the published accounts and accounts for tax, operate differently. The tax authorities adjust the financial statements for their own purposes later. In the US too, generally tax rules do not affect the financial reporting except in the cases of Last in First Out system of inventory valuation that can be used for tax accounting only if used in financial accounting. From this one can infer that when there are no rules in the accounting or when there is an

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<sup>160</sup> R. Ball, S.P. Kothari and A. Robin, "The Effect of International Institutional Factors on Properties of Accounting Earnings", 29 (1), *Journal of Accounting and Economics*: 1,2 (2000).

<sup>161</sup> Daimler-Benz AG (now Daimler-Chrysler), the first German company to list on the New York Stock Exchange, was required to reconcile its financial statements to US GAAP in accordance with the requirements of Form 20-F. For a discussion see, D. Alexander, A. Britton and A. Jorissen, "International Differences", *International Financial Reporting and Analysis* 34-36 (London: Thomson Learning, 2003) where the secret reserves and income smoothing are discussed.

<sup>162</sup> Supra note 113 at 2

alternative choice then companies will select methods that will reduce the tax liability rather than giving the true picture of the financial position.

### **3.2.4 Accounting Profession**

A well-developed accounting profession is another factor that will affect the accounting environment in different countries. The development of the accounting profession is a result of different factors such as the type of organisation and the way in which the business is financed. For example the role of audits will depend on the whether there are public companies with large shareholders or small privately held companies. Having a well-trained accounting professional lends credibility to the financial statements through audits.

The accounting profession also influence the regulations to a great extent. They interact with the government authorities for regulation of various laws relating to the accounting, reporting and taxation. In many countries the accounting profession themselves set the accounting standards for measurement and reporting like in India. Even in the US, the accounting profession initially set the standards before the SEC was made responsible for setting the standards. The professional body also ensures that there is a good system of training, which will enhance the quality of reports produced.

### **3.2.5 Other Factors**

Other factors such as inflation level, political and economic factors, educational level, historical background can cause differences in the accounting practices. For example in Mexico, where there is high inflationary rate, the accounting principles followed will be different as the historical cost of an asset becomes irrelevant. Such countries will follow some form of current cost accounting. The British Colonial rule has influenced the Indian and other Colonial country's legal system in many ways. The accounting and the legal system will be influenced by the British system. European countries follow the European Union directives. As boundaries for capital market are disappearing there is a need for comparison of disclosure regulations between several countries in order to improve the standards of disclosure regulations. The next section compares the disclosure regulations.

### **3.3 Comparison of Disclosure Regulations**

Accounting practices can be examined at two levels between countries: the macro level analysis and the micro level analysis. At the macro level, the analysis of the accounting systems will examine the accounting standards and the regulations formulated by different countries. Study of the accounting system also includes the process and procedures used to evaluate, set, revise and enforce accounting practices. The macro level analysis thus studies the uniformity in the disclosure environment. At the micro level, the analysis of the accounting methods used and applied by companies in different countries are compared. This dissertation compares the regulations of different countries at a macro level. It also examines the company level comparison of reporting standards of Indian companies.

Following the Nobes and Parker reasoning, the choice of countries selected for the study is based on criteria's such as strong accounting profession, existence of independent accounting body, countries of economic importance and having strong stock market.<sup>163</sup> The countries for this comparative study chosen are USA, UK and Germany, which are representative of the various legal systems. These countries can be divided into two broad categories of market-oriented system like the United Kingdom and the United States and planning-oriented system of Germany. A reason for selecting the UK is that the laws of the United Kingdom had a great influence on the laws of India due to colonial rule. The US disclosure standards are reported to be the best especially since it has a well-developed capital market and hence selected for the study.

In the following section a macro analysis of reporting regulation in different countries are analysed after tracing the development of accounting.

#### **3.3.1 Accounting Regulations in the UK, Germany, the USA, International Accounting Standards and India**

This section of the research compares the background and development of accounting disclosure for the United Kingdom, Germany, the United States, IAS

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<sup>163</sup> C. Nobes and R. Parker, *Comparative International Accounting* 12 (Singapore: Pearson Education, 2002)

and India. The development of international accounting standards is also discussed.

### **1. United Kingdom**

The Companies Act governs the rules relating to the financial reporting of companies. The accounting standards and the newly established Financial Services Authority's listing are other regulations that govern the disclosure requirements of listed companies. Certain industries like banking, insurance, municipal authorities, railways and the other major utilities are subjects of their own special legislation, and their own voluntary codes. Smaller businesses, such as private limited companies, are exempt from some of the disclosure requirements and are governed by rules for smaller enterprises.

Academic literature traces the development of the disclosure regulations to the early part of the twentieth century. The first Companies Act was enacted in 1844. The Acts of 1900, 1907, 1908, 1928 and 1948 had great impact on disclosures in the earlier years. These regulations required that the auditors of public companies report on the Balance Sheet, and the same was laid before the Annual General Meeting. During this period there was no uniformity in disclosure practices.<sup>164</sup> The 1907 Act, later incorporated into the Companies (Consolidation) Act of 1908, required public companies to file an annual balance sheet containing a summary of their capital, liabilities and assets. Particulars of the liabilities and assets and how the values of the fixed assets have been arrived were also required. No specific formats were prescribed nor the contents of the accounting reports were given. The profit and loss account was not legally required at that time. The period after 1908 was known as a period of limited publication of financial information, which was mandatory, and not much progress was made in the published reports.<sup>165</sup>

During the period from 1920 to 1947, major social and economic changes took place, which, led to increased levels of public financial disclosures by many companies. Companies raised money from the public through the major stock exchanges. The Companies Act of 1928-29 imposed additional disclosure

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<sup>164</sup> G.A Lee, "The Concept of Profit in British Accounting 1760-1900", XLIX(1) *Business History Review* (1975 ) at 19

<sup>165</sup> T. A. Lee, *Company Financial Reporting* 88 (London: Van Nostrand Reinhold, 1987)

requirements. The Director's reports and the profit and loss accounts were required to be presented to the shareholders. In the balance sheet, the fixed assets were to be distinguished from floating assets, instead of clubbing them under one head of assets, a practice followed till that time. Valuation of intangibles and tangibles like fixed assets, goodwill, patents and trademarks were required to be disclosed. The amounts due to and amounts due from subsidiaries, and loans to Directors and officers were to be separately disclosed. These developments were needed from the agency problem point of view. The detailed contents of the balance sheet and profit and loss account were not specified and the latter was not required to be audited.<sup>166</sup>

The 1929 Act did not have any provisions which required the disclosure of depreciation charges<sup>167</sup> or other items which would result in undisclosed understatement of net worth resulting from e.g. the excessive writing-down of assets, the overstatement of provisions and liabilities and the writing-off of additions to fixed assets as expenses (creation of secret reserves).<sup>168</sup> Companies had minimal disclosure requirements during this period and the legal requirements governing managerial behaviour and the disclosure of company affairs were unchecked and the company's Directors had a free hand in the management of the company and on the company's assets.<sup>169</sup> Matters of accounting were dealt with by private contract between shareholders and the Directors. Shareholders and creditors could choose whether they wish to enter into a relationship with the enterprise and both could look after their own interests by negotiating on accounting and auditing requirements.<sup>170</sup> Voluntary disclosure was backed by the Punishment of Frauds Act of 1857, which made it a criminal offence for any Director, officer or manager to falsify the company's books and accounts with intent to defraud any shareholder or creditor or to induce falsely any person to invest, either as a shareholder or creditor. This

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<sup>166</sup> J.R. Edwards, "The Accounting Profession and Disclosure in Published Reports, 1925-1935", *Accounting and Business Research* 6(3) 289-303 (1976), reprinted in *The Evolution of Corporate Financial Reporting* 275-98 (T. A. Lee and R.H.Parker eds., London: Nelson, 1979)

<sup>167</sup> J.R. Edwards, *Company Legislation and Changing Patterns of Disclosure in British Company Accounts 1900-40*, 5 (London: ICAEW 1981)

<sup>168</sup> R. Chandler, "Looking into Secret Reserves", 189(9) *Accountant*, 265, 265-70 (1983)

<sup>169</sup> Supra note 166 at 275 -298

<sup>170</sup> W.P. Kennedy, "Industrial Structure, Capital Markets and the Origins of British Economic Decline", 126 (Cambridge: Cambridge U.P 1987)

safety net ensured the quality of information rather than the disclosure of information itself. The result of such a weak reporting regulation and auditing was brought to public attention in the Royal Mail Case.<sup>171</sup>

The Royal Mail case involved the Chairman of the Board of Directors and the Auditor of the Royal Mail Steam Packet Company. Lord Kysant, the Chairman of Royal Mail Steam Packet Company, and H.J.Morland, Chief Accountant at Price, Waterhouse and Co., were charged with publishing a false prospectus in connection with public sale of its stocks. The company had followed accounting policies that hid the losses of the company. Excess provision was made, called as wartime taxation and later this provision was released into the profit and loss account. In this way the losses were transformed into apparent profits that were not evident from the published financial statements, which condensed the income into one head as balance for the year (after adjustment of taxation reserves and depreciation). Despite a trading loss the company reported a profit, which was mainly on account of the adjustment of the taxation reserves. The accounting policies came to light only when the company had financial problems and wanted restructuring of finances from the authorities and the preference shareholders for supporting the restructuring. As a result of this case, creating reserves became unacceptable accounting practices.<sup>172</sup> The practice of secret reserves was also dealt in the report of the Committee on the Company Law Amendment which stated that the existence of secret reserves itself would jeopardise the true and fair view rather than their undisclosed release into the financial statements.<sup>173</sup>

The Cohen Committee on Company Law Amendment was appointed in 1943, which had a great effect on the subsequent Acts. The Companies Act, 1948 brought substantial changes in the financial reporting practices and disclosures of companies with limited liability. Some of the major changes made were:

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<sup>171</sup> Rex V/s Lord Kysant and another, 1932 1. KB 442

<sup>172</sup> A.J. Arnold, "Secret Reserves or Special Credits? A Reappraisal of the Reserve and Provision Accounting Policies of the Royal Mail Steam Packet Company 1915-27", 21(83) *Accounting and Business Research* 203-214 (1991).

<sup>173</sup> A. J. Arnold "UK Accounting Disclosure Practices and Information Asymmetry During the First Quarter of The Twentieth Century: The Effects on Book Returns and Dividend Cover", 25(7) *Journal of Business Finance and Accounting* 775, 775-794 (1998)

<sup>174</sup> Supra note 173 at 775 -794

- all companies had to present annually an audited income statement and balance sheet to its shareholders
- Group accounts, had to be audited along with specified minimum disclosures
- Distinctions between reserves and provisions were instituted,
- Required disclosures were specified and increased (in the Eighth Schedule) including the disclosure of Directors remuneration, tax provisions and depreciation charge.<sup>174</sup>

Until the 1948 Act, the legislature required only minimum levels of disclosure. Following the Jenkins Committee report, many more disclosures were introduced to the profit and loss account and the Directors report especially the segmental information.<sup>175</sup> Most of the disclosures were adopted in the Indian Companies Act at different points in time. At present, the Companies Act, 1985 and the subsequent amendment in 1989 regulate the constitution and conduct of companies. Its provisions cover, company formation; company administration and procedure; allotment of shares and debentures; increases, maintenance and reduction of share capital; annual financial statements; audit of financial statements; and distribution of profits and assets. The requirement for all companies, both private and public, to prepare annual financial statements giving a true and fair view, to appoint auditors (very small companies are exempt from audit) and to file such financial statements with the Registrar of Companies, comes from the Companies Act. Holding companies of a certain size must file consolidated financial statements in addition to the individual company financial statements. It was only in the Companies Act 1989 that a definition of "accounting standards" was provided. Also companies over a certain size needed to state whether the financial have been prepared in accordance with applicable accounting standards.

The next important change in the reporting system came with the setting up of the Cadbury Committee and the report that was published. The Cadbury committee report had a great influence on reporting practices all over the world. Subsequently the Hampel Committee was established to review the implementation of the Cadbury Committee recommendations. Various other

committees were also established to look into the various control practices and the governance mechanism. For example the Turnbull Report and the Ruttman Report on the internal control systems.

To sum up, UK financial reporting stems from the Companies Act and the listing agreements. Initially they were left to self-regulation. However, the corporate failures forced the regulators to improve the reporting regulations and mandated many of the reporting requirements.

## 2. Germany

Germany is recognised as a Code Law country where the law regulates the aim of accounting and reporting of corporations. The earliest codification of commercial law was in 1794 where the development of the accounting law has been linked to the formation of the national state. German accounting practice is a result of detailed codification. The major sources of authoritative regulations on financial reporting are Commercial Law, Tax Law and Accounting Rules. The Accounting Directives Law of 1985 implemented the fourth, seventh and eighth European Union Directives have also impacted the reporting in Germany. Specific directives for industries like banks and insurance are also in existence. The various regulations related to accounting principles, auditing and disclosures are consolidated and codified into one single source in the Commercial Code. In addition, corporations are subject to requirements laid down in the Stock Corporation Law (AktG) and, Private Company Law (GmbHG). These laws define the shareholders rights, distributions of dividends and other provisions. Corporate form of organisations is required to follow additional financial reporting and disclosure requirements given in the Commercial Code.

Two major factors influencing accounting are the source of financing and the tax laws. The main source of finance to corporations was through debts and self-financing. Hence, the main aim of reporting and accounting was keeping in view the lenders and creditors perspective.<sup>176</sup> Conservatism principle or the

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<sup>175</sup> P. Gordon and S.Gray, *United Kingdom: Financial Reporting* (London: Routledge, 1994)

<sup>176</sup> Since banks were a major provider of finance, they were influential and also held positions in the supervisory board. Also see: P. Joos and M. Lang, "The Effect of Accounting Diversity: Evidence From European Union", 32(3) *Journal of Accounting Research* 383-405 (1994) W.Ballwieser, *Transnational Accounting* (D. Ordelheide and KPMG eds., New York: Palgrave, 2001) at 1241

prudence concept is the primary basis for accounting.<sup>177</sup> The result of this principle is reflected in the provisions made by the firms. Firms make additional provision for expenses even though there may not be any liabilities, creating 'secret reserves'. These provisions are written back in the future years when there are no profits i.e. like 'income smoothing'. The nature of provisions is also not disclosed which makes the reports less transparent. As banks were the major providers of finance the accounting reflected the lenders perspective. For example, the assets were valued at the current value correctly indicating the amount the creditors will get if the firm is wound up.

Tax laws have also impacted the accounting practices. As early as 1874 laws were passed declaring that commercial accounts would be the basis for tax accounts. The Massgeblichkeitsprinzip or the authoritative principle applies to the determination of taxable income. This principle states that tax accounts are based on the commercial balance sheet.<sup>178</sup> This means that the financial statements for the investors must reflect all the special deductions, depreciation and allowances in order to qualify as deductions from taxable income. Tax laws for example may give a higher rate of depreciation in which case it must be recorded in the statements to the investors. This may distort the financial position and the net result of companies.<sup>179</sup>

Tracing the history of accounting, the German Commercial Code of 1861 (HGB), required an 'inventory'. The word inventory meant the list of all the assets and liabilities. These assets were initially valued at the current market value instead of the usual historical cost. There was no requirement of the profit and loss statements, which meant that preparation of the profit and loss account was only a secondary function. Profits meant distributable profits, which would reduce the capital when distributed. In 1884, the Stock Corporations Act was passed which was again based on the balance sheet approach, with a change in the method of valuation of the asset, to be based on the historical costs for both the fixed assets and production costs. No formats were prescribed and the

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<sup>177</sup> L..Evans and C. Nobes, "Some Mysteries Relating to the Prudence Principle in the Fourth Directive and in German and British Law", 5(2) *European Accounting Review* 361-374 (1996)

<sup>178</sup> A.Haller, "The Relationship of Financial and Tax Accounting in Germany: A Major Reason for Accounting Disharmony in Europe", 27(4) *International Journal of Accounting* 310-323 (1992)

<sup>179</sup> An example of this distortion is found when Daimler Chrysler presented accounts under the US GAAP discussed earlier.

preparation of profit and loss account was not mandatory. Disclosures were meant to safeguard the interest of the public, creditors and the third parties.<sup>180</sup> Corporations were also permitted to create discretionary reserves along with the mandatory reserves. Failure of big banks in Germany around the 1930's made the government impose new rules regarding audit, format and content of the Balance Sheet and valuation aspects of assets and liabilities. The Commercial Code of 1897 was in existence for a long time until the amendment in 1985. The amendment of the Stock Corporation Law saw a few changes in the reporting and for the first time the shareholders interest was considered. Other than the Commercial Laws, there are sets of accounting rules and principles also known as GoB or Principle of Accounting that govern the reporting. Laws have also changed as a result of European countries harmonisation efforts, specially the European Union Directives. The Fourth and the Seventh Directives are related to the accounting. The Fourth Directive deals with the general rules of accounting in the European Union, which focuses on the individual accounts. The seventh directive focuses on the consolidated accounts. The directives are incorporated in the laws of each of the member countries. The directives specify a general set of rules with many options and flexibility. Commercial pressures on large companies have also influenced the reporting and accounting process along with the fact that many companies are raising capital in the international markets.

The Commercial Code (HGB) and the Accounting Standards (GoB) govern the main accounting rules. Financial statements of all business entities are required to be drawn up in accordance with Generally Accepted Accounting Principles. The Commercial Code provides that the annual financial statements must, comply with required accounting principles, present a true and fair view of the net worth, financial position and results. If special circumstances result in the financial statements not showing a true and fair view, additional disclosures are required in the notes. The rules also specify supplementary regulations for companies including requirements on classification of balance sheet and profit and loss account items, special valuation rules, notes to the accounts, management report, consolidation of accounts, audit and disclosure. Although true and fair view is incorporated in Section 264 of the HGB, no fundamental

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<sup>180</sup> *Transnational Accounting*, 1225 (D.Ordelheide and KPMG eds., New York: Palgrave, 2001)

changes has occurred in accounting and disclosure rules and more alternatives are available for accounting. In 1998, the Government allowed listed companies to adopt US GAAP or IAS for the consolidated financial statements.

To sum up, the financial accounting rules were a result of regulations, which was to protect the lenders and creditors. The main thrust of the accounting rules has been the prudence or the conservatism concept. The tax system has also influenced the accounting system. Changes in the law like other countries were as a result of failures of certain companies and banks and also pressures from the European Union.

### **3. United States of America**

United States is a federation of fifty states each of which has its own legislative body, which sets laws for business activity. Financing large operations for early industries like canals, railroads and utilities necessitated the need for large funds that led to the development of the capital markets. Parliament regulated business and capital markets through the state laws. Laws governing the transactions in securities were introduced by each state, however, they were not very effective. Stock exchanges of New York and the Philadelphia were founded in the late 18th century, which were instrumental in provision of capital for infrastructure development. Tracing the history of accounting, accounting practices were to some extent influenced by the regulations in the UK.<sup>181</sup>

Listed companies presented annual reports, which included financial statements but minimal in disclosures like the counterparts in the UK. By the mid 1800s, 'Statement of Cash' and 'Balance Sheet' were relatively common and, occasionally, income statements in some form were presented. There was little regulation beyond the demands of investors for information. Disclosure of financial information was voluntary. During the 19th and early 20th century the Balance sheet was paramount. The income statement was neglected because it was open to abuse as there were no accounting standard regulations. The income statement became more important only when industrial companies started to pay dividends based on earnings. The need for financial audits became more common only by the end of the 19th century.

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<sup>181</sup> Supra note 163 at 134

Regulations developed as a result of various frauds and other misdemeanours over time. In the 1890's government regulation, was demanded by the public, due to prevailing monopoly pricing and various predatory practices. States were generally unsuccessful in curbing these practices hence there was need for Federal Regulations. Federal regulations began with the Interstate Commerce Commission (ICC) Act of 1887 to regulated railroads. Federal antitrust began with the Sherman Act of 1890. From 1907, the US experienced a decade of reform legislation. The Clayton Act of 1913 was passed, the Federal Reserve was established the next year, as was the Federal Trade Commission.

The stock market crash of 1929 and the subsequent depression saw the establishment of two important legislations, The Securities Act 1933 and the Securities Exchange Act, 1934. The Securities Act was enacted for protecting investors from malpractices in the investment markets. The Act was modelled on various state regulations, British Companies Acts, and earlier Congressional legislation. The Securities Exchange Act of 1934 created the Securities Exchange Commission (SEC) to administer the legislation. The Securities Acts required companies to present registration statements with new public offerings of stocks, bonds, and other securities and to make "full and fair" disclosure of financial information. Information relevant to the investor was to be disclosed in the registration statement. Modern financial reporting and the development of Generally Accepted Accounting Principles (GAAP) started with this federal legislation. The SEC has the authority to regulate the accounting standards.

To sum up, the main driver of the accounting regulations in the United States has been some form of frauds and other market failures. The regulations were enacted to prevent frauds in the securities and capital market. In recent times the Sarbanes-Oxley Act, was enacted after the Enron collapse. Although initially modelled on the laws of UK, they are now more rule based.

#### **4. International Accounting Standards**

International Accounting Standards are the only standards set by an international body. The need for International Accounting Standards was attributed to; i) the growth of international investments and the problem the investors face in decision making based on diverse accounting principles and the

need for harmony in the accounting standards ii) The increasing prominence of multinational enterprises created a need for harmonisation of accounting standards to help avoid confusion and reduce the cost of producing multiple sets of accounts.

The international accounting body called the International Accounting Standards Committee was set up in 1972 that would deal with the issue of accounting diversity amongst various countries. The IASB was reconstituted as the IASB in the year 2001. The new Board has the right to make new standards and withdraw the earlier ones, however the International Accounting Standards (now named as International Financial Reporting Standards (IFRS)) continues to operate till they are changed. The objectives of the IASB are to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting and rigorously apply the standards. The IFRS gives the recognition, measurement, presentation and disclosure requirements dealing with transactions and events that are important in the financial statements.<sup>182</sup> There are 41 International Accounting Standards as on 31.3.2003.

Many international bodies including International Organisation for Securities Commission (IOSCO) felt the need for harmonisation. The Working Group of IOSCO prepared a report entitled 'International Equity Offers' which noted that development of a single disclosure document for use in cross border offerings would be greatly facilitated by the development of adequate internationally accepted accounting standards in 1989. This working group focussed on IAS instead of developing their own standards and required IAS to develop core standards. These core accounting standards has been endorsed by IOSCO and thus gained support in the member countries for harmonisation. Many stock exchanges, including those in London, Paris, Zurich, Rome, Frankfurt, Hong Kong, Luxembourg, Amsterdam, Stockholm, Thailand, Cyprus, Australia and the German Neuer Markt allow foreign-domiciled companies to present their accounts in accordance with IFRS. The critical exception to this is the US.

In the beginning, the IAS allowed a number of alternative treatments, which proved difficult for harmonisation. The IASC then issued E32 the comparability statement and also established a committee to justify or eliminate the accounting alternatives. The E32 included 32 issues, which were either taken as preferred treatments or eliminated after a due process. The IASC later issued a Statement of Intent: Comparability of Financial Statements in 1990. This comparability project initiated by the IASC for harmonisation of global accounting practises resulted in the issuance of many revised standards, with fewer alternative treatments than the originals.<sup>183</sup> Wherever there are alternatives IAS now shows a 'benchmark treatment' and 'allowed alternative' treatment. The IASB is considering the revision of at least eleven accounting standards in the near future.<sup>184</sup>

Many companies/countries have voluntarily adopted the International Accounting Standards.<sup>185</sup> From the year 2005 the European Union countries have a proposal to adopt the IFRS (IAS) in their consolidated financial statements. In addition, Russia, Australia and New Zealand have recently mandated that all reporting entities must adopt IFRS by 2004, 2005 and 2007 respectively. Due to these recent developments, many prominent commentators have predicted that convergence to one set of accounting standards worldwide is inevitable.<sup>186</sup> India too integrates with the IAS while formulating the Accounting standards wherever possible.

## **5. India**

The Indian legal and political system is largely influenced by the British System as it was under the colonial rule of the British. India has been included among the Anglo Saxon countries in many studies. As India adopted the corporate form of organisation following the UK. it was natural that the laws would take the shape of that in the UK. Corporate form of organisation with limited liability existed as early as 1848. The Bombay Stock Exchange was

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<sup>182</sup> [www.iasb.org.uk/docs/preface/ed-preface.pdf](http://www.iasb.org.uk/docs/preface/ed-preface.pdf) (July 12, 2003)

<sup>183</sup> S.B. Salter, and C. B. Roberts, "The IASC Comparability Project: A Cross National Comparison of Financial Reporting Practices and IASC Proposed Rules", 5(1)*Journal of International Accounting, Auditing and Taxation* 89, 89-112 (1996)

<sup>184</sup> IASB, Project Summary: Improvements to IASB Standards [www.iasb.org](http://www.iasb.org) (Feb 1, 2003)

<sup>185</sup> IASB, IAS around the world, source: [www.iasb.org](http://www.iasb.org) (Feb 1, 2003)

<sup>186</sup> B. Epstein and A. Mizra, *IFRS 2003: Interpretation and Application of International Accounting Standards* 19 (New Jersey: Wiley, 2003)

formed in 1875 under the name of Native Shares and Stockholders Association. Four major stock exchanges were functioning with listing trading and settlement rules in the early part of the twentieth century. At the time of independence India's manufacturing sector accounted for nearly 20% of the National Product.<sup>187</sup>

The corporate form of organisation grew along with a holding company or the managing company. This company was called as the "Managing Agency" The managing agencies could control the corporate with relatively low shareholding in each of the companies at the same time with dispersed ownership.<sup>188</sup> The owner investor of these companies thus enjoyed benefits disproportionate to their ownership. There were certain regulations imposed by the Act to control the managing agency and other problems related to the working of the agency system. Following the steps of the United Kingdom, India had in place Company law and various other laws. The Companies Act of 1866, 1882, and 1913 were modelled on the UK Companies Act. The Companies Act 1956 was as result of the commission set up in 1950 which though modelled on the UK Act had many other provisions considered to be superior from the British Act of 1948. For example the format of the Balance Sheet and the contents of the Profit and Loss statement was not provided in the UK regulations. Indian Companies Act required more demanding information than that in United Kingdom.<sup>189</sup>

In the early sixties and the seventies various policies (Industrial Policy Resolution) of the government and legislations passed thereafter became barriers to investments specially the foreign investments. The legislations relating to the Industries (Development and Regulation) Act, 1951, the Monopolistic and Restrictive Trade Practices Act, 1969 (MRTP Act) fostered entry barriers in the form of licences and other restrictions.<sup>190</sup> The MRTP act also

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<sup>187</sup> Sivasubramonian, "Income from the Secondary Sector in India 1900-47", 11(3) *The Indian Economic and Social History Review* (1977) at 489

<sup>188</sup> O. Goswami, "The Tide Rises Gradually: Corporate Governance in India" [www.oecd.org/dataoecd/6/47/1931364.pdf](http://www.oecd.org/dataoecd/6/47/1931364.pdf) (Sep 15, 2001)

<sup>189</sup> C. Marston, *Financial Reporting in India* 107 (London: Croom Helm, 1986)

<sup>190</sup> See Bagchi and also Ray for a detailed discussion on the growth of the Indian Industry since the early 1900's. A. K. Bagchi, *Private Investment in India: 1900-1939* (Cambridge: Cambridge University Press, 1972) and R. K. Ray, *Industrialisation in India: Growth and Conflict in the Private Corporate Sector, 1914-47* (New Delhi: Oxford University Press, 1979)

restricted the growth of the companies which had to seek licences for expansion. These legislations had an impact on the way the companies were formed and developed and to a certain extent on the disclosures made in the annual report. Subsequently, the accounting system and the development in financial reporting did not keep pace with the international developments.<sup>191</sup>

The securities market was governed by the Controller of Capital Issues (CCI) under the Department of Company Affairs and the Securities Contract Regulation Act. New issues were regulated through a merit based regulation where the CCI usually exercised its power with respect to the quantity, price and timing of the issues. The appraisal of the merits of the security was left to institutional holders and the public.<sup>192</sup> With the advent of the financial reforms the CCI was abolished in 1992. The new body regulating the securities market, the Securities and Exchange Board of India (SEBI) was established after the exit of CCI.

The Companies Act, 1956 governs the disclosures in accounting reports, along with the Accounting Standards. Listing agreements also mandate the companies to give additional disclosures in the Annual report. The accounting standards are influenced by the International Accounting Standards to a large extent. Over the years there has not been many changes in the disclosure regulations in the Companies Act. However, the Companies Act now mandates the accounting standards, thereby automatically imposing and expanding the corporate disclosures in India.

To sum up, reporting regulations in different countries have developed over a period of time as a result of various needs of the users. Many countries are now converging into the use of IAS (IFRS). The disclosure standards consist of reporting standards and the measurement standards that are dealt with separately as the factors influencing them will be different.<sup>193</sup> The next section deals with the reporting standards.

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<sup>191</sup> R. Narayanswamy, "The Development of Accounting Regulation In India", 1 (Supplement) *Research in Accounting Regulation* 331-365 (1997)

<sup>192</sup> K. Sekhar, *Guide to SEBI Capital Issues, Debentures and Listing* 4 (Nagpur: Wadhwa 2002)

<sup>193</sup> F.D.S. Choi, C.A. Frost and G.K. Meek, *International Accounting* 40 (New Jersey: Prentice Hall Inc. 1999)

### **3.4 Mandatory Reporting Standards**

Mandatory reporting standards are those relating to the reporting aspects with no measurement or accounting in it. These can be categorised into i) Disclosures under the Companies Act ii) Disclosures required by the Accounting Standards (AS) and iii) Disclosure under the Listing Agreement. List of accounting standards of the UK, Germany, the USA and IAS are given in Appendix 1, Panels B, C, D and E.

#### **3.4.1 Reporting Under the Companies Act and Similar Regulations**

The fundamental reporting requirement in all the countries is the preparation of the financial statements under any disclosure regulation. The financial statements viz. the Balance Sheet, the Profit and Loss Account and the Cash Flow Statement are required to be prepared in all the countries.

The Companies Act in India requires the presentation of the Balance Sheet in the format contained in Schedule VI. The contents of the Profit and Loss account are given in Part II of Schedule VI. The Cash flow statement is not required under the Act but is mandated under the listing agreement and as part of the accounting standards.

The US follows an integrated disclosure system. Here, the disclosures are specified by the SEC in the regulation S-X that gives the form and content of the financial statements to be filed with the SEC. There is no format specified but the major classifications and contents are given. The non-financial disclosures are given in the form S-K. Form 10-K has to be filed by listed domestic companies. It contains the financial statements as well as other information. It must be filed within 75 days (earlier 90 days) after the end of the financial year. From the year Dec 15, 2004 the reports have to be filed within 60 days from the end of the fiscal year. The quarterly information has to be filed within 45 days after December 15, 2004. From the year quarter ending after December 15, 2005 these reports have to be filed within 35 days.<sup>194</sup>

Foreign companies listed in the US have to prepare its statements in accordance with US GAAP, or reconcile statements prepared in accordance with

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<sup>194</sup> <http://www.sec.gov/rules/final/33-8128.htm#l> (Dec 03, 2003)

any another accounting standards, such as IAS to US GAAP in Form 20-F. US companies prepare only consolidated accounts and individual accounts are not normally presented.

The form and content of the financial statements in UK are given in the Schedule 4, Companies Act, 1985. The Act sets out two formats for balance sheet and four formats for the profit and loss account. Formats for other financial statements such as the cash flow statements and the statement of total recognised gains and losses are contained in the accounting standards. In Germany, the financial statements are prescribed in detail for limited companies under Section 266 of HGB and additional disclosures required in AktG.<sup>195</sup> These statements are to be published with the Commercial Register and the Federal Gazette, which then becomes a public document. Additional statements like, Statements of Changes in the shareholders equity and the Statement of comprehensive income are mandated in the United States. The Statement of recognised gains and losses and Statement of shareholders equity are required in UK. Germany requires the profit and loss appropriation account to be prepared.

The IAS prescribes a complete set of financial statements that include the basic financial statements along with a statement showing the changes in equity arising from transactions with owners as well other transactions on capital account. IAS does not prescribe any format prescribes minimum information to be presented in the financial statements. The financial statements are to be issued within six months from the date of the balance sheet. The comparative figures are for two years for all countries. The formats of the balance sheet and profit and loss account as mandated are given in Appendix 2.<sup>196</sup>

### **Presentation and contents: Balance Sheet**

The balance sheet gives the financial position of a company at a particular point of time. In a limited way they help the stakeholders to measure the firms liquidity, financial flexibility, ability to generate profits, pay dividends and to pay

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<sup>195</sup> Both the UK and Germany have to abide by the Fourth EC Directives that requires countries to adopt the prescribed formats. Hence to an extent the UK and German formats for reporting are similar.

<sup>196</sup> There is no format specified for Balance Sheet in the US, hence the format represents the contents of the balance sheet.

debts when due. The rights of the shareholders and those of the creditors are different and hence will need different sets of information to be disclosed. The disclosures of different rights are important objective in the presentation of the financial statement. Normally the rights of the creditors take precedence over the rights of the shareholders. The contents of disclosure requirements of the countries thus would reflect these requirements.

Items are classified in the balance sheet as Assets, Liabilities and Shareholders Funds. Assets are further classified into i) Fixed assets, ii) Investments iii) Current assets, Loans and Advances. Under the Asset side 'Miscellaneous Expenditure' and Losses (to the extent not written off) are also shown. Liabilities are categorised into i) Secured Loans, ii) Unsecured Loans and iii) Current liabilities and Provisions. Shareholders funds include, Share Capital and Reserves and Surplus. Assets are classified in the order of liquidity in the US and in the reverse order of liquidity in the UK and Germany. In India there is no particular order in the presentation of the balance sheet although it tends towards reverse order of liquidity. The items presented in the assets side are broadly grouped under Fixed Assets, Current Assets and Prepayments and Accrued Income. Fixed assets comprises of i) Intangible assets, ii) Tangible assets and iii) Investments.<sup>197</sup> Current assets comprises of Stock, Debtors and Investments. US requires similar presentation of information, although, no format is prescribed. Current investments are grouped under current assets in the UK, the US and Germany.

The IAS does not prescribe any format for balance sheet but requires minimum line items to be presented broadly in the order of liquidity. The classification of assets is primarily based on the current and non-current distinction. IAS also recommends firms to present a classified balance sheet (IAS1 paragraph 55), which distinguishes working capital from other assets and liabilities. Each line item should be further analysed to show amounts due to and from related parties.

Difference is observed in the classification of assets between India and other countries and IAS due to current, non-current classification. An item is

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<sup>197</sup> Investments are (Financial assets in Germany) non-current, primarily consisting of shares and loans given to affiliated enterprises and other long term investments and loans.

classified as current asset if it is involved in the entity's operating cycle or is expected to be realised within twelve months from the balance sheet date (IAS 1, paragraph 57). IAS 1 recommends the classification of current and non-current assets and liabilities for: monetary and non-monetary assets and liabilities, operating and financial assets and liabilities; and interest-bearing and non-interest-bearing liabilities and provisions. The Indian balance sheet does not clearly provide for this distinction in certain items. In particular, loans and advances classification may include non-current items. Investment is a separate line item with a current and long-term classification in the balance sheet.

Liabilities are classified as falling due within one year and liabilities falling due after one year i.e., into current and non-current liabilities in the UK, the US and IAS. The German format is similar to Indian format however; details of loans falling due within one year and others are required to be given in the notes.

A liability is classified as current liability under AS 1, when it is expected to be settled in the normal course of the operating cycle or it is due to be settled within twelve months of the balance sheet date. For example, debentures loans due for repayment within one year is shown under current liabilities and amounts due after one year will be shown as 'creditors: amounts falling due after one year'. Indian balance sheet classifies liabilities into Secured loans, Unsecured loans, Current liabilities and provisions. Schedule VI requires 'short term' classification for only a part of the unsecured loans, i.e. Short-term loans and advances from Banks and others.

IAS-1 also provides that irrespective of the method of presentation, an enterprise should give for each asset and liability the amount expected to be recovered or paid before and after 12 months from the date of the balance sheet (IAS 1 paragraph 54).<sup>198</sup>

AS and IAS frameworks defines equity as the residual interest in all assets after the deduction of the liabilities.<sup>199</sup> The components of equity are further divided into: i) Capital and ii) Reserves and Surplus. IAS and the US format also require similar classification but there are no separate groups as

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<sup>198</sup> Even debtors have to be classified into current and non-current under UK regulations

<sup>199</sup> ICAI, "Framework of Preparation and Presentation Of Financial Statements", Compendium of Accounting Standards 20 (New Delhi: ICAI 2002)

Reserves and Surplus and all the components are taken under Shareholders Equity. Companies report separate line items for equity capital, additional paid in capital, accumulated other comprehensive income and retained earnings in the US balance sheet. UK and Germany reflect the influence of EU directives. Germany requires legal reserves to be shown separately.

Content wise the items that are required to be disclosed (raw form) are comparable and in certain areas are more detailed than UK, USA as well as Germany. For example, investments must be further classified into quoted and unquoted, investments in subsidiaries, investment in government securities, trade and non-trade investments giving the name of companies and the details or types of investments made and the market value of the investments. Amounts due from subsidiaries, group companies and related companies need to be given. Additionally, disclosing the maximum amount due at any point of time during the year provides more insight into the associate payments, thus ensuring that even if the amounts are repaid at the end of the year the investors know what has been paid during the year.

The format and content of the balance sheet needs revision keeping in view the latest developments, and to converge with the international accounting standards. An essential requirement is the current and non-current break up of assets and liabilities. Under reserves and surplus, a distinction should be made for those relating to transactions with shareholders i.e. share premium account and other reserves.<sup>200</sup> The reserves may be further classified into available for distribution and those not available for distribution to shareholders as dividends. Profits not available for distribution can further classified into temporary waiting for realisation and others. Such a classification of reserves and surplus will be in alignment with the requirement of accounting standards discussed later.<sup>201</sup>

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<sup>200</sup> At present under the Companies Act, the balances in the securities premium reserve account can be adjusted towards writing off of Preliminary expenses and commission paid on issue of shares or debentures, for payment of premium on redemption of preferences shares or debentures etc. and are shown under Reserves and Surplus.

<sup>201</sup> For example the translation differences in integral foreign operation AS 11 require adjustments to the Balance sheet in the Other Comprehensive Income

## **Presentation and contents: Profit and Loss account**

The performance of a company is reported through the profit and loss account also called as the 'Income Statement'. This information is useful to all the stakeholders for decision-making. The information in the profit and loss account is always for a period, because of which, the transactions have to be artificially cut off, which represents an inherent weakness in the preparation of the statement. This implies that certain estimates and judgements have to be used for arriving at the result of the operation.

The profit and loss statement can be presented in two ways: the functional format or the type of expenditure format. The functional format categorises expenses as cost of sales, gross profit, distribution costs, administrative expenses and the results from operating activities. The type of expenditure format gives the changes in finished goods, working in progress, raw materials, other external charges, staff costs and the net result from operating activities. The formats can be vertical or horizontal.

No format is prescribed under the Companies Act however; companies are required to make complete disclosures of the results of the operations. Clause 2 Part II of Schedule VI, requires, 'that the profit and loss account must be made out clearly to disclose the results of the working of the company during the period and it shall disclose every material feature including non-recurring transactions or transactions of exceptional nature'. Although the word 'material feature' is not defined it would mean to give all information that will enhance the value to the user of the report. IAS 1 gives minimum information that needs to be disclosed in the face of the profit and loss account/income statement although no formats are suggested. The profit or loss from ordinary activities must be available separately from extraordinary items.

In the UK Companies Act 1985, prescribes four formats for presentation of the profit and loss account.<sup>202</sup> Both in UK and Germany expenditure may be

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<sup>202</sup> The accounting standards board in UK also gives a format for reporting the financial performance in FRS 3. The FRS 3 has been prepared after analysing many reports of various committees like Solomon's Report, and other Financial Reports in T.E. Cooke, M. Choudhary and R.S.O. Wallace, in *Transnational Accounting* (D.Ordelheide and KPMG eds., New York: Palgrave, 2001)

categorised either by function, showing gross profit (Section 275 (3) HGB), or by type of expenditure (Section 275 (2) HGB).

The format prescribed in the US is the functional format that gives the gross profit. US companies arrive at the profit and loss using the single step of income less expenses approach where all incomes are grouped together and all expenses are together or a multiple step statement, which differentiates, between the operating and non-operating activity. The Indian, UK and the German profit and loss accounts requires comparative figures for two years unlike US which prescribes comparative figures for three years.

IAS 1 requires the disclosure of profit or loss from ordinary activities and extraordinary items to shown as separate line items to arrive at the net profit or loss for the period. The profit or loss from operating activities has to be shown separately from discontinuing operations and these items are net of tax.

The UK format for reporting profit and loss must contain separate items for; i) results of continuing operations (including the results of acquisitions) ii) results of discontinued operations iii) profits or loss on the sale or termination of an operation, costs of a fundamental reorganisation or restructuring and profits or losses on the disposal of fixed assets; and (iv) extraordinary items. Turnover and operating profit are the minimum level of disclosure required in the Profit and loss account for continuing operations, acquisitions (where they are included as a component of continuing operations) and discontinued operations.

The US requirement for the profit and loss account is similar to IAS, where the profit from continuing operations is shown separately from discontinued operation. APB Opinion 9 requires the identification of the following in the income statements net of tax and has to be presented separately.

- Income from continuing operation (after tax)
- Unusual or infrequent items
- Discontinued operations of a component of an entity
- Extra ordinary items
- Cumulative effect of changes in accounting principles
- Equity in operations of investees

Differences are observed in the way the extraordinary items; prior period items are presented in the profit and loss account. AS-5 prescribes that

extraordinary items need to be disclosed in a way that its impact on the current profit can be perceived. Schedule VI prescribes that in respect of transaction of a kind, not usually undertaken by the company, or undertaken in circumstances of an exceptional or non-recurring nature must be shown separately. However, in spite of disclosing as separate line items, the net results from the operations (continuing operations) after tax will continue to include these items.

The items to be disclosed under the profit and loss account are prescribed in Schedule VI Part II. The Act also provides that when any item of expense exceeds one percent of the total revenue or Rs. 500, whichever is higher, must be shown separately. Expenditure incurred on consumption of stores and spares, power and fuel, rent, repairs to building, repairs to plant and machinery, salaries wages and bonus, contribution to provident and other funds and welfare expenses are required to be disclosed (Part II, 3(x)(a to h)). These requirements are more detailed as compared to the other countries profit and loss account disclosures. IAS -1 specifies certain minimum disclosures of line items on the face of the income statement and requires other items to be disclosed if necessary. Similar requirements are found in the US, the UK and Germany.

### **Other Statements**

#### **Comprehensive Income statement**

A Comprehensive income statement and Statement of shareholder equity are also prepared in the US. A comprehensive income is the change in the firm's equity during a period from transactions and events other than investment by or distribution to the owners. (SFAS 130 paragraph 8) They include net income and other changes in assets and liabilities that are not part of the net income. These items comprise of; i) unrealised foreign currency translation adjustments, ii) unrealised gains and losses of securities available for sale. Debt securities transferred from 'held to maturity' to 'available for sale'. Adjustments related to fair value of financial instruments like hedging and derivatives and iii) minimum pension liability adjustments. These are shown in other comprehensive income. Reclassification of items in the comprehensive income on realisation must be shown separately. Other comprehensive income includes the items in comprehensive income statement that are excluded from the net income. Comprehensive income statement thus measures items that are not in the

control of the management. Components of other comprehensive income may be reported net of tax or before related tax effects with one amount shown for the aggregate income tax expenses or benefits related to the total of other comprehensive income items. The accumulated balance or other comprehensive income should be shown as a separate component of equity and called as accumulated other comprehensive income. The advantage of having a comprehensive income statement is to recognise items that are different in nature such as gains and losses that are unrealised. This will further help in the harmonisation with other accounting standard setting bodies, as reporting comprehensive income is also a part of the IASB development of a single statement project. Having a comprehensive income statement will reflect the fair value based balances that will help predict the future cash flows.

### **Statement of Stockholders Equity**

The statement of stockholders equity shows the movements between the opening and closing balances of the shareholders equity (capital and retained earnings).

In the UK, The Companies Act, 1985, requires a 'Statement of Capital and Reserves' to be prepared. This statement shows the movements in share capital. FRS 3 requires companies to include a statement of total recognised gains and losses. This is a primary statement that shows the profit or loss for the year, adjustments to asset valuations, and differences in the net investment in foreign enterprises due to changes in foreign currency exchange rates. Contributions from or distributions to shareholders are excluded from the statement. In addition a note reconciling the changes in the total opening and closing shareholders' funds and movement on reserves for the period is required. This reconciliation may be combined with the notes or statement showing movements on reserves.

The movements in reserves as a result of profit appropriation are required to be disclosed by companies on the face of the profit and loss account after net profit or loss for the year or, alternatively, in the notes to the accounts in accordance with the format given in Sec 158 (1) AktG in Germany. Similar disclosure is recommended for GmbHs. Specifically transfers from capital

reserves, transfers to and from reserves like legal reserves, reserves for own shares and statutory reserves (as per articles of association) and others must be disclosed.

IAS 1 requires a separate statement of changes in equity showing the:

- i) net profit or loss for the period,
- ii) Each item of incomes and expenses, gains or losses, which require by the standards to be recognised directly in equity
- iii) cumulative effect of changes in the accounting policy and correction of fundamental errors dealt in 'benchmark treatment' under IAS 8

In addition within this statement, the following are presented

- capital transactions related to owners and distributions to owners
- the balances and the movements in the opening and closing balance of the profit and loss account
- Reconciliation between the opening and closing carrying amount of each class of capital, share premium and reserves

Prescribing a separate statement will highlight the firm's total gains and losses including those related to equity.

### Additional Disclosures

The Indian financial reports include certain item of disclosures, which were mandated at a time reflecting the economic policies of that period and are seldom found in other country's annual report. Some of these are discussed briefly next.

#### Turnover and closing stock

Schedule VI, Part II 3(i)(a) requires the sales amount for each class of goods along with the quantities to be disclosed. This item of disclosure was introduced in 1973, which is the simplest form of the present day segment reporting and gives the user an idea of the various products of the company. The companies have also to give the opening and closing stock of each class of goods along with the quantities. This information has been found very useful for the single segment companies.

#### Raw material consumption

The value of all-important raw materials consumed giving item wise break-up of the quantities, which individually account for more than 10 percent of the consumption. The opening and closing stock of goods produced also indicating the quantities. This information helps in computing the cost of raw material and estimating the future price trends and the profitability estimates. (Part II, 3(ii)(a) (1)(sub clause 2)

#### Computation of remuneration to managers, managing Directors

As there is a ceiling on the payment of remuneration, the annual report also requires the company to give the computation of net profits under Sec 349 of the Companies Act for payment of managerial remuneration. (Part II 4A)

#### Payment to Auditors

Information about the payment made to the auditors on account of fees as: a) auditors

b) as advisers or in any capacity in respect of;

i) taxation matters, ii) company law matters iii) management services

c) any other manner (Part II, 4 B).

Disclosure of the auditor's remuneration has now been mandated in many countries.

#### Capacity and production details of manufacturing companies

The section on production and sales were introduced during the licensing regime where the government controlled the allocation of resources and capacity was licensed. Production in excess of capacity meant violation of regulations. The details consist of licensed capacity, installed capacity and the actual production of the goods (Part II, 4C). This information is helpful to the users in determining the present capacity and the growth possibilities.

#### Payments in foreign exchange

Companies are required to disclose i) value of imports relating to raw materials, components and spare parts and capital goods on CIF basis ii) expenditure of foreign technology, know-how, consultation fees iii) value of imported raw materials etc as percentage of total consumption iv) amount remitted by way of dividend payments to non resident share holders and e) details of earnings in foreign exchange giving export of goods, royalty, know-

how, professional and consultation fees, interest and dividends and other incomes disclosed by way of a note. The purpose of these disclosures were to bring to light a company's dependency on the foreign resources at a time when the foreign exchange resources were scarce and needed to be saved. These information helps the user to determine the dependency on the foreign currency and the consequent foreign exchange risk and the risk related to the foreign markets (Part II 4D (a) (b) (c) (d) and (e))

### **Corporate Practices**

Part II of Schedule VI of the Act contains the information to be disclosed in a profit and loss account although no formats have been prescribed. Companies have presented information in different ways, which may affect the comparability of the financial statements across companies. For example, companies include excise duty and interdivisional transfer in the sales figures. In some companies this represents nearly 15 –20 % of the sales figure. Some companies present interest expenses and interest income separately, while some reduce the interest income from the interest payments in the schedule and present the net figure on the face of the profit and loss account. Some companies include differences in opening and closing inventory in their sales figure on the face of the profit and loss account and give the details in the schedules.<sup>203</sup> Some companies include very few line items on the face of the profit and loss account and include the rest in the schedules. Companies thus follow a variety of practices while disclosing.

The financial statements are usually prepared for a period of one year. When the financial statements are prepared for a period other than one year, IAS-1 requires a disclosure giving the reason for a different period being used. Such requirement must also be mandated in the Companies Act. Indian companies rarely give reason for the change in the accounting period. (For example RPG Life Sciences changed their accounting year from March 2000 to September 2001 and once again from September 2001 to March in 2003. Note 24 (page 28, 2001) states that the company has obtained permission under

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<sup>203</sup> See West Coast Paper Mills Ltd.(2002) where differences in inventory are added to sales. Although the schedule in the annual report gives the details of this.

Section 210 (4) of the Act for extension of the financial year up to September, a period of 18 months. No other explanation is provided in the report.)

To sum up, the format and content of the financial statements have evolved in all the countries over a period of time and countries are constantly reviewing the same and including information to make it more relevant to the investors. The Indian reporting system historically followed the UK system of reporting. UK and German formats are similar in many ways for reporting, indicating the European Union influence. The Indian balance sheet classifications are different from the other countries, and do not differentiate between the current and non-current items for both the assets and the liabilities. The number of items disclosed and the details of each of the disclosures are elaborate in the raw form as compared to others.

In the absence of specific format for the profit and loss account, companies are disclosing information in a variety of ways, which creates difficulty in comparison, so there is a need for specific format for disclosures. The profit and loss account does not directly give the result from continuing operations as it includes prior period and extraordinary items (although they are disclosed as line items). It is recommended that income from operations, extraordinary items, and discontinued operations be shown as separate line items net of tax to arrive at the final net income. Operating profit, other business profit and financial income be shown as separate line items.

In addition a comprehensive income statement and a statement of changes in the owner's equity or a similar statement be mandated which will give additional information that will enhance the understandability of the financial information, when the new accounting standards that makes adjustments in the retained earnings directly (see AS 11). Similarly accounting practices of reporting certain items below the bottom line figure (profit after tax) or through reserves should not be permitted. A simple format for presentation is given in the Appendix.

In the next section, reporting information under the accounting standards is discussed.

### **3.4.2 Reporting Information Under Accounting Standard (Reporting Standards)**

Accounting Standards regulates accounting, measurement and reporting of accounting information. This section deals with the standards predominantly related to reporting, although some have certain accounting aspects too. Specifically the reporting standards relates to: Disclosure of Accounting Policies AS-1, Cash Flow Statements AS-3, Contingencies and Events Occurring after the Balance Sheet Date AS-4, Net Profit or Loss for the Period, Prior Period and Extraordinary Items and Changes in Accounting Policies AS-5, Segment Reporting AS-17, Related party disclosures AS-18, Earnings per share AS-20, Consolidated Financial statements AS-21 Accounting for Investment in Associates in Consolidated Financial Statements AS-23, Discontinuing Operations AS-24 and Financial Reporting of Investments in Joint Ventures AS-27, Interim Financial Reporting AS-25.

#### **1. Disclosure of Accounting Policies - AS 1**

"Financial statements must be clear and understandable. They are based on accounting policies, which vary from enterprise to enterprise, both within a single country and among countries. Disclosure of the significant accounting policies on which the financial statements are based is therefore necessary so that they may be properly understood."<sup>204</sup>

The term accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements (IAS1 Para 20). Financial statement analysis usually begins with the analysis of a firm's accounting quality by identifying the key accounting policies used.<sup>205</sup> Understanding the methods and principles upon which firms base their earnings computations is essential for forecasting future earnings. If a user will be unsure about the accounting policies used in measuring income, they will face uncertainty in forecasting future earnings numbers. If a firm does not disclose its policies, a user cannot know if the firm is consistently following the same methods over time thereby affecting the quality of comparability. The AS states that all significant accounting policies adopted in the preparation and presentation of financial statements should be

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<sup>204</sup> IASB, International Accounting Standards 1, paragraph 10 (London: IASB, 2002)

<sup>205</sup> K.G.Palepu, P.M. Healy, and V.L. Bernard, *Business Analysis and Valuation* 3-7 (Cincinnati: South-Western Publishing Co, 2000)

disclosed in one place as part of the financial statements in order to facilitate a more meaningful comparison between financial statements of different enterprises and to promote better understanding of financial statements. The disclosure of the accounting policies as required by AS and IAS are given in Table 3.1 Panel A and B

Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in a later period should be disclosed. The AS also states that mere disclosure of accounting policies cannot rectify a wrong or inappropriate treatment in the accounts. All the countries under comparison require disclosure of accounting policies and are given in IAS 1, APB Opinion 22 and in SSAP 2 of UK and also in Germany. US GAAP requires disclosing of accounting principle and methods, when there is a selection from existing acceptable alternatives, industry peculiarities and there is unusual or innovative application of GAAP. The location of the disclosure is also recommended at the first note in the notes to the financial statements. SOP 94 also requires, financial statements to disclose that they were prepared using managements estimates. Panel C of Table 3.1 gives the disclosure of revenue recognition policy of three software companies.

## **2. Cash Flow Statements - AS 3**

A cash flow statement seeks to explain the causes for the changes in the balance of cash and cash equivalents between the opening and closing dates of a financial year arising from various activities. Cash flows are inflows and outflows of cash and cash equivalents.

A cash flow statement helps the user in understanding the liquidity position of the company and to evaluate the changes in the net assets of the company. Many studies have found the cash flow statements important and useful for decision-making.<sup>206</sup> It also helps in assessing the ability of the firm to generate cash and cash equivalents and to evaluate the future cash flows. The amount of cash flow arising from operations for example is a key indicator of the extent to which operations have generated cash flows to pay dividends and

repay loans or make investments. A cash flow statement when used with the other statements provides information to the user about the pattern of resources deployed in various assets and its financing structure. The comparability of the reporting of the operating activity is also enhanced as it eliminates the effects of using different accounting treatment for the same transactions and helps reconcile the accrual basis of accounting with cash.

A cash flow statement is divided into three components of operating, investment and financing activity.

- Operating activities are the principal revenue producing activities of the enterprise and other activities that are not investing or financing activities like cash generated from sales or amounts paid to suppliers.
- Investing activities are the acquisition and disposal of long-term assets like purchase and sale of fixed assets or property plant and equipment.
- Financing activities are activities that result in changes in the size and composition of both equity and preference capital and borrowings of the enterprise.
- Cash and cash equivalents include cash and bank balances (including bank deposits) and investments when it has a short maturity of less than three months from the date of acquisition.

Cash flow statement can be presented using the direct or the indirect method. Under the direct method, cash receipts and payments for operating costs and expenses are individually listed giving the cash effects of each major type of revenue and expenses. In the indirect method the net profit or loss is adjusted for the effects of transactions of a non-cash nature, and deferrals or accruals of past or future operating cash receipts or payments and for income or expenses associated with investing or financing cash flows. The direct method of presenting a cash flow statement is superior to the indirect method. As stated in AS 3, "The direct method provides information which may be useful in estimating the future cash flows which is not available in the indirect method and

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<sup>206</sup> S. Jones, C.A. Romano and K. X Smyrniotis, "An Evaluation of the Decision Usefulness of Statement of Cash Flows by Australian Reporting Entities", 25(98) *Accounting and Business Research* 115,115-116 (1995)

is therefore considered more appropriate than the indirect method.” The use of direct method has also received support from many research studies.<sup>207</sup>

The Companies Act does not prescribe the cash flow statements. Clause 32 of the Listing Agreements requires, cash flow statements to be presented along with the annual reports for listed companies. Cash Flow statements are mandatory in UK, USA and Germany as well as in IAS and AS.

Differences are observed in the presentation of cash flow statements in terms of interest payments. IAS offers flexibility in presentation of interest. Para 31 of IAS 7 states that cash flows from interest and dividends received should be classified in a consistent manner under operating, investment or financing activity. Under the US GAAP, interest paid must be included in operating activity and interest and dividend received must also be part of the operating activity. The Interest paid by a non-financial company is included under the financing activity as per the AS. The UK cash flow statements have differences with both IAS and the US GAAP as they classify items into eight categories including the additional five relating to: return of investments and servicing of finance, taxation, acquisitions and disposals, equity dividends paid, and management of liquid resources. Thus interest, dividends and taxes are separate items. In the UK, cash flows include only cash and do not include cash equivalents under FRS 1, as management of liquid resources is a separate heading. FRS 1 requires a note of reconciliation in the changes in the net debt while this is not required in IAS.

The Commercial codes require the cash flow statements to be prepared in Germany for the consolidated financial statements. No specific rules are mentioned and the companies can follow IAS or US GAAP for preparing and presenting cash flow statements. Cash flow statements are broadly classified as, current business activity, investment activity and financing activity under German Law. The cash and cash equivalents need reconciliation to the balance sheet figures like in India. Cash flow for extraordinary items and interest payments are not part of the line items in the cash flow of Germany.

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<sup>207</sup> G. V. Krishnan and J. A. Largay III, “The Predictive Ability of Direct Method of Cash Flow Information, Paper Presented at The 21<sup>st</sup> Annual Congress of the European Accounting Association, Belgium (1998) also see, M. S. Narasimhan, “ Statement of Cash Flows: An Analysis of Direct and Indirect Methods of Reporting”, 6(3) *Journal of Applied Finance* 81-91 (2000)

## **Corporate Practices**

The AS requires the components of cash and cash equivalents to be reconciled and presented. However, companies are not presenting this reconciliation or any explanation of how cash equivalent figures were arrived. Sometimes these figures have to be derived by the users. Most companies present the cash flow statement at the end of the annual report after all the schedules and notes. Some companies have shown it after the profit and loss statement.<sup>208</sup>

Companies have included interest paid either under financing or operating activities. For example Tata Chemicals (2002 page 53) have shown interest payments under operating activities, while Larsen and Toubro (page 84, 2002) and Reliance Industries Ltd (page 107, 2002) has included it under the financing activities. Thus, there is no uniformity in disclosures and companies have presented information to suit its own (self serving) requirements. As markets factor the information of 'Cash flow from operations' into the prices, flexibility should not be given to companies for presentation.<sup>209</sup>

It is recommended that the cash flow statements be presented before the schedules and notes and AS 3 format is strictly adhered to. The details of cash and cash equivalents must be given below the cash flow statements.

### **3. Contingencies and Events Occurring after the Balance Sheet Date - AS**

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There is a time gap between the balance sheet date of presentation and the date on which it is published. In spite of advances in technology there will be a gap between the two dates. During this period there will be variety of events that occur that may or may not influence the financial information provided. Such post balance sheet events are referred to as events occurring after the balance sheet date. Events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between balance sheet

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<sup>208</sup> Like GlaxoSmithkline Pharmaceuticals Ltd and Cummins India Ltd Page 24 and Page 34 of the respective annual reports of 2002.

<sup>209</sup> The listing agreement now requires companies to follow AS 3, hence this discrepancy will vanish in the subsequent annual reports.

date and date on which these statements are approved by Board of Directors. These events provide further evidence of conditions that existed on that date and those that are indicative of conditions that arose subsequently. These are treated differently in the financial reports.

IAS 10 deals with adjusting events and non-adjusting events. Adjusting events are recorded in the financial statements however no explicit definition is provided. IAS has given examples for such events like receipt of information that an asset was impaired on the balance sheet date, bankruptcy of a customer, discovery of frauds and errors that show the financial statements were incorrect. AS provides that the financial statements are to be adjusted if such events confirm the conditions existing on balance sheet date.

If conditions did not exist on balance sheet date, they need not be recorded but are only disclosed. Examples of such events given in IAS are announcement of business combinations, announcing plan to discontinue operation, destruction of equipment in a fire and others. US GAAP has similar disclosure requirements. AS requires disclosure should provide the information regarding the nature of event after balance sheet date.

Germany also requires disclosures regarding events like related to starting or closure of a new plant etc has to be given in the Management Report. UK distinguishes adjusting and non-adjusting events, however IAS 10 is more robust in its application. Differences between AS, IAS and US GAAP is observed in the proposed dividend. IAS Para 11, and also US GAAP does not require a firm to record dividend proposed or declared after the balance sheet date as a liability at the balance sheet date whereas this liability is recorded in India and UK.

#### **4. Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies – AS 5, Discontinuing Operations – AS 24**

Financial statements are used for comparison between firms as well as for a firm over a period of time. In order to enhance the comparability of the financial statements certain items have to be properly classified and disclosed.

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<sup>210</sup> This accounting standard has been revised in October 2003 and part of contingencies is considered in AS 29.

An overall presumption in the preparation of the financial segments is that accounting principles are applied consistently over a period of time. AS 5 deals with the presentation of profit or loss from ordinary activities, extraordinary items, changes in the accounting policies, treatment of estimates and errors. This standard ensures that financial statements are prepared and presented on a consistent basis and such items do not distort the comparability of the statements. There is no specific requirement in the Companies Act for prior period items, but a general requirement that profit and loss account shall be made out as clearly to disclose the result of the working of the company and disclosure of every material feature including credits or receipts or debits or expenses in respect of non recurring transactions or transactions of exceptional nature. The Act also provides that if material, the effect of changes in the basis of accounting must be disclosed separately in the profit and loss statement.

#### Profit and loss for the period

Profit and loss account must disclose the result of the operations of the current period in a distinct way. AS 5 deals with 'Net profit or loss for the period', which states that 'all items recognised in a period should be included in the net profit or loss for the period'. These profit or losses may arise from the ordinary activities and extraordinary items. Ordinary activities include activities that are part of its business and also incidental activities. AS and IAS requires a separate disclosure of certain items even if they are part of the ordinary activities, like inventory write down to the net realisable value and their reversal, disposal of items of fixed assets, restructuring activities, disposal of long term investments, litigation settlements, legislative changes having retrospective applications and other reversals of provision.

#### Extraordinary items

Extraordinary items are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.<sup>211</sup> IAS has a similar definition. Extraordinary items should be disclosed separately in the profit and loss statement so that a user can perceive its impact on the current profit or loss. As already discussed, the extraordinary items although are separate line items, the profit and loss for the period from the current operating

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<sup>211</sup> AS 5 para 4 page 86

activities will still include extraordinary items if these are not disclosed below the ordinary activities net of tax. IAS requires disclosures of the nature and amount of each extraordinary income to be made on the face of the profit and loss account or give the total amount on the face of the profit and loss account and the details in the notes.

German standards define extraordinary items as those, which arise out of normal course of business and must be unusual and material. Under FRS 3 in UK, reporting of extraordinary items will be rare, as the definition of ordinary activities has been widened.

US GAAP defines extraordinary items to include items that meet both the criteria of being 'unusual' and 'infrequent' (APB 30 paragraph 20). The activity must be unusual in nature (abnormal) and that it is infrequent i.e. which is not expected to occur in the foreseeable future. Items may be unusual but may be occurring frequently or it may be a usual item but occurs rarely. When both the conditions are satisfied only then they are extraordinary items. The extraordinary items are disclosed separately net of tax in the US GAAP. Details of the events and transactions along with the year of origin and the nature of adjustment in the current period must be given. If there is negative goodwill they must also be disclosed as extraordinary item.

#### Prior period Items

The AS defines prior period items 'as those income or expenses, which arise, in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods' (Para 15). Prior period items are required to be disclosed separately in a manner that its impact on the results can be perceived. AS (Para 19) states that the prior period items can be included to determine the net profit or loss for the current period. An alternative is to show it below the net profit or loss for the period. The prior period items get aggregated with the result from the ordinary activities if they are above the line also since there is no requirement for showing it net of tax.

IAS 8 deals with prior period items and is referred to as fundamental errors that are discovered in the current period. IAS requires fundamental errors to be corrected by adjusting the opening balances of the retained earnings. The comparative information should also be restated. An allowed alternative is to include it in the net profit or loss for the period. UK FRS requires the disclosures

of only fundamental errors. Fundamental errors in IAS require restating the comparative figures in the primary statements and notes. An adjustment in the opening balance of the retained earnings for the cumulative effect is also made. FRS 3 requires additional information relating to the effect on the current and previous results to be disclosed clearly.

SFAS 16 recognises prior period items as correction of error. SFAS 109 requires that prior period items should not be included in current period net income. APB 9 further requires adjustment in the prior period financial statements, if they are presented and also in the opening balances of the retained earnings. These are shown net of tax. As per APB 20, error may result from i) mathematical mistakes ii) using of accounting principles not in conformity with GAAP iii) applying GAAP principles incorrectly and disregarding facts that existed on the balance sheet date. In Germany prior period items are not treated as extraordinary items and must pass through the reported profits. Hence, they are at variance compared to IAS.

Disclosures requirements in IAS and US GAAP are more elaborate than AS. US GAAP requires disclosure of i) nature of the error ii) the amounts of correction for each prior period and the corrected comparative information for all statements presented iii) restated summary results. AS requires disclosures in the profit and loss account and no additional details are needed. There are no clear guidelines as to what should be disclosed under German GAAP. The prior period items thus pass through the profit and loss account. Disclosure of prior period items by Indian companies is given in Table 3.2. It is recommended that companies disclose more information and the standard should be converged on the lines of the benchmark treatment of IAS.

#### Changes in Accounting Policy and Estimates

An accounting policy as defined in the IAS 8 and AS 5 refers to a set of principles, bases and convention rules and practices adopted by companies for preparing the financial statements. Applying Generally Accepted accounting Principles, involves choosing from a number of acceptable methods. For example in valuing inventory one can use the First in First Out method or the Average method. Selecting one alternative from the other can have material effect on the results of the operations for the current as well as future period. An

assumption in the preparation of the financial statements is that the accounting principles are applied consistently from time to time so that comparability of statements is ensured.

Accounting for the changes in accounting policies can be done retrospectively (from the beginning, as if the transaction took place from its origin) or prospectively (from the future date) or changes in the current period and future periods. Differences in the treatment can affect the income statement differently.

An accounting policy change is permitted in the AS, only if such a change will reflect in more appropriate presentation of the statements or there is a change in the statutes or accountings standards. No method is prescribed in the AS-5 for such changes. Changes in accounting policies are dealt with in the respective accounting standards.

The revised IAS 8 requires that any voluntary change in the accounting policy has to be done retrospectively and the result must be changed in the opening balance of the retained earnings. Comparative information must also be restated including historical summaries of data (unless impracticable to do so) to achieve comparability of the figures. Such adjustments involve a lot of calculations and hence the IAS also provides in paragraph 52 that information presented for a prior period need not be restated if it requires undue efforts and cost. In which case, the new accounting policy should be applied from the next year prospectively so that restatement of the previous year results is not a problem. The allowed alternative treatment is to include the changes in the profit and loss of the current period when prior period changes cannot be reasonably determinable. In the UK GAAP, most accounting policy changes and all corrections of fundamental errors are dealt with by restating comparatives.

US GAAP identifies three types of changes: changes in the accounting principles, changes in the accounting estimates and the change in the reporting entity. A change in the accounting principle is a change from one acceptable principle, to another or a change in the method of applying the accounting principles (APB 20). The US GAAP requires that accounting changes are not to be made purely from the tax perspective and are allowed only if there is

adequate justification. Changes in accounting principles are accounted for currently using cumulative effect method where current year figures are taken as per the new method, and the cumulative effect of the changes, computed retrospectively net of tax should be disclosed just before the net income figure and after the extraordinary items. Previous years figures are not restated.<sup>212</sup>

Certain changes in principles from Last in First Out (LIFO) inventory method to another or changes in method of accounting for long term contracts, changes to or from full cost method of accounting in extractive industries require retroactive statement changes, where financial statements of the previous periods are restated and presented. All the changes in the previous periods (computed using the new principles) are reflected in the retained earnings. These disclosures are made in the notes and not on the face of the financial statements. Changes in principle to LIFO method need to be recorded for the current and the future periods only.

German accounting standards mandate that changes in accounting methods and policies can be made only in exceptional circumstances, like changes in commercial or tax law or other legal changes, material changes in shareholder structure or management, and debt restructuring activities. (IDW HFA 3/1997) Consequently, the cumulative result of a change in accounting policy is required to be included in the profit and loss account of the current period. In UK GAAP a change in an accounting policy is shown as an adjustment of the opening balance of reserves. The prior year comparative information is restated under the new policy. The cumulative adjustment is to be noted at the bottom of the statement of total recognised gains and losses of the current period, and included in the reconciliation of movements in shareholders' funds of the corresponding period.

### **Disclosure**

AS 5 require disclosure of changes in the accounting policies, along with the impact on the current year profit had the company continued to use the old method. IAS 8 requires the reasons for the change and the amount of adjustment included in the net profit or loss in the current period to be disclosed.

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<sup>212</sup> Restatement of prior period figures involves preparation of the financial statements again.

US GAAP requires the managements justification for such changes to be disclosed and also the per share information for all periods presented.

#### Changes in estimates

AS requires that changes in accounting estimates, the nature and amount of a change in an accounting estimate which has a material effect in the current period needs to be disclosed. Changes in estimates are done in the current income and prospectively in IAS and the US GAAP. In case of changes in estimates the IAS requires that changes be adjusted prospectively in the profit and loss. US GAAP requirements are similar to IAS.

The nature and amount of material changes in the estimates are required to be disclosed. If it is not practical to quantify then the same should be stated. US GAAP requires similar disclosures along with the disclosure of related per share income. Reclassification of items presented has to be clearly given by way notes under US GAAP.

Indian companies only mention that figures have been reclassified wherever necessary without precise reference to the line items concerned. It is suggested that disclosures under AS falls in line with IAS.

#### Discontinuing Operations - AS 24

Disclosure of information on discontinuing operations enhances the ability of the users of financial statements to make more reliable projections of an enterprise's cash flows, income generating capacity and financial position.

Discontinuing operation is a component of an enterprise which is i) disposing of substantially in its entirety, or by demerger or by a spin-off of ownership ii) disposing in a piecemeal way or by selling off assets and settling liabilities individually iii) or by abandoning a separate line of business or a geographical segment that can be distinguished for financial reporting purposes. Information of discontinuing operations should not be mixed with the current operation figures.

An initial disclosure event occurs when the firm has entered into a binding sale agreement or when the Board or other approving authority has approved a detailed formal plan and has announced the plan.

#### Disclosure

A description of the discontinuing operation and the segment in which it was reported under AS 17, the date and nature of initial disclosure event, the period in which it will be completed has to be disclosed. Revenue and expenses of operating activities of the discontinuing operation, the pre-tax profit or loss and the income tax related to the discontinued operations and the carrying amounts, of the assets and the total liabilities to be settled; and the cash flow of the discontinued and the gain or loss relating to disposal of discontinuing operation have to be show separately in the financial statements. Subsequent period financial statements should disclose any significant changes in the amount or timings of the cash flow relating to the assets to be disposed and the events causing the changes. Prior period information is required to be segregated for the discontinuing operation after the initial disclosure event.

The IAS 35 and AS 24 are substantially the same. Nevertheless, there are a few differences. Differences are observed in the timing of segregation of the information, selling of subsidiary whose activities are similar to the parent or other subsidiaries not found in AS. IAS also permits the vertically integrated operations to be identified as a separate segment. These additional items are disclosed in the notes to the financial statements in the AS; while in IAS they can be shown in the financial statements or in the notes (except those relating to the profits from operating activities and gains or losses from sale of assets). Prior period financial statements have to be changed to make the figures comparable.

There is no comparable requirement in the HGB, but certain information is required to be disclosed if the effect of discontinuance of a business activity is presented as an extraordinary item. Under the UK GAAP a discontinued operation is one when sale or termination is completed within the year or before the earlier of i) the end of the three month period after the year end or ii) the approval date of the financial statements. If termination activities have ceased permanently or the sale or termination has material effect on the nature and focus of the reporting entity's operations and represents a material reduction in operating facilities resulting from either withdrawal from a particular market or a material reduction in turnover from continuing markets, then discontinued assets, liabilities and operations are clearly distinguished for financial reporting purposes. The standard requires that as a minimum, turnover and operating

profit for the current period be analysed between continuing operations, acquisitions and discontinued operations on the face of the profit and loss account with analysis for the remaining statutory headings to operating profit shown in the notes.

Reporting of discontinued operation is found in APB 30 and SFAS 144 'Accounting for Impairment or Disposal of Long Lived Assets'. The result of continuing operation must be reported separately from discontinued business before extraordinary items. The discontinued operation is measured with reference to the measurement date. The loss or gain on discontinued operations should include the results of the operation of the discontinued component, the net loss/profit on disposal of the discontinued component along with the tax adjustments are to be given as line items on the measurement date on which the management approves of the discontinued operation. In the IAS, the actual operating results of a discontinuing operation are reported as incurred while in the US GAAP the estimated operating results are included. The loss on disposal is computed and recognised when the discontinued operation is classified as held for sale and if the total carrying amount exceeds the total fair value less cost to sell. Gains are recognised only when the actual sale occurs. Disclosures under the US GAAP are elaborate as in IAS.

To sum up, AS 5 needs considerable revision to have convergence with the IAS and also to achieve the quality of comparability. The practices of displaying prior period items are not uniform amongst Indian companies. Some companies show it as an 'above the line item' while some show as below the line item which can be referred to as an appropriation. The profit and loss for the current operating activity cannot be found accurately as they are distorted with prior period items and results from changed accounting policies and extraordinary items. IAS is more stringent with such items and requires them to be adjusted in the retained earnings opening balance. IAS also has stringent disclosures, requiring the company to state the reason for the change and the amount of the adjustments for the current period and for each prior period presented. More transparent and stringent disclosure norms need to be mandated for prior period items.

## **5. Segment Reporting - AS 17**

An important financial reporting disclosure that is useful and is of relevance to stakeholders is the disaggregation of financial reporting information. Organisations have grown and expanded considerably in the last few years where business has diversified into related and other areas. The increased globalisation of financial markets, deregulation of certain industries, and significant merger and acquisition activity has heightened the importance of segment reporting for analysts and investors. Information about the operations and performance of various segments of business is necessary to understand and evaluate the cash flows and to make informed decisions. Segment reporting is important as different business segments have different opportunities and risks and may be contributing to profitability and turnover of the company in different proportion. Segment reporting has also been found useful for equity valuation.<sup>213</sup> A primary objective of segment reporting is the comparability of information.

Reference of segment reporting is found in the Listing agreement and the Accounting Standard - AS 17 and also the Companies Act. Clause 41 requires publishing of segment reporting in the quarterly reports. Clause 49 Corporate governance reporting requires a discussion on Segment wise or product wise performance. Under the Companies Act, Schedule VI requires disclosure of licenced and installed capacity and the actual production and sales of each class of goods manufactured. The accounting standards on the segment reporting came into effect from the beginning of the financial year 2001. Segment reporting is also part of the quarterly financial reports published by the companies after September 2001.

Two kinds of segments are envisaged in the accounting standards: the 'Business Segment' and the 'Geographical Segment'. A business segment is a distinguishable component of a firm, or a group of related products or services that is subject to different risks and returns from those of other segments. Different factors are considered for determining the segments like the nature of products or services, the nature of production processes, or a type or class of a

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<sup>213</sup> S. Basu, D.B. Douthett Jr and S. C. Lim "The Usefulness of Industry Segment Information", [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=237333](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=237333) (Jan 11, 2003)

customer for the products or services, or methods used to distribute the products or can be based on the type of environment like banking etc.

The geographical segment is again a distinguishable component of an enterprise within a particular economic environment that has different risks and returns from those components operating in other environments. These can be determined by the similarity of economic and political conditions, proximity of operations, special risks with that area, exchange control regulation and the underlying currency risks.

A reportable segment is defined as a geographical or business segment for which segment information has to be disclosed. The AS requires the identification of reportable segments based on three tests. A reportable segment is one if any one of the conditions is satisfied:

- i) Its revenue from sales to external customers and from transactions with other segments is 10 percent or more of the total revenue external and internal of all segments.
- ii) Its segment result whether profit or loss is 10 percent or more of the a) combined results of all segments in profits or b) combined results of all segments is a loss whichever greater in absolute amount.
- iii) The segment assets are 10 percent or more of the total assets of all segments.

If total external revenue of reportable segments is less than 75% of the total company's revenue then, additional segments must be identified even if the threshold limits of 10 % is not satisfied.

AS requires companies to choose one of the segments as primary segment and the other as secondary segment and disclose information based on the dominant source of risk and returns. For example, if the risks and returns are predominantly affected by the geographical location or the countries in which it operates then the geographical segment becomes the primary reporting segment. The business segment related to products or services becomes the secondary segment-reporting format. The internal organisation, the management structure and the system of internal financial reporting to the Board or the management should form the basis of identifying the segments.

AS 17 requires disclosures of sales, profit, carrying amount of assets, liabilities, depreciation, and purchase of assets during the period for the primary or the main segment. For secondary segments information about sales, purchases and total carrying amount of segment assets is to be given, no profit or loss needs to be disclosed. The enterprise should also give the reconciliation statement between the information disclosed for reportable segments and the total information as given in its financial statements.

Segment reporting has been in some form or the other in other countries for many years. In the UK listed companies were required to disclose the turnover and profit amounts for each line of business as early as 1965 through the listing agreement and later mandated in the Companies Act in 1967. This was continued under SSAP 25. The production process and also the nature of products were not relevant for defining the segments giving considerable leeway to management and resulted in poor segment reporting. The present standards are close to IAS 14

In Germany, new disclosure legislation enacted in 1998 requires all listed corporations to provide segment reports in their consolidated financial statements for fiscal years ending on or after 1999. Prior to this there was no segment-reporting requirement in Germany. Only large companies and listed companies were required to disclose sales information by activities and by geographical markets if the activities and the geographical markets differed significantly from each other (Section 285 (4) and 314 (3) HGB). Unlike firms reporting under US GAAP or IAS, which were (and are) required to follow specific criteria, German firms had considerable discretion in defining their segments. Furthermore, segment sales could be suppressed if the disclosure was likely to significantly harm the firm or one of its subsidiaries, in which case the firm has to indicate that this protective clause had been applied (Section 286 (2) and 314 (2) of HGB).<sup>214</sup>The new accounting standards GAS 4 requires segment reporting which is similar to IAS. Germany has special segment reporting requirement for banks issued as separate standards.

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<sup>214</sup> C. Leuz, "Proprietary versus Non-Proprietary Disclosures: Evidence from Germany", *Working Paper*, 2003. <http://ssrn.com/abstract=99861> (Nov 05, 2003)

Segment reporting is prescribed in IAS 14, which was substantially changed in 1997. If the dominant source of risk and returns are based on the products and services then the primary segment is the business segment. If operating in different countries or geographical areas is the source of risk or return then the geographical segment is the primary segment. The internal organisational and management structure and the system of reporting to the Board of Directors and the chief executive officers is the basis of identifying the segments.

The Securities Exchange Commission in the US included the line of business disclosure in the registration requirements in 1969 and subsequently the same was mandated in form 10K. The companies were later mandated to disclose the same in the annual reports. FASB issued SFAS 14 in 1976 relating to segment reporting which was replaced by SFAS 131 as the reporting was lax under the earlier standard which were based on industry grouping for line of business. SFAS 131 requires segments to be identified by how the chief operating decision maker identifies a segment for assessing the performance of the segment of an organisation and is termed as 'operating segment'. This may or may not be based on the lines of business or the geographical area. Certain additional disclosures enterprise wide is also required under SFAS 131. These are revenues from each product or services if not already part of the segment reporting. Geographical segments are based on individual countries for the entire company. The amount of revenue from each customer is also required to be disclosed, if revenue of 10 % or more is derived from a single customer. Quarterly reporting also mandates segment reporting. The amounts disclosed for segment reporting are based on similar basis as used for internal reporting purposes. That is, the segment results are what are reported to the chief decision maker and may not have been prepared as per the accounting standards. Segment reporting practices of Indian companies are discussed later in the chapter.

## **6. Related Party Disclosures - AS 18**

Business transactions are normally required to be conducted in an arms length way. When close relations exist between parties who can control and

influence the transactions of the other, there is a concern that the parties may not transact in the best way or may be prevented from pursuing its own interest. In the absence of information, the users of the financial statement cannot make a judgement about the transaction from the related parties.

AS18 requires that companies provide full information on transactions that have taken place between related parties. These transactions can be for purchase/sales of goods or for giving services, giving loans including guarantees and collaterals (financing activity), purchases or sales of fixed assets, leasing or hire purchase arrangements, transfer of research and development, licence agreements etc., The agency problem and the promoters using of funds for subsidiaries and other related parties can come to light by this disclosure.

The Companies Act has several provisions dealing with related party disclosures. These include: i) Debts due by Directors or officers of the company or any of them severally or jointly with any other person or ii) Debts due by firms or private companies in which any Director is a partner or a Director or a member to be separately stated also giving the maximum amount due at any time during the year iii) Debtors and loans and advances due from other companies under the same management along with the names. In case of loans and advances the maximum amount due at any time during the year iv) Details of loans and advances given to subsidiaries, and partnership firms v) The number of shares held by the holding companies as well as ultimate holding companies vi) Calls unpaid by Directors vii) Loans and advance received from Directors, subsidiaries and any other liability to subsidiary and amount of guarantees has to be shown separately viii) Investments in companies under the same management have to be shown separately.

Under Companies (Auditor's Report) Order, (CARO) 2003, the auditor is required to comment on the terms and conditions of the loan given and the interest rate thereon. They also report on reasonableness of the transaction involving goods and services (transaction above Rs. 5 lakhs) and whether they have been made on the prevailing market price or at a price which similar transactions have been made with other parties.

## Disclosure

The accounting standard requires that names of all related parties where control exists be given, along with the relationship. Disclosure of information can be presented in an aggregate format.<sup>215</sup> The format for reporting presents disclosures of aggregate transactions between a) Holding companies b) Subsidiaries, c) Fellow Subsidiaries d) Associate companies, e) Key management personnel and f) Relatives of key management personnel. Information needs to be disclosed if there have been transactions between related parties, during the existence of a related party relationship. The information disclosed are a) name of the party, b) nature of transaction c) volume of transactions as amount or appropriate proportion c) the amounts of outstanding items relating to the related parties at the balance sheet date d) provisions for doubtful debts and e) the amounts written off or written back from or to related parties. Disclosures may be in aggregate format.

The related party disclosures are substantially similar to IAS except for a few differences. AS deals with Joint venture, which is not part of IAS list of related parties. Disclosures are not needed in separately issued financial statements of wholly owned subsidiaries if the holding companies have incorporated the same in IAS. AS requires disclosure of transactions in each financial statement as well as the consolidated statement. AS requirements are more stringent in definition and disclosure than that required under IAS. AS requires disclosure of transaction, if the parties are related any time during the year (which is not the case with IAS). As defined in the AS the term 'control' would include control of the composition of the Board, which is not there in IAS. The word substantial interest is defined by a 20 % threshold limit for voting power, which is not explicitly defined under IAS. AS requires additional disclosures on the amount of written off or written back as compared to IAS. This is useful, as many Indian companies have written off loans and advances given to related parties. (An advances of Rs. 45.76 crores has been written off during the year from subsidiary company of Himachal Futuristic Communication Ltd. page 34, Annual report 2002). IAS 24 requires disclosures of specific pricing policy which is not there in AS.

The SEC defines related in S-X 210.1-02(t) and requires extensive disclosure of material related party transaction (Reg S-X 210.4-8). Under US GAAP, SFAS 57 definition of related parties include principle owners and their relatives and further principle owners are beneficial owners of more than 10 % voting interest.<sup>216</sup>

As compared to US GAAP and UK, IAS does not require the names of the related party and the amounts involved in the transaction. US GAAP requires, the effects of changes in the terms of the transaction compared to the preceding periods to be disclosed. US GAAP also requires that firms should disclose transactions even if there are no accounting implications. German AS is similar to IAS although only a few items need to be disclosed.

As companies are diverse and lot of judgement is involved in accounting, transparency on certain transactions can be ensured only when all related party transaction are disclosed in detail so as to judge its impact on the financial statements. Proper method of identifying the related parties and related party transactions as they are not always easily identifiable and the auditor relies primarily upon management and principal owners to identify all related parties and related party transactions. ICAI has issued guidelines for auditing the related party transactions. Strict enforcement of the disclosure will help in identifying owner's financial indiscipline through subsidiary companies and other related parties. Indian companies reporting practices on related party transactions are discussed later.

## **7. Earnings per share - AS 20**

An earnings per share (EPS) is important information that is widely used for assessing the performance of a company and its ability to pay dividends. The

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<sup>215</sup> Compendium of Accounting standards as per the General Clarification 2/2202

<sup>216</sup> The disclosure of related party transaction has been criticised by many researchers on its approach and is ambiguous in many areas. Enron entered into transactions with limited partnerships (the Related Party) whose general partner's managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron. The Form 10-K of Enron, mentioned the related party transaction for hedging and other administrative service, management, construction, supply, and operating agreements with its unconsolidated equity affiliates were entered into and they were in reasonable terms compared to those which could have been negotiated with unrelated third parties. See, D.C. Ohly, "In GAAP we Trust". *The CPA Journal* at <http://www.blankrome.com/publications/Articles/TheCPAJournal2.htm>(Dec 11, 02)

main purpose of providing EPS is to aid in the comparison of information. This accounting standard is mandatory and is applicable to all listed companies.

A company is required to present the basic and diluted EPS on the face of the profit and loss account for each class of equity shares that has a different rights for all periods presented. EPS has to be disclosed in both the individual and consolidated financial statements

Basic EPS is calculated by dividing profit attributable to equity shareholders by the weighted number of equity shares outstanding during the period. The diluted EPS is calculated by dividing the net profit or loss for the period attributable to the equity shareholders divided by the weighted number of equity shares outstanding during the period after adjusting for dilutive potential equity shares. The limited revision to AS 20 requires that EPS should be reported on the basis of earnings excluding extraordinary items net of tax expenses.

IAS 33 and AS 20 are in substantial conformity. Differences exist in a few areas. For example, AS 20 deals with equity shares of different nominal values and also situation where the share application money is utilised by the company, pending allotment of shares, these are not explicitly considered in the IAS. IAS deals with a situation where the subsidiary or joint venture or an associate issues potential equity shares, which is included in the consolidated financial statements, which is not specifically considered in the AS. IAS requires the calculation of year to date diluted EPS based on weighed average of the number of potential ordinary shares in the Interim reports. US GAAP requires the basic and diluted EPS from continuing operations, extraordinary item, discontinuing operations, and cumulative effect of a change in the accounting policy to be reported in the profit or loss statement. US GAAP recommends the use of treasury stock method on a year to date basis and do not average the interim period calculations. FRS 14 is in substantial agreement with IAS 33 but varies on the disclosures required. In Germany EPS presentation is not mandated.

EPS is reported on the face of the profit and loss statement in a prominent way. An enterprise should present basic and diluted earnings per share for each class of equity shares and for all years presented. Para 9 of the AS states that even loss making companies have to report a negative EPS. The amount used

in the numerator and denominator must be disclosed. US GAAP also requires EPS information on extraordinary items, discontinued operations and the cumulative effect on accounting changes to be reported in addition to the basic and dilutive EPS.

### **Corporate Practices**

Companies follow variety of practices while disclosing the EPS.

- Tata Electric and Locomotive Company Ltd does not give the basic and dilutive EPS for both the years as the years results are negative although even negative EPS has to be reported. (page 5, Annual Report, 2002)
- ESCORTS Ltd has not presented the EPS for the previous year (Page 31, 2002).
- Tata Tea Ltd. has not disclosed diluted EPS (page 39,2002). (They could have mentioned that the basic and diluted EPS are the same of the face of the Profit and loss statement itself)
- India Cements Ltd has a loss for the year and profit for the previous year. The company does not give EPS. (Annual report, 2002)
- Visual Soft Technology Ltd has given the EPS in the notes to the accounts and not on the face of the profit and loss account. (Annual Report, 2002)

In spite of being mandatory, information on EPS has not been presented properly by companies as required under the AS. It is also recommended that, when companies have an accounting period more or less than twelve months, the annualised EPS may be shown.

### **8. Consolidated financial statements - AS 21; Accounting for investment in associates in consolidated financial statements- AS 23; and Financial reporting investments in joint venture AS 27**

Preparation of Consolidated financial statements of group companies is considered important in financial reporting. The external stakeholders have to be made aware of the economic resources controlled by a group, the obligations of the group and the results that a group has achieved. The purpose of consolidation is to present the result of the operation and financial position as if the group were a single enterprise.

A long demand in India had been for consolidation of accounts of subsidiary companies. Consolidated financial reports are mandatory for listed companies in India through the Listing Agreements and Accounting standards. Consolidated financial statements are presented by a parent (also known as the holding company). The parent company has to prepare separate financial statements and consolidated financial statements. Both domestic and foreign subsidiaries are consolidated. Consolidated statement will include the balance Sheet, Profit and Loss Account, Notes, Cash Flow statement and any other statement and explanatory material, which are part of the financial statements.

The essential starting place for consolidation is to distinguish between 'control', 'significant influence' and 'joint control'. Control establishes a subsidiary; significant influence establishes an associate and joint control establishes a joint venture. Control requires ownership directly or indirectly through subsidiaries of more than half the voting power or control of the composition of the Board of Directors. Significant influence is the power to participate in the financial and operating policy decisions of the companies and not control over the policies. There is a presumption of existence of significant influence when there is direct or indirect ownership of 20% or more. In a joint venture the control is contractually agreed amongst the joint venture parties and are in the form of participating rights. The accounting treatment will depend on the type of control. If there is no significant influence the investments will be treated as in AS 13 at cost or revalued amount depending on the type of holding. If the control is significant then consolidation will be based on equity method. Subsidiaries will be consolidated on line-by-line basis and joint ventures will be consolidated on proportionate consolidation basis.

### **Method of consolidation for subsidiaries**

The consolidation of the financial statements is done on a line-by-line basis by adding together items of assets, liabilities, income and expenses. Intra group balances, intragroup transactions and resulting unrealised profits should be eliminated in full. Unrealised losses resulting from intragroup transactions should also be eliminated unless cost can be recovered. AS 21 also requires the comparison of cost of acquisition with the net worth and the excess is treated as goodwill while the deficit is treated as Capital Reserve. Consolidated financial

statements should be prepared using uniform accounting policies for like transactions. Minority interests should be presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the income of the group should also be separately presented.

IAS and AS are substantially similar. Differences are observed in a few areas. Control of subsidiary is the basis for consolidation for both AS and IAS, however the term 'control' is defined differently. Control is defined in IAS 27 as 'the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities'. Control is defined in AS 'as the ownership through more than one half of the voting power or through the control of the composition of the Board of Directors'. This definition is wider than AS in some respects. SIC 12 deals with Special Purpose Entities, which may or may not be a company and requires consolidation of such entities when they are controlled enterprises.

Under IAS 27, a parent, which is a wholly owned subsidiary, need not present consolidated financial statements, and it is sufficient if they mention the reason for not consolidating along with a few other particulars. The goodwill or the capital reserve is determined on the basis of historical cost of the net asset. The IAS considers the recognition of net assets based on the fair values of the assets.<sup>217</sup> AS does not deal with amalgamation and its effect on consolidation including goodwill arising on amalgamation. IAS 21 gives detailed guidelines for amortisation of goodwill whereas the AS has no specific requirements and is in contradiction with AS 14. IAS recognises the cost method for accounting. On acquisition of the investment in an associate, any difference (whether positive or negative) between the cost of acquisition and the investor's share of the fair values of the net identifiable assets of the associate is accounted for like goodwill in accordance with IAS 22, Business Combinations. Appropriate adjustments to the investor's share of the profits or losses after acquisition are accounted for in the carrying amount of investments.

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<sup>217</sup> (The good will is the difference between the cost of acquisition and the parent's share of the value of the assets and liabilities)

IAS 27 provides for accounting for investments of subsidiaries in parents separate financial statements at i) cost or ii) using equity method or iii) as available for sale. Under AS 21, parent's separate financial statements, investments in subsidiary should be accounted as prescribed in AS 13 (which is the cost and adjusted for permanent diminution in value of those investments). Impairment of investments in associates is dealt with like an impairment of asset under IAS, however in AS they are treated like long-term investments. Loss in excess of equity investment are recognised to the extent there is an obligation to fund such amounts. AS also deals with the financial statements of subsidiary if not prepared on the date of investment. Financial statements of subsidiaries up to six months of the date of the parent's financial statements can be consolidated while this is three months in the IAS.

SFAS 94 contains the relevant rules for consolidation under US GAAP. Unlike IAS, it does not have a wider definition of the word control and is focussed on the percentage voting power. US GAAP does not require consolidation of subsidiaries if they are disposed off during the year as against consolidation till the date of disposal in AS. The recent changes require consolidation of a subsidiary, even if the control is a temporary one, unlike AS and IAS. As US GAAP does not mandate separate parent company financial statements, these companies would provide less information depending on the activity of the firm. Loss in excess of equity investment is used to reduce the basis of other investments such as loans to the investee in the US GAAP. Both AS and IAS deals with losses attributable to minority in excess of minority interest in equity and unrealised losses from inter company transactions on fixed assets, US GAAP is silent on this. IAS and AS requires that the parent and the subsidiary apply the same accounting policy for similar transactions. However, if it is not practical then the fact together with the proportion of items in the consolidated financial statements applied should be disclosed. Similar provisions are not found in the US GAAP. Both US GAAP and IAS deals with deferred tax on consolidation but there is no corresponding provision in AS. AS 21 does not deal with amalgamation and their effects on consolidation including goodwill that arises on consolidation.

IAS and UK GAAP are substantially similar. German companies are required to prepare consolidated financial statements. The rules applicable under HGB for individual companies are also applicable for consolidation. The valuation however, can be different. Listed companies can use IAS or US GAAP for consolidation.

AS requires additional disclosures on the effect of acquisition or disposal of subsidiary on the financial statements of the company and also the nature of relationship between companies consolidated, when the parent does not own more than one half of the voting power. A list of all subsidiary companies including the names, proportion of ownership interest, and the voting power needs to be disclosed.

Under AS-23, investment in associate companies should be accounted for in the consolidated financial statements under the equity method. An associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor. The equity method is a method of accounting whereby the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition. The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee. The consolidated statement of profit and loss reflects the investor's share of the results of operations of the investee. IAS 28 and AS are in substantial confirmation with some slight differences. US GAAP is in variation with IAS in respect of adjusting of transactions in the intervening period and the accounting policies that are to be followed. Although not required by IAS 28 or AS it is useful to disclose the following for significant associates: i) reconciliation of movements in the investment in associates during the period and ii) summarised financial data.

Accounting for investments in Joint ventures (JV) is considered in AS 27, which sets out the principles and procedures for accounting interests in joint venture assets, liabilities, incomes and expenses of the venturers and investors. The investments are accounted for in the same way as in AS 13.

Some differences are found between AS-27 and IAS. AS deals with joint ventures that are subsidiaries of the parent companies, in which case it is not consolidated. Similar provisions are not found in the IAS. IAS does not deal with

joint venture in the individual financial statements of the venturer. Accounting for investment in joint ventures is not separately considered in US GAAP and are accounted for under the equity method. Additional information relating to joint ventures can be mandated like the contingent liabilities that may arise out of the joint venture its share in each of the contingent liabilities which have been incurred jointly with other ventures, the share of the contingent liabilities of the joint ventures themselves for which it is contingently liable and those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

The classification of investments is very crucial for the purpose of consolidation. Difficulties may arise when a subsidiary entity is treated as a jointly controlled entity as a result of the contractual agreement. Further, paragraph 9 makes a distinction between protective and participative rights, which according to some experts may lead to interpretation problems.<sup>218</sup>

#### Consolidation of accounts and Subsidiary Companies Information

Prior to the mandatory consolidation requirements, companies were required to give the annual reports of subsidiary companies along with the parent company under section 212 of the Companies Act. The Company Law Committee did not adopt the group accounts consolidation as given in the English Companies Act, 1948. They felt that more information was derivable by attaching the individual company's balance sheet than by consolidating the information. Moreover, it was felt that the preparation would add complications without any additional benefits.<sup>219</sup> A preliminary examination of the annual reports of companies listed in the BSE 100 index indicated that the number of subsidiary companies they had ranged from minimum of 0 to a maximum of 30 subsidiary companies indicating the importance of monitoring these companies.

With the accounting standards becoming mandatory, companies have applied for exemption under section 212 (8) to the Department of Company Affairs from attaching the individual subsidiary reports to the shareholders, in lieu of the consolidation requirement under the accounting standards from 2003. In

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<sup>218</sup> Y. H Malegam, "Financial Reporting under New Accounting Standards", *Paper presented in the 35th SIRC of ICAI Conference* (Chennai: SIRC, 2003) at 26c

<sup>219</sup> *Supra* Note 99 at 1682

the absence of individual reports, the Directors report of the subsidiary giving the performance review and other information presented therein will not be available to the investors, though the Directors report must include, if material, the changes which have occurred during the financial year in the company's subsidiaries or in the nature of business carried on by them. The segment reporting may not be adequate to give information on the working of the subsidiary companies.

In the absence of individual subsidiary companies reports, the working of the subsidiary companies get consolidated and disaggregated information is available only in the tabular statement, which gives, the name, financial year, the number, face value, the extent of holding, the amount of profit or loss and how it is dealt with in the annual accounts. These are presented along with the holding company's annual report.<sup>220</sup> The summary information can also include a report on the working of all the subsidiaries and contingent liabilities information that will have an impact on the working of the parent company. Subsidiary companies are believed to have been vehicles for diverting the funds of the holding companies. As subsidiary company accounts are not presented to the shareholders the information about the related party transactions becomes more important.

Since the information about the individual subsidiary is not available, it is recommended that additional information about the performance of all the subsidiary companies be mandated in the Director's report. Specifically, the discussion must include details on performance, profit or losses, future outlook of the subsidiaries and the contingent liabilities that may affect the parent's financial statements. Some companies are now giving consolidated accounts but do not discuss the performance of the subsidiaries anywhere. It is also recommended that the Subsidiary Companies annual reports be posted on the company's website and be provided to the shareholders free of cost when requested.

### **Corporate Practices**

#### **Mahindra and Mahindra Ltd.**

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<sup>220</sup> Arvind Mills Ltd has not given this required information although certain information is given in the narrative form in Page 24 and 25 of the Annual report, 2003

The company has not enclosed the annual report of subsidiaries while the approval is pending from the central government requiring permission for not attaching the subsidiary accounts and have stated that reports will be given on request (Mahindra and Mahindra Ltd, Page 6, 2003) The consolidated accounts does not have a Director's report where the performance of the subsidiary can be discussed. The performance of 3(out of 26) subsidiary companies is discussed very briefly in the Management Discussion and Analysis under the "segment wise" discussion requirement. (pages 24,25 2003). In the absence of more stringent disclosure norms subsidiary accounts consolidation will not result in transparent disclosures.

#### RPG Life Sciences Ltd

The auditors have given a qualified report about the subsidiary stating that: "The company has made investment aggregating to Rs. 341,308 thousand in the shares and debentures, given loans and advance aggregating to Rs. 824,990 thousands and given a corporate guarantee of Rs. 700,000 thousands to a financial institution ... On behalf of Instant Trading Company Ltd., a wholly owned subsidiary company .....whose net worth has been substantially eroded")

### **9. Interim Financial Reporting AS -25**

The financial statements presented to the shareholders are received after a considerable period of time after the year-end. Investors need timely information for decision-making and the interim reports are one way to reduce information asymmetry between managers and investors that provide timely information. <sup>221</sup> Contrary to annual reports, interim reports are more focused to supply information for one important interest group of investors. Clause 41 of the listing agreement requires listed companies to publish un-audited interim financial quarterly information.

The accounting standard was issued to bring about some uniformity in the minimum components, the form, content and restatement of items previously

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<sup>221</sup> P.M Healy and K. G. Palepu. "The Challenges of Investor Communication- The Case of CUC International, Inc.", 38(2) *Journal of Financial Economics* 111-40 (1995)

reported in interim periods. An interim financial report is defined as a report consisting of a set of complete financial statements or a set of condensed financial statement for an interim period. An interim period is a period shorter than a full financial year. The interim financial reporting can be viewed in two ways: The interim period can be treated as a distinct accounting period and is called as a 'discrete approach' or to treat the interim period as the part of the overall annual accounting period and is referred to as the 'integral approach'. Under the integral approach, annual operating expenses are estimated and then allocated to the interim time periods based on the forecasted annual activity levels such as sales volumes. The results of subsequent interim periods must be adjusted to reflect estimation errors. The AS prefers the discrete approach.

The interim financial report consists of the complete set of financial statements, notes and other explanatory material. The minimum components presented are the headings and the sub headings as used in the annual report. Earnings per share must also be disclosed. The explanatory material should include the accounting policies, any unusual and extraordinary items, changes in estimates, dividends, issues and buybacks, segment information, impact of major events and material changes in contingent liabilities. IAS 34 gives the minimum contents of the interim financial reporting although it does not require companies to publish interim financial reports. A full financial interim reporting should follow the complete requirement of IAS1. The IAS requirements and the AS requirements are similar in most aspects.

SEC requires companies to file condensed quarterly information in Form 10-Q. At minimum, gross revenues, provision for income tax, extraordinary items, net income, comprehensive income, cumulative changes in principle, discontinued operations, earnings per share and contingencies needs to be disclosed. APB 28 preferred the integral approach and detailed guidelines are given for measuring and presentation of various items.

As reporting periods are shortened, the effects of errors in estimation and allocation are magnified. For example, computation of deferred tax, major repair expenses, advertising expenses are often concentrated in one period but may belong to the whole year. The 'short termism' puts undue pressure on the management to show continuously good results for the market participants. This

demand by investors for real time disclosures will also put pressures on auditing as well standard setters for developing standards that will enhance the relevance and reliability of the financial reporting.

### **3.4.3 Additional Disclosures Under the Listing Agreement**

Additional disclosures in the annual report have been mandated from time to time, to make it more useful to the investors. The Management Discussion and Analysis (MDA) is one such report, mandated through the listing agreement. Earlier companies presented only the Directors report that was considered inadequate by the investors. The MDA is a separate item of annual report.

The purpose of any MDA is to communicate to the user the non-financial information that gives an overview of the performance about the present and the future of the company through the eyes of the management. It provides more natural format in explaining the implications of the financial policy and the major transactions and other events given in the financial statements. MDA helps in enhancing the understandability and the usefulness of the annual report.

A broad set of terms to be covered is prescribed in the listing agreement, however the detailed items that are to be included are left to the discretion of the management. Information related to Industry structure and developments, Opportunities and threats, Segment wise - product wise performance, Outlook, Risks and Concerns, Internal control systems and their adequacy, Discussion of operational performance, Material developments in Human Resources/ Industrial relations, including number of people employed needs to be given.

The management report is a statutory requirement in Germany, which is similar to MDA and the Director's report. This report provides the observations by the management on the performance (situation of the company) of the company and the business developments. Current information as well as forward-looking information is required to be disclosed. The report also requires disclosures on events occurring after the balance sheet date and also research and development efforts. Under the 1998 Control and Transparency law (the "KonTraG"), the report of the Supervisory Board included in the annual report should give corporate governance disclosures: the nature and number of committees formed; how often the Board and the various committees met; and how the Board exercises supervision over the company management. The

accounting standards HFA 1 titled 'Preparation of a Management Report' was issued as it was found that the reports were only general statements. Reporting of risks is an important disclosure and there is a separate accountings standards for the same. Management Report has to be audited according to auditing standards a unique requirement unlike other countries.

IAS 1 encourages companies to present information by management that describes and explains the main features of the enterprise's financial performance and position, and the principal uncertainties it faces. Such a report may include: A review of changes in the business environment and their effects on the company, the company's source of funding and risk management policies and the strengths and resources of the company that are not reflected in the balance sheet. The standard also specifies that presentation of environmental reports and value added statements if it is relevant.

The London Stock Exchange recommends that listed companies comply with the Operating and Financial Review (OFR) statement issued by the Accounting Standards Board. An OFR includes a discussion and interpretation of the business, including uncertainties that underlie it and the structure of it's financing. The financial review also requires discussion on aspects that of the business that are relevant to an assessment of future prospects. Discussion on financial statements requires a commentary on the operating results, review of financial needs and resources and a commentary on the shareholders return and value. The Stock Exchange also requires UK listed companies to make a statement of compliance with the Combined Code on Corporate Governance in their annual report although the code is voluntary.

MDA was introduced in 1968, when the SEC made MDA as part of the guidelines for preparation and filing of registration statements (Securities Act Release 334936). In 1974, the SEC required, that corporate annual reports include a discussion and analysis of the summary of operations (Securities Act Release IC-8175). In 1980 the SEC adopted the MDA as a separate requirement and changed the focus from operating results to the financial statements as a whole (Release 34-17114). This 1980 amendment began the formal requirement for a discussion of issues and trends relating to liquidity, capital resources and the results of operations.

Listed companies in US must give MDA in their annual report with focus on three key aspects of, liquidity, capital resources and any other information that will help in understanding the results of the operation and changes in the financial condition. The detailed contents of the MDA are governed by Regulation S-K 303 of the SEC, together with further interpretative rules in the SEC's Financial Reporting Release 36. MDA requirements are intended to provide in one section of a filing, material historical and prospective disclosures that will enable in assessing the financial condition of the company. The MDA covers three-year period of the financial statements. If trends are important, reference to the summary of five-year selected financial data is given. When compared to other countries the US requirement is more elaborate and requires companies to cover the various aspects of the operations of the companies. The format is flexible but the reporting must contain information on:

- The company's liquidity position identifying issues relating to long term and short term.
- Capital resources giving details of future capital expenditure changes expected in the capital structures and sources for future capital
- Result of operations includes significant transactions, trends, impact of inflation and changing prices on sales, revenues and operations, impact of foreign exchange rates of financial statements, material changes in line terms of consolidated financial statements, known material events that may make the financial statements not indicative of future operations or future conditions and any items that may be useful for understanding the financial statements.
- The recent changes require specific MDA disclosures on material off-balance sheet transactions, arrangements and obligations that may have a material effect on the company's financial condition, results of operations, liquidity, capital expenditures and resources or significant components of revenues and expenses and disclosure in the MDA of a company's aggregate contractual commitments in a tabular format and a summary of its contingent liabilities in either a textual or tabular format.<sup>222</sup>

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<sup>222</sup> See SEC Release No. 33-8144 Release 33-8182; 34-47664 [www.sec.gov](http://www.sec.gov) (Mar 05, 2003) Schroeder and Gibson (1990) tested the readability of the MDA report of 40 randomly selected companies from Fortune 500 and concluded that many of the companies did not communicate

The disclosure requirement in India is not adequate compared to other countries specially the UK and the US. It is recommended that the ICAI provide some guidelines on minimum matters that must be covered in the MDA, without restricting the company's own style, as the information given is general now.

Companies themselves are better positioned than outsiders to provide accurate, balanced and contextual information to capital markets. It is critical for management credibility that the MDA report be balanced in its disclosures, openly reporting risks and opportunities, and bad news as well as good news, thus avoiding the creation of optimistic or pessimistic expectations. MDA complements as well as supplement financial statements and hence must integrate forward looking information along with long and short term focus and must present information that embody the qualities of reliability, comparability, consistency, relevance and understandability.

### **Corporate Practices**

Some companies have not given information required in the MDA. Hence strict enforcement is essential. For example, Essar Steel Ltd: The Director's report is titled as "Directors Report and Management Discussion and analysis". Discussion on risks and concern, internal control systems, Industrial relations, number of people employed is not found. (Pages 9, 10 of 2003 annual report)

Product wise, segment wise performance are not discussed by a few companies who claimed to be in single segment like, Britannia Industries Ltd (2002) and Cipla Ltd. Many companies do not cover the risks and concerns or cover them adequately for example Hero Honda Ltd, GlaxoSmithkline Ltd. Some companies have also presented the MDA after the financial statements in a separate section. (SSI Ltd Annual Report 2002 Page, 54). Some additional disclosures that need to be included in the MDA are discussed in Chapter 5.

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properly in the MDA report. N.Schroeder and C.Gibson, "Readability of Management's Discussion and Analysis", 4(4) *Accounting Horizons* 78-87 (1990)

## 3.5 Corporate Reporting Practices

In this section reporting practices followed by the companies, relating to segment reporting, related party disclosures, risk related information, and shareholder information are analysed and discussed.

### 3.5.1 Segment reporting

Users of financial statements have insisted upon segment wise information for a long time. A disclosure that is useful and of relevance to the investors is the disaggregation of financial information through segment reporting. The increased globalisation of financial markets, deregulation of certain industries, and diversification of businesses resulting from significant merger and acquisition activity have heightened the importance of segment reporting for analysts and investors. Financial analysts recognise the importance of segment reporting and acknowledge the need for disaggregated financial data as being vital, indispensable and integral part of the investment analysis process.<sup>223</sup> Segment reporting is needed for predicting future cash flows and for monitoring the management decisions on mergers and other corporate decisions.

Prior research indicates that segment reporting by companies have been weak in many countries as there is considerable scope for management discretion in identifying the segments.<sup>224</sup> Thus, there was a greater demand for improving the segment reporting in the US as compared to the earlier pronouncements of SFAS 14. With the revised standard, companies in US greatly improved disclosures on segment reporting. Yet, some companies continued to disclose poorly.<sup>225</sup> Segment reporting can be based on the line of business or a geographical segment. Reporting of geographical segments is

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<sup>223</sup> Association for Investment Management and Research (AIMR), *Financial Reporting in the 1990s and Beyond A Monograph* (New York: AIMR, 1993)

<sup>224</sup> Following studies find that segment reporting was weak in UK, Japan, US and Australia, C. Emmanuel and S.J Gray, "Segment disclosures and the Segment Identification Problem", 7 (Winter) *Accounting and Business Research* 37-50 (1977), see also; V. Mande and R.Ortman "Are Recent Segment Disclosure on Japanese Firms Useful? Views of Japanese Financial Analysts", 37(1) *The International Journal of Accounting* 27-46 (2002), M. Aitken, R. Czernkowski and C. Hooper, "The Information Content of Segment Disclosures: Australian Evidence", 30 (1) *Abacus* 65-77 (1994)

<sup>225</sup> D.L. Street, N.B. Nichols and S. J. Gray, " Segment Disclosures Under SFAS No. 131: Has Business Segment Reporting Improved?" 14(3) *American Accounting Association* 259, 259-285 (2000)

required country wise in the US, while a few are giving country wise details, a significant group still aggregates the data.<sup>226</sup>

Recent clarification issued by ICAI states that, if on application of the segment definition it is concluded that there is neither more than one business segment nor more than one geographical segment, segment information is not required to be disclosed. In the next section the Indian companies practices on segment reporting is examined.

### **Methodology, Sample and Results of the Study**

The sample companies selected are BSE 100 non-banks and non-financial sector companies. The year of study is the year ended 2002 as this the first year when the accounting standards became effective. Companies in the sample are from different industries like Software, Cement, Pharmaceutical, Petroleum, Food and Beverages, Steel, Auto, Diversified and Others. In the sample many of the companies are highly diversified and with high market capitalisation and sales. These include Hindustan Lever, Reliance Industries, Larsen and Toubro, Dabur, ITC, Grasim Industries etc. The segment reporting practices are examined for both line of business and geographical segments. To arrive at the conclusion in remarks column, the segment reporting under AS 17 is compared with MDA and also the Director's report. The chairman's speech and the product wise sales details available in the annual report were also examined to arrive at the risk return levels of each product following the method used in prior studies on segment disclosures.<sup>227</sup>

The list of companies and their results are given in Appendix 3 under Panel A, B and C. Out of the sample of 86 companies, 20 companies (23%) claim to be in single segment. Of these 5 companies are in the pharmaceutical, 4 auto, 2 each in cement, aluminium, petroleum and one each in software, food and others. One company has got exemption from segment reporting on account of supplies to the defence sector. At least 13 companies given in Panel A could have given segment reporting in one form or other. Analysis of information in Panel B shows that diversified companies give segment reporting and many of the software companies and others also give segment reporting. Pharmaceutical

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<sup>226</sup>N.B. Nichols, D.L. Street, and S.J. Gray, "Geographic Segment Disclosures in the United States: Reporting Practices Enter a New Era", 9(1) *Journal of International Accounting, Auditing and Taxation* 59-82 (2000)

companies, large auto firms, and those in petroleum are weak in segment reporting. These companies have distinguishable segments as indicated in the MDA, which have different risk and returns. As indicated in the remarks column many of the companies could have given better disclosures for segment reporting. For example in the auto industry, TELCO provides segment information in the form of Automotive and others. In the automotive trucks and passenger cars and multi-utility vehicle are all aggregated together. These products have distinctive features and have different sets of risks as mentioned in the annual report itself, and this warrants separate disclosures.

In the pharmaceutical industry most of the companies have two segments of 'Pharmaceuticals' and 'Others'. A few companies reported animal health as additional segment. Some companies are clearly into bulk drugs and formulations that should have been disclosed as distinct segments e.g. Ranbaxy Laboratories (bulk drugs, formulations and generics). Companies that could have given additional segments are given in Panel B. For example Larsen and Toubro, and Mahindra and Mahindra have important segments that have been aggregated with other segments. Companies such as Tata Steel (maker of flat and long steel products), Nestle India (confectionery, culinary products and semi-processed foods and beverages)) and Reliance Industries, do not make adequate disclosures of various segments. Certain companies have reported two segments with major products aggregated and others. Panel C contains companies where disclosures are adequate and in line with the MDA.

Geographical segment reporting is not provided by 50% of the companies (43 companies). Out of the remaining 27 companies have reported geographical segments based on Domestic and Outside India. Only 13 companies have provided information based on country wise or at least grouped continent wise details. One company has disclosed the geographical segment reporting as the primary segment. The requirement of segment assets to be disclosed for secondary segment is also not reported. Only one company has reported geographical segment based on the domestic market itself. 4 companies have not given geographical segment reporting in spite of having export revenue contributing 10% of the total sales. Software industry revenue is primarily from

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<sup>227</sup> Supra Note 224, 225 and 226 where this methodology has been used.

exports hence these companies have given geographical segment reporting (e.g. USA, Europe and rest of the world). Six companies having revenue from exports of more than 20% disclose only India and rest of the world. Not many have given the break-up of revenue country wise. Many companies have not given all the information required under the segment reporting. Sales and profits are disclosed but other details such as total segment liabilities, total amount of depreciation have not been disclosed. Similarly geographical segment information by companies in many cases includes only the revenue information.

Two public sector companies have reported segments based on the plant locations. Companies in the IT sector have given geographical segment reporting as the secondary segment. Infosys reports primary segments based on the services provided to different industries i.e. business verticals. GTL Ltd has also given a comprehensive segment reporting. However, Infosys does not allocate expenses or depreciation although they are significant to total expenses. Three companies in IT have not given primary segment reporting. Companies in IT industry must be made to disclose information based on industries or other suitable criteria so that adequate disclosures are given to the stakeholders.

To sum up, segment reporting requires elements of judgement in both reporting the segments and also the allocation of the assets. Management has great discretion in deciding whether a segment is primary or secondary. While AS-17 strictly requires the use of internal reporting system to identify the segments, it appears that some of the firms are not doing so in spite of the indication in the MDA about the organisation structure revealing different segments.<sup>228</sup> There is no uniformity of disclosures within the industry too. There is no consistency between what is reported in the management discussion and analysis and the segment reporting for many companies. Out of the companies only a small percentage of companies have not disclosed segment reporting. In particular pharmaceuticals, auto and petroleum do not give adequate disclosures. Some large companies are also aggregating the segments and thus defeating the purpose of segment reporting. Geographical segment reporting is also found deficient in many companies. Companies must also look into special

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<sup>228</sup> These results are similar to those in the study conducted prior to the year when Accounting standards were mandatory. S.Vijayalkashmi, "The Segment Reporting of Indian Companies", Working Paper, IIM Kozikide (2002)

issues like proximity of operations, special risks to a particular unit or area criteria before deciding geographical segments. Companies may start disclosing less in the MDA of the Annual Report to avoid reporting under the accounting standards.

There is an urgent need to monitor segment disclosures by companies and take remedial action on companies in case they change the reporting practices. Some good companies disclosing information may stop giving the information following the other companies in the industry. The role of auditors in enforcing reporting practices is very important. Although voluntary initiatives by companies are the best way to disclose, companies may find themselves in disadvantage as compared to competitors who may not disclose. To supplement segment information for service industries certain reporting norms for services or business verticals must be made mandatory. ICAI too needs to develop a model reporting for segments in various industries. In case no enforcement action is taken, other better disclosure companies will also start aggregating the segments. Further, it is recommended that companies are mandated to give more elaborate enterprise wise details for products and country wise details for geographical segments and major customer information (if a customer accounts for more than 10% of the total revenues) like in the US SFAS 131 specially the non manufacturing companies.

### **3.5.2 Related Party Disclosures**

The same sample for segment reporting was used to study the disclosure practices of companies on related party transactions. The study of related party disclosures reveal that companies have not given information in the true spirit of the standard. The accounting standards give an alternate way of reporting whereby information about the related party transactions can be given in an aggregate form instead of parties wise. That is information of each related party need not be given but they can be aggregated broadly into i) Holding Company ii) Subsidiaries iii) Fellow Subsidiaries iv) Associates v) Key management Personnel (KMP) and vi) Relatives of Key management Personnel. The limited revision of the accounting standards state that "Items of a similar nature may be disclosed in aggregate by type of related party except when separate disclosure is necessary for an understanding of the effects of related party transactions on

the financial statements of the reporting enterprise".<sup>229</sup> While the aggregate format is easier to prepare, major transactions with related parties may get lost.

The results of related party disclosures study are summarised in Table 3.3. Out of the 86 companies, only 8 companies gave party wise details and one company has disclosed details in the Directors report. Remaining companies have aggregated the transaction under various broad heads thereby defeating the very purpose of related party transactions disclosures. Some companies have aggregated certain related parties like 'Associates and Joint Venture', 'Holding company and fellow subsidiaries' a few have 'other related parties' which is general in nature. Companies have also identified related parties as 'Firms in which Key management personnel exert influence', 'Promoters' (when they are not key management personnel)). In one company's report, the list of related parties, have been made by the Directors pursuant to the legal opinion taken.<sup>230</sup>

In view of the importance of related party transaction to many stakeholders, it is suggested that aggregation should not be done. As indicated in many of the annual reports related parties are identified by company and relied by auditors, hence aggregating the information would not amount to transparent disclosures. Moreover transactions may relate to only a single related party and by aggregating them, information will be lost. It is also recommended, that related party transaction in subsidiary companies (consolidated reports) be disclosed along with the main reports so that all the related party information is available at one place.

### **3.5.3 Shareholding Pattern**

Companies have to present information on the holding pattern of the shareholder to be filed in the prescribed format to the stock exchange. This information is given in the annual report, although the format is not specified. Information on the name, number of shares held and percentage shareholding of entities / persons holding more than 1 percent of the shares of the company is filed with the stock exchange.

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<sup>229</sup> Limited revision of AS 18, Related Party Disclosures [www.icai.org/common/index.html](http://www.icai.org/common/index.html)

<sup>230</sup> See Sonata Software Ltd Page 51 Annual Report 2003

Some companies have not reported shareholding information in a transparent manner and have reported only the distribution based on number of shareholders and denomination of holdings. Certain companies have not disclosed the promoter holding and have given only the share holding based on broad criteria like individuals, bodies corporate making it an opaque disclosure. While the SEBI does not specify what is to be reported in the annual report, some companies have disclosed in the SEBI format, which is filed with the stock exchange. Some companies like Reliance Industries Ltd., Gujarat Ambuja Cements Ltd have not given the promoter holdings. Table 3.4 gives examples of such companies along with transparent reporting by certain other companies.

It is recommended that reporting in SEBI format be mandated for the annual report also. The word promoter is generally construed as people who have formed the company. When companies are acquired at a later date, the promoter holdings do not exist. In such cases the companies must be mandated to disclose the shareholdings of the management and their associates along with the names of top 10 shareholders. The shareholders are not limited to individuals but should include all categories of holders.

### **3.6 Chapter Summary**

The global phenomena of an integrated and interdependent global economy have resulted in the free flow of goods, services and capital amongst countries. An important feature is the integration of capital markets, which has resulted in advantages to both the users, and suppliers of funds. An important impediment faced by the suppliers of funds relates to the interpretation of the financial statements based on different accounting and reporting rules.

Accounting system in any country is influenced by many factors. These include the source of financing, the legal and taxation system and the development of accounting profession. Other factors such as historical background, the education system, the political and economic conditions also affect the development of accounting in a country. Development of the accounting system in USA, UK, Germany and India reflects the influence of many of these factors. European Union Directives have greatly influenced the reporting in Germany and UK.

This chapter examined the regulation and practices of reporting standards. They were also compared with the reporting requirements of the UK, Germany, US, and the IAS. As countries are moving towards the International Accounting Standards, many countries are falling in line with the presentation requirement of the IAS. Indian AS needs to align with IAS in many areas.

The results of the comparative study indicate that the contents of the balance sheet (include those disclosed in the notes and schedules) in the raw form are quite elaborate and as compared to others. But, there are differences in the way they are presented in the financial statements. An important difference is in the presentation of the current and non-current items. Presentation of Reserves and Surplus should also be modified to provide better information. A clear distinction needs to be made for those relating to transactions with shareholders, legal reserves and other reserves. The reserves may be further classified into available for distribution and those not available for distribution to shareholders as dividends. Those not available for distribution can be further classified into temporary waiting for realisation and others. Such a classification of reserves and surplus will be in alignment with the requirement of accounting standards discussed later.

Companies have reported the profit and loss statement in variety of ways. The present format of reporting the profit and loss has many differences when compared to US GAAP and IAS. The income from operating activities, discontinuing operations, extraordinary items and items transferred from reserves need to be disclosed in a better way. Stringent definitions of what is to be reported in sales and presentation of the profit and loss account have to be mandated.

There is a need for mandating a standard format for reporting in the profit and loss account through a consultative process. Additional statements like the comprehensive income statement is required to be mandated to capture certain unrealised transactions resulting from the application of the accounting standards. Most of the reporting standards are now in alignment with IAS except for AS 5 where substantial difference is observed. Greater differences are observed between US GAAP and AS.

Baring the differences discussed at the appropriate places, the regulatory requirements are in alignment and are higher in certain aspects compared to countries in the study. Disclosure practices of companies are poor. Companies have not strictly followed the AS and in some cases management have used their discretion in reporting. In particular, segment reporting practices and related party disclosures of companies were studied. The study finds that reporting of segments is weak for many big companies and the auditors/authorities have to enforce the regulations strictly. Further, it is recommended that companies be mandated to give more elaborate enterprise wise details for products and country wise details for geographical segments and major customer information (if a customer accounts for more than 10% of the total revenues) like in the US SFAS 131. It is also recognised that related party transactions should not be aggregated or at least major transaction in each category of related party must be disclosed. Other practices examined are shareholder information and risk related disclosures. Here again companies have not adhered to the true spirit of the standard. It is recommended that top 10 shareholders (not just individuals) names be given in the annual report. In the MDA, broad items have been prescribed. ICAI or SEBI must give more specific guidelines to improve the reporting practices under the MDA. Stringent enforcement of the disclosures in accounting standards is also required which are discussed in Chapter 6.

**Table 3.1 Panel A: Disclosures of Accounting Policies as Required Under IAS 1**

1	Revenue recognition	11	Business combinations
2	Consolidation principles, including subsidiaries and associates	12	Joint ventures
3	Recognition and depreciation / amortisation of tangible and intangible assets	13	Investment properties
4	Capitalisation of borrowing costs and other expenditure	14	Construction contracts
5	Financial instruments and investments	15	Employee benefit costs
6	Research and development costs	16	Leases
7	Inventories	17	Provisions
8	Taxes, including deferred taxes	18	Government grants
9	Foreign currency translation and hedging	19	Definition of cash and cash equivalents
10	Definition of business and geographical segments and the basis for allocation of costs between segments	20	Inflation accounting

**Table 3.1 Panel B: Disclosures of Accounting Policies Required Under AS 1**

1	Method of Depreciation	6	Valuation of Fixed Assets
2	Treatment of expenditure during the construction period	7	Treatment of contingent liabilities
3	Valuation of inventories	8	Amount of Goodwill
4	Retirement Benefits	9	Retirement Benefits
5	Translation of foreign currency items	10	Long term construction contracts

**Table 3.1 Panel C****Disclosures of Revenue Recognition Policies of Software Companies**

Infosys Ltd: Revenue from software development on fixed price contracts is recognised based on milestones achieved as specified in the contracts on the proportionate completion method based on work completed. One time material contracts, revenue is recognised based on software developed and invoiced as per the terms of specific contracts. Annual Technical Service is recognised proportionately over the period in which services are rendered. Revenue from sale of user licences for software application is recognised on transfer of the title in the user licence. Interest is recognised using the time proportion method, based on the rates implicit in the transaction. Dividend income is recognised when the company's right to receive dividends is established. (Page 69, 2002)

Wipro Ltd : Sales which are subject to detailed acceptance test, revenue is reckoned based on the milestones for billing as provided in the contracts. Revenue from software development services includes revenue from time and material and fixed price contracts. Revenue from time and material contracts are recognised as related services are performed. Revenue on fixed price contracts is recognised in accordance with percentage completion method of accounting.

**Table 3.2: Corporate Disclosures of Prior Period Items**

<u>Zee Tele films Ltd: (page 39 , 2002)</u>	
1. Prior period adjustments (Net) 3.22 Crores	
2. Provision for taxation for earlier years (note 4 (a))	
No explanation in notes etc on the nature of prior period items in 1.	
<u>GTL Ltd Details are given in Note 6(b) Page 159, 2002)</u>	
1. Income tax refund on extraordinary income	3676 lacs
2. Short provision for tax including interest	(46.22)
3. Short provision for merger expenses	(107.22)
4. Excess provision for expenses of earlier years	1.38
<u>Nestle Ltd. (Page 15 ad 24 2002)</u>	Rs. Thousands
Profit before Tax and Exceptional item	3188443
Provision for Tax	1119370
Profit before exceptional item	2069073
(Exceptional items In relation to earlier years – net of tax)	53889
Net Profit after exceptional items	2015184
(Items are considered net of tax and profit from operations is separated from exceptional items net of tax.) Note 4 states: The company has reclassified certain specialised fixed assets to align better wit those specified in Schedule XIV of the Companies Act, 1956 which has resulted a depreciation charge of Rs 53889 thousand in relation to earlier years.	
<u>Essar Steel Ltd (Page 19,2003)</u>	
Profit/(loss) before charges pertaining to earlier years (net) and taxation changes pertaining to earlier years (net)	
Raw materials consumed	2.29 crores
Finance cost	25.16
Others	14.46
<u>Reliance Ltd</u>	
<u>Schedule O: Item 9 page 95</u>	
A sum of Rs. 7.07 crores (net debit) previous year Rs. 3.01 crore (net debit) is included in General Expenses representing net prior period items	

**Table 3.3: Disclosures on Related Party Transactions**

<b>Companies Giving Details Party wise</b>	Bajaj Auto, Britannia Industries, GAIL Ltd, GTL Ltd. TVS Motors, VSNL, Wipro Ltd and Dr. Reddy's Laboratories Ltd. and Infosys Technologies Ltd
<b>Companies Aggregating Related Party Transactions</b>	
Digital Global Soft Ltd	Gross amounts to all entities of Compaq and Holding company given together
EIH Ltd	Subsidiaries, Associates and JV's are aggregated, Enterprise in which KMP* have influence, Enterprise in which EIH has influence, KMP
Essel Propack	Subsidiaries, Associates, Other related parties
G.E. Shipping	Subsidiaries, Associates, <b>Other related Parties</b> , KMP (controlling persons)
Nirma Ltd	Subsidiary, Other Related Parties, KMP, JV
Hindalco	Subsidiaries, Joint ventures and KMP. No mention of associates
SSI Ltd	All related parties are given together and all transactions given under single head
Tata Iron and Steel Co Ltd	Subsidiary, <b>Associates and JV</b> , KMP, Promoters
Videocon International	Subsidiary, <b>JV and Associates</b> , KMP
Wockhardt Ltd	<b>Subsidiaries and associates</b> are together. KMP
Zee Tele Films	Subsidiaries, Associates, <b>Other Related parties</b> , KMP
	*KMP =Key Management Personnel JV = Joint Venture

**Table 3.4: Disclosure of Shareholder Information**

Name of the Company	Types of Disclosures	Observations
Reliance Industries Ltd	Only a Pie Chart giving details of Bodies Corporate, International Investors and Indian FII's	Promoters Holdings are not indicated and cannot be identified.
Visual Soft Technologies	Combined Shareholding and debenture holding distribution is given with break-up on the basis of the number shares held by shareholders. No break up of the promoters holding etc.	This information is of no relevance for the user wanting to know the pattern of shareholding.
India Cements Ltd	-Information on number of shareholders. - <u>Pattern of shareholding given:</u> *GDR Holders, * FII, *Overseas bodies, NRI, FI, *Mutual Funds, *Corporate Bodies, *Directors and Relatives.	The Promoters holding cannot be clearly identified, as it appears that holdings are clubbed based on the form of organisation holdings.
Gujarat Ambuja Cements	* Bodies Corporate, * International Finance Corporation, *Affinity Investments Ltd Mauritius *Foreign Institutional Investors, * Non Resident Indian's Other Corporate Bodies *Mutual Funds, Banks and Institutions *GDR Holders *Others	No details about promoters holding
<p><b><u>Example of transparent reporting: BHEL and Nicholas Piramal Ltd</u></b></p> <p><u>Category:</u></p> <p><u>Promoters Holdings</u>                      Indian Promoters, Foreign Promoters and Persons acting in Concert</p> <p><u>Non Promoters Holding:</u></p> <p>Institutional investors                      Mutual Funds and UTI, Financial institutions</p> <p>Others:    FII Private Corporate Bodies, Non Residents Employees, Trusts and Indian Public</p>		
<p>BHEL: Also gives the Top Five Shareholders Names</p>		