Directorate of Distance Education

UNIVERSITY OF JAMMU

JAMMU

SELF LEARNING MATERIAL

OF

FINANCIAL REPORTING

FOR

M.COM 1ST SEMESTER

For Examinations to be held in 2023 Onwards

COURSE NO. M.COM-C150 **UNIT : 1-IV**

LESSON NO. 1 TO 20

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DIRECTORATE OF DISTANCE EDUCATION
UNIVERSITY OF JAMMU
M.COM. FIRST SEMESTER (NON CBCS)
FINANCIAL REPORTING
(Core Course)

Course : MCOM150	**Max Marks : 100 Marks**
Credit : 4	**External : 80 Marks**
Time : 3:00 Hrs	**Internal : 20 Marks**

(Syllabus for the examinations to be held in December 2022, 2023, 2024)

COURSE OBJECTIVE :

1. To sensitize the students about the problems of accounting such as measuring and reporting issues related to assets and liabilities and preparing the financial statements.
2. To make the students familiar with the financial reporting standards issued by IASB and application in India.
3. To develop an understanding among the students about the various forms of reporting (other than financial statements) and accounting for special transactions and apply such knowledge in problem solving.
4. To provide the students a thorough grounding of forensic accounting, creative accounting & environmental accounting and preparation of financial reports with their analysis for decision making and control.

COURSE OUTCOMES

After the completion of this course, the student will be able to :

1. gain the skill of using accounting information as a tool in applying solutions for managerial problems, evaluating the financial performance, interpreting the financial structure and analyzing general purpose financial reports;

2. acquire the ability to integrate and solve problems in practical scenarios on Accounting Standards. Guidance Notes and Indian Accounting Standards for deciding the appropriate accounting treatment and formulating suitable accounting policies;
3. evaluate different types of performance measurement systems in accounting and commonly used financial control systems;
4. combine practice and theoretical knowledge of financial accounting and develop awareness of emerging trends in financial accounting; and
5. demonstrate proficiency with the ability to engage in competitive exams like CA, CS, ICWA and other courses.

UNIT I INTRODUCTION

Basics of reports, essential requirements of a good report, steps for making the report more effective. Financial reporting: Nature, importance and objectives; Types of financial reporting; Users of financial reporting; Process of financial reporting; Difference between financial reporting and management reporting; Issues and challenges in financial reporting with special reference to published financial statements; Financial reporting for management-top level management, middle level management and lower level management; Guiding principles for reporting to different levels of management; Financial reporting practices in Indian companies.

UNIT II FINANCIAL REPORTING STANDARDS

Accounting Standards: Basics of accounting standards; Areas where accounting standards needs to be framed; Procedures for setting Indian and International accounting standards; Overview of international financial reporting standards (IFRS); International financial reporting standards issued by the IASB; Structure of IFRS; Process of IFRS; Problems in understanding and application of IFRS; IFRS adoption or convergence in India.

UNIT III CORPORATE REPORTING

International financial reporting qualities; Objectives of corporate financial reporting; Development of financial reporting objectives: Accounting Principle Board (APB, Statement No. 4); Financial Accounting Standard Board (FASB, Concept No.l); True-blood report and Stamp report objectives; Specific purpose reporting; Reporting by diversified companies - Segment reporting: Nature, objectives and problems; Disclosure requirements of different users group of segment reporting; Interim reporting: Nature, objectives, problems and suggestions to improve interim reporting; Harmonisation in reporting: Nature, need, benefits and obstacles in convergence and harmonisation; Suggestions for increased convergence and harmonisation; Corporate governance reporting; Value added reporting and HR Reporting.

UNIT IV DEVELOPMENT IN FINANCIAL REPORTING

Creative accounting: Basics, methods, types and importance; Forensic accounting: Nature and essentials of forensic accounting; Functional areas of forensic accounting; Forensic accounting in India; Environment accounting : Nature, need of environmental accounting; Scope of environmental accounting; Forms of environmental accounting; Elements of environmental accounting; Advantages of environmental accounting; Mechanism of environmental accounting; Social accounting : Nature, features, needs and benefits; Social accounting and audit practice TATA.

Suggestive Readings

1. Lal, J. Financial Reporting-Theory and Practices. Taxmann, New Delhi.
2. David, F. H. Corporate Financial Reporting. Text and Cases, Irwin Publications, New Delhi.
3. Lal, J. Accounting Theory–Himalaya Publications House, New Delhi.
4. Steven M. Bragg : The Vest Pocket IFRS, John Wiley Publications, Hoboken. New Jersey.

5. Gupta, S. K. Contemporary Issues in Accounting, Kalyani Publishers, New Delhi.

Note : Latest edition of the books may be preferred.

NOTE FOR PAPER SETTING

The paper consists of two sections. Each section will cover the whole of the syllabus without repeating the question in the entire paper.

Section A : It will consist of eight short answer questions, selecting two from each unit. A candidate has to attempt any six and answer to each question shall be within 200 words. Each question carries four marks and total weightage to this section shall be 24 marks.

Section B : It will consist of six essay type questions with answer to each question within 800 words. One question will be set atleast from each unit and the candidate has to attempt four. Each question will carry 14 marks and total weightage shall be 56 marks.

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INTRODUCTION

BASICS OF REPORTS, ESSENTIAL REQUIREMENTS OF A GOOD REPORT, STEPS FOR MAKING THE REPORT MORE EFFECTIVE

1.1 INTRODUCTION

1.2 OBJECTIVES

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1.1 INTRODUCTION

Writing an effective business report is a necessary skill for communicating ideas in the business environment. Reports usually address a specific issue or problem, and are often commissioned when a decision needs to be made. They present the author's findings in relation to the issue or problem and then recommend a course of action for the organisation to take. The key to a good report is in-depth analysis. Good writers will show their reader how they have interpreted their findings. The reader will understand the basis on which the conclusions are drawn as well as the rationale for the recommendations.

1.2 OBJECTIVES

After going through this lesson, you will be able to understand:

- the meaning and definitions of reports;
- the importance of reports;
- the nature of financial reports;
- the essential requirements of a good report; and
- the steps for making the reports more effective.

1.3 BASICS OF REPORTS - MEANING AND DEFINITION OF REPORT

The word "Report" is derived from the Latin word 'portare" which means 'to carry'. So, 'Report' is a document which carries some information. A report may be defined as a statement or an account, either big or small, on some happenings, findings, observations or recommendations prepared either by an individual or by a group.It is a set of documents of the activities of a business, person, or other entity prepared by a single individual (like a secretary or a departmental head or an investigator) or by a group of persons or a committee or a sub-committee. A report may be prepared at regular interval of time (like annual report of an organisation or a monthly report by a branch to the head office) or only once (like a report by an enquiry committee).

In almost every business organisation, whether small or large, financial reports are prepared. A financial report generally contains summary of accounting data for that period, with background notes, forms and other information. It highlights the financial state of any company. It includes the balance sheet, statement of income of the company from which the net profit and loss can be measured. Financial report features the detailed explanation of financial data which comprises income from all sources and the outlays, assets and liabilities as well. Financial report renders the financial status or performance of a company.

The following are the various definitions of reports:

- According to **G.R. Terry** "Report is a written statement based on a collection of facts, events and opinions and usually expresses a summarised and interpretativevalue of this information. It may deal with past accomplishments, present conditions or probable future developments".
- "A Good business report is a communication that contains factual information, organised and presented in clear, correct and coherent language". -**Johnson and Savage**
- In the words of **Zairi,** "For the reports to be useful they must be relevant, understandable, reliable, complete, timely and comparable."
- **M.C.Shukla and S.S.Gulshan** opines "A report is any written or oral communication in which according to the nature and purpose of the report, the reporter presents a collection of facts or a number of alternative propositions, states his conclusions and (if called upon to do so) submits his recommendations".

In simple words, report can be defined as "a form of statement which presents and examines facts relating to an event, problem, progress of action, state of business affairs etc. and for the purpose of conveying information, reporting findings, putting forward ideas and making recommendations as the basis of action.

So, report is 'an impartial presentation of factual information. In fact report is a communication from someone who has the information to someone who wants to use that information. The facts presented in report may arise out of available factual data or through enquiry, investigation, survey, interview, experiments or research. A mere expression of opinion without supporting data is not a report.

1.4 IMPORTANCE OF REPORTS

Importance of reports in organisational life and for general administration is inordinate. Decisions are very often taken on many controversial and problematic issues based upon some reports. Members of an organisation or a committee or a department, etc., can know many relevant and material facts about the organisation or committee or group itself or of other organisations, committees or groups through reports thereon. General administration is guided very much by different kinds of internal and external reports.

Sometimes reports have to be prepared, submitted, and circulated statutorily. For example, annual reports of a company. A report has a documentation value. It is a source of reference, evidence, and history. The secretary of an organisation or a committee or a sub-committee, etc. has great responsibility in connection with reports because he is involved in report making process.

Thus, the importance of reports cannot be over emphasized. It is required by each and every stakeholder for multiple reasons and purposes. The following points highlights importance of reports:

(i) Means of communication

The basic purpose of preparing reports is to facilitate upward communication. Through reports, someone who has information communicates to higher authority who needs that information for carrying out various functions of management. Reports serve as a communication mode to communicate relevant information to management executives, government agencies, shareholders, creditors, suppliers, customers or general public. Reports also communicate authentic information to research scholars who are interested in collecting data information for various research matters. Hence, reports can be considered most effective mode of communication.

(ii) Helpful in record keeping

Financial reports can also facilitate the function of record keeping. Since reports provide valuable and authentic records for future references. Reports usually includes facts and findings of investigations which can be stored as a valuable information. These stored facts can be of great importance in future.

(iii) Fulfil legal requirements

Some of the reports are also prepared and submitted to fulfill legal requirements. For instance, annual report of company's accounts is necessary to be furnished to the shareholders under Companies Act 2013. Similarly, audit report of accounts must accompany the Income tax return under Income tax Act, 1961.

(iv) Provide basis for taking important decisions

Reports usually contain factual information related with some event. Reports kept as a valuable record also help management in providing basis for taking important decision. For instance, salesman's report and dealer's report will provide basis for taking any decision related with sales matters.

(v) Build public relations

Sometimes reports are also written and submitted presenting information of general progress of business and utilisation of national resources. These reports are usually available for general public and help in enhancing goodwill of the reporting entity and hence in developing public relations.

(vi) Act as a basis to measure performance

Routine reports about the work performance of employees help the management to measure performance in view of the objects. The reports on performance of employees shall also become basis for promotions and incentives.

(vii) Facilitates control

Reports also facilitate control process in the organisation. Reports provide a relevant basis of any control process. In normal course of the business, it is on the basis of reports, actions are initiated and instructions are given to improve the performance.

(viii) Feedback

Reports also help the lower levels in providing feedback to the management in form of reactions on decisions' taken by the management. **Anthony and Reece** have rightly said, "Reports on what has happened in a business, are useful for two general purposes which may be called information and control respectively." So, information reports are useful to tell management what is going on. Control reports on the other hand, are useful in assessing personal performance and economic performance.

(ix) Help in combating changes

Since business itself is dynamic one, business conditions keep on changing, They pose a serious challenge to the existence of a corporate entity. Reports aim at analysing the impact of business dynamics and how best changes can be exploited to the benefit of the company.

(x) Facilitates coordination

Reporting also helps in coordinating the activities in an organisation. The act of co-ordinating can be best performed with the help of various reports.

(xi) Contact with users

Reports act as a mean to remain in touch with consumers, suppliers, shareholders and Government agencies.

1.5 NATURE OF REPORTS

Report is a valuable document which gives information and guidance to the management while framing future policies. It facilitates planning and decision making. Reports are also useful for solving problems faced by a business enterprise. A report serves as a permanent record relating to certain business matter. It is useful for future reference and guidance. The below mentioned points will explain the nature of reports:

(1) A report is based upon facts and also very often supported with some statistical data, references etc.

(2) A report has to be prepared in a proper form and style. The form and style depend on the purpose of the report.

(3) A report has definitely a purpose. One common purpose is spreading of information. Other purposes are—compiling of record, providing guidance to action or judgement, making of evidence, etc.

(4) A report is meant for circulation either exclusively to an individual, or group of individuals, or members of an organisation or public at large.

(5) A report shall satisfy all the characteristics for its effectiveness.

(6) Reports are of various types.

(7) Reports are closely related to meetings.

(8) The basic function of a report is that it is a means of communication of some facts.

(9) A report is addressed to some definite reader or readers.

(10) A report has invariably a bearing on time.

(11) A report may be just received or adopted, or tabled (i.e., deferred for taking any action), or referred back to committee for reconsideration. So, a report may be treated differently.

1.6 TYPES OF REPORTS

Reports are of various types. They are classified on the basis of various principles. Such classification is also based on groups. They are detailed below:

(1) Routine and Special:

A routine report is prepared and presented as a routine work and at a regular period of time. For example, the annual report of an association or a company which has to be prepared by the secretary or by the Board of Directors at the end of every financial year and copies have to be distributed among the members.

A routine report contains some facts or information either in detail or in a summarised form. It may also be of critical type containing some remark or opinion. For example, the auditor's report on the final accounts of a company. Departmental managers or branch managers have to regularly submit routine reports to the higher authorities.

A special report is prepared and presented not as a matter of routine. This is prepared on the basis of some enquiry or investigation either by a single individual or by a body or a committee or a subcommittee or a commission specially formed and entrusted with the duty.

The secretary of an organisation, by virtue of his position, is often entrusted with the duty of preparing reports on certain department or person or event to be submitted to the top management people for taking decisions. The Government very often sets up committees or commissions to make investigation on some matter or person and to submit report. A special report is in many cases of confidential type and contains apart from facts and information, some recommendations. A technical report prepared by technologists on some specific issue is a kind of special report.

Whether the report is ordinary or special, it may be an item of discussion at any general or committee or Board meeting and the fact has to be mentioned in the agenda of the meeting.

(2) General and Confidential:

A general report is that which is for distribution among many, like the members of an organisation. Such reports may be printed in large numbers or even published in newspapers for the public information. The Government publishes reports of different committees or commissions and places them on sale to the public.

A confidential report is meant for some superior person or persons and is not for general information. Sometimes, the report may be so confidential that the secretary or any other person preparing it writes it by hand or types it out himself.

(3) Formal and Informal:

A formal report is that which is prepared according to some prescribed form and at a prescribed time and is presented according to a conventional procedure. For example, the annual report of a company or any association, a report of a branch to its head office, etc.

Sometimes formal reports are further classified into two parts namely statutory and non-Statutory.

(a) Statutory reports are those which have to be prepared by a company under the provisions of the Companies Act or by a registered society registered under the Societies Registration Act or by a co-operative society registered under the Cooperative Societies Act and a copy of such report have to be submitted to the respective Registrar. For example, the annual report of a company or a society. The statutory report is to be prepared and submitted by every public limited company also comes into this category.

(b) Non-statutory reports are those which have to be prepared formally but there is no compulsion under law to be submitted to any authorised person. For example, a report prepared and submitted by a Committee set up by the Board of Directors of a company for a particular purpose, e g. on development of market. The submission of the report shall be to the Board of Directors. Formal but non-statutory reports are also prepared and submitted by the secretary to the Board of Directors on different issues.

Informal reports are those which need not to be prepared or presented according to some prescribed form or procedure. An informal report is generally a kind of personal communication and may be even in the form of a letter. For example, a newly appointed employee has to submit a joining report to his boss.

(4) Verbatim and Summarised:

Such classification is generally related to reports on meetings. After any meeting is over, a report on the same has to be prepared and presented by the secretary. A Verbatim report of a meeting means a report containing all the details, word for word, on what events have occurred at the meeting, what words have been spoken by the different participants and what decisions have been taken.

In other words, the record of full proceedings of a meeting can be called verbatim report. Such reports are necessary for every Assembly or Parliament session or for a case in a court of law.

A summarised report means a report taking into consideration the main points of discussion at a meeting and the short description of events happening at a meeting. For example, a press report prepared after a meeting, whether public or private, to be sent to different newspapers for the favour of publication.

A report, whether verbatim or summarised, must be however, based on facts because the readers of such reports will depend on the information supplied. A summarised report must not be confused with the minutes of the meeting.

(5) Privileged and Non-Privileged:

Reports can be further classified into privileged or non-privileged. A privileged report is that which contains statements or remarks made by some people which may be defamatory to some others but permitted to be spoken under privilege in speech.

A report on proceedings of a case in a court of law or in Assembly or Parliament session, etc. is allowed to be published in newspapers or otherwise. But such a privilege is a ‘qualified’ privilege and will be allowed provided the report is accurate and meant for public interest.

But the report containing privileged speeches on a private meeting like the annual general meeting of a company, cannot be published as a privileged report.

Every other kind of report is a non-privileged report. Reports in general are non-privileged.

(6) Other Types:

Reports can be further classified into with or without recommendations. Generally, reports prepared for information only do not contain recommendation but reports prepared by some enquiry committee contain recommendations.

Lastly, reports can be classified one-man report or group report. A report may be prepared by an individual only like any report by a secretary or it may be prepared by a group or a committee.

Even in case of a committee, there is a secretary or convenor to each committee who drafts the report on behalf of the committee and gets it confirmed by others, with or without modifications. A committee may be divided into reports, one by the majority and the other by the minority, may be separately submitted. Therefore, reports may be of majority and minority types.

1.7 STEPS FOR MAKING THE REPORTS MORE EFFECTIVE

A report is a vehicle carrying information to those who need it. A report is written and prepared by putting in labour by executives. The effectiveness and usefulness of report will depend upon its quality and the way in which it has been presented and communicated. A report should be prepared in such a way that it serves the purpose and is presented at a time when it is needed. Good reporting is, thus, essential for effective communication. A good report should have the following requisites:

(1) Good form:

Form of the report should be adopted in a way that it must leave its impression on the user of the report. An ideal form should have a proper title, headings sub heading and paragraph division. The title of the report itself will explain the purpose for which the report has been prepared. The title also enables to point out the persons who need the report. A sales report may have a title as “Sales Report for the month of January 2022”. This title explains the purpose and period of preparing the report.

(2) Contents:

The following points must be kept in mind while preparing a report:

(i) If statistical figures are to be given in the report, then only significant figures and totals should be made a part of it and other detailed figures should be given in appendix.

(ii) The reports should contain facts only and not opinions.

(iii) The report must contain the date of its preparation and date of submission.

(iv) If the report is prepared in response to a request or letter then it should bear reference number of such letter or request.

(v) The contents of a report must serve the purpose for which it has been prepared. Separate reports may be prepared for different subjects.Various aspects of the subject should be properly conveyed.

(vi) The contents of the report should be in a logical sequence.

(vii) The contents of the report should be relevant. Irrelevant information should not be included.

(3) Simplicity:

The report should be presented in a simple, unambiguous and in a clear language. The language used in report should be non- technical. If the report is loaded with technical terminology, it will reduce its utility because the reader may be unfamiliar with that language. If technical terminology is the essential requirement of the subject covered some explanation of technical terms must be given to make the report understandable. The user of the report should be able to understand the report without any difficulty. The report should also be readable. The figures should be rounded off so as to make them easily understandable. If possible, charts, diagrams or graphs should be used for presenting information.

(4) Promptness:

Promptness in submitting a report is an essential requisite of a good report. The reports should be sent at the earliest. Reports prepared by various responsibility centers with the organisation are required for studying the progress and performance of responsibility centers. A considerable delay in the occurrence of an event and reporting of the same will defeat the objective and purpose of reporting. Information delayed is information denied. The quick supply of report will enable the management to take corrective actions well in time. The reports are to be based on information, the promptness in reporting will depend on quick collection of facts and figures. Following steps may help in quick reporting:

(i) A proper record keeping system should be introduced in the organisation to meet various informational needs.

(ii) To avoid clerical errors mechanised accounting should be used.

(iii) The accounting work should be centralised to avoid bottlenecks in collecting information.

(5) Relevency:

Reports should be presented only to those persons who need them. Reports should be submitted to relevant authorities. Sometimes reports are sent to various divisions in routine way, then it will involve unnecessary expenditure and wastage of time. Reports will not remain secret also. The persons or departments to whom the report is to be sent should be clear to the sender of the report. So, this type of practice involves unavoidable expenditure and reduces the importance of reports.

(6) Consistency:

There should be consistency in the preparation of reports. For consistency, the reports should be prepared from the same type of information and statistical data. This will be possible if same accounting principles and concepts are used for collecting, classifying, tabulating and presentation of information. Consistency in reporting enhances their utility.

(7) Accuracy: The reports should be reasonably accurate. Statistical reports may sometimes be approximated to make them easily understandable. The production of figures accurate upto date may be difficult to be remembered.Their reasonable approximation may make them readable and understandable. The degree of accuracy depends upon the nature of information and purpose of its collection. The approximation should not be done upto the level where information loses its form and utility. So, accuracy should be used to enhance the use of reports.

(8) Factual:

The reports should be prepared on the basis of factual information. Any predictions should be avoided in reports unless and until it becomes necessity. Fictional items should not form the content of any report.

(9) Controllability:

The reports should be addressed to appropriate persons in respective responsibility centers. The report should give detail of variances which are related to that centre. This will help in taking corrective measures at appropriate levels. The variances which are not controllable at a particular responsibility centre may also be mentioned separately in the report.

(10) Cost Consideration:

The cost benefit analysis should be done in respect to the preparation of the reports. The cost of preparing and presenting the report should not be the more than the advantages desired from such reports. The cost should be reasonable so that reporting may be used by all types of concerns. The cost benefit analysis will help in deciding about the adoption of reporting system.

(11) Comparability:

The reporting system is meant to help the management in taking correct decisions and improving the operational efficiency of the organisation. This objective will better be achieved if reports give comparative information.The comparative information can be in relation to previous periods, current standards or budgets. This information helps in finding out deviations or variances. Where performance is below standards or expectations, such variances can be highlighted in the reports. The management by exception is possible when exceptional information will be supplied to the management. The comparative reporting will at once, help the user to reach at conclusions about the performance of the responsibility centers mentioned in the report.

(12) Frequency of reports:

Along with promptness, the frequency of reporting is also significant. The reports should be sent regularly when they are required. The timing of reporting will depend upon nature of the information and its purpose. Some reports may be sent daily, some weekly, some monthly and so on. Frequency of reports means that these should be sent when required. The reports are prepared at appropriate times and sent to appropriate persons as per their requirement.

(13) Decorative:

Reports particularly prepared for general public or external users should be decorative. Various attractive pictures on front page of the report can be presented. Pictorial information usually has more attraction of the user than descriptive information. Any report fully loaded with statistical data presented with colourful diagrams and beautiful pictures on its title page will leave ever lasting impression on external users.

(14) Clarity and analysis:

A good report must be clear and analytical with the purpose of its use. Lack of clear information and analysis will not be able to serve the basic purpose and object of reporting.

(15) Brevity:

A brief report is always desirable on account of various reasons as under:

(i) Lengthy reports are very costly.

(ii) Lengthy reports are time consuming.

(iii) Long reports reflect inefficiency.

(iv) Long reports usually ignore the main issue.

(16) Planned and organized:

A planned and organized report is always regarded as a good report. A planned report will include following points:

(i) The object of report, methodology used for collecting data.

(ii) Summary of conclusions.

(iii) Problems and solutions.

(iv) Recommendations.

(v) Annexures.

(17) Properly addressed:

A report must be addressed to the users of the report, for instance, Manager, Board of Directors, Managing Director etc.

(18) Duly signed and dated:

Report prepared by any department must be properly dated and signed by responsible Head of the department. Undated reports may not be able to fix the historicity of the report on some future date.

(19) Terms of reference:

A report should contain various terms of reference which will explain the objects and contents of report.

1.8 ESSENTIAL REQUIREMENTS OF A GOOD REPORT

To make reporting more effective, the following are the essential steps should be taken into consideration while preparing reports :

(a) Reporting should be the logical output of accounting routine.

(b) Duplication in work should be avoided. Various basic books of accounts i.e. journal and ledger should be designed in such a way that data is available without any further effort.

(c) Mechanization and codification should be used, which would be helpful in speeding up the routine work.

(d) Accounting process should be completed, a few days before the closing, date. For instance accounts relating to the month of March may be closed on the 20th March. The period from 21st March to 31st March may be used for data processing and final reports may be sent on 1st April.

(e) The interim estimates may be used in place of actual data if not readily available. The quality of reports in such cases would depend upon quality of estimates made. The actual data may later on be compared with estimated data and deviations if any should be found out.

(f) Constant receiving of reports should be done so that no executive is starved of information and no manager is fed with unwanted data.

1.9 SUMMARY

Speedily shifting business environment, modern concepts of information technology and computerized official work has changed the informational needs of the modern management. The process of providing information to the management has created new dimensions to the internal reporting system. A technological improvement in management information system is the need of the hour. Management reporting is an integral part of modern management information system. Reporting is not equivalent to communication. Communication is always both way i.e., downward and upward.

Downward communication emphasizes on communication of decisions to lower levels of the organization where as upward communication includes reactions of lower levels to the top management. The effectiveness of management reporting is based on form and contents of a good report. The reports are prepared by management accountants and are sent for the review of top management.

1.10 GLOSSARY

- **Report**- a document which carries some information.
- **Good form** - an ideal form should have a proper title, headings, sub heading and paragraph division.
- **Cost consideration**- the cost benefit analysis done in respect to the preparation of the reports.
- **Simplicity**- simple, unambiguous and in a clear language.
- **Feedback-** responses to the management in form of reactions on decisions' taken by the management.

1.11 SELF ASSESSMENT QUESTIONS (SAQ)

Q.1. What do you understand by reports?

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Q.2 What are the essential requirements of a good report?

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1.12 EXAMINATION ORIENTED QUESTIONS

Q.1. "Accounting reports are a matter of necessity for the management and not a matter of convenience". Explain critically.

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2. Discuss various kinds of reports prepared by the management accountant.

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3. Discuss various objects and purpose of reporting.

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1.13 SUGGESTED READINGS

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- Writing a Business Report (wgtn.ac.nz)
- Reports: Definition, Features and Types | Company Management (yourarticlelibrary.com)

UNIT-I M.Com 1st Semester

Course No. M.Com-C150 Lesson No. 2

INTRODUCTION

FINANCIAL REPORTING : NATURE, IMPORTANCE, OBJECTIVES, TYPES OF FINANCIAL REPORTING

2.1 INTRODUCTION

2.2 OBJECTIVES

2.3 MEANING OF FINANCIAL REPORTING

2.4 IMPORTANCE OF FINANCIAL REPORTING

2.5 NATURE OF FINANCIAL REPORTING

2.6 OBJECTIVES OF FINANCIAL REPORTING

2.7 TYPES OF FINANCIAL REPORTING

2.8 GLOSSARY

2.9 SUMMARY

2.10 SELF ASSESSMENT QUESTIONS (SAQ)

2.11 EXAMINATION ORIENTED QUESTIONS

2.12 SUGGESTED READINGS

2.1 INTRODUCTION

Financial report is a set of documents of the financial activities of a business, person, or other entity by government agencies at the end of an accounting period.

Financial report generally contains summary of accounting data for that period, with background notes, forms and other information. It highlights the financial state of any company. It includes the balance sheet, statement of income of the company from which the net profit and loss can be measured. Financial report features the detailed explanation of financial data which comprises income from all sources and the outlays, assets and liabilities as well. Financial report renders the financial status or performance of a company.

2.2 OBJECTIVES

After going through this lesson, you will be able to understand :

- the meaning of financial reporting;
- the importance of financial reporting;
- the objectives of financial reporting; and
- the types of financial reporting.

2.3 MEANING OF FINANCIAL REPORTING

Financial reporting is the formal record of the financial transactions and activities of a business, person or an entity. It deals with the structural representation of the financial position of business enterprise. Financial reporting is the depiction of the true and fair view of the business, showing the net cash inflows or outflows of an enterprise and changes in the financial position of a business over a period of time.

Financial reporting is an essential part of corporate governance. It involves the revealation of financial information to management and the public about how the company is performing over a specific period of time. Financial reporting is the process of producing statements that disclose an organization's financial status to management, investors and the government. Financial report is a set of documents of the financial activities of a business, person, or other entity by government agencies at the end of an accounting period.

Financial report generally contains summary of accounting data for that period, with background notes, forms and other information. It highlights the financial state of any company. It includes the balance sheet, statement of income of the company from which the net profit and loss can be measured. Financial reporting serves two primary purposes. Firstly, it helps management to engage in effective decision-making concerning the company's objectives and overall strategies. The data disclosed in the reports can help management in judging the strengths and weaknesses of the company. Secondly, financial reporting provides vital information about the financial health and activities of the company to its stakeholders including its shareholders, potential investors, consumers, public, debt providers and government regulators. It is a means of ensuring that the company is being run appropriately.

In case of listed companies, the frequency of financial reporting is quarterly & annual. Financial Reporting is usually considered as end product of accounting. The typical components of financial reporting are:

1. The financial statements – Balance Sheet, Profit & loss account, Cash flow statement & Statement of changes in stock holder's equity
2. The notes to financial statements
3. Quarterly & Annual reports (in case of listed companies)
4. Prospectus (In case of companies going for IPOs)
5. Management discussion & analysis (In case of public companies)

The Government and the Institute of Chartered Accounts of India (ICAI) have issued various accounting standards & guidance notes which are applied for the purpose of financial reporting. This ensures uniformity across various diversified industries when they prepare & present their financial statements.

Significant financial information is presented in a structured manner and in a form easy to understand. They typically include basic financial statements such as-

1. A balance sheet is a snapshot of what the company owns and how it financed what it owns, through borrowing or through the company owners' investments. Now, let's look at it in a more technical sense. A balance sheet is based on the standard accounting model: Assets = Liabilities + Equity. The balance sheet breaks down these components and reports the company's assets, liabilities, and equity.

Assets are the things that a company owns or is owed, including cash. Liabilities are what the company owes to other companies or to individuals. Equity is the amount that the owners (including shareholders, if applicable) have invested, plus retained earnings or losses; these are the earnings (or losses) that have accumulated since the company was started that were not paid out as dividends, which means they were reinvested into the company.

2. A statement of comprehensive income or income statement, statement of revenue & expense, P&L or profit and loss report, reports on a company's profits and losses over a specific period of time. A profit and loss statement provides information on the operation of the enterprise. These include sales and the various expenses incurred during the stated period.

3. A statement of changes in owner's equity or statement of retained earnings, reports on the changes in owner's equity during the stated period.

4. A cash flow statement usually reports on a company's cash inflows and outflows activities, predominantly its operating, investing and financing activities.

For large corporations, these statements may be complex and may include an extensive set of footnotes to the financial statements and management discussion and analysis. The notes typically describe each item on the balance sheet, income statement and cash flow statement in further detail. Notes to financial statements are considered an integral part of the financial statements.

2.4 IMPORTANCE OF FINANCIAL REPORTING

The importance of financial reporting cannot be over emphasized. It is required by each and every stakeholder for multiple reasons & purposes. The following points highlights the importance of financial reporting :–

1. It helps the organization to comply with various statues and regulatory requirements. The organizations are required to file financial statements to Government Agencies. In case of listed companies, quarterly as well as annual results are required to be filed to stock exchanges.

2. It facilitates statutory audit. The Statutory auditors are required to audit the financial statements of an organization to express their opinion.

3. Financial Reports forms the backbone for financial planning, analysis, bench marking and decision making. These are used for above purposes by various stakeholders.

4. Financial reporting helps organizations to raise capital both domestic as well as overseas.

5. On the basis of financial reports, the public in large can analyze the performance of the organization as well as of its management.

6. For the purpose of bidding, labour contract, government supplies etc., organizations are required to furnish their financial reports & statements.

2.5 NATURE OF FINANCIAL REPORTING

Financial Reporting involves the disclosure of financial information to the various stakeholders about the financial performance and financial position of the organization over a specified period of time. These stakeholders include investors**,** creditors, public, debt providers & government agencies. The following points explain the nature of financial reporting:

1. **Recorded facts :** The term 'recorded facts' refers to the data taken out from the accounting records. The records are maintained on the basis of actual cost data. The original cost or historical cost is the basis of recording various transactions. The figures of various accounts such as cash in hand, cash at bank, bills receivables, sundry debtors, fixed assets etc. are taken as per the figures recorded in the accounting books. The assets purchased at different times and at different prices are put together and shown at cost prices. As recorded facts are not based on replacement costs, the financial statements do not show current financial condition of the concern.

2. **Accounting conventions :** Certain accounting conventions are followed while preparing financial statements. The convention of valuing inventory at cost or market price, whichever is lower, is followed. The valuing of assets at cost less depreciation principle for balance sheet purposes is followed.

   The convention of materiality is followed in dealing with small items like pencils, pens, postage stamps, etc. These items are treated as expenditure in the year in which they are purchased even though they are assets in nature. The stationery is valued at cost and not on the principle of cost or market price whichever is less. The use of accounting conventions makes financial statements comparable, simple and realistic.

3. **Postulates :** The accountant makes certain assumptions while making accounting records. One of these assumptions is that the enterprise is

treated as a going concern. The other alternative to this postulate is that the concern is to be liquidated, if management shows an intention to liquidate the concern. So, the assets are shown on a going concern basis. Another important assumption is to presume that the value of money will remain the same in different periods.

Though there is a drastic change in purchasing power of money the assets purchased at different times will be shown at the amount paid for them. While preparing profit and loss account, the revenue is treated in the year in which the sale was undertaken even though the sale price may be received in a number of years. The assumption is known as realization postulate.

4. **Personal Judgments :** Even though certain standard accounting conventions are followed in preparing financial statements but still personal judgment of the accountant plays an important part. For example, in applying the cost or market value whichever is less to inventory valuation, the accountant will have to use his judgment in computing the cost in a particular case. There are a number of methods for valuing stock, viz.; last in first out, first in first out, average cost method, standard cost, base stock method, etc. The accountant will use one of these methods for valuing materials. The selection of depreciation method, to use one of the several methods for estimating uncollectible debts, to determine the period for writing off intangible assets are some of the examples where judgment of the accountant will play an important role in choosing the most appropriate course of action.

2.6 OBJECTIVES OF FINANCIAL REPORTING

According to International Accounting Standard Board (IASB), the objective of financial reporting is "to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions."

Financial reports are the documents and records that are put together to track and review how much money the business is making (or not). The purpose of financial reporting is to deliver this information to the lenders and shareholders & stakeholders of the business. If someone else is supporting part of the business, financial reporting must be part of the essential contract between the business and them. The lenders and investors have the right to know if their money is being spent wisely and returning a profit.

A good financial report should answer certain basic financial questions:

- Is the business making a profit or suffering a loss, and how much ?
- How do assets stack up against liabilities?
- Where did the business get its capital, and is it making good use of the money?
- What's the cash flow from the profit or loss for the period?
- Did the business reinvest all its profit?
- Does the business have enough capital for future growth?

The following points sum up the objectives and purposes of financial reporting –

1. To provide useful information to management of an enterprise for planning, analysis, benchmarking and economic decision making.
2. To provide information useful to investors, financial institutions, money lenders promoters and creditors to facilitate them to make rational and practical decisions regarding credit and investment.
3. To provide useful information to shareholders & public at large in case of listed companies about various aspects of an enterprise.
4. Providing information about the economic resources of an organization, claims to those resources (liabilities & owner's equity) and how these resources and claims have undergone change over a period of time.

5. Providing information as to how an organization is procuring & using various resources.

6. Providing information to various stakeholders regarding performance of management of an organization as to how diligently & ethically they are discharging their fiduciary duties & responsibilities.

7. Providing information to the statutory auditors which in turn facilitates audit.

8. Enhancing social welfare by looking into the interest of employees, trade union & Government.

So, we can conclude from the above points that financial reporting is very important from various stakeholders point of view. At times for large organizations it becomes very complex but the benefits are far more than such complexities. We can say that financial reporting contains reliable and relevant information which are used by multiple stakeholders for various purposes. A sound and robust financial reporting system across industries promotes good competition and also facilitates capital inflows. This, in turn, helps in economic development.

2.7 TYPES OF FINANCIAL REPORTING

Financial reports represent a formal record of the financial activities of an entity. These are written reports that quantify the financial strength, performance and liquidity of a company. Financial statements reflect the financial effects of business transactions and events on the entity.

Generally speaking, financial reporting in organisations are of four types which are as follows :–

1. ***Reporting of Income statement:*** This reporting reveals the financial performance of an organization for the entire reporting period. It begins with sales, and then deduct all expenses incurred during

the period to arrive at a net profit or loss. An earning per share figure may also be added if the financial statements are being issued by a publicly-held company. This is usually considered the most important financial statement, since it describes performance. Income Statement, also known as the Profit and Loss Statement, reports the company's financial performance in terms of net profit or loss over a specified period. Income Statement is composed of the following two elements:

- Income: What the business has earned over a period (e.g. sales revenue, dividend income, etc)
- Expense: The cost incurred by the business over a period (e.g. salaries and wages, depreciation, rental charges, etc)

2. ***Reporting of Balance sheet.*** This reporting shows the financial position of a business as of the report date (so it covers a specific point in time). The information is aggregated into the general classifications of assets, liabilities, and equity. Line items within the asset and liability classification are presented in their order of liquidity, so that the most liquid items are stated first.

It is comprised of the following three elements:

- Assets: Something a business owns or controls (e.g. cash, inventory, plant and machinery, etc)
- Liabilities: Something a business owes to someone (e.g. creditors, bank loans, etc)
- Equity: What the business owes to its owners. This represents the amount of capital that remains in the business after its assets are used to pay off its outstanding liabilities. Equity therefore represents the difference between the assets and liabilities

3. ***Reporting of Cash flow statement:*** This reporting reveals the cash inflows and outflows experienced by an organization during the reporting period. It presents the movement in cash and bank balances over a period. The movement in cash flows is classified into the following segments:

   - Operating Activities: Represents the cash flow from primary activities of a business.
   - Investing Activities: Represents cash flow from the purchase and sale of assets other than inventories (e.g. purchase of a factory plant)
   - Financing Activities: Represents cash flow generated or spent on raising and repaying share capital and debt together with the payments of interest and dividends.

4. ***Reporting of Statement of changes in equity:*** This reporting provides information about all changes in equity during the reporting period. These changes include the issuance or purchase of shares, dividends issued, and profits or losses. This document is not usually included when the financial statements are issued internally, as the information in it is not overly useful to the management team.

   When issued to users, the preceding types of financial statements may have a number of footnote disclosures attached to them. These additional notes clarify certain summary-level information presented in the financial statements, and may be quite extensive. Their exact contents are defined by the applicable accounting standards.

Besides the above four reports other financial reports includes the following :

(1) Classification on the basis of object and purpose

(a) External reports

The reports prepared for external users or for the persons outside the business are known as external reports. External users may include shareholders investors creditors, suppliers and bankers. Though company may not be answerable to outsiders but still some reports are meant for outsiders. The company publishes income statement and balance sheet at the end of every financial year and these statements are filed with the Registrar of companies and stock exchanges. Final statements of accounts are expected to conform to certain basic details in India, it is mandatory to disclose some minimum information in final accounts.

(b) Internal reports

Internal reports refers to those reports which are meant for different level of management. Internal reports are not public documents and they are not expected to conform to any standards. These reports are prepared by keeping in view the needs of disposal for scanning them. These reports may be meant for top level, middle level and lower level management. The report meant for different levels of management may be regarded as internal reports. The frequency of these reports vary in accordance with purpose they serve. Some of the internal reports that are commonly used include period report about profit and loss account and financial position, statement of cash flow, changes in working capital, report about cost of production, production trends and utilisation of capacity. Labour turnover reports, material utilisation reports, periodic reports on sales, credit collection periods and selling and distribution expenses, report on stock position etc.

(2) Classification on the basis of nature

According to nature, reports can be classified into three categories

(a) Enterprise reports

These reports are prepared for the concern as a whole. These reports serve as a channel of communication with outsiders. Enterprise reports may concern all activities of the enterprise or may be related to different activities. Enterprise reports may include balance sheet, income statement, income tax returns, employment report, chairman's report. These reports contain standardized information and are beneficial to outsiders. The interpretation of financial statement can also be undertaken from these reports. The reports are important from financial analysis point of view.

(b) Control reports

Control reports deal with two aspects where one aspect relates to the personal performance and the other aspect deals with the economic performance. The first type of reports are prepared and reported to judge performance of managers and heads of various responsibility centres. The reasons for deviations in performance are also identified. The second type of reports show how well the responsibility centre has faired as an economic activity? Such analysis is made periodically. This type of analysis requires the use of full cost accounting rather than responsibility accounting. Control reports should consider the following:

(i) control reports should be related to personal responsibility.

(ii) They should compare actual performance with the standards.

(iii) They should highlight significant information.

(iv) These reports should be sent at a proper time as to enable taking corrective measures.

(v) If possible various accounting ratios may be calculated.

(c) Investigating reports

These reports are linked with control reports. In case, some serious problem arises then the causes of this situation are studied and analysed. Investigative reports are based on outcome of special solution studies. These reports are generally prepared only when a situation arises. They are prepared according to the nature of every situation. They are helpful to the management in analysing the causes of some problem.

(3) Classification on the basis of period

According to the period, reports can be classified as under :

(a) Routine reports

These reports are prepared about day to day working of the concern. They are periodically sent to various levels of management. Routine reports may relate to sales information, production figures, capital expenditures, purchases of raw materials, market trends etc). There is a tendency to ignore routine reports by all recipients because of their routine nature.

Important information in the report should be highlighted or presented in a different way or may be written in a different ink.

(b) Special reports

The management may confront with some difficulties and routine report may not give sufficient information to tackle such situations. Under such circumstances, special reports are called for. Special reports are required for special purposes only. These reports are prepared according to the need of situation. Available accounting information may not be sufficient, so data may have to be specially collected. There may be need to put extra staff for compiling these reports. It may also involve co-ordination of different departments and different levels of management. Special reports may deal with following topics:

(i) Information about market analysis and methods of distribution of competitors.

(ii) Technological changes in industry.

(iii) Problems about the purchase of materials.

(iv) Reports about change in methods of production and their implications.

(v) Trade association matters.

(vi) Report by secretary on company matters.

(vii) Political development at home and abroad having impact on business.

(viii) Report effect of idle -capacity on cost of production.

(ix) Make or buy decisions.

(x) Report on most suitable method of raising funds.

(xi) The effect of labour disputes on production and cost of production.

(xii) Report on general economic forecast.

(xiii) Feasibility study for a project.

(xiv) Report on effect of change in Government Policy.

(4) Classification of reports on the basis of functions

According to function, the reports may be divided into two categories namely Operating Reports and Financial Reports

(a) Operating reports. These reports provide information about operations of the concern. The operating reports may consist of the following :–

(i) Control reports. These reports are used for management control purposes. They are intended to spot deviations from budgeted performance without loss of time so that corrective action can be taken. Control reports are also used to assess the performance of individuals.

(ii) **Information reports.** These reports are prepared to provide useful information which will enable planning and policy formation for future. Information reports can take the form of trend reports and analytical reports. Trend reports provide information in comparative form over a period of time. Graphic presentation can be effectively used in trend reports. As opposed to trend reports, analytical reports provide information in a classified manner about composition of certain results so that one can identify specific factors in the overall total.

(b) **Financial Reports.** These reports provide information about the financial position of the concern on specific dates or movement of finances during a specific period. The Balance Sheet provides information about a concern on a specific date. On the other hand Cash Flow Statement provides data about the movement of cash during a particular period. These reports can be either static or dynamic.

(5) Classification of financial status report

It contains the statement or summary of disbursement over a particular time frame which can be sent to the sponsors. It comprises general funds, major invigilators, capital amendment programs, sponsoring agencies and budget adjustment etc. This report is usually made at the end of any budget period.

The different types of financial status reports are:

(a) **Interim financial status report:** An Interim financial status report gives the summary of expenditure over a longer budget period, may be quarterly or semi-annually.

(b) **Annual financial status report:** As the name suggests, the annual financial status report covers the period of a whole year. The annual report of the expenditure can be procured from the annual financial status report.

(c) **Final financial status report:** After the completion of a project the final financial status report is used to be prepared. That's why it is called final financial status report.

(d) **Utilities of financial status report:** This report includes the update of a city's capital improvement program. It also shows the budget adjustment and fund balance analysis for every fund.

The commencement of a fund balance is separately embodied into that report. It includes transactions from which we get the total outlays, refunds, rebates, net outlays etc.

It highlights on the actual comparison of earnings and expenditure over a complete fiscal quarter.

From this disclosure, report sponsors can compute the non obligatory balance as well.

(6) Classification on the basis of stock financial report

Stock financial report contains the information regarding all the dealings of shares of a company that have been performed by the share holders having at least 10% of the company's stock. The stock report contains different types of information. They are as follows:

(a) **Traders' report:** This is to forecast the stocks of attractive prices. In the same way, the information about the saleable stocks have been conveyed to the members. The users can select their stock by searching with the criteria that they want which, inturn, will minimize the risk factor.

(b) **Investors' report:** This report is designed to help the investors before investing. It can be seen as a knowledge centre that have been built by extensive market research, members' call and email. The investors can get plethora of information from it and also can make idea of high quality shares which will be able to give consistent long term returns. Also this report can enhance the investors towards the improvement of their investment results.

(c) **Focus stocks:** It contains the report about those stocks which have got the focus over the week.

(d) **Market wrap & news:** It focuses on the latest development of the shares in the market and also on the company forecasts. From this report, any one not only can get the idea of the stocks which are comparatively good but also can avoid any possible blab that is going around the market regarding stocks.

(e) **Portfolio:** Here, one can monitor the stocks that are going to be purchased in the future and also can get the updates regarding any further developments of stocks. The different types of portfolios are:

a) Growth portfolio.

b) Balance portfolio.

c) Income portfolio.

d) Absolute return portfolio.

(f) **Contracts for difference report (CFD) :** Contracts for difference report is used by the investors and traders from different background to minimize the risks and enlarge their return. In the share business, it is a rapid developing tool. It contains overseas market wrap, share treading ideas, analysis and trading details, foreign exchange analysis and trading etc.

(7) Annual financial report

Annual financial report offers the elaborated picture of a company or organization's financial condition after the completion of a year to the employees as well as to the different investors and lenders of funds.

The major elements of Annual financial report are the history of stock price, total revenue, expenses, earnings, management's discussion and analysis and last but not the least, balance sheet that's known as the statement of financial position and gives the assets, liabilities and owners' equity of the company at a particular point of time. Any investor ought to read it before investing into the companies' stock.

The annual financial report includes the essential disclosures of additional data, assumptions and methodologies used. To testify that the financial statements have been examined by independent auditors, the annual financial report of the public limited are used to add an auditor's report.

This report also contains cash flows.

2.8 GLOSSARY

- **Stock financial report-** contains information regarding all the dealings of shares of a company that have been performed by the share holders having at least 10% of the company's stock.
- **Traders' report-**contain information about the saleable stocks that have been conveyed to the members.
- **Investors report-** is designed to help the investors before investing.
- **Focus stocks-**contains the report about those stocks which have got the focus over the week.
- **Market wrap & news-** focuses on the latest development of the shares in the market and also on the company forecasts.

2.9 SUMMARY

Financial reporting is the depiction of the true and fair view of the business, showing of the net cash inflows or outflows of an enterprise and changes in the financial position of a business over a period of time. Financial reporting is an essential part of corporate governance. It involves the revelation of financial information to management and the public about how the company is performing over a specific period of time. Financial reporting is the process of producing statements that disclose an organization's financial status to management, investors and the government. Financial report is a set of documents of the financial activities of a business, person, or other entity by government agencies at the end of an accounting period. It generally contains summary of accounting data for that period, with background notes, forms and other information. It highlights the financial state of any company. It includes the balance sheet, statement of income of the company from which the net profit and loss can be measured. Financial reporting serves two primary purposes. First, it helps management to engage in effective decision-making concerning the company's objectives and overall strategies. The data disclosed in the reports can help management in judging the strengths and weaknesses of the company. Second, financial reporting provides vital information about the financial health and activities of the company to its stakeholders including its shareholders, potential investors, consumers, and government regulators.

2.10 SELF ASSESSMENT QUESTIONS (SAQ)

Q.1 Discuss the meaning and importance of financial reporting.

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Q. 2 State the objectives of financial reporting.

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Q. 3 Explain the various types of financial reports.

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2.11 EXAMINATION ORIENTED QUESTIONS

1. Discuss various types of financial reports that are usually prepared by business enterprises.

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2. How far financial reporting is helpful to the parties interested to know the position of the enterprise?

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3. “Financial reporting reflects a combination of recorded facts and personal judgement”. Discuss.

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2.12 SUGGESTED READINGS

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UNIT-I | M.Com 1st Semester

Course No. M.Com-C150 | Lesson No. 3

INTRODUCTION

USERS, PROCESS OF FINANCIAL REPORTING

3.1 INTRODUCTION

3.2 OBJECTIVES

3.3 USERS OF FINANCIAL REPORTING

3.4 PROCESS OF FINANCIAL REPORTING

3.5 LIMITATIONS OF FINANCIAL REPORTING

3.6 SUMMARY

3.7 GLOSSARY

3.8 SELF ASSESSMENT QUESTIONS

3.9 EXAMINATION ORIENTED QUESTIONS

3.10 SUGGESTED READINGS

3.1 INTRODUCTION

Financial reporting is the process of producing statements that disclose an organization's financial status to management, investors and the government.

Financial report is a set of documents of the financial activities of a business, person, or other entity by government agencies at the end of an accounting period. Financial report generally contains summary of accounting data for that period, with background notes, forms and other information. It highlights the financial state of any company. It includes the balance sheet, statement of income of the company from which the net profit and loss can be measured.

3.2 OBJECTIVES:

After going through this lesson, you will be able to understand-

- the users of financial reporting;
- the process of financial reporting; and
- limitations of financial reporting

3.3 USERS OF FINANCIAL REPORTING

Financial reporting is proposed to be understandable by readers who have “a reasonable knowledge of business and economic activities and accounting and who are willing to study the information diligently”.

There are different kinds of users of financial reporting. The users of financial reporting may be inside or outside the business. The users of financial reporting use financial statements for a large variety of business purposes and their ability to understand and analyze financial statements helps them to succeed in the business world.

The financial statements are used by different categories of people for different purposes. The various users of financial statements are classified and detailed as follows:

(A) Internal Users

The internal users of financial statements are individuals who have direct bearing with the organization. They may include:

(i) Managers and owners: For the smooth operation of the enterprise, the managers and owners need the financial information for taking day to day business decisions. To provide a more comprehensive view of the financial position of an organization, financial analysis is performed with the information supplied in the financial statements. The financial statement is used to formulate contractual terms between the company and other organizations.

A variable of the financial statement like the current debt to equity ratio is important in deciding the amount of long term capital that would be required to be raised. The financial statements of other companies can also provide investment solutions to different companies. Sometimes, it becomes difficult to decide the right field in which financial resources may be channelized. In such situations, the financial statements of other companies provide the appropriate guidelines.

(ii) Employees: The financial reporting is of immense use to the employees of the company for making collective bargaining agreements. Such statements are used for discussing matters of promotion, rankings and salary hike.

(B) External Users

The External users comprise the following :–

(i) Institutional investors: The external users of financial statements are basically the investors who use the financial statements to assess the financial strength of a company. This would help them to make logical investment decisions.

(ii) Financial institutions: The users of financial statements are also the different financial institutions like banks and other financial institutions who decide whether to help the company with working capital or to issue debt security to it.

(iii) Government: The financial statements of different companies are also used by the government to analyze whether the tax paid by them is accurate and is in line with their financial strength.

(iv) Vendors: The vendors who extend credit facility to a business require financial statements to assess the creditworthiness of the business.

(v) General mass and media: The common people as well as media also make part of the users of financial statements.

(vi) Other users of financial statements :

- Existing equity investors and lenders, to monitor their investments and to evaluate the performance of management.
- Prospective equity investors and lenders, to decide whether or not to invest.
- Investment analysts, money managers, and stockbrokers, to make buy/sell/hold recommendations to their clients.
- Rating agencies (such as Moody's, Standard & Poor's, and Dun & Bradstreet), to assign credit ratings.

  Major customers and suppliers, to evaluate the financial strength and staying power of the company use financial statements as a dependable resource for their business.

- Labor unions, to gauge how much of a pay increase a company is able to afford in upcoming labor negotiations.
- Boards of directors, to review the performance of management.
- Management, to assess its own performance.
- Corporate raiders, to seek hidden value in companies with under priced stock.
- Competitors, to benchmark their own financial results.
- Potential competitors, to assess how profitable it may be to enter an industry.
- Government agencies responsible for taxing, regulating, or investigating the company.
- Politicians, lobbyists, issue groups, consumer advocates, environmentalists, think tanks, foundations, media reporters, and others who are supporting or opposing any particular public issue the company's actions affect. Actual or potential joint venture partners, franchisors or franchisees, and other business interests who need to know about the company and its financial situation.

3.4 PROCESS OF FINANCIAL REPORTING

The process of financial reporting involves series of steps starting with identifying the business transactions, recording business transactions and leading up to the preparation of financial statements and then communicating the information to various interested parties for decision making. This financial process demonstrates the purpose of financial reporting–to create useful financial information in the form of general-purpose financial statements. In other words, the sole purpose of recording transactions and keeping track of expenses and revenues is to provide financial information by presenting it in the form of a balance sheet, income statement, statement of owner's equity, and statement of cash flows.

The financial reporting is a set of steps that are repeated in the same order every period. The culmination of these steps is the preparation of financial statements. Some companies prepare financial reports on a quarterly basis whereas other companies prepare them annually. Process of financial reporting starts with a business event. Bookkeepers analyze the transaction and record it in the general journal with a journal entry. The debits and credits from the journal are then posted to the general ledger where an unadjusted trial balance can be prepared.

After accountants and management analyze the balances on the unadjusted trial balance, they can then make end of period adjustments like depreciation expense and expense accruals. These adjusted journal entries are posted to the trial balance turning it into an adjusted trial balance.

Now that at the end of the year adjustments are made and the adjusted trial balance matches the subsidiary accounts, financial statements can be prepared. After financial statements are published and released to the public, the company can close its books for the period. Closing entries are made and posted to the post closing trial balance.

At the start of the next accounting period, occasionally reversing journal entries are made to cancel out the accrual entries made in the previous period. After the reversing entries are posted, the reporting cycle starts all over again with the occurrence of a new business transaction.

The following are the eight main steps in financial reporting:-

1. **Identify business events**

   In the first step, the business transaction has to be identified. Obviously, if you don't know a transaction occurred, you can't record one.

2. **Analyze these transactions**

After an event is identified to have an economic impact on the accounting equation, the business event must be analyzed to see how the transaction changed the accounting equation. When the company purchased the vehicle, it spent cash and received a vehicle. Both of these accounts are asset accounts, so the overall accounting equation didn't change. Total assets increased and decreased by the same amount, but an economic transaction still took place because the cash was essentially transferred into a vehicle.

3. **Record them as journal entries**

After the business event is identified and analyzed, it can be recorded. Journal entries use debits and credits to record the changes of the accounting equation in the general journal. Traditional journal entry format dictates that debited accounts are listed before credited accounts. Each journal entry is also accompanied by the transaction date, title, and description of the event.

Since there are so many different types of business transactions, accountants usually categorize them and record them in separate journal to help keep track of business events. For instance, cash was used to purchase this vehicle, so this transaction would most likely be recorded in the cash disbursements journal. There are numerous other journals like the sales journal, purchases journal, and accounts receivable journal.

4. **Post journal entries to ledger accounts**

Ledger accounts use the T-account format to display the balances in each account. Each journal entry is transferred from the general journal to the corresponding T-account. The debits are always transferred to the left side and the credits are always transferred to the right side of

T-accounts. The purpose of journalizing is to record the change in the accounting equation caused by a business event. Ledger accounts categorize these changes into specific accounts, so management can have useful information for budgeting and performance purposes.

Since management uses these ledger accounts, journal entries are posted to the ledger accounts regularly. Most companies have computerized accounting systems that update ledger accounts as soon as the journal entries are input into the accounting software. Manual accounting systems are usually posted weekly or monthly. Just like journalizing, posting entries is done throughout each accounting period.

5. Prepare an unadjusted trial balance from the general ledger

An unadjusted trial balance is a listing of all the business accounts that are going to appear on the financial statements before year-end adjusting journal entries are made. That is why this trial balance is called unadjusted. As with all financial reports, trial balances are always prepared with a heading. Typically, the heading consists of three lines containing the company name, name of the trial balance, and date of the reporting period.

6. Analyze the trial balance and make end of period adjusting entries

Adjusting entries, also called adjusting journal entries, are journal entries made at the end of a period to correct accounts before the financial statements are prepared.

There are three different types of adjusting journal entries as follows :

(a) Prepayments

(b) Accruals

(c) Non-cash expenses

7. **Post adjusting journal entries and prepare the adjusted trial balance**

An adjusted trial balance is a listing of all company accounts that will appear on the financial statements after year-end adjusting journal entries have been made.

An adjusted trial balance is formatted exactly like an unadjusted trial balance. Three columns are used to display the account names, debits, and credits with the debit balances listed in the left column and the credit balances are listed on the right. As with all financial reports, trial balances are always prepared with a heading. Typically, the heading consists of three lines containing the company name, name of the trial balance, and date of the reporting period.

8. **Prepare general purpose financial statements/ reports**

Preparing general-purpose financial statements/ reports; including the balance sheet, income statement, statement of retained earnings, and statement of cash flows is the most important step in the financial reporting cycle because it represents the purpose of financial accounting.

In other words, the concept of financial reporting and the process of the accounting cycle are focused on providing external users with useful information in the form of financial statements. These statements are the end product of the accounting system in any company. Basically, preparing these statements is what financial reporting is all about.

Preparing general-purpose financial reports can be simple or complex depending on the size of the company. Some statements need footnote disclosures while other can be presented without any.

3.5 LIMITATIONS OF FINANCIAL REPORTING

The financial reporting suffers from the following limitations:

1. Historical in nature:

Financial reporting deals with historical data. Net effect of transactions are recorded in financial reporting which has happened in past. These accounts are just post-mortem of all events of business in past. These records do not help for future planning and other managerial decisions. Financial reporting shows the profitability of business but it is unable to tell that is it good or bad. Financial reporting fails to explain the reasons of low profitability position.

2. Financial reporting deals with overall profitability:

Accounts of business are made by a way which shows only overall profitability. It does not shows net profit per product, or per department or according to job. Thus, it is difficult to find all activities which do not give profit. So, it creates inefficiency in business activities.

3. Absence of full disclosure of facts:

In financial reporting, only those activities and transactions can be recorded which can be measured in money. There are many other facts of business which are non financial and non monetary like efficient management, demand of products of firm, good relations in industry, good working environments which cannot be known by financial reporting.

4. Financial reports are interim report of business:

Financial reporting is the interim report of firm's all business work but financial position and profitability which are shown in it is not fully true. Due to adopting cost concept, all transactions are recorded on real cost but by changing in the time; it is the need of time to adjust cost of assets and liabilities according to the inflation of market. Because, financial reporting does not record according to inflation, so its result does not show true position of business.

5. **Financial statements are affected from personal judgment:**

   Many events of financial statements are affected from personal judgement of accountant. Method of calculating depreciation, rate of provision of doubtful debts and stock valuation method are decided by accountant. Thus, financial statements do not show true and fair view of business.

6. **No detail information about cost:**

   Financial reporting provides information as a whole in terms of income, expenses, assets and liabilities. It does not provide detail of cost involved by departments, processes, products, services or other unit of activity within the organisation.

7. **Absence of cost control method:**

   It does not have proper mechanism to control expenditure on various elements of cost, viz, material and labour. As a result, misappropriation, wastage and losses of materials are left unchecked. Proper utilization of labour becomes impossible and suitability of different labour incentive plans goes without evaluation.

8. **No information on efficiency:**

   It does not have a system to judge the efficiency in the use of material, labour and overhead costs of the organisation in comparison to the standard fixed for their use.

9. **No classification of expenses:**

   It fails to classify expenses as direct and indirect or fixed and variable. Besides, these are also not allocated to different stages of production or departments or processes to show the controllable and uncontrollable items on overhead cost.

10. Not helpful in price fixation:

It does not provide adequate cost information to fix up the price of products manufactured and service rendered by the organisation.

11. No analysis of losses:

It does not provide detail information about the reasons of losses. It also does not help to determine the variations in the cost between different working times, idle time and seasonal conditions of the industry.

12. No technique to evaluate alternative methods:

In planning expansions contraction of plants, equipments, products and processes, it is not poses to calculate and compare the profitability of alternatives with the help Financial reporting.

13. No cause and effect analysis:

As financial account fails to provide profit information product-wise, the causes of profit or loss cannot effectively determined and analysed.

14. No data for comparison:

It does not provide data to facilitate comparision of costs of operation of the firm with other firms in the industry. Cost Accounting is developed from within the accounting process to overcoat the limitations of financial reporting and it helps in calculating, controlling and reducing cost.

3.6 SUMMARY

Financial reporting is the process of producing statements that disclose an organization's financial status to management, investors and the government. Financial report is a set of documents of the financial activities

of a business, person, or other entity by government agencies at the end of an accounting period. Financial report generally contains summary of accounting data for that period, with background notes, forms and other information. It highlights the financial state of any company. It includes the balance sheet, statement of income of the company from which the net profit and loss can be measured.

There are different kinds of users of financial reporting such as shareholders, management, investors, creditors, employees, government, financial analyst, financial institutions etc. The users of financial reporting may be inside or outside the business. The users of financial reports use financial statements for a large variety of business purposes and their ability to understand and analyze financial statements helps them to succeed in the business world.

3.7 GLOSSARY

- **Users of financial reporting-** readers who have a reasonable knowledge of business and economic activities and accounting and who are willing to study the information diligently.
- **An unadjusted trial balance**-it is a listing of all the business accounts that are going to appear on the financial statements before year-end adjusting journal entries are made. That is why this trial balance is called unadjusted.
- **Adjusting entries**-also called adjusting journal entries, are journal entries made at the end of a period to correct accounts before the financial statements are prepared.
- **General purpose financial statements**- it includes balance sheet, income statement, statement of retained earnings, and statement of cash flows.
- **Vendors**- those who extend credit facility to a business are called vendors.

3.8 SELF ASSESSMENT QUESTION

Q.1 Who are the users of financial reporting? Explain.

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Q.2 Give the process of financial reporting.

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Q.3 State the limitations of financial reporting.

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3.9 EXAMINATION ORIENTED QUESTIONS

1. Discuss briefly the information needs of various users of financial reporting.

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2. Discuss in detail the process of financial reporting.

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3. What is meant by financial reporting? Highlight the limitations of financial reporting.

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UNIT-I **M.Com 1st Semester**

Course No. M.Com-C150 **Lesson No. 4**

INTRODUCTION

DIFFERENCE BETWEEN FINANCIAL REPORTING AND MANAGEMENT REPORTING; ISSUES AND CHALLENGES IN FINANCIAL REPORTING WITH SPECIAL REFERENCE TO PUBLISHED FINANCIAL STATEMENTS

4.1 INTRODUCTION

4.2 OBJECTIVES

4.3 DIFFERENCE BETWEEN FINANCIAL REPORTING AND MANAGEMENT REPORTING

4.4 ISSUES AND CHALLENGES IN FINANCIAL REPORTING WITH SPECIAL REFERENCE TO PUBLISHED FINANCIAL STATEMENTS

4.5 SUMMARY

4.6 GLOSSARY

4.7 SELF ASSESSMENT QUESTIONS

4.8 EXAMINATION ORIENTED QUESTIONS

4.9 SUGGESTED READINGS

4.1 INTRODUCTION

Financial reporting is the process of providing financial information to company's stakeholders in order to influence business goals. The main objective of financial reporting is to provide useful information to various interested parties for decision making. They require information at regular intervals in order to make various decisions. Management reporting is a key to a company's operation and performance. It uses financial reports and taps other sources of information too. These reports are used in such a way that they are helpful to the management in planning and forecasting various policies and plans.

4.2 OBJECTIVES

After going through this lesson, you will be able to understand:

- difference between financial reporting and management reporting; and
- issues and challenges in financial reporting with special reference to published financial statements.

4.3 DIFFERENCE BETWEEN FINANCIAL REPORTING AND MANAGEMENT REPORTING

Accountants, who handle the financial and management reporting, act as advisors for their companies on a daily basis. Companies often look to hire a single person who can do both, but this is unadvisable due to the differences in both types of reporting. The following are the main points of difference between financial reporting and management reporting :–

S.No.	Financial Reporting	Management Reporting
1	Financial reporting is the process of providing information to company's stakeholders to make decisions.	Management reporting is the outcome of the process of financial reporting.
2	Financial reports are prepared to find out overall financial and profitability position of the business enterprise at the end of the financial year.	Management accounting reports are prepared to help different levels of management in formulating policies and plans.
3	Financial reports are useful for outsiders like bankers, investors, shareholders, creditors, debenture holders, Government agencies etc.	Management accounting reports are useful for internal management only.
4	Financial reports are prepared for a specific period and on a particular date.	There is no binding for preparing management accounting reports for a specific period and on a particular date.
5	Financial reports are prepared on the basis of historical data. It records only those information which have already taken place.	Management reports deals with projection of the data for the future.
6	Financial reports are external reports that require certain standards and guidelines to be followed.	Management accounting reports are internal reports, including information regarding banks, investors and CEOs. No set principles are followed in management reporting.
7	Financial reporting looks back on the company's performance over the past year.	Management reporting looks forward and helps maintain the company's future.

8	Financial reporting demonstrates the company's overall performance.	Management reporting demonstrates the company's reports for segments.
9	Financial reporting is done accurately by a sharp and diligent professional.	Management reporting is done by a critical thinker to produce the best results.
10	Financial reporting is slow and time consuming because profit & loss account and balance sheet are prepared at the end of the financial year.	Management reporting is very quick as the management is fed with reports at regular intervals.
11	In financial reporting, only those information are reported which can be expressed in terms of money. Information relating to non-monetary events do not find place in financial reports.	It includes information relating to both monetary and non monetary events such as competition in the market, impact of political changes, environmental factors etc.
12	Only actual figures are reported in financial reporting and there is no room for approximate figures.	No emphasis is given to actual figures. The approximate figures are reported and are given due consideration than the actual figures.
13	Financial reporting is compulsory in certain undertakings while these are a necessity in others.	Preparation of management accounting reports is not compulsory as it is only a service function. The management is free to use or not to use management accounting reports.
14	Financial reports like profit & loss account and balance sheet are published for the benefit of the public.	Management accounting reports are prepared for the benefit of the management only and these are not published.

4.4 ISSUES AND CHALLENGES IN FINANCIAL REPORTING WITH SPECIAL REFERENCE TO PUBLISHED FINANCIAL STATEMENTS

The business become so complex that mere final accounting information is not sufficient in meeting the informational needs of various stakeholders of company. Financial accounting measures have developed in every country that has organized trade over hundreds of years. As trade becomes more global and complex in scope, the financial accounting industry faces increasing struggles with capturing the new economic realities in numbers. Companies that operate in multiple countries also struggle to report each unit consistently, but still within the accounting regulations of each country.

1. **Valuation:** Most financial accounting rules are based on historical cost valuation. That means valuing assets and liabilities at what they cost initially. Some assets are depreciated over time in order to represent their loss in value. However, the actual market value of assets or liabilities may be significantly different than their stated, or book, value. This makes traditional financial statements a poor indicator of the actual worth of the company. In particular, equity investments and land may rise in value over their book amounts, and this will not be reflected in the statements. International accounting standards are in the process of moving closer to market value accounting to address this reality.

2. **Multi-jurisdictional reporting:** Companies that have branches or subsidiaries in multiple countries face many challenges in reporting accurately. They must legally prepare financial statements in each country they operate in based on the generally accepted accounting principles of that country. These standards vary widely. The company must also report the entire group of companies on a consolidated basis, which requires restating all foreign reporting into the standards of the parent's home country. It is a time-consuming and complicated process. Many countries

are agreeing to adopt the standards of the International Accounting Standards Board to make financial accounting more uniform across the board.

3. **Non-financial measures:** There are many factors that indicate whether a company will be successful or not in the future. Many of these benchmarks are not financial in nature, such as customer satisfaction levels, the value of the company's reputation and its employment policies. None of these measures are captured in the traditional financial accounting model. They are also subjective and open to interpretation of the user, making it difficult to develop measurement standards. This continues to be one of the most pervasive challenges facing financial accounting.

4. **Financial instruments:** As trade becomes more complex across the world, so does financing. Financing agreements can include many assets that have no real physical substance, such as repurchase agreements, forward contracts and options. The complexity of these financial instruments makes valuing them difficult. It also makes it easier for a company to manipulate the values of financial instruments. This was the evident in the sub-prime mortgage collapse in the United States in 2008. When the valuation was reviewed, it was discovered that these instruments were significantly over-valued. While financial accounting standards in many countries attempt to address this valuation issue, financial instruments become more complex and more difficult to account for.

5. **Historical nature.** Financial reporting is historical in nature because it records information relating to those economic events which have already taken place in the business during a particular period of time. The impact of future uncertainties has no place in financial reporting. As management needs information for future planning, financial reporting provides information only about what has happened and about what will happen. It does not suggest what should be done to increase the efficiency of the concern.

6. **Information not provided activity-wise.** In financial reporting, information is provided about total expenses and total receipts only for whole of the organisation. The information is not provided product-wise, process-wise, department-wise or any other line of activity. It is essential to provide information activity-wise so as to help management in cost determination and cost control.

7. **Price fixation not possible:** Financial reporting is not helpful in fixing the price of the products. The cost of a particular product can be obtained only when all expenses have been incurred, it is not possible to determine the price in advance. Price fixation require information about variable cost, fixed cost, direct cost, indirect cost etc.

8. **Cost control not possible:** Financial reporting is not helpful in controlling the cost of various products because the cost figures are reported only at the end of financial year when the cost has already been incurred. In such a situation nothing can be done to control costs. There is no appropriate technique which can help the management in ascertaining whether the cost is more or less when the expenses are being incurred.

9. **Financial policies and plans cannot be appraised properly**: With the help of financial reporting, it is not possible to appraise various policies and plans of the organisation. There is no standard criteria for comparing the actual performance with the budged performance. It is not possible to evaluate whether the work is going on as per planned scheduled or not. Profit is the only criteria for judging the overall financial performance of the enterprise and profits of an enterprise are influenced by large number of factors outside the organisation. So, it is not possible to ascertain the efficiency of management and appraise the policies and plans effectively.

10. **Price level changes cannot be reported:** Financial reporting reports only actual cost paid for acquiring materials, property or other assets. The price of goods keeps on changing from time to time. The present

value of assets may be absolutely different from the recorded cost. Financial reporting do not provide information about price level changes and it is very difficult in determining the exact values of assets.

11. **Not helpful in taking strategic decisions:** In every organisation management is required to take various strategic decisions regarding replacement of machinery, expansion of business, introduction of new product, make or buy decisions, continue or shut down decision etc. The impact of these decisions and cost involved should be ascertained in anticipation and various alternative solutions should be studied before taking a final decision. Financial reporting cannot provide necessary information for taking important decisions because information is recorded for the whole of the organisation and it is available only when the event has taken place.

12. **Quantitative information:** Financial reporting reports only those information which can be quantitatively measured. Anything which cannot be quantitatively measured will not form a part of financial reporting even though it is important for the business. The policies and plans of the government have direct impact on the working of business enterprises, but these things are not reported in financial reporting.

13. **Lack of unanimity about accounting policies**: While preparing various financial statements accountants differs on the use of accounting principles. In-spite of the efforts of IASC, there is lack of unanimity on the use of accounting principles and procedures. The methods of valuing inventory and methods of charging depreciation are the most controversial issues on which unanimity is not possible. The preference for the use of different accounting principles brings in an element of subjectivity. The use of different methods reduces the usefulness and reliability of financial reports.

14. **Manipulation** : There are chances of manipulating the financial statements to suit the urge of the management. The over or under valuation of inventory

may change the figures of profits. More profits can be shown to get more remuneration, issue more dividends and to raise the price of company's share whereas, less profits can be shown to save taxes or for not paying bonus to workers etc. The possibility of manipulating the financial statements reduces the usefulness and reliability of financial reports.

4.5 SUMMARY

Financial reporting is the process of providing financial information to company stakeholders in order to influence business goals. The main objective of financial reporting is to provide useful information to various interested parties for decision making. They require information at regular intervals in order to make various decisions. Management reporting is key to a company's operation and performance. It uses financial reports and taps other sources of information too. These reports are used in such a way that they are helpful to the management in planning and forecasting various policies and plans.

The business become so complex that mere final accounting information is not sufficient in meeting the informational needs of various stakeholders of company. Financial accounting measures have developed in every country that has organized trade over hundreds of years. As trade becomes more global and complex in scope, the financial accounting industry faces increasing struggles with capturing the new economic realities in numbers. Companies that operate in multiple countries also struggle to report each unit consistently, but still within the accounting regulations of each country.

4.6 GLOSSARY

- **Financial reporting**- Financial reporting is the process of providing information to company stakeholders to make decisions.
- **Management reporting**- Management reporting is the outcome of the process of financial reporting.

- **Historical nature-** It means economic events which have already taken place in the business during a particular period of time.
- **Financial instruments-**It includes many assets that have no real physical substance, such as repurchase agreements, forward contracts and options.
- **Non-financial measures-** It includes many factors that indicate whether a company will be successful or not in the future. Many of these benchmarks are not financial in nature, such as customer satisfaction levels, the value of the company's reputation and its employment policies.

4.7 SELF ASSESSMENT QUESTIONS (SAQ)

Q.1 "Financial policies and plans cannot be appraised properly through financial reporting". Elaborate.

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Q.2 How Companies that have branches or subsidiaries in multiple countries face many challenges in reporting accurately? Explain.

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4.8 EXAMINATION ORIENTED QUESTIONS

1. Discuss the issues and challenges in financial reporting with special reference to published financial statements.

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2. Differentiate between financial reporting and management reporting.

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4.9 SUGGESTED READINGS

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UNIT-I	M.Com 1st Semester
Course No. M.Com-C150	Lesson No. 5

FINANCIAL REPORTING FOR MANAGEMENT-TOP LEVEL MANAGEMENT, MIDDLE LEVEL MANAGEMENT AND LOWER LEVEL MANAGEMENT; GUIDING PRINCIPLES FOR REPORTING TO DIFFERENT LEVELS OF MANAGEMENT; FINANCIAL REPORTING PRACTICES IN INDIAN COMPANIES

5.1 INTRODUCTION

5.2 OBJECTIVES

5.3 FINANCIAL REPORTING FOR MANAGEMENT

5.4 REPORTING FOR TOP LEVEL MANAGEMENT

5.5 REPORTING FOR MIDDLE LEVEL MANAGEMENT

5.6 REPORTING FOR LOWER LEVEL MANAGEMENT

5.7 GUIDING PRINCIPLES FOR REPORTING TO DIFFERENT LEVELS OF MANAGEMENT

5.8 REPORTING SYSTEM

5.9 GENERAL PRINCIPLES OF A GOOD REPORTING SYSTEM

5.10 FINANCIAL REPORTING PRACTICES IN INDIAN COMPANIES

5.11 SUMMARY

5.12 GLOSSARY

5.13 SELF ASSESSMENT QUESTIONS

5.14 EXAMINATION ORIENTED QUESTIONS

5.15 SUGGESTED READINGS

5.1 INTRODUCTION

At present, the business operates in an environment which is more difficult and complex to predict as compared to earlier times. The growth of the size of business has necessitated the delegation of authority at various levels of management. There are problems of control, co-ordination and communication. The decision making task has become a very difficult task. The decisions have wider ramifications for the business and a wrong decision may lead to its closure. Management needs full information before taking any decision. Good decisions can minimise costs and optimise returns. Management information system can be helpful to the management in undertaking managerial functions smoothly and effectively. It is an approach of providing timely, adequately and accurate information to the right person in the organisation which helps in taking right decisions.

5.2 OBJECTIVES

After going through this lesson, you will be able to understand-

- the various levels of management;
- reporting for different levels of management;
- guiding principles for reporting to different levels of management; and
- reporting system & general principles of a good reporting system.

5.3 FINANCIAL REPORTING FOR MANAGEMENT

Broadly speaking, there are three levels of management and their informational needs are quite different. Same type of information and in the same form and content may not be needed at all the levels of management. They need different kinds of reports depending upon the nature of functions they do. The reporting levels in the internal management fall into three broad categories.

(a) Top level management

(b) Middle level management

(c) Lower level management

The information to be presented and the method of reporting should meet the specific requirements of various levels of management.

5.4 REPORTING FOR TOP LEVEL MANAGEMENT

Top management which consists of owners, Board of Directors, Managing Director, Chief Executive and General Manager establishes policies, plans and objectives. It requires more of conceptual innovative decision making and human skills as compared to technical skills. Top management, is concerned with policy formulation and laying down of objectives has different reporting needs. The goals are set for the organisation and policies are framed to achieve these goals. Top management is also involved in exercising effective control and providing overall leadership. The work of executing policies is left to the middle level management. Reports for top level management includes the following:

(i) Periodic report about profit and loss account and balance sheet.

Top management needs periodic report about Income statement so as to have a look upon results of operations made during the period under report. Top management has to review its business policies in light of the periodic report on income statement. Top management, on the other hand, is also interested to have periodic report of balance sheet which will make them to understand financial condition of the entity. Top management is also interested to have information about liquidity and solvency position of the entity. Thus, periodic reports on profit and loss account and balance sheet help the management in taking such decisions.

(ii) Statement of fund flow and cash flows at regular intervals.

Top management is also interested to look upon movement of working capital and cash between two dates of balance sheets. Sometimes, a Balance Sheet does not help the management in taking certain decision regarding movement of funds. An additional report on movement of working capital is required for proper management of working capital. On the other hand, cash being absolute liquid also plays a dominant role in assessing the liquidity position of the entity. A statement of cash flow helps the management to have a detailed view on the movement of cash during stated intervals.

(iii) Report on production trends and utilisation of capacity.

Top management of manufacturing organisation may need regular reports on production trends and utilisation of capacity for devising production policies and programmesfor future periods.

(iv) Report about cost of production.

Board of directors of top level management is also interested in cost information related to production. They are interested to know cost per unit and total cost. Top level management is also interested to know cost of each element involved.

(a) Raw material consumed

(b) Direct labour cost

(c) Direct expenses

(d) Prime cost

(e) Factory cost

(f) Net factory cost

(g) Cost of production

(h) Cost of goods sold

(i) Cost of sales

(v) Reports on sales, credit collection period and selling and distributionexpenses.

Top management is also interested in having a regular look upon sales trend, debtors schedule along with credit collection period and details of selling and distribution expenses.

5.5 REPORTING FOR MIDDLE LEVEL MANAGEMENT

The middle level management is assigned the work for executing various policies framed by top management. The objects or goals are set by Board of Directors.The requisite authority is delegated to middle level management so that organizational goals may be achieved. The reports submitted to middle level management are detailed so that a corrective view of performance of different departments is undertaken. The work of co-coordinating activities of different departments is also undertaken by middle level management. The reports submitted to middle level management may be classified as follows :–

(a) Reports for Production Manager

(i) Actual production figures along with budgeted figures. These reports can be sent daily, weekly or monthly.

(ii) Report showing actual output made against the standard output along with report on variance.

(iii) Capacity utilisation reports.

(iv) Labour turnover reports.

(v) Absenteeism reports

(vi) Material usage report.

(vii) Machine and labour utilisation report

(viii) Report on analysis of idle time

(ix) Report on cost variances

(x) Cost of each process or product duly analysed by component of cost

(xi) Scrap report

(xii) Machine hours lost report

(xiii) Report on stock position

(xiv) Analysis of power consumption

(xv) Analysis of maintenance cost

(xvi) Report on work in progress

(xvii) Report on abnormal loss

(xviii) Report on spoilage and defectives

(xix) Reports on overtime and shift working

(xx) Report on pending orders

(b) Reports for Sales Manager

(i) Reports on actual and budgeted sales

(ii) Weekly reports on orders booked; orders executed, and pending orders.

(iii) Report on credit collection, and bad debts.

(iv) Report on product wise and area wise sales.

(v) Market survey reports.

(vi) Reports on stock position of finished goods.

(vii) Analysis of selling and distribution expenses.

(viii) Reports on customer's complaints.

(ix) Report on effectiveness of sales promotion programmes.

(x) Analysis of gross profit carried in each area.

(xi) Report on credit worthiness of customers.

(xii) Report on selling and distribution overheads and cost of sales ratio.

(xiii) Dealers report.

(c) Reports for Purchase Manager

(i) Report on raw material purchased, actual materials received and pending.

(ii) Report on raw material consumed.

(iii) Report on material turnover ratio and material conversion period.

(iv) Report on minimum stock level and maximum stock level and re-order level.

(v) Analysis of purchase expenses.

(vi) Budgeted cost of purchases and actual cost of purchases.

(vii) Report on suppliers list.

(viii) Material quality reports.

(ix) Report on economic order quantity

(x) Report on suppliers.

(d) Reports for Cost Manager

(i) Inventory reports.

(ii) Report on scrap.

(iii) Report on product cost estimate.

(iv) Report on carrying cost and ordering cost of materials.

(v) Report on labour efficiency and productivity

(vi) Report on idle capacity.

(vii) Report on number of accidents.

(viii) Report on overhead cost variance.

(ix) Report on under and over absorption of overheads.

(x) Report on research and development cost.

(xi) Comparative income statement product wise.

(xii) Report on idle time costs.

(e) Reports for Financial Manager

(i) Report on cash and bank balances.

(ii) Periodic fund flow and cash flow statements.

(iii) Debtor collection reports.

(iv) Report on average payment period.

(v) Analysis of working capital.

(vi) Report on profit variance.

(vii) Statement of financial position.

(viii) Capital expenditure reports.

(ix) Expansion project report.

5.6 REPORTING FOR LOWER LEVEL MANAGEMENT

Lower level management usually consists of foremen or sectional in charges.They are responsible for execution of policies. They are in touch with day to day performance of their sections. They get daily reports from their juniors. Junior level management prepares and sends regular reports to middle level management. These reports may include the following:

(i) Labour utilisation reports and causes of lost time.

(ii) Workers efficiency report.

(iii) Confidential reports.

(iv) Scrap report.

(v) Actual expenses of shop along with budgeted expenses.

(vi) Maintenance cost reports.

5.7 GUIDING PRINCIPLES FOR REPORTING TO DIFFERENT LEVELS OF MANAGEMENT

The following are the major guiding principles for reporting to different levels of management:

(1) The lower the level of management, the more detailed will be the report and higher the level of the management the shorter or summarized will be the reports. The lower level management consisting of foremen, section incharges, supervisors etc. need more detailed reports because they are concerned with actual execution of work. On the other land, top management has limited time and needs summarized reports. Sometimes, only exceptional matters are reported to this level.

(2) The frequency of reports is also connected with the level of management, the lower the level of management, the higher will be the frequency of reporting. The middle level and junior levels of management need the reports more frequently because they deal with day to day operations of business. The top level management will ask for the reports when some decision is to be taken or some policy has to be decided.

(3) The number of reports to be sent is also concerned with, the levels of management. The top level management will get maximum number of reports and lower levels will get lesser number of reports. The top level management is to get reports about every activity in the business while lower levelmanagement is concerned with a particulars department or section so it will get information about this area only. The Board of Directors will receive a large number of reports because it controls every function in the organization.

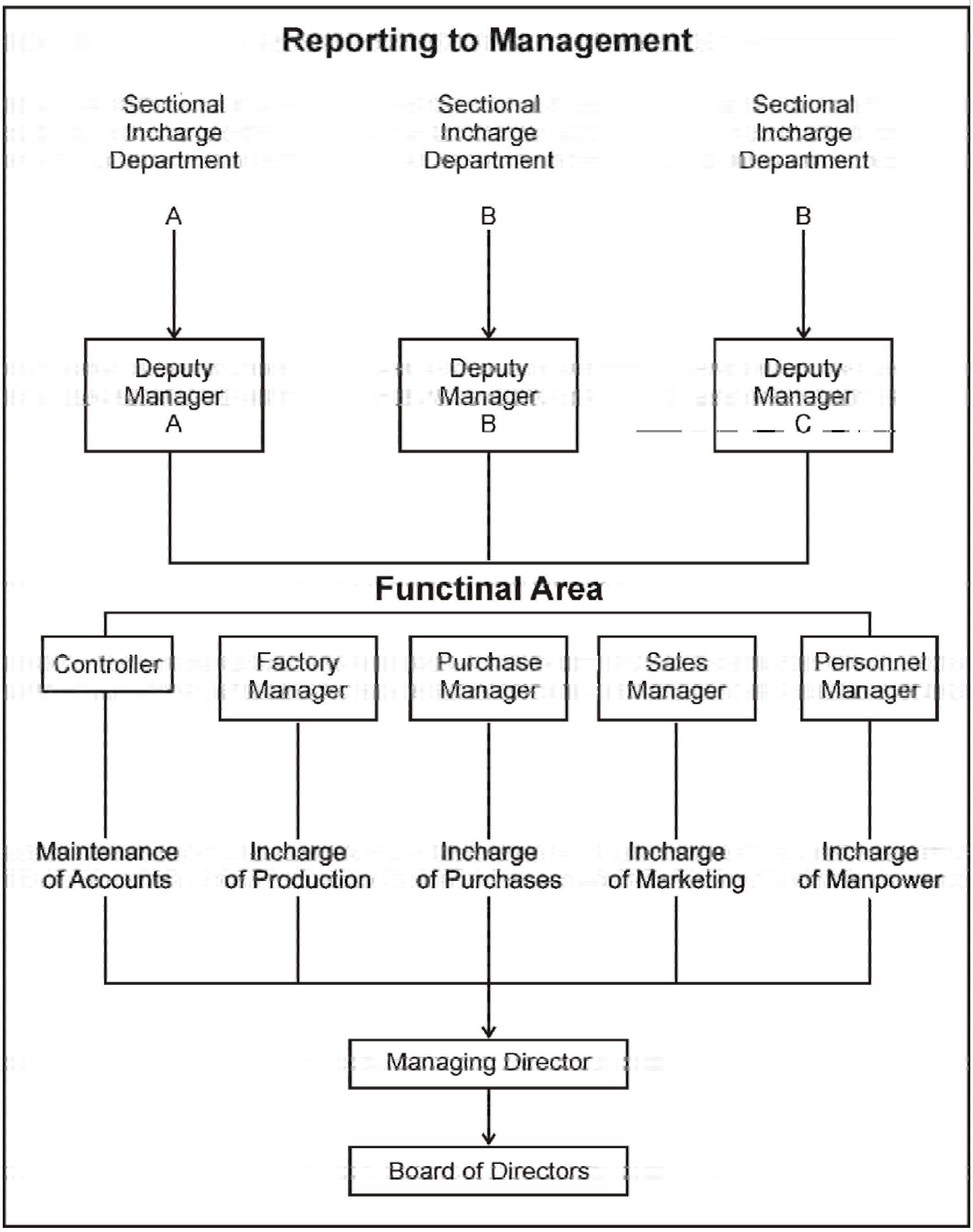
5.8 REPORTING SYSTEM

The reporting system involves all levels of management. The reports generally originate from junior levels of the management and go upto top level of management i.e. BOD. As already discussed, reporting is always upward. The origin of reporting is always lower levels of management. It starts from sectional in-charges of various departments and moves through scalar chain in the organisation and ultimately is received by Board of Directors in a final form.

The sectional in-charge of every section regularly reports. the progress of his section to his supervisor. In the diagram, given on next page functional managers has deputy managers who control departmental sections. The combined reports ofdifferent sections reach the departmental managers, called functional managers.

Different functional managers submit the progress of their departments to Managing Director. The brief summaries of departmental reports are submitted to the Board of Directors for receiving policies and making strategy for the future. An effective reporting system will enable the top management to remain in constant touch with the progress of different departments. Following example of a production section will enable to understand the working of a reporting system in a large organisation.

REPORTING SYSTEM



Each production section sends daily efficiency report and performance report to foremen containing comparison of standard hours with actual labour hours and actual performance with standard performance with a purpose to remove causes of inefficiency.

Report on loss or idle time containing analysis of labour time records for finding out idle time with the purpose of determining causes of idle time and cost effect thereof so that it may be sent daily or weekly to the factory manager.

Labour turnover report containing percentage change in labour force withthe purpose of determining causes of labour turnover and taking remedial steps may be sent monthly or quarterly to Board of Directors. In the same way, overtime report containing analysis of overtime wages with purpose of justifying overtime may be sent to Board of Directors.

Special report on wage increases revealing effect of wage increases on cost of production and profits with the purpose of giving management a basis for collective bargaining may be sent to the Board of Directors.

5.9 GENERAL PRINCIPLES OF A GOOD REPORTING SYSTEM

A good reporting system is helpful to the management in planning and controlling. Every level of management needs information relating to its activities centre so that effective planning may be undertaken and current activities may be controlled and necessary corrective measures may also be taken in time, if needed. Some general principles are followed for making the reporting system effective. These principles are discussed as follows:

1. Proper flow of Information

A good reporting system should have a proper flow of information. The information should flow from the proper place to the right levels of management. The information should be sent in the right form and at a proper time so that it helps in planning and co-ordination. The frequency of reports will depend upon the nature of report, the types of data required for preparing the information and cost involved in preparing such reports. The flow of reports should be such that it does not cause delay in taking decisions. The reports should flow at regular intervals so that informational needs of different managerial levels are met at a proper time.

Flow of information is a continuous activity and affects all the levels of the organisation. Information may flow upward, downward or sideways within an organisation. Orders, instructions, plans etc. may flow from top to bottom. Reports, grievances, suggestions etc. may flow from bottom to top. Notifications, letters, settlements, complaints may flow from outside. Information also flows sideways from one manager to another at the same level through meetings, discussions etc.

2. Proper timing

Since reports are used as a controlling device so they should be presented at the earliest or immediately after the happenings of an event. The time required for preparation of reports should be reduced to the minimum for routine reports. The period should be known and strictly adhered to. It will be waste of time and effort to prepare information which is too late to be of any use. The absence of information when needed will either mean wrong decisions or deferment of decisions on matters which may be urgent in nature.

3. Accurate information

The information should be as accurate as possible. If the information supplied is inaccurate it may result in making wrong decisions. However, the degree of accuracy may differ in different reports. Sometimes, part information may be supplied as a guide for future policy making, so the degree of accuracy may be less. The supply of exact figures may involve a problem of understanding. Approximate figures are more understandable than accurate figures given upto paisa. Accuracy should also not involve excessive cost of preparation nor it should be achieved at the sacrifice of promptness of presentation. It will be better to have approximate figures at a proper time than delayed information prepared accurately.

4. Basis of comparison

The information supplied through reports will be more useful when it is supplied in comparison with past figures, standards set or objectives laid down. The comparison of information with past or budgeted figures will enable the reader to find out trends of variations. The decision taking authority will be able to make use of comparative figure while taking a decision. Corrective measures can also be initiated to improve upon the past performance. The management accountant can make the reports more useful by giving his own interpretations to the information.

5. Reports should be clear and simple

The purpose of preparing reports is to help management in planning, coordinating and controlling. This purpose can be achieved only when the reports are easily understood by the readers. The information should be presented in a clear manner by avoiding extraneous data. Only relevant important information should become the part of a report. If supporting information cannot be avoided then it should either be given in appendix or separate chart should be attached for it. The method of presenting information should be such that it attracts the eye, and enables the reader to form an opinion about the information. The graphic presentation of information will enable the reader to find out the trends and also to determine deviations more quickly than in other methods. The arrangement of presentation should be brief, clear and complete. Simplicity is a good guide for reports preparation.

6. Cost

The benefits derived from reporting system must be commensurate with the cost involved in it. Though it is not possible to assess the benefit of this system in monetary terms, there should be an endeavour to make the system as economical as possible.

7. Evaluation of responsibility

The reporting system should enable the evaluation of managerial responsibility. The targets are fixed for various functional departmental heads. The record of actual performance is monitored along with the standards so as to enable management to assess the performance of different individuals. So, management reporting should be devised in a way that it helps in evaluating the work assigned to various persons.

8. Adequacy

A good reporting system will be that system of reporting in which adequate data is given to the management to suggest possible courses of action. Adequate data provided in reports saves valuable time of management and ensures prompt attention.

9. Visual reporting

A good reporting system will have visual reporting. It has been observed that visual reporting with the help of graphs, charts and diagrams in comparison to descriptive reporting attracts the eye more quickly and leaves a lasting impression on the mind of the users.

10. Principle of consistency

Principle of consistency is followed in a good reporting system. Various formats being used for the preparation of various reports should not be frequently changed from time to time. If in certain cases, any format is changed for making any improvement, changes in contents or format should be justified.

11. Factual Information

A good reporting system should be based on reports containing factual information. Management has to take decision in future on the basis of the information contained in various reports. Any false information contained in the reports will not be helpful in taking correct decisions.

12. Principle of brevity

Principle of brevity should be followed while reporting since long reports are very difficult to analyse and long reports generally rely greatly on highlighting irrelevant minor details and major issues involved are not taken up properly.

13. Principle of scheduling

Principle of scheduling should also be followed in a way that reports can be prepared without excess burden on the staff. Employees must be given sufficient time to do the work well on the preparation of report. Time lag between collection of data and finished report should not be much longer.

5.10 FINANCIAL REPORTING PRACTICES IN INDIAN COMPANIES

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

1. PUBLISHED FINANCIAL STATEMENTS

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

- Notice of annual general meeting
- Director's report
- Management discussion and analysis
- Risk Management Report
- Audited Standalone financial statements
- Audited Consolidated financial statements
- Corporate governance report
- Shareholders Information
- Auditor's report on financial statements
- CAG's Comments on Accounts (in case of Government Companies)
- Business Responsibility Report
- Information on human resources
- Value added statement
- Corporate social responsibility policy/report
- Environmental report
- Information on Brand/ Intangibles
- EVA report

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

2. BUSINESS RESPONSIBILITY REPORT

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

3. CORPORATE SOCIAL RESPONSIBILITY REPORTING

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

5.11 SUMMARY

The growth of the size of business has necessitated the delegation of authority at various levels of management. There are problems of control, co-ordination and communication. The decision making task has become a very difficult task. The decisions have wider ramifications for the business and a wrong decision may lead to its closure. Management needs full information before taking any decision. Good decisions can minimise costs and optimise returns. Management information system can be helpful to the management in undertaking managerial functions smoothly and effectively. It is an approach of providing timely, adequately and accurate information to the right person in the organisation which helps in taking right decisions.

The three levels of management are Top level management, Middle level management and Lower level management. The information to be presented and the method of reporting should meet the specific requirements of various, levels of management. Top management which consists of owners, Board of Directors, Managing Director, Chief Executive and General Manager establishes policies, plans and objectives. It requires more of conceptual innovative decision making and human skills as compared to technical skills. Top management, is concerned with policy formulation and laying down of objectives has different reporting needs.

The middle level management is assigned the work for executing various policies framed by top management. The objects or goals are set by Board of Directors. The requisite authority is delegated to middle level management so that organizational goals may be achieved. The reports submitted to middle level management are detailed so that a corrective view of performance of different departments is undertaken. The work of co-coordinating activities of different departments is also undertaken by middle level management. Lower level management usually consists of foremen or sectional in charges. They are responsible for execution of policies. They are in touch with day to day performance of their sections. They get daily reports from their juniors. Junior level management prepares and sends regular reports to middle level management.

India is a federal state with unitary bias. This is perhaps why, unlike in the USA, there is no separate company law for any state in India. Apart from professional regulation, corporate financial reporting in India is governed primarily by the Companies Act, 2013.

Another body that has a major influence in reshaping Indian financial reporting is the Securities and Exchange Board of India (SEBI). The Companies Act, 2013 prescribes the financial reporting requirements for all the companies registered under it. The reporting requirements that are imposed by the SEBI through its Guidelines and through the Listing Agreement are in addition to those prescribed under the Companies Act.

SEBI requirements are to be followed by the companies listed on the Indian stock exchanges. The Companies Act and the SEBI requirements together provide the legal framework of corporate reporting in India.

5.12 GLOSSARY

- **Top level management-** Top management which consists of owners, Board of Directors, Managing Director, Chief Executive and General Manager establishes policies, plans and objectives.
- **Middle level management-** The middle level management is that level of management which is assigned the work for executing various policies framed by top management.
- **Lower level management-** Lower level management is that level of management which usually consists of foremen or sectional in charges.
- **Factual report-** A reports containing factual information.

5.13 SELF ASSESSMENT QUESTIONS (SAQ)

Q.1. Discuss informational needs of top levels of management.

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Q.2. Explain the informational needs of middle levels of management.

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Q3. What do you mean by a goods reporting system?

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5.14 EXAMINATION ORIENTED QUESTIONS

1. What are the objectives of reporting to management? Discuss various guiding principles of reporting to different levels of management.

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2. Explain significance of a reporting system in effective management. Discuss various kinds of reports prepared for different levels of management.

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5.15 SUGGESTED READINGS

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FINANCIAL REPORTING STANDARDS

BASICS OF ACCOUNTING STANDARDS; AREAS WHERE ACCOUNTING STANDARDS NEEDS TO BE FRAMED; PROCEDURE FOR SETTING INDIAN AND INTERNATIONAL ACCOUNTING STANDARDS

6.1 INTRODUCTION

6.2 OBJECTIVES

6.3 BASICS OF ACCOUNTING STANDARDS - MEANING AND DEFINITION

6.4 NEED OF ACCOUNTING STANDARDS

6.5 OBJECTIVES OF ACCOUNTING STANDARDS

6.6 IMPORTANCE OF ACCOUNTING STANDARDS

6.7 DEVELOPMENT OF ACCOUNTING STANDARDS

6.8 FINANCIAL ACCOUNTING STANDARD BOARD (FASB)

6.9 ADVISORY GROUPS IN INDIA

6.10 FUNCTIONS OF ASB

6.11 PROCEDURE FOR SETTING INDIAN ACCOUNTING STANDARDS

6.12 PROCEDURE FOR SETTING INTERNATIONAL ACCOUNTING STANDARDS

6.13 AREAS WHERE ACCOUNTING STANDARDS NEEDS TO BE FRAMED

6.14 SUMMARY

6.15 GLOSSARY

6.16 SELF ASSESSMENT QUESTIONS

6.17 EXAMINATION ORIENTED QUESTIONS

6.18 SUGGESTED READINGS

6.1 INTRODUCTION

The British introduced the term 'standards' in place of 'principles' when they set up their Accounting Standards Steering Committee at the end of 1969 and the Americans adopted the same term ('standard') in 1973. The change from 'principles' to 'standards' is not without significance, it is a wise one. In this case, the change of nomenclature had an impact on events in accounting'. The Wheat Committee in USA, which recommended the transition from the Accounting Principles Board to the Financial Accounting Standards Board, found the word 'standards' more suitable. In India, this term has become popular since the formation of Accounting Standards Board (ASB) in April 1977 by the Institute of Chartered Accountants of India.

6.2 OBJECTIVES

After going through this lesson, you will be able to understand-

- the meaning of accounting standards;
- areas where accounting standards are needed; and
- procedures for setting Indian and International accounting standards.

6.3 BASICS OF ACCOUNTING STANDARDS - MEANING AND DEFINITION

The term 'Accounting Standard' may be defined as written statements issued from time to time by institutions of the accounting profession or institutions in which it has sufficient involvement and which are established expressly for this purpose. Such accounting institutions/bodies are currently found in many countries of the world, e.g., Accounting Standards Board (India), Financial Accounting Standards Board (USA), Accounting Standards Board (UK), Accounting Standards Committee (Canada), etc. At the international level, International Accounting Standards Board (IASB) has been created "to formulate and publish, in public interest, basic standards to be observed in the presentation of audited accounts and financial statements and to promote their worldwide acceptance and observance."

Accounting standards deal mainly with financial measurements and disclosures used in producing a set of fairly presented financial statements. In this respect, accounting standards can be thought of as a system of measurement and disclosure. They also draw the boundaries within which acceptable conduct lies and in that and many other respects, they are similar in nature to laws. Accounting standards can, thus, be seen as a technical response to- calls for better financial accounting and reporting; or as a reflection of a society's changing expectations of corporate behaviour and a vehicle in social and political monitoring and control of the enterprise.

- **Littleton** defines 'standard' as follows:

"A standard is an agreed upon criteria of what is proper practice in a given situation; a basis for comparison and judgment, a point of departure when variation is justifiable by the circumstances and reported as such Standards are not designed to confine practice within rigid limits but rather to serve as guide to post truth, honesty and fair dealing. They are not accidental but intentional in origin, they are expected to be expressive of the deliberately chosen policies of the highest types of businessmen and the most experienced accountants, they direct a high but attainable level of performance, without precluding justifiable departures and variations in the procedures employed."

- **Bromwich** observes:

"Accounting standards (are) uniform rules for financial reporting applicable either to all or to a certain class of entity promulgated by what is perceived of as predominantly an element of the accounting community specially created for this purpose. Standard setters can be seen as seeking to prescribe a preferred accounting treatment from the available set of methods for treating one or more accounting problems. Other policy statements by the profession will be referred to as recommendations."

Accounting standards, however, do not aim to put accounting in a straight jacket. Rather, they attempt to limit the theoretically possible flexibility and to give practitioners realistic working guidelines. If the individual circumstances of a particular business firm are such that an existing standard is not suitable, then alternative practices regarded as more suitable can be adopted. It is therefore, possible to achieve both uniformity and flexibility in accounting practice. These two apparent opposites, i.e., uniformity and flexibility are not incompatible.

It is also important to recognize that if standards are not acceptable, if they are not enforceable, and if they are not enforced, then they are not standards in any meaningful sense of the word. The process of enforcement is essential because if standards are not made compulsory, they lose their utility and cease to be standards.

6.4 NEED OF ACCOUNTING STANDARDS

Practically speaking, in order to avoid the variance which may arise between the accounting principles and accounting practice and also to find a uniformity among diversity among the various underlying principles of accounting. The Accounting Standards framed by the IASC or IAS (Indian Accounting Standard, based on IASC) for maintaining accounting practice in our country are very important for maintaining uniformity in preparation of accounts. However, the reasons for setting the Standards are:

(a) Comparison between two firms is possible if both of them maintain the same principle, otherwise proper comparison is not possible. For example, if Firm A follows the FIFO method of valuation of stock whereas Firm B follows the LIFO method for valuing stock, the comparison between the two firms becomes useless. The same is possible only when both of them follow identical method of valuing closing stock.

(b) The firms are not allowed to maintain and present their accounts according to their own will or choice or cannot prepare report of financial statements for various interested groups. The same is possible only when there is some fixed standard for setting practice.

(c) The Accounting Standards recognise the principle of equity applicable for different users of accounting information, viz. creditors, investors, shareholders etc. Thus the purpose of setting Accounting Standards is nothing but to find a uniformity in accounting practice while formulating financial reports and make consistency and proper comparison of data which are contained in financial statements for the users of accounting information. Practically, Accounting standards have been presented in order to maintain fairness, consistency and transparency in accounting practice which will satisfy the users of accounting.

6.5 OBJECTIVES OF ACCOUNTING STANDARDS

The main objective of accounting standards is to harmonize the different accounting policies. The policies are used in the preparation of financial reports.

These reports could be prepared by different enterprises. This would bring about a certain degree of confusion at the time of comparison. The following are the objectives of accounting standards:

- To provide a standard for the diverse accounting policies and principles.
- To put an end to the non-comparability of financial statements.
- To increase the reliability of the financial statements.
- To provide standards which are transparent for users.
- To define the standards which are comparable over all periods presented.
- To provide a suitable starting point for accounting.
- It contains high quality information to generate the financial reports. This can be done at a cost that does not exceed the benefits.
- For the eradication the huge amount of variation in the treatment of accounting standards.
- To facilitate ease of both inter-firm and intra-firm comparison.

6.6 IMPORTANCE OF ACCOUNTING STANDARDS

At present, accounting standards are regarded a major component in the framework of accounting and reporting practices. Standards exist to help the accounting practitioners to apply those accounting practices regarded as the most suitable for the circumstances covered. Further, they help individual companies and their managements to justify whatever practices they adopt when producing their financial statements. The benefits of establishing accounting standards manifest themselves in different ways, either because they are real effects of those standards because people perceive certain effects, or because they expect certain effects to follow and modify their behaviour accordingly. The benefits of accounting standards may be listed as follows: -

(1) Improves the credibility and reliability of financial statements

It is the function of accounting (and auditing) standards to create sense of confidence by providing a structural framework within which credible financial statements can be produced. Where various alternative methods of measuring an economic activity exists, it is important that the best available one be used uniformly within a firm, by different firms, and to the extent practicable, by different industries. This guideline is required in - order to meet a basic need of managers, investors and creditors to compare results and financial conditions of different segments of firms, different periods of a firm, different firms, and different industries. The value of the information provided by each enterprise to its investors is greatly enhanced if it can be compared easily with information from other enterprises. In the absence of standards, there would be no incentives to encourage an enterprise to conform to any particular model for the sake/of comparability. Thus, the main aim of accounting standards is to protect users of financial statements by providing them with information in which they can have confidence.

(2) Benefits accountants and auditors

Accountants and auditors with the passage of time and a changing climate of opinion, have to work in an environment where they face the threat of stern sanctions and bad name to their professions. These result partly from changed penalties and remedies available under the company law and partly from the greater willingness of aggrieved parties and to take their causes before the courts. The risk to auditors of these developments are considerable, whether in terms of uncovered financial exposure to liability or adverse effects on professional reputation resulting from unfavourable publicity. Particularly, dangerous are cases of undetected fraud, and of audited accounts, which are held to be misleading due to insufficient disclosure or use of inappropriate accounting principles.

Though individual accountant and chartered accountancy firm are concerned with their own reputations, the other accountants' and firms' misconduct would prove costly since all accountants belong to a class in the eyes of public. While members of a chartered accountancy firm can discipline their fellow, partners, it is difficult to' monitor the performance of other chartered accountants. For this purpose, the establishment of standard to which all chartered or certified accountants subscribe is useful. Thus, accounting standards are beneficial not only to the business enterprises but also to the accountants and auditors as well.

(3) Determines managerial accountability

Accounting Standards aim to ensure consistency and comparability in place of (imposed) uniformity in financial reporting to permit better comparisons in profitability, financial 'position, future prospects and other performance indicators associated with different business firms. Management's basic purpose should be to make a choice of the best method (standard) available. The guidelines of relevance and appropriateness to intended use may be so crucial in a given setting that a departure from uniformity of practice (with full disclosure) may be justified. On the other hand, uniformity should never be the justification for inappropriate information. An accounting standard should significantly reduce the amount of manipulation of the reported accounting numbers that is likely to occur in the absence of the standard. If the standard is subject to manipulation, its effect is more likely to be dysfunctional, since the managers can hide their actual performance under the cloak of reporting according to externally determined accounting standards.

(4) Reform in Accounting Theory and Practice

In 1960s, there was an outbreak in the accounting literature concerned with the issues and arguments about basic concepts in accounting; accounting standard, rules and law; wider effects of accounting policy choices. The search for the golden boomerang of accounting has yielded achievements and resulted into a greater awareness of alternative possibilities for defining and measuring financial performance.

Accounting Standards can be described as a vehicle whereby the wisdom and experience of the profession emerges as a consensus in a complex and changing economic and business situation in preference to the views of individual compilers of financial statements. Accounting as a "language of business" communicates the financial results and health of an enterprise to various interested parties by means of periodical financial statements. Like any other language, accounting should have its grammar (set of rules) and that is Accounting Standards.

6.7 DEVELOPMENT OF ACCOUNTING STANDARDS

A. International Accounting Standards (IAS)

International Accounting Standard Committee (IASC):

It came into being on 29th June 1973 when 16 accounting bodies (Viz. The Institute of Chartered Accountants from 10 nations i.e., USA, Canada, UK and Ireland, Australia, France, Germany, Japan, Mexico and Netherlands) signed the constitution for its formation. Its headquarters is situated at London. The Objectives of IAS is to develop accounting standards which are to be observed in the presentation of audited financial statements and to promote their worldwide acceptance.

Moreover, its other responsibility is to keep member bodies informed of the latest development and standards by issuing exposure drafts from time to time. Needless to mention that the Institute of Chartered Accountants of India and the

Institute of Cost and Works Accountants of India are members of the International Accounting Standards Committee.

The objectives of IASC, which are set out in its revised agreement and constitution (Nov. 1982), are:

(i) To formulate and publish in the public interest, accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observation, and

(ii) To work for the improvement and harmonisation of regulating accounting standards and procedures relating to the presentation of financial statements.

Moreover, The International Federation of Accountants (IFAC)—which was held at the IX International Congress of Accountants in October 1977 had been set up in order to harmonise accounting, auditing and reporting practices in an area which will see growing interdependence of the commercial and industrial systems of the world.

In order to formalize their relationship, International Accounting Standards Committee (IASC) and International Federation of Accountants (IFAC) constituted a working group which has, in the meantime) issued a statement of 'Mutual Commitments'. Practically, this statement, inter alia, accepts IASC as the sole body responsible for issuing pronouncements on international accounting standards. The Council of IFAC has approved it on May 1981.

At regional level, 'International Cooperation in Accountancy' was actually the theme of the Confederation of Asian and Pacific Accountants (CAPA) conference held in 1979 in recognition of the universality of accounting and the consolidation of efforts of accounting organisations throughout the world. Similarly, the Financial Accounting Standards Board (FASB) of USA has recently issued a number of Statements on conceptual framework for financial accounting and reporting in order to develop the respective standards.

Till 1st January 2004, International Accounting Standards have been issued by IASC. Some standards have been withdrawn and some were revised.

The standards are:

IAS 1: Presentation of Financial Statements

IAS 2: Valuation and Presentation of Inventories

IAS 7: Cash Flow Statement

IAS 8: Net Profit or Loss for the Period? Fundamental Errors and Changes in Accounting Policies

IAS 10: Events occurring after Balance Sheet Date

IAS 11: Accounting for Construction Contracts

IAS 12: Accounting for Taxes on Income

IAS 14: Reporting Financial Information by Segments

IAS 15: Information reflecting the effects of Changing Prices

IAS 16: Accounting for Property, Plant and Equipment

IAS 17: Accounting for Leases

IAS 18: Revenue Recognition

IAS 19: Accounting for Retirement Benefits of Employees in the Financial Statements of Employers

IAS 20: Accounting for Government Grants and Disclosure of Government Assistance

IAS 21: Accounting for Effects of Changes in Foreign Exchange Rates

IAS 22: Accounting for Business Combinations

IAS 23: Capitalizations of Borrowing Costs

IAS 24: Disclosure of Related Party Transactions

IAS 26: Accounting and Reporting by Retirement Benefits Plans

IAS 27: Consolidated Financial Statements and Accounting for Investments

IAS 28: Accounting for Investments in Associates

IAS 29: Financial Reporting by Hyperinflationary Economics

IAS 30: Disclosure of Financial Statement and Banks and Similar Financial Institutions

IAS 31: Financial Reporting of Interests in Joint Ventures

IAS 32: Financial Instruments—Disclosure and Presentations

IAS 33: Earning per Share

34: Accounting for Interim Financials Reporting

IAS 35: Discontinuing Operations

IAS 36: Impairment of Assets

IAS 37: Provisions, Contingent Liabilities and Contingent Assets

IAS 38: Intangible Assets

IAS 39: Financial Investments—Recognition and Measurement

IAS 40: Investment Property

IAS 41: Accounting for Agriculture.

B. International Financial Reporting Standards (IFRS) (Standards Issued after 2001)

International Financial Reporting Standards (IFRS) are practically principle-based standards interpretations and the framework which were adapted by the International Accounting Standard Boards. Some International Accounting Standards (IAS) which were issued between 1973 and 2001 by the IASC (International Accounting Standards Committee) form a part of International Financial Reporting Standards (IFRS).

International Accounting Standards Board (IASB) took the responsibility to set the various International Accounting Standards on 1st April 2001 from the IASC. The International Accounting Standards Board will continue to develop various needed standards which are popularly known as IFRS. In short, IFRS are nothing but a set of accounting standards which are developed by the IASB. These standards are global standards in order to prepare the financial statement of public company.

At present about 120 nations require IFRS for their domestic companies which are listed. Of them, 90 countries have totally conformed with IFRS which are promulgated by IASB. It includes a statement acknowledging such conformity in their audit reports. India has adopted IFRS in April 2011. As such, Indian listed companies are trying to achieve the important milestones while adopting various clauses of the regulations of IFRS. The European Securities Committee (ESC) needs 'EU adopted IFRSs equivalence from those companies who are following, Third World Country. Naturally, those companies should have to fill financial reports as per the 'EU adopted IFRSs' for the purpose of using and listing securities in the absence of equivalence.

Presently, the EC (European Commission) has notified that Indian Accounting Standards must be treated as par with EU adopted IFRSs for the time being which are applicable for those companies that are incorporated in US, Mexico, Canada, Japan, South Korea, and China. These companies must follow the requirements of IFRSs within the next three years.

Advantages of IFRS

For the conversion from IAS to IFAS, the following advantage are advocated:

(a) IFRS helps to raise Capital abroad since both the countries use IFRS for their allocating standards, i.e., the basis is same.

(b) IFRS helps to present its financial statement on the identical basis like its foreign competitors, i.e., comparisons become easy.

(c) Subsidiary of a foreign company must use IFRS if its parent company follows the same.

(d) It helps the foreign investors who are using IFRS.

(e) One accounting language may be applied in case of a foreign company having subsidiary to some other countries.

Disadvantages of IFRS

The IFRS even is not free from snags. Some of them are:

(a) There are certain use issuers who will resist IFRS as they do not have any market incentive for the preparation of IFRS financial statements.

(b) Adopting IFRS is costly.

Structures of IFRS

IFRSs are basically 'principle-based set of Standards' which frame results and various specific treatments of financial statement. It computes:

(a) Framework for the preparation and presentation of Financial Statement 1989.

(b) Standing Interpretation Committee (SIC) issued before 2001.

(c) International Accounting Standards (IAS) issued before 2001.

(d) Interpretations Originate from the International Financial Reporting Interpolations Committee (IFRIC) — issued after 2001.

(e) International Financial Reporting Standards (IFRS) —Issued after 2000.

List of IFRS

The list of FIRS comprises:

IFRS 1: First Time Adoptions of IFRS

IFRS 2: Share-Based Payments

IFRS 3: Business Combination

IFRS 4: Insurance Contracts

IFRS 5: Non-Current Assets held for Sale and Discontinued Operations

IFRS 6: Exploration for and Evaluation of Mineral Resources

IFRS 7: Financial Instruments; Disclosures

IFRS 8: Operating Segments

IFRS 9: Financial Instruments.

C. Indian Accounting Standards (OLD)

Accounting Standard Board of India:

On 21st April 1977, The Institute of Chartered Accountants of India, as a premier accounting body in our country, set up the "Accounting Standard Board" (ASB) to harmonise the diverse accounting policies and practice prevalent in our country.

The primary duty of ASB is to formulate the accounting standards for India. These standards may be established by the Council of the Institute in India. During formulation of accounting standards, the ASB considered the applicable laws, usages, customs and the business environment existing in our country. For this purpose, ASB took the valued views and guidelines of various industrial houses, the Government, and other interested parties.

The body consists of the following members: Company Law Board, CBDT, Central Board of Excise and Customs, Controller General of Accounts, SEBI, Comptroller and; Auditor General of India, UGC, Educational and Professional Institutions, Council of the Institute and representatives of Industry, Banks.

The Accounting Standards will, however, be issued under the guidance of the Council. As such, ASB has given the authority of propagating the Accounting Standards and instituting the parties to prepare and present the accounts on the basis of Accounting Standards. ASB will explain the basic concepts on which accounting principles should be oriented and will also explain the accounting principles on which the practice and procedures should conform while performing its functions.

However, this Council of the Institute of Chartered Accountants of India (ICAI) has issued 32 Accounting Standards (AS) so far.

These Accounting Standards are presented:

Accounting Standards (OLD)

AS Title/Head No.

1. Disclosure of Accounting Policies

2. Valuation of Inventories

3. Cash Flow Statement

4. Contingencies and Events Occurring After Balance Sheet Date

5. Net Profit or Loss for the Prior Period Items and Changes in Accounting Policies—Revised

6. Depreciation Accounting—Revised

7. Construction Contract—Revised

8. Accounting for Research and Development [Withdrawn from 1.4.2003]

9. Revenue Recognition

10. Accounting for Fixed Assets

11. Accounting for the Effects of Changes in Foreign Exchange Rates—Revised
12. Accounting for Government Grants
13. Accounting for Investments
14. Accounting for Amalgamation
15. Accounting for Employee Benefits
16. Borrowing Costs
17. Segment Reporting
18. Related Party Disclosures
19. Leases
20. Earning per Share
21. Consolidated Financial Statements
22. Accounting for Taxes on Income
23. Accounting for Investments in Associates in Consolidated Financial Statement
24. Discounting Operations
25. Interim Financial Reporting
26. Intangible Assets
27. Financial Reporting of Interest in Joint Ventures
28. Impairment of Assets
29. Provisions, Contingent Liabilities and Contingent Assets
30. Financial Instruments: Recognition and Measurement
31. Financial Instruments: Presentations
32. Financial Instruments: Disclosures

D. Accounting Standards (New):

Mr. S. Khursheed had announced a three phase convergence schedule in Jan. 2011:

In **first phase,** the listed companies, including those on overseas exchanges and with a Net worth of Rs. 1,000 crores, will adopt IFRS Standards in April 2011.

In **Second Phase,** companies having a Net worth of Rs. 500 crores to Rs. 1,000 crores, which will move to IFRS standing from April 2013.

In **Third Phase,** listed companies having a Net worth of Rs. 500 crores or less will adopt it in April 2014.

Accordingly, the following new Indian Accounting Standards (Ind AS) have been introduced from April 2011.

(Ind AS) 1: Presentation of Financial Statements

(Ind AS) 2: Valuation of Inventories

(Ind AS) 7: Statement of Cash Flow

(Ind AS) 8: Accounting Policies, Changes in Accounting Estimates and Errors

(Ind AS) 10: Events after the Reporting Period

(IndAS) 11: Construction Contracts

(Ind AS) 12: Income-Taxes

(Ind AS) 16: Property, Plant and Equipment

(Ind AS) 17: Leases

(Ind AS) 18: Revenue

(Ind AS) 19: Employee Benefits

(Ind AS) 20: Accounting for Government Grants and Disclosure of Government Assistance

(Ind AS) 21: The Effect of Changes in Foreign Exchange Rates

(Ind AS) 23: Borrowing Costs

(Ind AS) 24: Related Party Disclosures

(Ind AS) 27: Consolidated and Separate Financial Statements

(Ind AS) 28: Investments Associates

(Ind AS) 29: Financial Reporting in Hyperinflationary Economics

(Ind AS) 31: Interests in Joint Ventures

(Ind AS) 32: Financial Instruments: Presentation

(Ind AS) 33: Earning per Share

(Ind AS) 34: In-term Financial Reporting

(Ind AS) 36: Impairment of Assets

(Ind AS) 37: Provisions, Contingent Liabilities and Contingent Assets

(Ind AS) 38: Intangible Assets

(Ind AS) 39: Financial Instruments: Recognition and Measurement

(Ind AS) 40: Investment Property

(Ind AS) 101: First-Time Adoption of Indian Accounting Standards

(Ind AS) 102: Share-based Payment

(Ind AS) 103: Business Combination

(Ind AS) 104: Insurance Contract

(Ind AS) 105: Non-Current Assets held for Sale and Discontinued Operations

(Ind AS) 106: Exploration for and Evaluation of Minerals Resources

(Ind AS) 107: Financial Instruments: Disclosure

(Ind AS) 108: Operating Segments

Comparative Study at a Glance

A. International Accounting Standards. IAS

IAS 1 : Presentation of Financial Statements.
2 : Inventories.
7 : Statement of Cash Flow.
8 : Net Profit or Loss for the period- Fundamental Errors & changes in Accounting Policy.
10 : Events after Reporting period.
11 : Construction contracts.
12 : Income taxes.
16 : Property, Plant & Equipment.
17 : Leases.
18 : Revenue.
19 : Employee Benefits.
20 : Accounting for Govt. Grants & Disclosure of Govt. Assistance.
21 : The Effects of Changes in Foreign Exchange.
23 : Borrowing Costs.
24 : Related Party Disclosure.
26 : Accounting & Reporting by Retirement Benefit Plans.
27 : Consolidated & Separate Financial Statements.
28 : Investments in Associates.
29 : Financial Reporting in Hyperinflationery Economics.
31 : Interest in Joint Venture.
32 : Financial Instruments : Presentation
33 : Earning Per Share.
34 : Interim Financial Reporting.
36 : Impairment of Assets.
37 : Provisions, Contingent liabilities and Contingent Assets.
38 : Intangible Assets.
39 : Financial Instruments– Recognition and Measurement.
40 : Investment Property
41 : Agriculture

B. International Financial Reporting Standards : IFRS

IFRS 1 : First Time Adoption of IFRS
2 : Share-Based Payments
3 : Business Combination
4 : Insurance Contract
5 : Non-Current Assets held for Sales & Discontinued Operations
6 : Exploration of Mineral Resources
7 : Financial Instruments – Disclosure
8 : Operating Segments
9 : Financial Instruments

C. Indian Accounting Standards–As (Old)

AS 1 : Disclosure of Accounting Policies
2 : Valuation of Inventories
3 : Cash Flow Statement
4 : Contingency & Events Occurring after Balance Sheet Date
5 : Net Profit or Loss for the period, prior period items and changes in accounting policies.
6 : Depreciation accounting
7 : Construction Contracts
8 : Accounting for Research & Development (withdrawn on and from 1.4.2003)
9 : Revenue Recognition
10 : Accounting for Fixed Asset
11 : Accounting for effects of changes in foreign exchange rates.
12 : Accounting for Govt. Grants
13 : Accounting for Investment
14 : Accounting for Amalgamation
15 : Accounting for Employee Benefit
16 : Borrowing Costs
17 : Segment Reporting
18 : Related Party Disclosure
19 : Leases
20 : Earning per Share
21 : Consolidated Financial Statements
22 : Accounting for taxes in Income
23 : Accounting for Investments
24 : Discontinuing Operations
25 : Interim Finance Reporting
26 : Intangible Assets
27 : Financial Reporting of Interest in Joint Venture
28 : Impairment of Assets
29 : Provision, Contingent Liabilities & Contingent Assets
30 : Financial Instruments–Recognition & Measurement
31 : Financial Instrument– Presentation
32 : Financial Instrument– Disclosure

D. Indian Accounting Standards : Ind AS (New)

Ind AS 1 : Presentation of Financial Statement
2 : Inventories
7 : Statement of Cash Flow
8 : Accounting Policies Changes in Accounting Estimates and Errors
10 : Events after the Reporting Date
11 : Construction Contracts
12 : Income Taxes
16 : Property, Plant and Equipment
17 : Leases
18 : Revenue
19 : Employee Benefits
20 : Accounting for Govt. Grants and Disclosure of Govt. Assistance
21 : The Effect of change in Foreign Exchange
23 : Borrowing Cost
24 : Related Party Disclosure
27 : Consolidate & Separate Financial Statement
28 : Investments in Associates
29 : Financial Reporting in Hyperinflationery Economics
31 : Interest in Joint Venture
32 : Financial Instrument– Presentation
33 : Earnings per Share
34 : Interim Financial Reporting
36 : Impairment of Assets
37 : Provisions, Contingent Liabilities & Contingent Assets
38 : Intangible Assets
39 : Financial Investment– Recognition and Measurement
40 : Investment Property
101 : First Time Adoption of Indian Accounting Standard
102 : Share Based Payment
103 : Business Combination
104 : Insurance Contract
105 : Non-Current Assets held for Sale and Discontinued Operation
106 : Exploration for and Evaluation of Mineral Resources
107 : Financial Instruments– Disclosure
108 : Operating Segments

6.8 FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)

In October 1985, the FASB issued a statement explaining its mission: "to establish and improve standards of financial accounting and reporting for the guidance and education of the public including issuers, auditors and users of financial information." The statement further says that the Board seeks to accomplish its mission by the following measures:

(1) Improving the usefulness of financial reporting by focusing on certain primary characteristics (relevance, reliability, comparability, and consistency)

(2) Keeping standards up to date.

(3) Considering areas of financial reporting that need improvement.

(4) Improving the general understanding of financial reporting, its nature, and its purposes

In pursuing these aims, the Board follows the following precepts:

(1) To be objective in its decision making and preserve neutrality in the information that results from its standards.

(2) To weigh the views of its constituents but ultimately to rely on its own judgment.

(3) To issue standards only when benefits are expected to exceed costs

(4) To minimise disruption when making needed changes

(5) To review past decisions and to make changes when necessary.

6.9 ADVISORY GROUPS IN INDIA

To assist the Standing Committee, Advisory Groups were constituted in different areas of the financial system under the Chairmanship of eminent experts, generally not holding official positions in government or other regulatory bodies in ten major areas - accounting and auditing, banking supervision, bankruptcy, corporate governance, data dissemination, fiscal transparency, insurance regulation, transparency of monetary and financial policies, payments and settlement system and securities market regulation. The Advisory Groups had, in general, the following terms of reference: -

(i) to study present status of applicability and relevance and compliance of relevant standards and codes,

(ii) to review the feasibility of compliance and the time frame over which this could be achieved given the prevailing legal and institutional practices,

(iii) to compare the levels of adherence in India vis-a-vis in industrialised and also emerging economies particularly to understand India's position and prioritise actions on some of the more important codes and standards, and

(iv) to chalk out a course of action for achieving the best practices.

6.10 FUNCTIONS OF ASB

Keeping in mind the need to harmonise the diverse accounting policies and practice in India and keeping in view the international development in the field of accounting, the Institute of Chartered Accountants of India constituted the Accounting Standards Board (ASB) in April 1977. The ASB is entrusted with the following functions:

(1) To formulate accounting standards which may be established by the Council of 1CAI in India. While formulating standards, the ASB is required to take into consideration the applicable laws, customs and usages and business environment; it is also required to give due consideration to International Accounting Standards issued by IASC and to integrate them, to the extent possible, in the light of the conditions and practices prevailing in India.

(2) To propagate the Accounting Standards and persuade the concerned parties to adopt them in the preparation and presentation of financial statements

(3) To issue guidance notes on the Accounting Standards and give clarifications on issues arising there from

(4) To review the Accounting Standards at periodical intervals

The date from which a particular standard will come to effect, as well as the class of enterprises to which it will apply, will also be specified by the Institute. Unless otherwise stated, no standard will have retrospective application. Normally, before formulating the standards, ASB will hold discussions with the representatives of the Government, Public Sector Undertakings, Industry and other organizations, for ascertaining their views. An exposure draft of the proposed standard will be prepared and issued for comments by members of the Institute and the public at large. After considering the comments received, the draft of the proposed standard will be finalized by ASB and submitted to the Council which will study it, modify it if necessary and issue it under its own authority.

6.11 PROCEDURE FOR SETTING INDIAN ACCOUNTING STANDARDS

The existing procedure for formulating and issuing accounting standard followed by the Accounting Standards Board of the 1CAI is as follows:

- ASB determines the broad areas in which Accounting Standards need to be formulated and the priority with regard to issuance thereof.
- In the preparation of Accounting Standard, ASB is assisted by Study Groups constituted to consider specific subjects. In the formation of Study Groups, provision is made for wide participation by the members of the Institute and others.
- The Board considers the draft as submitted by the study group and finalizes the same for issue to all members of the Council of the 1CAI as well as to the bodies listed below for their comments.

- Associated Chambers of Commerce and Industry, Federation of Indian Chambers of Commerce and Industry, Institute of Cost and Works Accountants of India, Standing Conference of Public Enterprises, Institute of Company Secretaries of India, Central Board of Direct Taxes, Department of Company Affairs, Comptroller and Auditor General of India, Reserve Bank of India, Indian Banks' Association, Securities and Exchange Board of India, Confederation of Indian industries.
- ASB holds a meeting with the representatives of specified outside bodies listed above to ascertain their views.
- On the basis of the comments received from the Council members as well as the outside bodies, the Board finalizes the Exposure Draft and exposes it for public comments:
- To all members of the profession through the medium of their Journal.
- To principal Chambers of Commerce and Industry through direct communications.
- To all recognised Stock Exchanges through direct communication
- To the Institute of Cost and Works Accountants of India through direct communication.
- To the Institute of Company Secretaries of India through direct communication.
- To the Ministry of Corporate Affairs, Central Board of Direct Taxes and the Comptroller and Auditor General by direct communication.
- To principal financial institutions, Reserve Bank of India, Life Insurance Corporation, General Insurance Corporation, Unit Trust of India and Indian Banks Association by direct communication.

- To all Regional Councils and Branches of the 1CAI by direct Communication.
- To all Council Members.
- To Securities and Exchange Board of India by direct communication.
- After taking into account the comments received from various quarters, the draft of the proposed standard is finalized by the Board and submitted to the Council for its consideration.
- The Council of the Institute considers the final draft of the proposed Standard, and if necessary, modifies the same in consultation with ASB.
- The Accounting Standard on the relevant subject is then issued under the authority of the Council.

6.12 PROCEDURE FOR SETTING INTERNATIONAL ACCOUNTING STANDARDS

The IASC, now IASB follows the following procedure in developing the international accounting standards:

1. The IASC Board selects a topic and assigns it to a steering committee which is made of four representatives of, at least one of which is a board member and at least one of which is from a developing country.
2. The steering committee studies the issues involved and presents to the board a point outline on the topic.
3. The board gives its comments to the steering committee which then prepares a preliminary draft of the proposed standard.
4. The board reviews preliminary draft of the new standard and then circulates it among all the member bodies for their comments.
5. Based on these comments, the steering committee prepares a revised draft and a final exposure draft is submitted to the board for approval.

6. If approved by a Two-Third vote of the board, the exposure draft will be sent to IASC members. The exposure draft is published in all member countries and worldwide public comments are invited from all interested parties, both professional and non-professional.

7. At the conclusion of the exposure period, usually six months, the comments submitted are considered by the steering committee, and then a final standard is drafted.

8. The steering committee submits the revised draft of the final standard to the board for its approval; and if approved by at least 8 out of the 14 members of the board, it will be issued as a new IAS.

6.13 AREAS WHERE ACCOUNTING STANDARDS NEED TO BE FRAMED

The following are the areas in which different accounting standards needed to be adopted by different enterprises:

(a) Methods of depreciation, depletion and amortization

(b) Treatment of expenditure during construction

(c) Conversion or translation of foreign currency items

(d) Valuation of inventories

(e) Treatment of goodwill

(f) Valuation of investments

(g) Treatment of retirement benefits

(h) Recognition of profit on long-term contracts

(i) Valuation of fixed assets

(j) Treatment of contingent liabilities.

Considerations in the Selection of Accounting standards

The primary consideration in the selection of accounting standards by an enterprise is that the financial statements prepared and presented on the basis of such accounting standards should represent a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit. For this purpose, the major considerations governing the selection and application of accounting standards are:

a. Prudence

In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

b. Substance over Form

The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form.

c. Materiality

Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements.

6.14 SUMMARY

'Accounting Standard' may be defined as written statements issued from time to time by institutions of the accounting profession or institutions in which it has sufficient involvement and which are established expressly for this purpose. Such accounting institutions/bodies are currently found in many countries of the world, e.g., Accounting Standards Board (India), Financial Accounting Standards

Board (USA), Accounting Standards Board (UK), Accounting Standards Committee (Canada), etc. At the international level, International Accounting Standards Board (LASB) has been created "to formulate and publish, in public interest, basic standards to be observed in the presentation of audited accounts and financial statements and to promote their worldwide acceptance and observance.

6.15 GLOSSARY

- **IAS-** International Accounting Standard
- **ICAI-** Institute of Chartered Accountant of India
- **IASC-** International Accounting Standard Committee
- **IASB-** International Accounting Standard Board
- **ASB-** Accounting Standard Board
- **FASB-** Financial Accounting Standard Board
- **SAB-** Standard Advisory Board

6.16 SELF ASSESSMENT QUESTIONS

Q.1 What do you mean by Accounting Standards Board of India ?

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Q.2 Write a detailed note on IFRS.

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6.17 EXAMINATION ORIENTED QUESTIONS

1. What is meant by accounting standards? Explain the areas where accounting standards needs to be formulated.

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2. Explain the procedure for setting Indian accounting standard.

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FINANCIAL REPORTING STANDARDS

OVERVIEW OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

7.1 INTRODUCTION

7.2 OBJECTIVES

7.3 AN OVERVIEW OF IFRS

7.4 THE PRINCIPAL OBJECTIVES OF THE IASB

7.5 SUMMARY

7.6 GLOSSARY

7.7 SELF ASSESSMENT QUESTIONS

7.8 EXAMINATION ORIENTED QUESTIONS

7.9 SUGGESTED READINGS

7.1 INTRODUCTION

It is well known that companies all over the world have become more and more internationally oriented during last few decades. They create fusion, make investment, conduct trade and co-operate over country borders. International Financial Reporting Standards (IFRS) is becoming the global language of business with over 40% of the world having moved to IFRS in the past few years. Today, it is expected that all companies in major markets are using IFRS. The globalisation creates an increased need for communication in the terms of language, awareness of culture differences and domestic customs. Moreover, the financial communication such as accounting and financial results is just as important for business leaders and employees to master.

7.2 OBJECTIVES

After going through this lesson, you will be able to understand-

- the overview of IFRS;
- process of IFRS;
- challenges and issues in IFRS; and
- objectives of IASB

7.3 AN OVERVIEW OF IFRS

International Financial Reporting Standards (IFRS) are designed as a common global language for business affairs so that company accounts are understandable and comparable across international boundaries. They are a consequence of growing international shareholding and trade and are particularly important for companies that have dealings in several countries. They are progressively replacing the many different national accounting standards. IFRS began as an attempt to harmonize accounting across the European Union but the value of harmonization quickly made the concept attractive around the world. They are sometimes still called by the original name of International Accounting Standards (IAS). IAS were issued between 1973 and 2001 by the Board of the International Accounting Standards Committee (IASC). On 1 April 2001, the new International Accounting Standards Board (IASB) took over from the IASC the responsibility for setting International Accounting Standards. During its first meeting, the new Board adopted existing IAS and Standing Interpretations Committee standards (SICs). The IASB has continued to develop standards calling the new standards "International Financial Reporting Standards". In the absence of a Standard or an Interpretation that specifically applies to a transaction, management must use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable. In making that judgement, IAS requires management to consider the definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the Framework. A financial reporting system supported by strong governance, high quality standards, and firm regulatory framework is the key to economic development. Indeed, sound financial reporting standards underline the trust that investors place in financial reporting information and thus play an important role in contributing to the economic development of a country. Needless to mention, internationally accepted accounting standards play a major role in this entire process. It is in this context that the role of an independent, global standard-setting body such as the International Accounting Standards Board (IASB) is of critical importance.

7.4 THE PRINCIPAL OBJECTIVES OF THE IASB

To develop a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRSs) through its standard-setting body, the IASB aims—

- To promote the use and rigorous application of those standards;
- To take account of the financial reporting needs of emerging economies and small and medium-sized entities (SMEs); and
- To bring about convergence of national accounting standards and IFRSs to high quality solutions. Converging to global accounting standards i.e. IFRS facilitates comparability between enterprises operating in different jurisdictions. Thus, global accounting standards would remove a frictional element to capital flows and lead to wider and deeper investment in markets. Convergence with IFRS is also in the interest of the industry since

compliance with them would be able to create greater confidence in the mind of investors and reduce the cost of raising foreign capital. It is also burdensome and costly for enterprises operating across several countries to comply with a multitude of national accounting standards and convert them to a single standard for group reporting purposes. Convergence would thus help reduce both the cost of capital and cost of compliance for industry. In pursuit of its objectives, the IASB works in close cooperation with stakeholders around the world, including investors, national standard-setters, regulators, auditors, academics, and others who have an interest in the development of high-quality global standards. Progress toward this goal has been steady. All major economies have established time lines to converge with or adopt IFRSs in the near future and more than hundred countries require or permit the use of IFRSs.

7.5 SUMMARY

Recent years have seen major changes in financial reporting worldwide under which the most obvious is the continuing adoption of IFRS worldwide. More than 100 countries have converged or recognized the police of convergence with the IFRS. IFRS are the globally accepted accounting standards and interpretations adopted by the IASB. An upcoming economy on world economic map, India, too, decided to converge to International Financial Reporting Standards (IFRS).

7.6 GLOSSARY

- **SEC-** Securities Exchange Commission
- **GAAP-** Generally Accepted Accounting Principles
- **IFRS-** International Financial Reporting Standard
- **IASB-** International Accounting Standard Board
- **ICAI-** Institute of Chartered Accountant of India

7.7 SELF ASSESSMENT QUESTIONS

Q1. Give the history of IFRS.

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Q2. Discuss the challenges that will be faced on the way of IFRS convergence.

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Q3. Discuss the process of convergence with IFRS.

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7.8 EXAMINATION ORIENTED QUESTIONS

1. What do you mean by IFRS? Discuss the principle objectives of IFRS.

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2. Give the historical background of accounting standard.

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3. Discuss in detail the overview of IFRS.

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7.9 SUGGESTED READINGS

- Barnea, A. Ronen, J. and Sadan, J. (1976). Classificatory Smoothing of Income with Extraordinary Items. *The Accounting Review.*
- Copenland, R. M. (1968). Income Smoothing. *Journal of Accounting Research*.
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FINANCIAL REPORTING STANDARDS

SIGNIFICANT DIFFERENCE BETWEEN IFRS AND INDIAN ACCOUNTING STANDARDS

8.1 INTRODUCTION

8.2 OBJECTIVES

8.3 IFRSs DIFFERENCE BETWEEN IFRS AND Ind AS

8.4 SUMMARY

8.5 GLOSSARY

8.6 SELF ASSESSMENT QUESTIONS

8.7 EXAMINATION ORIENTED QUESTIONS

8.8 SUGGESTED READINGS

8.1 INTRODUCTION

The Ind ASs placed on the Ministry of Corporate Affairs (MCA) website when notified under Section 211 (3) (c) of the Companies Act, 2013 by the MCA will be applicable to the companies from the date specified in the said notification. Section I of the note contains IFRSs deferred by the MCA. Section II contains carve outs from IFRSs in the relevant Ind ASs. Section III contains 'Other major changes in Indian Accounting Standards vis-à-vis IFRSs not resulting in carve outs'. Section IV contains a comparative chart of IFRSs and corresponding Ind ASs indicating, inter alia, IFRSs in respect of which no corresponding Ind AS has been formulated and reasons there for.

8.2 OBJECTIVES:

After going through this lesson the students will be able to understand the difference between IFRS and Ind AS.

8.3 DIFFERENCE BETWEEN IFRS AND Ind AS

The Institute of Chartered Accountants of India (ICAI) aims to bring out the differences between the IFRSs as applicable on 1st April, 2011 and the corresponding Indian Accounting Standards (Ind ASs) placed by the Ministry of Corporate Affairs (MCA), Government of India, on its website after recommendation of the same by the National Advisory Committee on Accounting Standards (NACAS) and the ICAI.

I. IFRSs deferred by MCA

1. Ind AS 11, *Construction Contracts*

IFRIC 12 and SIC 29, *Service Concession Arrangements* and *Service Concession Arrangements: Disclosures,* respectively, which are included as Appendices A and B to Ind AS 11, *Construction Contracts,* respectively, would not be notified along with the other standards and their application has been deferred.

Reasons

MCA received feedback regarding the adverse consequences which may ensue to the Indian companies in the event of immediate adoption of the IFRIC 12. Hence, MCA decided that Appendix A to Ind AS 11, corresponding to IFRIC 12, *Service Concession Arrangements* should be deferred and the same may be examined and applied with or without modification later.

Appendix B to Ind AS 11, corresponding to SIC 29, *Service Concession Arrangements: Disclosures,* is related to IFRIC 12. Therefore, it has also been deferred.

2. Ind AS 17, *Leases*

IFRIC 4 Determining Whether an Arrangement contains a Lease, which is included as Appendix C to Ind AS 17, Leases would not be notified alongwith the other standards and its application has been deferred.

Reasons

MCA received feedback regarding the adverse consequences which may ensue to the Indian companies in the event of immediate adoption of the Appendix C to Ind AS 17, corresponding to IFRIC 4. Hence, MCA decided that the Appendix should be deferred and the same may be examined and applied with or without modification later.

3. Ind AS 106, *Exploration for and Evaluation of Mineral Resources*

Ind AS 106 corresponding to IFRS 6, *Exploration for and Evaluation of Mineral Resources,* would not be notified immediately as it is under consideration of the Government.

Reasons

MCA is of view that the standard is open-ended offering freedom to companies to follow virtually any policy they like. The standard does not prescribe any standardization. In such circumstances, the standard does not serve any useful purpose and may create a wrong impression in the mind of the stakeholders that the entity concerned has complied with a strict standard when in fact, the company is free to apply any accounting treatment it wants. This may even be counter productive from a regulatory point of view by giving a false sense of correctness. Hence, this Ind AS may not be notified immediately.

II Carve Outs

A. Carve-outs which are due to differences in application of accounting principles and practices and economic conditions prevailing in India.

1. Ind AS 21, *The Effects of Changes in Foreign Exchange Rates*

As per IFRS

IAS 21 requires recognition of exchange differences arising on translation of monetary items from foreign currency to functional currency directly in profit or loss.

Carve out

Ind AS 21 permits an option to recognise exchange differences arising on translation of certain long-term monetary items from foreign currency to functional currency directly in equity. In this situation, Ind AS 21 requires the accumulated exchange differences to be amortised to profit or loss in an appropriate manner. IAS 21 does not permit such a treatment.

2. Ind AS 28, *Investment in Associates*

As per IFRS

IAS 28 requires that difference between the reporting period of an associate and that of the investor should not be more than three months, in any case.

Carve out

The phrase 'unless it is impracticable' has been added in the relevant requirement i.e., paragraph 25 of Ind AS 28.

Reasons

Since the investor does not have control over the associate, it may not be able to influence the associate to change its accounting period if it does not fall within 3 months.

3. Ind AS 32, *Financial Instruments: Presentation* Carve out

An exception has been included to the definition of 'financial liability' in paragraph 11 (b) (ii), Ind AS 32 to consider the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of entity's own equity instruments as an equity instrument if the exercise price is fixed in any currency. This exception is not provided in IAS 32.

Reasons

This position is not appropriate in instruments such as FCCBs since the number of shares convertible on the exercise of the option remains fixed and the amount at which the option is to be exercised in terms of foreign currency is also fixed; merely the difference in the currency should not affect the nature of derivative, i.e., the option.

4. Ind AS 39, *Financial Instruments: Recognition and Measurement*

As per IFRS

IAS 39 requires all changes in fair values in case of financial liabilities designated at fair value through Profit and Loss at initial recognition shall be recognised in profit or loss. IFRS 9 which will replace IAS 39 requires these to be recognised in 'other comprehensive income'

Carve out

A proviso has been added to paragraph 48 of Ind AS 39 that in determining the fair value of the financial liabilities which upon initial recognition are designated at fair value through profit or loss, any change in fair value consequent to changes in the entity's own credit risk shall be ignored.

Reasons

It is felt that recognition of gain in profit or loss or in 'other comprehensive income' on deterioration of own credit risk is not proper because such deterioration ordinarily occurs when an entity is incurring losses. Thus, if an entity is allowed to recognise gain on deterioration of its own credit risk, it will book gains when its performance is not upto the mark. In the recent financial crisis in USA, it was noted that some banks booked gains while they were incurring losses due to the crisis.

5. **Ind AS 103, *Business Combinations* As per IFRS**

IFRS 3 requires bargain purchase gain arising on business combination to be recognised in profit or loss.

Carve out

Ind AS 103 requires the same to be recognised in other comprehensive income and accumulated in equity as capital reserve, unless there is no clear evidence for the underlying reason for classification of the business combination as a bargain purchase, in which case, it shall be recognised directly in equity as capital reserve.

Reasons

It is felt that recognition of such gains in profit or loss would result into recognition of unrealised gains as the value of net assets is determined on the basis of fair value of net assets acquired

6. **Ind AS 101, First-time Adoption of Indian Accounting Standards**

(i) **Presentation of comparatives in the *First-time Adoption of Indian Accounting Standards* (Ind AS) 101 (corresponding to IFRS 1)**

IFRS 1 defines transitional date as beginning of the earliest period for which an entity presents full comparative information under IFRS. It is this date which is the starting point for IFRS and it is on this date the cumulative impact of transition is recorded based on assessment of conditions at that date by applying the standards retrospectively except to the extent specifically provided in this standard as optional exemptions and mandatory exceptions. Accordingly, the comparatives, i.e., the previous year figures are also presented in the first financial statements prepared under IFRS on the basis of IFRS.

Carve out

Ind AS 101, requires an entity to provide comparatives as per the existing notified Accounting Standards. It is provided that, in addition to aforesaid comparatives, an entity may also provide comparatives as per Ind AS on a memorandum basis.

Reason

This would facilitate smooth convergence with IFRS as comparatives are not required to be in accordance with the Ind ASs. It is also felt that since Ind AS 101 would not be considered to be in existence for the comparative period, requiring comparatives to be prepared on the basis of Ind AS may not be legally defensible.

(ii) Presentation of reconciliation

As per IFRS

IFRS 1 requires reconciliations for opening equity, total comprehensive income, cash flow statement and closing equity for the comparative period to explain the transition to IFRS from previous GAAP.

Carve out

Ind AS 101 provides an option to provide a comparative period financial statements on memorandum basis. Where the entities do not exercise this option and, therefore, do not provide comparatives, they need not provide reconciliation for total comprehensive income, cash flow statement and closing equity in the first year of transition but are expected to disclose significant differences pertaining to total comprehensive income. Entities that provide comparatives would have to provide reconciliations which are similar to IFRS.

Reason

This would facilitate smooth convergence with IFRS.

(III) Cost of *Non-current Assets Held for Sale and Discontinued Operations* on the date of transition on *First-time Adoption of Indian Accounting Standards* (Ind AS)

Carve out

Ind AS 101 provides transitional relief that while applying Ind AS 105 – *Non-currentAssets Held for Sale and Discontinued Operations,* an entity may use the transitional date circumstances to measure such assets or operations at the lower of carrying value and fair value less cost to sell.

Reason

This would facilitate smooth convergence with IFRS

(iv) Foreign currency gains/losses on translation of long term monetary items

Carve out

Ind AS 101 provides that on the date of transition, if there are long-term monetary assets or long-term monetary liabilities mentioned in paragraph 29A of Ind AS 21, an entity may exercise the option mentioned in that paragraph regarding spreading over the unrealised Gains/Losses over the life of Assets/Liabilities either retrospectively or prospectively. If this option is exercised prospectively, the accumulated exchange differences in respect of those items are deemed to be zero on the date of transition.

Reason

Exemption given as a consequence of optional treatment prescribed in Ind AS 21, *TheEffects of Changes in Foreign Exchange Rates,* in context of exchange differences arising on account of certain long-term monetary assets or long-term monetary liabilities.

(v) Definition of previous GAAP under Ind AS 101 *First-time Adoption of Indian Accounting Standards*

As per IFRS

IFRS 1 defines previous GAAP as the basis of accounting that a first-time adopter used immediately before adopting IFRS.

Carve out

Ind AS 101 defines previous GAAP as the basis of accounting that a **first-timeadopter** used immediately before adopting Ind ASs for its reporting requirements in India. For instance, for companies preparing their financial statements in accordance with the existing Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 shall consider those financial statements as previous GAAP financial statements.

Reason

The change makes it mandatory for Indian companies to consider the financial statements prepared in accordance with existing notified Indian accounting standards as was applicable to them as under Companies (Accounting Standards) Rule, 2006 as previous GAAP when it transitions to Ind AS as the law prevailing in India does not recognise the financial statements prepared in accordance with Accounting Standards other than those prescribed under the Companies Act.

(vi) Cost of Property, Plant and Equipment (PPE), Intangible Assets, Investment Property, on the date of transition of First-time Adoption of Indian Accounting Standards.

Ind AS 101 provides an entity an option to use carrying values of all assets as on the date of transition in accordance with previous GAAP as an acceptable starting point under Ind AS

Reasons

The existing Indian notified Accounting Standards are not significantly different from IFRS as all the standards have been based on IFRS. It will minimise the cost of convergence.

B. Carve-outs for specific industries

As per IFRS

On the basis of principles of the IAS 18, IFRIC 15 on *Agreement for Construction ofReal Estate, prescribes* that construction of real estate should be treated as sale of goods and revenue should be recognised when the entity has transferred significant risks and rewards of ownership and has retained neither continuing managerial involvement nor effective control.

Carve out

IFRIC 15 has not been included in Ind AS 18, *Revenue.* Such agreements have been scoped out from Ind AS 18 and have been included in Ind AS 11, *ConstructionContracts.*

Reasons

IFRIC 15, would have required the real estate developers to recognize the revenue in their financial statements based on the completion method i.e., only in the last year of the completion of the project. In that case, the profit and loss account of the developers will not truly reflect the performance of the business, as during the years the real estate project continues, no revenue will be recognised. In other words, profit and loss account will not reflect proper measure of performance of business.

2. Ind AS 18, *Revenue*

Carve out

A footnote has been added in paragraph 1 to Ind AS 18, *Revenue,* that for rate regulated entities, this standard shall stand modified, where and to the extent the recognition and measurement of revenue of such entities is affected by recognition and measurement of regulatory assets/liabilities as per the Guidance Note on the subject being issued by the Institute of Chartered Accountants of India.

Reason

Rate regulated entities such as electricity companies are subject to tariff fixation by the relevant authorities. Tariff is fixed on the basis of certain costs which are different from the expenses recognised in financial statements. Such differences may result into certain regulatory assets and regulatory liabilities which are presently not recognised as per the IFRS. Such entities feel that such assets and liabilities exist and, therefore, should be recognised in financial statements. IASB had earlier taken up a project on this subject which has been dropped from its Agenda. ICAI is developing a Guidance Note on the subject.

3. Indian Accounting Standard on *Agriculture* (Corresponding to IAS 41)

As per IFRS

IAS 41, *Agriculture,* requires measurement of biological assets, viz., living animals and plants at fair value and recognizing gains and losses arising on such measurement in profit or loss, unless ascertainment of fair value is unreliable.

Carve out

It has been decided to revise the Standard and not to issue the standard as it is.

Reasons

(i) There is difficulty in identifying the attributes of biological assets, the cost of fair valuation, and high volatility of significant qualitative factors (not within the control of the entity) leads to greater subjectivity in estimating fair value.

(ii) The quoted market price for bearer biological assets (e.g. long-term assets that produce each year such as tea, coffee, rubber and palm oil trees) is not easily available, since these are not traded in the open market.

8.4 SUMMARY

The Institute of Chartered Accountants of India (ICAI) aims to bring out the differences between the IFRSs as applicable on 1st April, 2011 and the corresponding Indian Accounting Standards (Ind ASs) placed by the Ministry of Corporate Affairs (MCA), Government of India, on its website after recommendation of the same by the National Advisory Committee on Accounting Standards (NACAS) and the ICAI.

MCA received feedback regarding the adverse consequences which may ensue to the Indian companies in the event of immediate adoption of the IFRIC 12. Hence, MCA decided that Appendix A to Ind AS 11, corresponding to IFRIC 12, *Service Concession Arrangements* should be deferred and the same may be examined and applied with or without modification later.

MCA is of view that the standard is open-ended offering freedom to companies to follow virtually any policy they like. The standard does not prescribe any standardization. In such circumstances, the standard does not serve any useful purpose and may create a wrong impression in the mind of the stakeholders that the entity concerned has complied with a strict standard when in fact, the company is free to apply any accounting treatment it wants. This may even be counter productive from a regulatory point of view by giving a false sense of correctness.

8.5 GLOSSARY

- **IFRS-** International financial reporting standard
- **IFRIC-** International financial reporting interpretation committee
- **Ind AS-** Indian Accounting Standard
- **Ind AS 40-** Indian Accounting Standard that deals with Investment Property
- **Ind AS 33-** Indian Accounting Standard that deals with Earnings per Share

8.6 SELF ASSESSMENT QUESTIONS

Q1. Explain the Ind AS 33.

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Q2. Explain the Ind AS 34.

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Q3. Explain the Ind AS 40.

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8.7 EXAMINATION ORIENTED QUESTIONS

1. Give the definition of previous GAAP under IAS 101 *First-time Adoption of Indian Accounting Standards.*

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2. *Differentiate between IFRS and Ind AS.*

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3. Discuss in detail the IAS 21-The Effects of Changes in Foreign Exchange Rates

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8.8 SUGGESTED READINGS

- Barnea, A. Ronen, J. and Sadan, J. (1976). Classificatory Smoothing of Income with Extraordinary Items. *The Accounting Review.*
- Copenland, R. M. (1968). Income Smoothing. *Journal of Accounting Research*.
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FINANCIAL REPORTING STANDARDS

INTERNATIONAL FINANCIAL REPORTING STANDARDS ISSUED BY THE IASB

9.1 INTRODUCTION

9.2 OBJECTIVES

9.3 INTERNATIONAL FINANCIAL REPORTING STANDARDS ISSUED BY IASB

9.4 SUMMARY

9.5 GLOSSARY

9.6 SELF ASSESSMENT QUESTIONS

9.7 EXAMINATION ORIENTED QUESTIONS

9.8 SUGGESTED READINGS

9.1 INTRODUCTION

International Financial Reporting Standards, usually called IFRS are standards issued by the IFRS Foundation and the International Accounting Standard Board (IASB) to provide a common global language for business affairs so that company accounts are understandable and comparable across international boundaries. They are a consequence of growing international shareholding and trade and are particularly important for companies that have dealings in several countries. They are progressively replacing the many different national accounting standards. They are the rules to be followed by accountants to maintain books of accounts which are comparable, understandable, reliable and relevant as per the users internal or external. IFRS, with the exception of IAS 29 Financial Reporting in Hyperinflationary Economies and IFRIC 7 Applying the Restatement Approach under IAS 29, are authorized in terms of the historical cost paradigm. IAS 29 and IFRIC 7 are authorized in terms of the units of constant purchasing power paradigm. IAS 2 is related to inventories in this standard we talk about the stock its production process etc IFRS began as an attempt to harmonize accounting across the European Union but the value of harmonization quickly made the concept attractive around the world.

9.2 OBJECTIVES

After going through this lesson, the students will be able to understand the international financial reporting standards (IFRS) issued by IASB.

9.3 INTERNATIONAL FINANCIAL REPORTING STANDARDS ISSUED BY IASB

The various IFRS issued by IASB are outlined below:

IFRS 1: First- time Adoption

A first-time adopter is an entity that adopts IFRS for the first time as a basis for preparing its general purpose financial statements. An entity can said to be a first-time adopter if, in the preceding year, a set of IFRS are not available to owners or external parties such as investors or creditors. If a set of IFRS financial statements was to made available to owners or external parties in the preceding year, then the entity will already be considered to be on IFRSs, and IFRS 1 does not apply. The main objectives of IFRS is to set out the procedures that an entity must follow when it adopts IFRSs for the first time as the basis for preparing its general purpose financial statements. The IFRS grants limited exemptions from the general requirement to comply with each IFRS effective at the end of its first IFRS reporting period. An entity can also be a first-time adopter if, in the preceding year, its financial statements: asserted compliance with some but not all IFRSs, or included only a reconciliation of selected figures from previous GAAP to IFRSs.

Important Adjustments at the time of first-time adoption

Eliminate previous-GAAP assets and liabilities

The entity should eliminate previous-GAAP assets and liabilities from the opening balance sheet if they do not qualify for recognition under IFRSs. For example:

- IAS 38 does not permit recognition of expenditure on any of the following as an intangible asset:
- Research
- advertising and promotion
- training
- start-up, pre-operating, and pre-opening costs
- moving and relocation

Recognition of contingent assets and accrual liabilities should also be excluded in the opening IFRS balance Sheet.

Recognition of some assets and liabilities not recognised under previous GAAP

Conversely, the entity should recognise all assets and liabilities that are required to be recognised by IFRS even if they were never recognised under previous GAAP.

Reclassification

The entity should reclassify previous-GAAP opening balance sheet items into the appropriate IFRS classification. Examples:

- IAS 10 does not permit classifying dividends declared or proposed after the balance sheet date as a liability at the balance sheet date. If such liability was recognised under previous GAAP it would be reversed in the opening IFRS balance sheet.

- If the entity's previous GAAP had allowed treasury stock (an entity's own shares that it had purchased) to be reported as an asset, it would be reclassified as a component of equity under IFRS.

- Items classified as identifiable intangible assets in a business combination accounted for under the previous GAAP may be required to be reclassified as goodwill under IFRS 3 because they do not meet the definition of an intangible asset under IAS 38. The converse may also be true in some cases.

- IAS 32 has principles for classifying items as financial liabilities or equity. Thus mandatorily redeemable preferred shares that may have been classified as equity under previous GAAP would be reclassified as liabilities in the opening IFRS balance sheet.

  It must be noted that IFRS 1 makes an exception from the "split-accounting" provisions of IAS 32. If the liability component of a compound financial instrument is no longer outstanding at the date of the opening IFRS balance sheet, the entity is not required to reclassify out of retained earnings and into other equity the original equity component of the compound instrument.

- The reclassification principle would apply for the purpose of defining reportable segments under IFRS 8.

- The scope of consolidation might change depending on the consistency of the previous GAAP requirements to those in IAS 27. In some cases, IFRS will require consolidated financial statements where they were not required before.
- Some offsetting (netting) of assets and liabilities or of income and expense items that had been acceptable under previous GAAP may no longer be acceptable under IFRS.

Disclosures in the financial statements of a first-time adopter

IFRS 1 requires disclosures that explain how the transition from previous GAAP to IFRS affected the entity's reported financial position, financial performance and cash flows. This includes:

i. Matching of equity reported under previous GAAP to equity under IFRS both (a) at the date of the opening IFRS balance sheet and (b) the end of the last annual period reported under the previous GAAP.

ii. reconciliations of total comprehensive income for the last annual period reported under the previous GAAP to total comprehensive income under IFRSs for the same period.

iii. explanation of material adjustments that were made, in adopting IFRSs for the first time, to the balance sheet, income statement and cash flow statement.

iv. if errors in previous GAAP financial statements were discovered in the course of transition to IFRSs, those must be separately disclosed.

v. if the entity recognised or reversed any impairment losses in preparing its opening IFRS balance sheet, these must be disclosed.

vi. appropriate explanations if the entity has elected to apply any of the specific recognition and measurement exemptions permitted under IFRS 1 – for instance, if it used fair values as deemed cost

Optional exemptions from the basic measurement principle in IFRS 1

There are some basic optional exemptions to the general restatement and measurement principles. The following exceptions are individually optional. They relate to:

- business combinations
- and a number of others
- share-based payment transactions
- insurance contracts
- fair value or revaluation as deemed cost
- leases
- employee benefits
- cumulative translation differences
- investments in subsidiaries, jointly controlled entities, associates and joint ventures
- assets and liabilities of subsidiaries, associated and joint ventures
- compound financial instruments
- designation of previously recognised financial instruments
- fair value measurement of financial assets or financial liabilities at initial recognition

- decommissioning liabilities included in the cost of property, plant and equipment
- financial assets or intangible assets accounted for in accordance with IFRIC 12 Service Concession Arrangements borrowing costs
- transfers of assets from customers
- extinguishing financial liabilities with equity instruments
- severe hyperinflation
- joint arrangements

IFRS 2: Share-based Payment

A share-based payment may be defined as a transaction in which an entity acquires goods or services either as consideration for its equity instruments or by incurring liabilities for amounts based on the price of the entity's shares or other equity instruments of the entity. In accounting share-based payment depends on how the transaction will be settled.

IFRS 2 came in to force, in February 2004 and first applied to annual periods beginning on or after 1 January 2005. It generally applies to all entities. There is no exemption for private or smaller entities. It does not apply to share-based payment transactions other than for the acquisition of goods and services. Share dividends, the purchase of treasury shares, and the issuance of additional shares are therefore outside its scope. It requires an entity to recognise share-based payment transactions in its financial statements, including transactions with employees or other parties to be settled in cash, other assets, or equity instruments of the entity.

IFRS 3 Business combinations:

A business combination is a transaction or event in which an acquirer obtains control of one or more businesses. There is some disagreement on the precise meaning of various terms relating to the forms of business combinations, viz; merger, amalgamation, absorption, consolidation, acquisition, takeover, etc. Sometimes, these terms are used interchangeably, in broad sense even when there are legal distinctions between the kinds of combinations. We have discussed these terms in the following pages keeping in mind the relevant legal framework in India.

(a) Merger or Amalgamation

A merger is a combination of two or more companies into one company. It may be in the form of one or more companies being merged into an existing company or a new company may be formed to merge two or more existing companies. The Income Tax Act, 1961 of India uses the term 'amalgamation' for merger.

According to Section 2 (IA) of the Income Tax Act, 1961, the term amalgamation means the merger ? one or more companies with another company or merger of two or more companies to form one company in such a manner that:

(i) all the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of the amalgamation.

(ii all the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of the amalgamation.

(iii) Shareholders holding not less than nine—tenths in value of the shares in the amalgamating company or companies (other than shares already held therein immediately before the amalgamation by or by a nominee for, the amalgamated company by virtue of the amalgamation.

Thus, merger or amalgamation may take any of the two forms:

(i) merger or amalgamation through absorption.

(ii) merger or amalgamation through consolidation.

(i) **Absorption:** A combination of two or more companies into an existing company is known as 'absorption.' In a merger through absorption all companies except onego into liquidation and lose their separate indentities. Suppose, there are two companies, A Ltd. and B Ltd, Company B Ltd. is merged into A Ltd. leaving its assets and liabilities to the acquiring company A Ltd; and company B Ltd. is liquidated. It is a case of absorption. An example of this type of merger in India is the absorption of Reliance Polyproplene Ltd. (RPPL) by Reliance Industries Ltd. As a result of the absorption, the RPPL was liquidated and its shareholders were offered 20 shares of RR. for every 100 shares of RPPL held by them.

(ii) **Consolidation:** A consolidation is a combination of two or more companies into a new company. In this form of merger, all the existing companies, which combine, go into liquidation and form a new company with a different entity. The entity of consolidaitng corporations is lost and their assets and liabilities are take over by the new corporation or company. The assets of old concerns are sold to the new concern and their management and control also passes into the hands of the new concern. Suppose, there are two companies called A Ltd. and B. Ltd ; and they merge together to form a mew company called AB Ltd. or C Ltd; it is a case of \ consolidation. The term 'consolidation' is also, sometimes used as 'amalgamation.' However, a merger through absorption may be distinguished from a merger through consolidation. One concern acquires the business of I another concern without forming a new company in the case of an absorption whereas a new concern is formed \ by the union of two or more concerns in case of consolidation. Consolidation, generally, takes place between ' two equal—size concerns and the size of concerns considerably differs in case of a merger through absorption.

Generally a small concern is merged with a big concern. Though both the terms are used interchangeably. The methods and problems of financing mergers through absorption and consolidations are also similar.'

(b) Acquisition and Take—Over: An essential feature of merger through absorption as well as consolidation is the combination of the companies. The acquiring company takes over the ownership of one or more other companies and combine their operations. However, an acquisition does not involve combination of companies. It is simply an act of acquiring control over management of other companies. The control over management of another company can be acquired through either a 'friendly take—over' or through 'forced' or 'unwilling acquisition'. When a company takes—over the control of another company through mutual agreement, it is called acquisition or friendly take—over. On the other hand, if the control is acquired through unwilling acquisition, i.e., when the take—over is opposed by the 'target' company it is known as hostile take —over.

IFRS 3 does not apply to the formation of a joint venture, combinations of entities or businesses under common control. The IASB added to its agenda a separate agenda project on common control transactions in December 2007. Also, IFRS 3 does not apply to the acquisition of an asset or a group of assets that do not constitute a business.

IFRS 4 : Insurance Contracts

A fire insurance is a contract under which the insurer in return for a consideration (premium) agrees to indemnify the insured for the financial loss which the latter may suffer due to destruction of or damage to property or goods, caused by fire, during a specified period. The contract specifies the maximum amount, agreed to by the parties at the time of the contract, which the insured can claim in case of loss. This amount is not , however , the measure of the loss. The loss can be ascertained only after the fire has occurred. The insurer is liable to make good the actual amount of loss not exceeding the maximum amount fixed under the policy.

A fire insurance policy cannot be assigned without the permission of the insurer because the insured must have insurable interest in the property at the time of contract as well as at the time of loss. The insurable interest in goods may arise out on account of (i) ownership, (ii) possession, or (iii) contract. A person with a limited interest in a property or goods may insure them to cover not only his own interest but also the interest of others in them.

Types of Fire Insurance Policies:-

- **Specific policy**:- is a policy which covers the loss up to a specific amount which is less than the real value of the property. The actual value of the property is not taken into consideration while determining the amount of indemnity. Such a policy is not subject to 'average clause'. 'Average clause' is a clause by which the insured is called upon to bear a portion of the loss himself.

- **Comprehensive policy**:- is also known as 'all in one' policy and covers risks like fire, theft, burglary, third party risks, etc. It may also cover loss of profits during the period the business remains closed due to fire.

- **Valued policy**:- is a departure from the contract of indemnity. Under it the insured can recover a fixed amount agreed to at the time the policy is taken. In the event of loss, only the fixed amount is payable, irrespective of the actual amount of loss.

- **Floating policy**:- is a policy which covers loss by fire caused to property belonging to the same person but located at different places under a single sum and for one premium. Such a policy might cover goods lying in two warehouses at two different locations. This policy is always subject to 'average clause'.

- **Replacement or Re-instatement policy**:- is a policy in which the insurer inserts a re-instatement clause, whereby he undertakes to pay the cost of replacement of the property damaged or destroyed by fire. Thus, he may re-instate or replace the property instead of paying cash. In such a policy, the insurer has to select one of the two alternatives, i.e. either to pay cash or to replace the property, and afterwards he cannot change to the other option.

Accounting policies

The IFRS exempts an insurer temporarily from some IFRS requirements such as the requirement to consider IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors in selecting accounting policies for insurance contracts. However, the standard: prohibits provisions for possible claims under contracts that are not in existence at the reporting date. It requires a test for the adequacy of recognised insurance liabilities and an impairment test for reinsurance assets. IFRS 4 requires an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and prohibits offsetting insurance liabilities against related reinsurance assets and income or expense from reinsurance contracts against the expense or income from the related insurance contract

IFRS 4 permits an insurer to change its accounting policies for insurance contracts only if, as a result, its financial statements present information that is more relevant and no less reliable, or more reliable and no less relevant.

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations:

IFRS 5 was issued in March 2004 and applies to annual periods beginning on or after 1 January 2005. This IFRS outlines how to account for non-current assets held for sale. In general terms, assets held for sale are not depreciated, are measured at the lower of carrying amount and fair value less costs to sell, and are presented separately in the balance sheet. Specific disclosures are also required for discontinued operations and disposals of non-current assets.

IFRS 6 Exploration for and Evaluation of Mineral Resources:

IFRS 6 was issued in December 2004 and applies to annual periods beginning on or after 1 January 2006. Exploration for and evaluation of mineral resources mean the search for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources after the entity has obtained legal rights to explore in a specific area, as well as the determination of the technical feasibility and commercial viability of extracting the mineral resource. Exploration and evaluation expenditures are expenditures incurred in connection with the exploration and evaluation of mineral resources before the technical feasibility and commercial viability of extracting a mineral resource is demonstrable.

IFRS 6 requires entities recognising exploration and evaluation assets to perform an impairment test on those assets when facts and circumstances suggest that the carrying amount of the assets may exceed their recoverable amount. IFRS 6 also provides guidance on how to identify cash-generating units.

IFRS 7 Financial Instruments:

IFRS 7 was originally issued in August 2005 and applies to annual periods beginning on or after 1 January 2007. This IFRS requires certain disclosures to be made by category of instrument based on measurement categories. Certain other disclosures are required by class of financial instrument. For such type of disclosures an entity must combine its financial instruments into classes of similar instruments as appropriate to the nature of the information presented.

The two main categories of disclosures required by IFRS 7 are:

1. information about the significance of financial instruments
2. information about the nature and extent of risks arising from financial instruments

Information about the significance of financial instruments:

Balance sheet

Disclose the significance of financial instruments for an entity's financial position and performance. This includes disclosures for each of the following categories:

i. financial assets measured at fair value through profit and loss, showing separately those held for trading and those designated at initial recognition

ii. held-to-maturity investments

iii. loans and receivables

iv. available-for-sale assets

v. financial liabilities at fair value through profit and loss

vi. financial liabilities measured at amortised cost

Nature and extent of exposure to risks arising from financial instruments

Qualitative disclosures

- The qualitative disclosures describe
- risk exposures for each type of financial instrument
- management's objectives, policies, and processes for managing those risks
- changes from the prior period

Quantitative disclosures

- The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel. These disclosures include:
- summary quantitative data about exposure to each risk at the reporting date
- disclosures about credit risk, liquidity risk, and market risk and how these risks are managed as further described below
- concentrations of risk

Credit Risk

Credit risk is the risk that one party will cause a loss for the other party by failing to pay for its obligation.

Disclosures about credit risk include:

- maximum amount of exposure, description of collateral, information about credit quality of financial assets that are neither past due nor impaired, and information about credit quality of financial assets whose terms have been renegotiated
- for financial assets that are past due or impaired, analytical disclosures are required
- information about collateral

Liquidity Risk

Liquidity risk is the risk that an entity will have difficulties in paying its financial liabilities.

Disclosures about liquidity risk include:

- a maturity analysis of financial liabilities
- description of approach to risk management

Market Risk

Market risk reflects interest rate risk, currency risk and other price risks.

Disclosures about market risk include:

- a sensitivity analysis of each type of market risk to which the entity is exposed
- additional information if the sensitivity analysis is not representative of the entity's risk exposure

IFRS 8 Operating Segments:

IFRS 8 was issued in November 2006 and applies to annual periods beginning on or after 1 January 2009. It requires particular classes of entities to disclose information about their operating segments, products and services, the geographical areas in which they operate, and their major customers. IFRS 8 applies to the separate or individual financial statements of an entity whose debt or equity instruments are traded in a public market or that files, or is in the process of filing, its (consolidated) financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market .

However, when both separate and consolidated financial statements for the parent are presented in a single financial report, segment information need be presented only on the basis of the consolidated financial statements

IFRS 8 requires an entity to report financial and descriptive information about its reportable segments.

Disclosure requirements

Required disclosures include:

- ➢ basic information about how the entity identified its operating segments
- ➢ information about the types of products and services from which each operating segment derives its revenues
- ➢ information about the reported segment profit or loss and the basis of measurement
- ➢ reported segment profit or loss, segment assets, segment liabilities and other material items to corresponding items in the entity's financial statements
- ➢ entity-wide disclosures that are required even when an entity has only one reportable segment, including information about each product and service or groups of products and services
- ➢ analyses of revenues and certain non-current assets
- ➢ information about transactions with major customers

IFRS 9 Financial Instruments:

IFRS 9 was originally issued in November 2009, reissued in October 2010, and applies to annual periods beginning on or after 1 January 2015. IFRS 9 sets out the recognition and measurement requirements for financial instruments and some contracts to buy or sell non-financial items. IFRS 9 is a 'work in progress' and will eventually replace IAS 39 in its entirety.

Under IFRS 9, all financial instruments are initially measured at fair value. IFRS 9 divides all financial assets that are currently in the scope of IAS 39 into two classifications - those measured at amortised cost and those measured at fair value. It doesn't change the basic accounting model for financial liabilities under IAS 39. Two measurement categories continue to exist: fair value through profit or loss (FVTPL) and amortised cost. Financial liabilities held for trading are measured at FVTPL, and all other financial liabilities are measured at amortised cost unless the fair value option is applied.

IFRS 10 Consolidated Financial Statements:

IFRS 10 was issued in May 2011 and applies to annual periods beginning on or after 1 January 2013. It outlines the requirements for the preparation and presentation of consolidated financial statements, requiring entities to consolidate entities it controls. The main objective of IFRS 10 is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.

The Standard:

- requires a parent entity to present consolidated financial statements
- defines the principle of control, and establishes control as the basis for consolidation
- set out how to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee

- sets out the accounting requirements for the preparation of consolidated financial statements
- defines an investment entity and sets out an exception to consolidating particular subsidiaries of an investment entity*.

IFRS 11 Joint Arrangements:

IFRS 11 is applicable to annual reporting periods beginning on or after 1 January 2013. IFRS 11 outlines the accounting by entities that jointly control an arrangement. There are no disclosures specified in IFRS 11. Instead, IFRS 12 Disclosure of Interests in Other Entities outlines the disclosures required.

The term joint arrangement is defined as an arrangement in which two or more parties have joint control. A joint arrangement is either a joint operation or a joint venture.

A joint arrangement has the following characteristics:

- there is a contractual arrangement between two or parties, and
- the contractual arrangement gives two or more parties joint control of the arrangement.

Joint Control

Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

Types of Joint Arrangements

Joint arrangements are either joint operations or joint ventures:

- A **joint operation** is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. Those parties are called joint operators.

- A **joint venture** is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Those parties are called joint venturers.

IFRS 12 Disclosure of Interests in Other Entities:

IFRS 12 was issued in May 2011 and applies to annual periods beginning on or after 1 January 2013. IFRS 12 deals with consolidated disclosure standard which requires a wide range of disclosures about an entity's interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. The main objective of IFRS 12 is to require the disclosure of information that enables users of financial statements to evaluate-

- the type and nature of risks associated with its interests in other entities, and
- the effects of those interests on its financial position, financial performance and cash flows.

IFRS 12 is required to be applied by an entity that has an interest in any of the following:

- subsidiaries
- joint arrangements (joint operations or joint ventures)
- associates
- unconsolidated structured entities

This IFRS 12 does not apply to certain employee benefit plans, certain interests in joint ventures held by an entity that does not share in joint control, and the majority of interests in another entity accounted for in accordance with IFRS 9 Financial Instruments.

IFRS 13 Fair Value Measurement :

IFRS 13 was originally issued in May 2011 and applies to annual periods beginning on or after 1 January 2013. IFRS 13 applies to IFRSs that permits fair value measurements or disclosures and provides a single IFRS framework for measuring fair value and requires disclosures about fair value measurement.

Objective

- To set a single IFRS a framework for measuring fair value, and
- To disclosures about fair value measurements.

IFRS 14 Regulatory Deferral Accounts

IFRS 14 was originally issued in January 2014 and applies to an entity's first annual IFRS financial statements for a period beginning on or after 1 January 2016. This IFRS permits an entity which is a first-time adopter of International Financial Reporting Standards to continue to account, with some limited changes, for 'regulatory deferral account balances' in accordance with its previous GAAP, both on initial adoption of IFRS and in subsequent financial statements. Regulatory deferral account balances, and movements in them, are presented separately in the statement of financial position and statement of profit or loss and other comprehensive income, and specific disclosures are required.

IFRS 15 was issued in May 2014 and applies to an annual reporting period beginning on or after 1 January 2018. On 12 April 2016, clarifying amendments were issued that have the same effective date as the standard itself. This IFRS specifies how and when an IFRS reporter will recognise revenue as well as requiring such entities to provide users of financial statements with more informative, relevant disclosures. The standard provides a single, principles based five-step model to be applied to all contracts with customers.

IFRS 16 Lease Accounting

IFRS 16 was issued in January 2016 and applies to annual reporting periods beginning on or after 1 January 2019. IFRS 16 specifies how an IFRS reporter will recognise, measure, present and disclose leases. The standard provides a single lessee accounting model, requiring lessees to recognise assets and liabilities for all leases unless the lease term is 12 months or less or the underlying asset has a low value.

Lessors continue to classify leases as operating or finance, with IFRS 16's approach to lessor accounting substantially unchanged from its predecessor, IAS 17.

IFRS 17 Insurance Contracts

IFRS 17 was issued in May 2017 and applies to annual reporting periods beginning on or after 1 January 2021. IFRS 17 establishes the principles for the recognition, measurement, presentation and disclosure of insurance contracts within the scope of the standard. The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents those contracts. This information gives a basis for users of financial statements to assess the effect that insurance contracts have on the entity's financial position, financial performance and cash flows.

9.4 SUMMARY

In short, International Financial Reporting Standards are the standards issued by the IFRS Foundation and the International Accounting Standard Board (IASB) to provide a common global language for business affairs so that company accounts are understandable and comparable across international boundaries. They are a consequence of growing international shareholding and trade and are particularly important for companies that have dealings in several countries. They are progressively replacing the many different national accounting standards. They are the rules to be followed by accountants to maintain books of accounts which are comparable, understandable, reliable and relevant as per the users internal or external. IFRS, with the exception of IAS 29 Financial Reporting in Hyperinflationary Economies and IFRIC 7 Applying the Restatement Approach under IAS 29, are authorized in terms of the historical cost paradigm. IAS 29 and IFRIC 7 are authorized in terms of the units of constant purchasing power paradigm. IAS 2 is related to inventories in this standard we talk about the stock its production process etc IFRS began as an attempt to harmonize accounting across the European Union but the value of harmonization quickly made the concept attractive around the world. However, it has been debated whether or not de facto harmonization has occurred. Standards that were issued by IASC (the predecessor of IASB) are still within use today and go by the name International Accounting Standards (IAS), while standards issued by IASB are called IFRS.

9.5 GLOSSARY

- **Share-based Payment-** A transaction in which an entity acquires goods or services either as consideration for its equity instruments or by incurring liabilities for amounts based on the price of the entity's shares or other equity instruments of the entity.

- **Joint operation** - A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.

- **Joint venture-** A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

- **Joint control-** The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

- **Credit risk-** The risk that one party will cause a loss for the other party by failing to pay for

- **Liquidity Risk-** The risk that an entity will have difficulties in paying its financial liabilities.

9.6 SELF ASSESSMENT QUESTIONS

Q.1 Discuss briefly the IFRS 8 (Operating segments).

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Q.2 Explain IFRS 6 Exploration for and Evaluation of Mineral Resources.

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Q.3 Explain briefly IFRS 3 (Business Combination).

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9.7 EXAMINATION ORIENTED QUESTIONS

1. Discuss the main categories of disclosures required by IFRS 7.

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2. Discuss the basic provisions of IFRS 5 relating to assets held for sale.

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3. Explain the disclosure requirement of IFRS 4 relating to insurance contracts.

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4. Explain briefly the various IFRS issued by IASB.

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9.8 SUGGESTED READINGS

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FINANCIAL REPORTING STANDARDS

STRUCTURE OF IFRS; PROCESS OF IFRS; PROBLEMS IN UNDERSTANDING AND APPLICATION OF IFRS; IFRS ADOPTION OR CONVERGENCE IN INDIA

10.1 INTRODUCTION

10.2 OBJECTIVES

10.3 STRUCTURE OF IFRS

10.4 PROCESS OF IFRS

10.5 PROBLEMS IN UNDERSTANDING AND APPLICATION OF IFRS

10.6 IFRS ADOPTION OR CONVERGENCE IN INDIA

10.7 BENEFICIARIES OF CONVERGENCE WITH IFRS IN INDIA

10.8 SUMMARY

10.9 GLOSSARY

10.10 SELF ASSESSMENT QUESTIONS

10.11 EXAMINATION ORIENTED QUESTIONS

10.12 SUGGESTED READINGS

10.1 INTRODUCTION

International Financial Reporting Standards (IFRS) set common rules so that financial statements can be consistent, transparent and comparable around the world. IFRS are issued by the International Accounting Standards Board (IASB). They specify how companies must maintain and report their accounts, defining types of transactions and other events with financial impact. IFRS were established to create a common accounting language, so that businesses and their financial statements can be consistent and reliable from company to company and country to country.

10.2 OBJECTIVES

After going through this lesson, you will be able to understand-

- structure of IFRS;
- process of IFRS;
- problems in understanding and application of IFRS; and
- IFRS adoption or convergence in India.

10.3 STRUCTURE OF IFRS

The International Accounting Standards Board (IASB) is organised under an independent foundation named the IFRS Foundation. The Foundation is a not-for-profit corporation which was created under the laws of the State of Delaware, United States of America, on 8 March 2001. The components of the overall structure of the IFRS Foundation are set out below. The obligations and high-level operating procedures for most components are established under the IFRS Foundation Constitution.

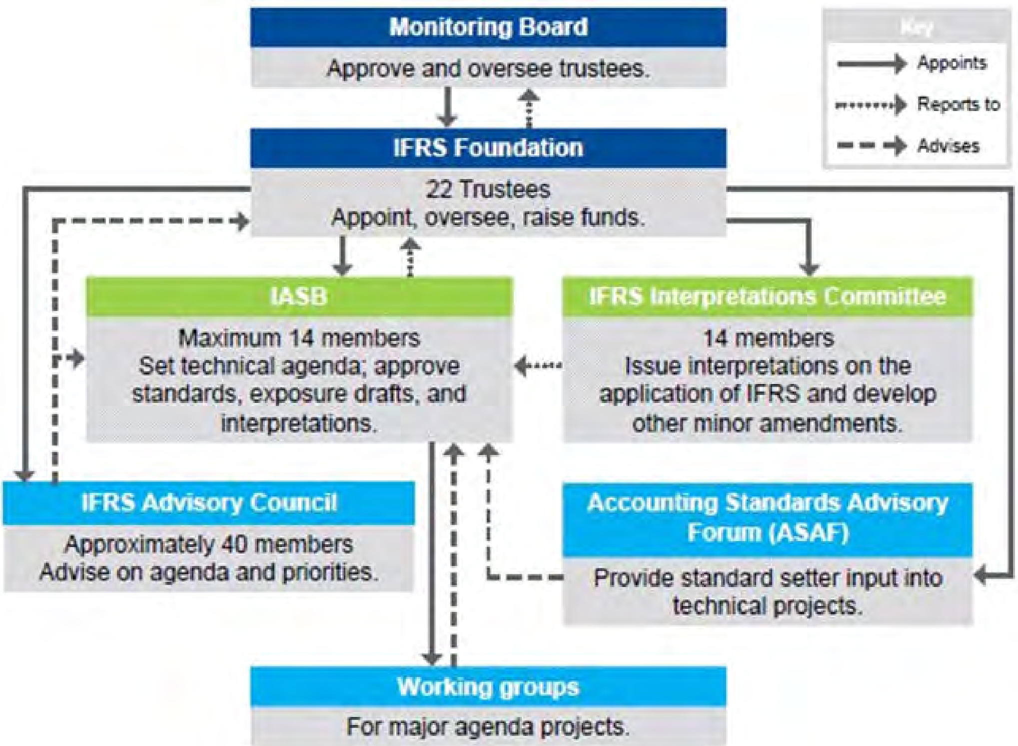
STRUCTURE OF IFRS

Group	Role	Formed
Governance		
IFRS Foundation	Oversees the work of the IASB, the structure, and strategy, and has fund raising responsibility.	8 March 2001
Due Process Oversight Committee (DPOC)	Trustee committee responsible for the Trustee's oversight function under the IFRS Foundation Constitution.	2006
Monitoring Board	Oversees the IFRS Foundation Trustees, participates in the Trustee nomination process, and approves appointments to the Trustees.	1 February 2009
Technical		
International Accounting Standards Board (IASB)	Sole responsibility for establishing International Financial Reporting Standards (IFRSs).	1 April 2001 (1)
IFRS Interpretations Committee (2)	Develops interpretations for approval by the IASB, and undertakes under tasks at the request of the IASB	1 April 2001 (2)
Working groups	Expert task forces for individual agenda projects	Formed as needed
Advisory		
Accounting Standards Advisory Forum (ASAF)	Advises on the technical standard-setting activities of the IASB	Announced 1 February 2013
IFRS Advisory Council (3)	Advises the IASB and the IFRS Foundation	25 June 2001

Specialised Advisory Groups	Capital Markets Advisory Committee (4)	2003
	Effects Analyses Con sultative Group	2012
	Emerging Economies Group .	26 July 2011
	Financial Crisis Advisory Group (jointly with FASB)	30 December 2008
	Global Preparers Forum	
	IFRS Taxonomy Con sultative Group	29 April 2014
	Joint Tran sition Resource Group for Revenue Recog - nition	June 2014
	SME Implemen tation Group (SMEIG)	2010
	Transition Resource Group for Im pairment of Financial In struments	August 2014
	Transition Resource Group for IFRS 17	September 2017

1. The IASB replaced the IASC Board of the International Accounting Standards Committee (IASC) with effect from this date. The IASC was formed in 1973.

2. Until 31 March 2010, the IFRS In-ter-pre-ta-tions Committee was named the International Financial Reporting In-ter-pre-ta-tions Committee (IFRIC). IFRIC replaced the Standards In-ter-pre-ta-tions Committee (SIC) of the IASC with effect from 1 April 2001. The SIC was part of the original IASC structure formed in 1973.



3. Until 31 March 2010, the IFRS Advisory Council was named the Standards Advisory Council (SAC).

4. Formerly the Analyst Rep-re-sen-ta-tive Group (ARG).

10.4 PROCESS OF IFRS

The Standard Setting Process of International Financial Reporting Standards (IFRSs) are developed through an international consultation process, the "due process", which involves interested individuals and organisations from around the world. The due process comprises six stages, with the Trustees of the IFRS Foundation having the opportunity to ensure compliance at various points throughout:

1. Setting the agenda

2. Planning the project

3. Developing and publishing the discussion paper

4. Developing and publishing the exposure draft

5. Developing and publishing the standard

6. After the standard is issued

1. **Setting the agenda :** The IASB, by developing high quality financial reporting standards, seeks to address a demand for better quality information that is of value to those users of financial reports. When deciding whether a proposed agenda item will address users' needs the IASB considers: The relevance to users of the information and the reliability of information that could be provided, Existing guidance available, The possibility of increasing convergence, The quality of the IFRS to be developed, Resource constraints. To help the IASB in considering its future agenda, its' staff is asked to identify, review and raise issues that might warrant the IASB's attention. New issues may also arise from a change in the IASB's Conceptual Framework for Financial Reporting. In addition, the IASB raises and discusses potential agenda items in the light of comments from other standard-setters and other interested parties, the IFRS Advisory Council and the IFRS Interpretations Committee, and staff research and other recommendations.

2. **Planning the Project :** When adding an item to its active agenda, the IASB decides whether to conduct the project alone or jointly with another standard-setter. Similar due process is followed under both approaches. When considering whether to add an item to its active agenda, the IASB may determine that it meets the criteria to be included in the annual improvements process. The IASB assesses the issue against criteria such as Clarifying, Correcting, Well defined and sufficiently narrow in scope that the consequences of the proposed change have been considered, Completed on a timely basis, All criteria must be met to qualify for inclusion in annual improvements. Once this assessment is made, the amendments

included in the annual improvements process will follow the same due process as other IASB projects. The primary objective of the annual improvements process is to enhance the quality of IFRSs by amending existing IFRSs to clarify guidance and wording, or correcting for relatively minor unintended consequences, conflicts or oversights. After considering the nature of the issues and the level of interest among constituents, the IASB may establish a working group at this stage and a project team for the project will be selected. The project manager draws up a project plan under the supervision of the directors of the technical staff and the project team may also include members of staff from other accounting standard-setters, as deemed appropriate by the IASB.

3. **Developing and publishing the discussion paper :** A discussion paper is not a mandatory step in the IASB's due process. Normally the IASB publishes a discussion paper as its first publication on any major new topic as a vehicle to explain the issue and solicit early comment from constituents. If the IASB decides to omit this step, it will state its reasons. Typically, a discussion paper includes a comprehensive overview of the issue, possible approaches in addressing the issue, the preliminary views of its authors or the IASB, and an invitation to comment. This approach may differ if another accounting standard-setter develops the research paper. Discussion papers may result either from a research project being conducted by another accounting standard-setter or as the first stage of an active agenda project carried out by the IASB. If research has been performed by another accounting standard-setter, issues related to the discussion paper are discussed in IASB meetings, and publication of such a paper requires a simple majority vote by the IASB. If the discussion paper includes the preliminary views of other authors, the IASB reviews the draft discussion paper to ensure that its analysis is an appropriate basis on which to invite public comments. For discussion papers on agenda items that are under the IASB's direction, or include the IASB's preliminary views, the IASB develops the paper or

its views on the basis of analysis drawn from staff research and recommendations, as well as suggestions made by the IFRS Advisory Council, working groups and accounting standard-setters and presentations from invited parties. All discussions of technical issues related to the draft paper take place in public sessions. When the draft is completed and the IASB has approved it for publication the discussion paper is published to invite public comment. The IASB normally allows a period of 120 days for comment on a discussion paper, but may allow a longer period on major projects (which are those projects involving pervasive or difficult conceptual or practical issues). After the comment period has ended the project team analyses and summarises the comment letters for the IASB's consideration. Comment letters are posted on the IASB's website.

4 **Developing and publishing the exposure draft:** Publication of an exposure draft is a mandatory step in due process. An exposure draft is the IASB's main vehicle for consulting the public. Unlike a discussion paper, an exposure draft sets out a specific proposal in the form of a proposed IFRS (or amendment to an IFRS). The development of an exposure draft begins with the IASB considering issues on the basis of staff research and recommendations, as well as comments received on any discussion paper, and suggestions made by the IFRS Advisory Council, working groups and accounting standard-setters and arising from public education sessions. After resolving issues at its meetings, the IASB instructs the staff to draft the exposure draft. When the draft has been completed, and the IASB has balloted on it, with a minimum of nine votes necessary to publish an exposure draft, the IASB publishes it for public comment. An exposure draft contains an invitation to comment on a draft IFRS, or draft amendment to an IFRS, that proposes requirements on recognition, measurement and disclosures. The draft may also include mandatory application guidance and implementation guidance, and will be accompanied by a basis for conclusions on the proposals and the alternative views of

dissenting IASB members (if any). The IASB normally allows a period of 120 days for comment on an exposure draft. If the matter is exceptionally urgent, the document is short, and the IASB believes that there is likely to be a broad consensus on the topic, the IASB may consider a comment period of no less than 30 days, but it will set such a short period only after formally requesting and obtaining prior approval from 75 per cent of the Trustees. The project team collects, summarises and analyses the comments received for the IASB's deliberation. After the comment period ends, the IASB reviews the comment letters received and the results of other consultations. As a means of exploring the issues further, and soliciting further comments and suggestions, the IASB may conduct field visits, or arrange public hearings and round-table meetings. The IASB is required to consult the IFRS Advisory Council and maintains contact with various groups of constituents.

5. **Developing and publishing the standard :** The development of an IFRS is carried out during IASB meetings, when the IASB considers the comments received on the exposure draft. Changes from the exposure draft are posted on the website. After resolving issues arising from the exposure draft, the IASB considers whether it should expose its revised proposals for public comment, for example by publishing a second exposure draft. If the IASB decides that re-exposure is necessary, the due process to be followed is the same as for the first exposure draft As it moves towards completing a new IFRS or major amendment to an IFRS, the IASB prepares a project summary and feedback statement. These give direct feedback to those who submitted comments on the exposure draft, identify the most significant matters raised in the comment process and explain how the IASB responded to those matters. At the same time, the IASB prepares an analysis of the likely effects of the forthcoming IFRS or major amendment. The analysis will therefore attempt to assess the likely effects of the new IFRS on: The financial statements of those applying

IFRSs, The possible compliance costs for preparers, The costs of analysis for users (including the costs of extracting data, Identifying how the data have been measured and adjusting data for the purposes of including them in, for example, a valuation model, The comparability of financial information between reporting periods for an individual entity and between different entities in a particular reporting period, and The quality of the financial information and its usefulness in assessing the future cash flows of an entity. When the IASB is satisfied that it has reached a conclusion on the issues arising from the exposure draft, it instructs the staff to draft the IFRS. A pre-ballot draft is usually subject to external review, normally by the IFRS Interpretations Committee. Shortly before the IASB ballots the standard, a near-final draft is posted on its limited access website for paying subscribers. Finally, after the due process is completed, all outstanding issues are resolved, and the IASB members have balloted in favour of publication, the IFRS is issued, followed by publication of any project summary and feedback statement and any effect analysis.

6. **After the standard is issued :** After an IFRS is issued, IASB members and staff hold regular meetings with interested parties, including other standard-setting bodies, to help understand unanticipated issues related to the practical implementation and potential impact of its provisions. The IFRS Foundation also fosters educational activities to ensure consistency in the application of IFRSs. The IASB carries out a post-implementation review of each new IFRS or major amendment. This is normally carried out two years after the new requirements have become mandatory and been implemented. Such reviews are normally limited to important issues identified as contentious during the development of the pronouncement and consideration of any unexpected costs or implementation problems encountered. A review may also be prompted by: Changes in the financial reporting environment and regulatory requirements, Comments made by the IFRS Advisory Council, the IFRS

Interpretations Committee, standard-setters and constituents about the quality of the IFRS. The review may lead to items being added to the IASB's agenda. The IASB may also continue informal consultations throughout the implementation of the IFRS or amendment.

10.5 PROBLEMS IN UNDERSTANDING AND APPLICATION OF IFRS

IFRS are formulated by International Accounting Standard Board. However, the responsibility of convergence with IFRS vests with local government and accounting and regulatory bodies, such as the ICAI in India. Thus ICAI need to invest in infrastructure to ensure compliance with IFRS. India has several constraints and practical challenges to adoption and compliance with IFRS. So there is a need to change some laws and regulations governing financial accounting and reporting in India.

Therefore, there are several challenges and problems that will be faced by the organisations in understanding and applications of IFRS. These are :–

1. **Difference in GAAP and IFRS:**

   Adoption of IFRS means that the entire set of financial statements will be required to undergo a drastic change. The differences are wide and very deep routed. It would be a challenge to bring about awareness of IFRS and its impact among the users of financial statements.

2. **Training and education:**

   Lack of training facilities and academic courses on IFRS will also pose challenge in India. There is a need to impart education and training on IFRS and its application.

3. **Legal consideration:**

   Currently, the reporting requirements are governed by various regulators in India and their provisions override other laws. IFRS does not recognize such overriding laws. The regulatory and legal requirements in India will pose a challenge unless the same is been addressed by respective regulatory.

4. **Taxation effect:**

IFRS convergence would affect most of the items in the financial statements and consequently the tax liabilities would also undergo a change. Thus the taxation laws should address the treatment of tax liabilities arising on convergence from Indian GAAP to IFRS.

5. **Fair value measurement:**

IFRS uses fair value as a measurement base for valuing most of the items of financial statements. The use of fair value accounting can bring a lot of instability and prejudice to the financial statements. It also involves a lot of hard work in arriving at the fair value and valuation experts have to be used.

10.6 IFRS ADOPTION OR CONVERGENCE IN INDIA

To rationalize accounting practices in the country, the Indian government in 1949, established Institute of Chartered Accountants of India by passing ICAI Act, 1949. Accounting Standard Board was Constituted by ICAI in 1977 in order to create harmony among the diversified accounting policies and Practices in India. Three steps process was laid down by the accounting professionals in India which are Summarized as follows:

Step 1-IFRS Impact Assessment

This is the first step. In this step the firm will assess the impact of IFRS adoption on Accounting and Reporting issues, on procedures and systems, and on core business of the entities. Then the firm will find the key conversion dates according to IFRS training plan has laid down. As and when the training plan is in place, the firm will have to identify the important Financial Reporting

Standards which will apply to the firm and also the variations among the present financial reporting standards being followed by the firm and IFRS both.

Step 2-Preparations for IFRS Implementation

This is the second step of the process, which will carry out such activities required for IFRS implementation process. Then the firm will reform the internal reporting systems and processes. IFRS first deals with the adoption and implementation offirst time adoption process.

Step 3-Implementation

This is the final step of the process which deals with the actual implementation of IFRS. The initial phase of this step is to prepare an opening Balance Sheet at the date of transition to IFRS. To understand the actual impact of the transition from the Indian Accounting Standards to IFRS is to be developed. This will follow the full application of IFRS as and when it is required.

10.7 BENEFICIARIES OF CONVERGENCE WITH IFRS IN INDIA

Some of the beneficiaries of IFRS is discussed below..

1. **The Investors :** Convergence of Indian Accounting Standards with IFRS makes accounting information more reliable, relevant, timely and comparable across different legal and economic frameworks and requirements since it would then be prepared by using a common set of accounting standards which will facilitate the investors who willing to invest in the countries apart from India. It will also develop better understanding of financial statements worldwide which increase the confidence among the people as investors., from whole of the world.

2. **The Industry:** The other important is the industry which in the event of convergence with IFRS will be benefited because of some basic reasons. Firstly it will enhance confidence in the minds of the foreign investors, secondly, it decreases the burden of financial reporting, thirdly, it would

make the process of preparing the individual and group financial statements easier and simplest, and the last and important one is that this will reduce cost of preparing the financial statements using different sets of accounting standards.

3. **Accounting Professionals**: However, there would be initially many problems but convergence with IFRS would surely benefit the accounting professionals and it will be helpful them to sell their talent and expertise across the globe.

4. **The Economy**: All the discussions made above explains how convergence with IFRS would help industry grow and is beneficial to the corporate entities in the country as this would make the internal and external highly consisted, and it will report improvement in the risk rating among the foreign investors. Moreover, the international comparability is also benefiting the industrial and capital markets in the country which lead to better economy across the country.

10.8 SUMMARY

IFRS are designed to bring consistency to accounting language, practices and statements, and to help businesses and investors make educated financial analyses and decisions. The IFRS Foundation sets the standards to "bring transparency, accountability and efficiency to financial markets around the world… fostering trust, growth and long-term financial stability in the global economy." Companies benefit from the IFRS because investors are more likely to put money into a company if the company's business practices are transparent. IFRS are used in at least 120 countries, as of March 2018, including those in the European Union (EU) and many in Asia and South America, but the U.S. uses GAAP. IFRS are sometimes confused with International Accounting Standards (IAS), which are the older standards that IFRS replaced. IAS was issued from 1973 to 2000, and the International Accounting Standards Board (IASB) replaced the International Accounting Standards Committee (IASC) in 2001.

10.9 GLOSSARY

- **LTIF -** Lost time injury frequency
- **IASB -** International Accounting Standard Board
- **IFRS -** International Financial Reporting Standard
- **IAS -** International Accounting Standard
- **ASB -** Accounting Standard Board
- **SAC - Standard Advisory Committee**

10.10 SELF ASSESSMENT QUESTIONS (SAQ)

Q. 1 Discuss in brief the changing attitudes of businesses and stakeholders towards IFRS.

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Q.2 Discuss in detail the various problems in understanding IFRS.

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10.11 EXAMINATION ORIENTED QUESTIONS

1. Give the Structure of IFRS.

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2. Discuss in detail the process of IFRS.

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3. Explain in detail the complexities of understanding IFRS.

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INTERNATIONAL FINANCIAL REPORTING QUALITIES; OBJECTIVES OF CORPORATE FINANCIAL REPORTING; DEVELOPMENT OF FINANCIAL REPORTING OBJECTIVES; ACCOUNTING PRINCIPLE BOARD (APB, STATEMENT NO. 4)

11.1 INTRODUCTION

11.2 OBJECTIVES

11.3 INTERNATIONAL FINANCIAL REPORTING QUALITIES

11.4 OBJECTIVES OF CORPORATE FINANCIAL REPORTING

11.5 DEVELOPMENT OF FINANCIAL REPORTING OBJECTIVES: ACCOUNTING PRINCIPLE BOARD (APB, STATEMENT NO. 4)

11.6 SUMMARY

11.7 GLOSSARY

11.8 SELF ASSESSMENT QUESTIONS

11.9 EXAMINATION ORIENTED QUESTIONS

11.10 SUGGESTED READINGS

11.1 INTRODUCTION

Financial reporting may be defined as communication of published financial statements and related information from a business enterprise to third parties (external users) including shareholders, creditors, customers, governmental authorities and the public. It is the reporting of accounting information of an entity (individual, firm, company, government enterprise) to a user or group of users. Company financial reporting is a total communication system involving the company as issuer (preparer); the investors and creditors as primary users, other external users; the accounting profession as measurers and auditors; and the company law regulatory or administrative authorities.

11.2 OBJECTIVES

After going through this lesson, you will be able to understand-

- the qualities of international financial reporting;
- the objectives of corporate financial reporting; and
- development of financial reporting objectives.

11.3 INTERNATIONAL FINANCIAL REPORTING QUALITIES

As we understand that different users require financial information for assistance in their economic decisions. Entities publish financial statements so that users can get their information needs fulfilled. The dependence of users' economic decision on financial statements is crucial and if the financial information is not accurate or is not true and fair then users may end up making wrong decisions. Therefore, financial statements need to have certain qualitative characteristics in order to be useful to its users. IASB Framework for presentation and preparation of financial Statements states the following qualities of financial statements:

a. **Understandability:** The information must be readily understandable to users of the financial statements. This means that information must be clearly presented, with additional information supplied in the supporting footnotes as needed to assist in clarification. Users cannot use such financial information that they cannot understand. Problems in understanding may arise due to user's inabilities or because of the information itself. Definitely entity cannot do anything about users and its upon the user to have atleast basic level of understanding about financial statements. Also, users are not required to be professional accountants and that is why where we expect to have complex information then its neither fault on part of user nor from the side of the entity preparing financial statements. However, entity can present information in such a manner that it helps in understanding. Further, with proper explanation, financial statements can be made more understandable. Therefore, entity is required to take reasonable measures in order to make financial statements easy to understand. However, it does not mean that complex information which is also of material nature should be excluded from the financial statements on the basis that it is creating problems in overall understandability of financial statements.

b. **Relevance:** The information must be relevant to the needs of the users, which is the case when the information influences the economic decisions of users. This may involve reporting particularly relevant information, or information whose omission or misstatement could influence the economic decisions of users. Information is considered relevant which adds value to the decision making process by providing the required bits and pieces of past, present and future times. Through relevant information, users can evaluate whether they are moving along the right path i.e. making correct decisions. Information is also said to be relevant when it is capable of confirming or correcting the existing thought process and information. It is generally considered that financial statements always relates to past (financial period that have already passed) then how come past information can help us in making decisions? For example, we all use our experience to decide about something and certainly experience is always what we already know from the past. Same way, past information given in financial statements help us in predicting the financial position and financial performance of the company in upcoming financial periods. So, even past information can be relevant.

c. **Reliability.** The information must be free from material error and bias, and not misleading. Thus, the information should faithfully represent transactions and other events, reflect the underlying substance of events, and prudently represent estimates and uncertainties through proper disclosure.

d. **Comparability.** The information must be comparable to the financial information presented for other accounting periods, so that users can identify trends in the performance and financial position of the reporting entity. Comparability of information refers to its ability to stand useful overtime and against the financial information from other sources. Users cannot evaluate different aspects of entity's financial position and financial performance if they are unable to compare the financial information of one period with another or financial information of one entity with another entity's financial information. In order to have comparable information, entities prepare their financial statements by following a uniform pattern of presentation which is usually as instructed by the International or Local Accounting Standards and after they adopt a particular style they remain consistent in its application. However, comparability does not require that one stays uniform even if there are other ways to make financial statements even more reliable and relevant.

From the above discussion, we can observe one fact that all four principal qualities are interrelated and higher level is achieved in one area at the expense of the other. For example, in order to make financial statements more reliable, entity may include such financial information which is complex thus higher level of reliability is achieved at the expense of understandability.

It is the responsibility of the management to have an optimum mix of all four important qualitative characteristics of financial statements.

11.4 OBJECTIVES OF CORPORATE FINANCIAL REPORTING

An evaluation of company financial reporting requires some agreement on its objectives. Financial reporting is not an end in itself but is a means to certain objectives. The objectives of financial reporting and financial statements have been discussed for a long time. While there is no final statement on objectives, to which all parties (of financial reporting) have agreed, some consensus has been developing on the objectives of financial reporting.

At present, the following may be described as the primary objectives of financial reporting: Investment decision-making and Management accountability.

a. **Investment decision-making:** The basic objective of financial reporting is to provide information useful to investors, creditors and other users in making sound investment decisions. These decisions concern the efficient allocation of investment funds and the selection among investment opportunities.

   The True-blood Committee stated that "…the basic objective of financial statements is to provide information useful for making economic decisions." Recently, the FASB (USA) in its Concept No. 1 also concluded that financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions. It is essential to have an understanding of the investment decision process applied by external users in order to provide useful information to them. The investors seek such investment which will provide the greatest total return with an acceptable range of risk. Investment return is comprised of future interest or dividends and capital appreciation (or loss).

The investors while making investment decisions aim to determine the amount and certainty of a company's future earning power in order to estimate their future cash return in dividends and capital appreciation. Earning power is the ability of a business firm to produce continuous earnings from the operating assets of the business over a period of years, which may differ from accounting net income.

The financial statements and other business data are analysed in relation to the enterprise's environment to project this future earning power. Investors compare returns on alternative investments relative to risk, which (risk) is the degree of uncertainty of future returns. The risk premium is a measure of uncertainty which is defined as the possible variation of the actual from the expected return.

The investment decision process may be pictured as a three-legged stool. One leg is the analysis of the company and its securities and of the industry in which it operates. The second is the assessment of the economic environment, including the business outlook, financial markets and interest rates, international trade and finance, and political and regulatory developments. The third is the portfolio decision in which these two streams of information are integrated into an investment appraisal related to the objectives of the investor—individual or fund.

Investment decision and investment values, both, are comparative, not absolute. In all investment decisions, comparison is made in order to determine the most attractive (greatest) returns in relation to risk first, comparison between types of securities. Secondly, comparison between one company vs. another within each category; Thirdly, comparison within a company over time.

Comparison requires uniform standards of measurement. Where different accounting measurements are used in similar situations, investors and financial analysts make their own accounting adjustments to achieve comparability, provided adequate information is available to do so.

But the attribute of comparability can be achieved at a lower cost (associated with financial reporting system), and with equal benefit for all investors, by eliminating the alternatives.

b. Management accountability:

A second basic objective of financial reporting is to provide information on management accountability to judge management's effectiveness in utilizing the resources and running the enterprise.

Management of an enterprise is periodically accountable to the owners not only for the custody and sale-keeping of enterprise resources, but also for their efficient and profitable use and for protecting them to the extent possible from unfavorable economic impacts of factors in the economy such as technological changes, inflation or deflations.

Ijiri opines that "Management accountability presumes a relationship between two parties, namely someone (an accountor) is accountable to someone else (an accountee) for his activities and their consequences. The accountability relationship may be created by a constitution, a law, a contract, an organisational rule, a custom, or even by an informal moral obligation. A corporation is accountable to its shareholders, creditors, employees, customers, the government, or the public in general based on a variety of relationships created between them. In this sense, it would not be an exaggeration to say that our present society is founded upon accountability networks. An accountant joins the accountability relationship between an accountor and an accountee as a third party. The term 'accountant' includes not only an actual bookkeeper, but also an auditor and any authoritative body which defines accounting principles, such as the Financial Accounting Standards Board. The primary role of the accountant is to assist the accountor in accounting for his activities and their consequences and, at the same time, provide information to the accountee. Thus, an accountant has a dual relationship, one with the accountor and the other with the accountee."

Management accountability is of very great interest not only to existing shareholders and other users but also to potential shareholders, creditors and users. A company generally offers shares, debentures etc., to the prospective investing public and therefore it should accept accountability responsibilities to prospective investors also. Certainly annual and other financial statements is intended to play a major role in this regard.

The management accountability concept includes information about future activities, budgets, forecast financial statements, capital expenditure proposal etc. Accountability is beyond the narrow limits of companies' regal responsibilities to shareholders and sometimes debenture-holder and creditors.

It obviously includes the interests of persons other than existing shareholders. Management is accountable for the values of assets as well as for their costs. In this way, the financial statements not only inform but also protect the various interests of the shareholders and other users.

There is a school of thought which contends that financial accounting and reporting based on 'decision-making' may differ from financial accounting and reporting based on 'accountability objective'.

This is because decision-making objective and accountability objective differ from each other in some respects such as the following:

Firstly, 'economic decision-making objective' focus on the contents of financial statements and how the information reported therein are useful to economic decisions. This objective emphasises more the reliability of information than the accounting system used in producing financial statements.

For instance, cash balance appearing on a balance sheet, if it reflects actual cash balance, will contribute to the decision-making objective and it is immaterial whether cash balance has been determined on the basis of cash book or after mere cash count at the end of an accounting period.

On the other hand, 'management accountability objective' mainly emphasises accounting system and procedures used in producing financial statements and other related information. It implies that financial statement figures are supported by adequate documents, records and system.

Secondly, the decision-making objective assumes that the accountant should aim at serving the decision-makers' informational requirements. That is, his task is to design an information system which is most useful to users in helping them to make sound decisions.

The accomplishment of accountability objective involves a conflict of interests between the accountor and the accountee with regard to the extent of disclosure and method of performance measurement. The accounting system, which is stressed in accountability objective, needs to be evaluated in dual aspects, its relation to the accountor and its relation to the accountee, and the need to resolve the conflicting pressures equitably.

Thirdly, the two objectives-decision-making and accountability influence the accountor's interest differently with respect to information reported, especially information relating to accountor's performance. The decision objective tends to encourage subjective information assuming that it will be unbiased.

The accountability objective anticipates the pressure to bias the information and attempts to establish a system that is strong enough to withstand such pressure. Not just unbiased information, but 'unbiasable' information is what ultimately aimed for in the accountability approach.

Contrary to above, there is another school of opinion which does not favour any distinction between the two objectives. A question arises: why distinguish between these functions of accounting and reporting? Are the distinctions superfluous? It would seem that accounting reports on management's fulfilment of their responsibility to outside owners (the old stewardship notion) would have always necessitated considering management's effectiveness and efficiency (the new in-formativeness role).

Nevertheless' accounting's role in informativeness and efficiency, in a social context, has been increasingly emphasized by the profession.

The **AICPA** frames these relationships in the following way:

"Financial statements are often audited by independent accountants for the purpose of enhancing confidence in their reliability.... Well-developed securities markets tend to allocate scarce resources to enterprises that use them efficiently and away from enterprises that use them inefficiently.... Financial reporting is intended to provide information that is useful in making reasoned choices among alternative uses of scarce resources in the conduct of business activities".

These views, reiterated **by FASB pronouncement (1978),** IASC (July 1989), have formed the basis of accounting objectives, practices, standards, and principles into the 1990s.

As is apparent from these statements, the informational role of accounting is regarded as a crucial link in the efficient allocation of society's resources by individuals, enterprises, and government. The recent emphasis on the role of accounting in the efficient allocation of resources has been classified under the user-in-formativeness approach.

To conclude, the above two basic objectives associated with company financial reporting contribute in making wise economic decisions and determining the economic performance.

Both these objectives lead to broader social goals, of efficient allocation of investment funds and proper selection among alternative investment opportunities. Thus, accomplishment of these financial reporting objectives influence capital formation and flow of funds and perform a vital role in the successful functioning of an economy.

11.5 DEVELOPMENT OF FINANCIAL REPORTING OBJECTIVES: ACCOUNTING PRINCIPLE BOARD (APB, STATEMENT NO. 4)

The subject of financial reporting objectives has been generally recognized as very important in accounting area since a long time. Many accounting bodies and professional institutes all over the world have made attempts to define the objectives of financial statements and financial reporting which are vital to the development of financial accounting theory and practice.

This section describes developments in this area at the international level, particularly USA and UK. It can be rightly said that most of the attempts in the area of financial reporting objectives has been made in USA and UK and accounting developments in these countries have great impact on accounting developments and practices in other countries of the world.

Accounting Principle Board (APB) Statement No. 4:

In USA, the APB Statement No. 4 "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises", (1970) was the first publication which formulated the objectives of financial statements. These objectives may be summarised as follows:

1. The particular objectives of financial statements arc to present fairly, and in conformity with generally accepted accounting principles, financial position, results of operations, and other changes in financial position.

2. The general objectives of financial statements are:

   (a) To provide reliable information about economic resources and obligations of a business enterprise in order to:

      - Evaluate its strengths and weakness,
      - Show its financing and investment,
      - Evaluate its ability to meet its commitments, and
      - Show its resource base for growth;

   (b) To provide reliable information about changes in net resources resulting from a business enterprise's profit-directed activities in order to:

      - Show to investors expected dividend return,
      - Show the operation's ability to pay creditors and suppliers, provide jobs for employees, pay taxes, and generate funds for expansion,
      - Provide management with information for planning and control, and
      - Show its long-term profitability;

   (c) To provide financial information useful for estimating the earnings potential of the firm;

   (d) To provide other needed information about changes in economic resources and obligations; and

   (e) To disclose other information relevant to statement users' needs.

3. The qualitative objectives of financial accounting are the following:

   (a) Relevance, which means selecting the information most likely to aid users in their economic decisions.

(b) Under-stand-ability, which implies not only that the selected information must be intelligible but also that the users can understand it.

(c) Verifiability, which implies that the accounting results may be corroborated by independent measurers using the same measurement methods.

(d) Neutrality, which implies that the accounting information is directed towards the common needs of users rather than the particular needs of specific users.

(e) Timeliness, which implies an early communication of information to' avoid delays in economic decision-making.

(f) Comparability, which implies that differences should not be the result of different financial accounting treatments.

(g) Completeness, which implies that all the information that 'reasonably' fulfils the requirements of other qualitative objectives should be reported.

11.6 SUMMARY

Financial Reporting involves the disclosure of financial information to the various stakeholders about the financial performance and financial position of the organization over a specified period of time. These stakeholders include – investors, creditors, public, debt providers, governments & government agencies. In case of listed companies, the frequency of financial reporting is quarterly & annual. According to International Accounting Standard Board (IASB), the objective of financial reporting is "to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions." It provides information to management of an organization which is used for the purpose of planning, analysis, benchmarking and decision making. It provides information to investors, promoters, debt provider and creditors which is used to enable them to male rational and prudent decisions regarding investment, credit etc. It provides information to shareholders and public at large in case of listed companies about various aspects of an organization. It informs about the economic resources of an organization, claims to those resources (liabilities & owner's equity) and how these resources and claims have undergone change over a period of time. It provides information as to how an organization is procuring & using various resources. It provides information to various stakeholders regarding performance management of an organization as to how diligently & ethically they are discharging their fiduciary duties & responsibilities. It provides information to the statutory auditors which in turn facilitates audit. It enhances social welfare by looking into the interest of employees, trade union and Government. It helps an organization to comply with various statues and regulatory requirements. The organizations are required to file financial statements to ROC, Government Agencies. In case of listed companies, quarterly as well as annual results are required to be filed to stock exchanges and published. It facilitates statutory audit. The Statutory auditors are required to audit the financial statements of an organization to express their opinion. Financial Reports forms backbone for financial planning, analysis, bench marking and decision making. These are used for above purposes by various stakeholders. It helps organizations to raise capital both domestic as well as overseas. On the basis of financials, the public in large can analyze the performance of the organization as well as of its management. For the purpose of bidding, labor contract, government supplies etc., organizations are required to furnish their financial reports & statements.

11.7 GLOSSARY

- **Relevance-** Information is reliable when it is dependable and this is possible if it is: free from errors, especially material errors, complete free from bias

- **Faithful representation-** Financial statements should be complete and free from bias and error.
- **Comparability-** comparison of financial statements from one period to the next or for two companies in the same industry so that you can make informed decisions about the companies.
- **Verifiability-** Different people could reach the same decision based on the information, but not necessarily reach complete agreement.
- **Timeliness-** Make information available to users in good time. Historical information quickly becomes out of date.
- **Understandability-** Present and classify information clearly and concisely to make it understandable to users.

11.8 SELF ASSESSMENT QUESTIONS

Q1. "Financial reports must be relevant". Do you agree with this statement? If yes, comment.

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Q2. "Financial reports must be understandable". Do you agree with this statement? Give reasons in support of your answer.

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Q3. Discuss briefly the objectives of corporate financial reporting.

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11.9 EXAMINATION ORIENTED QUESTIONS

1. Discuss the qualities of international financial reporting.

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2. State the importance of corporate financial reporting.

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3. Discuss the recent developments in the objectives of corporate financial reporting.

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11.10 SUGGESTED READINGS

- Barnea, A. Ronen, J. and Sadan, J. (1976). Classificatory Smoothing of Income with Extraordinary Items. The Accounting Review.
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CORPORATE ACCOUNTING

FINANCIAL ACCOUNTING STANDARD BOARD (FASB CONCEPT NO.1); TRUE BLOOD REPORT AND STAMP REPORT-OBJECTIVES

12.1 INTRODUCTION

12.2 OBJECTIVES

12.3 FINANCIAL ACCOUNTING STANDARD BOARD (FASB) Concept No. 1

12.4 TRUEBLOOD REPORT - OBJECTIVES

12.5 CANADIAN INSTITUTE OF CHARTERED ACCOUNTANT (CICA) CICA'S STAMP REPORT - OBJECTIVES

12.6 GENERAL PURPOSE FINANCIAL REPORTING

12.7 SPECIFIC PURPOSE REPORTING

12.8 SUMMARY

12.9 GLOSSARY

12.10 SELF ASSESSMENT QUESTIONS

12.11 EXAMINATION ORIENTED QUESTIONS

12.12 SUGGESTED READINGS

12.1 INRTODUCTION

Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources and the effects of transactions, events, and circumstances that change resources and claim to those resources. Financial reporting should provide information about an enterprise's financial performance during a period. Investors and creditors often use information about the past to help in assessing the prospects of an enterprise. Thus, although investment and credit decisions reflect investors' and creditors' expectations about future enterprise performance, those expectations are commonly based at least partly on evaluations of past enterprise performance. The primary focus of financial reporting is information about an enterprise's performance provided by measures of earning and its components. Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distribution of enterprise resources to owners, and about other factors that may affect an enterprise's liquidity or solvency.

12.2 OBJECTIVES:

After going through lesson, the students will be able to understand :

- financial Accounting Standard Board Concept no. 1
- the objectives developed by Trueblood Report and Stamp Report.

12.3 FINANCIAL ACCOUNTING STANDARD BOARD (FASB) CONCEPT NO. 1

Probably the most comprehensive statement on objectives of financial reporting is FASB (USA) Concept No. 1 "Objectives of Financial Reporting by Business Enterprises" issued in November 1978 by US Financial Accounting Standards Board.

The objectives of financial reporting developed in this statement are the following:

Financial reporting should provide information that is useful to present and potential investors, creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.

Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. The prospects for those cash receipts are affected by an enterprise's ability to generate enough cash to meet its obligations when due and its other cash operating needs, to reinvest in operations, and to pay cash dividends, and may also be affected by perceptions of investors and creditors generally about that ability, which affect market prices of the enterprise's securities.

Thus, financial reporting should provide information to help investors, creditors, and others assess the amount, timing and uncertainty of prospective net cash inflows to the related enterprise.

Financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it.

Financial reporting should provide information that is useful to managers and directors in making decisions in the interests of owners.

Besides the above objectives, the FASB Concept No. 1 contains the following important highlights:

1. Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions.

2. The objectives of financial reporting are not immutable—they are affected by the economic, legal, political and social environment in which financial reporting takes place.

3. The objectives are also affected by the characteristics and limitations of the kind of information that financial reporting can provide.

   (i) The information pertains to business enterprises rather than to industries or the economy as a whole.

   (ii) The information often results from approximate, rather than exact, measures.

   (iii) The information largely reflects the financial effects of transactions and events that have already happened.

   (iv) The information is but one source of information needed by those who make decisions about business enterprises.

   (v) The information is provided and used at a cost.

4. The objectives in this Statement (Concept No. 1) are those of general purpose external financial reporting by business enterprises.

   (i) The objectives stem primarily from the needs of external user- who lack the authority to prescribe the information they want and must rely on information management communicates to them.

   (ii) The objectives are directed toward the common interest of many users in the ability of an enterprise to generate favourable cash flows but are phrased using investment and credit decisions as a reference to give them a focus. The objectives are intended to be broad rather than narrow.

   (iii) The objectives pertain to financial reporting and are not restricted to financial statements.

5. Investors' and 'Creditors' are used broadly and include not only those who have or contemplate having a claim to enterprise resources but also those who advise or represent them.

6. Although investment and credit decisions reflect investors' and creditors' expectations about future enterprise performance, those expectations are commonly based at least partly on evaluations of past enterprise performance.

7. The primary focus of financial reporting is information about earnings and its components.

8. Information about enterprises earning based on accrual accounting generally provides a better indication of an enterprise's present and continuing ability to generate favourable cash flows than information limited to the financial effects of cash receipts and payments.

9. Financial reporting is expected to provide information about enterprises financial performance during a period and about how management of an enterprise has discharged its stewardship responsibility to owners.

10. Financial accounting is not designed to measure directly the value of a business enterprise, but the information it provides may be helpful to those who wish to estimate its value.

11. Investors, creditors, and others may use reported earnings and information about the elements of financial statements in various ways to assess the prospects for cash flows. They may wish, for example, to evaluate management's performance, estimate 'earning power', predict future earnings, assess risk, or to confirm, change, or reject earlier predictions or assessments. Although financial reporting should provide basic information to aid them, they do their own evaluating, estimating, predicting, assessing, confirming, changing, or rejecting.

12. Management knows more about the enterprise and its affairs than investors, creditors, or other 'outsiders' and accordingly can often increase the usefulness of financial information by identifying certain events and circumstances and explaining their financial effects on the enterprise.

12.4 TRUEBLOOD REPORT- OBJECTIVES

To develop objectives of financial statements, a Study Group was appointed in 1971 by American Institute of Certified Public Accountants under the Chairmanship of **Robert M. Trueblood.** The Study Group solicited the views of more than 5000 corporations, professional firms, unions, public interest groups, national and international accounting organisations and financial publications. The Study Group conducted more than 50 interviews with executives from all sectors of the business and from government. To elicit the widest possible range of views, 35 meetings were held with institutional and professional groups representing major segments of the US economy.

The Study Group submitted its report to AICPA in October 1973. The objectives developed in the Study Group Report are as follows:

1. The basic objective of financial statements is to provide information useful for making economic decisions.
2. An objective of financial statements is to serve, primarily, those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities.
3. To provide information useful to investors and creditors for predicting, comparing and evaluating potential cash flows to them in terms of amount, timing and related uncertainty.
4. To supply information useful in judging management's ability to utilise enterprise resources effectively in achieving the primary enterprise goal.

5. To provide factual and interpretative information about transactions and other events which is useful for predicting, comparing and evaluating enterprise earning power. Basic underlying assumptions with respect to matters subject to interpretation, evaluation, prediction, or estimation should be disclosed.

6. It should provide information concerning enterprise transactions and other events that are part of incomplete earning cycles. Current values should also be reported when they differ significantly from historical costs. Assets and liabilities should be grouped or segregated by the relative uncertainty of the amount and timing of prospective realisation of liquidation.

7. The net result of completed earning cycles and enterprise activities resulting in recognisable progress towards completion of incomplete cycles should be reported. Changes in values reflected in successive statements of financial position should also be reported, but separately, since they differ in terms of their certainty realisation.

8. This statement should report mainly on factual aspects of enterprise transactions having or expected to have significant cash consequences. This statement should report data that require minimal judgement and interpretation by the compiler.

9. To provide information useful for the predictive process. Financial forecasts should be provided when they will enhance the reliability of users' predictions.

10. An objective of financial statements for governmental and non-profit organizations is to provide information useful for evaluating the effectiveness of management of resources in achieving the organisation's goals. Performance measures should be qualified in terms of identified goals.

11. An objective of financial statements is to report on those activities of the enterprise affecting society which can be determined and described or measured and which are important to the role of the enterprise in its social environment.

12.5 CANADIAN INSTITUTE OF CHARTERED ACCOUNTANT (CICA) CICA'S STAMP REPORT- OBJECTIVES

The Canadian Institute of Chartered Accountants (CICA) published a report in June 1980 on 'Corporate Reporting: Its Future Evolution' which was written by **Edward Stamp.** Popularly known as **Stamp Report,** it mentions the following as the important objectives of company's financial reporting:

1. One of the primary objectives of published corporate financial reports is to provide an accounting by management to both equity and debt investors, not only a management's exercise of its stewardship function but also of its success (or otherwise) in achieving the goal of producing a satisfactory economic performance by the enterprise and maintaining it in a strong and healthy financial position.
2. It is an objective of good financial reporting to provide such information in such a form as to minimise uncertainty about the validity of information, and to enable the user to make his own assessment of the risks associated with the enterprise.
3. It is necessary that the standards governing financial reporting should have ample scope for innovation and evolution as improvements become feasible.
4. The objectives of financial reporting should be taken to be directed towards the need of users who are capable of comprehending a complete (and necessarily sophisticated) set of financial statements or alternatively, to the needs of experts who will be called on by the unsophisticated users to advise them.

The Stamp Report has not found FASB's Conceptual Framework and objectives on financial reporting suitable and useful for Canada because of the environmental difference between USA and Canada. This is true not only in case of any particular country but applicable equally to other countries as well.

Financial reporting-its objectives and scope are influenced by the economic, legal, political, institutional and social factors prevailing in a country. Therefore, these factors need to be considered before developing financial reporting objectives in any country. The company financial reporting is intended to provide external users information that is useful in making business and economic decisions, that is, for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities. Thus, users are potentially interested in the information provided by financial reporting. Among the potential users are owners, lenders, suppliers, potential investors and creditors, employees, management, directors, customers, financial analysts and advisors, brokers, stock exchanges, lawyers, economists, taxing authorities, regulatory authorities, legislators, financial press and reporting agencies, labour unions, trade associations, business researchers, teachers and students, and the public. Some users-such as owners, creditors, and employees—have or contemplate having direct economic interests in particular business enterprises. Managers and directors, who are charged with managing the enterprise in the interest of owners, also have a direct interest.

Some users-such as financial analysts and advisors, regulatory authorities, and labour unions-have indirect interests because they advise or represent those who have or contemplate have direct interests. Potential users of financial information most directly concerned with a particular business enterprise are generally interested in its ability to generate favourable cash flows because their decisions relate to amounts, timing, and uncertainties of expected cash flows. To investors, lenders, suppliers, and employees, a business enterprise is a source of cash in the form of dividends or interest and, perhaps, appreciated market price, repayment of borrowing, payment of goods or services, or salaries or wages. They invest cash, goods, or service in an enterprise and expect to obtain sufficient cash in return to make the investment worthwhile. To customers, a business enterprise is a source of goods or services, but only by obtaining sufficient cash, to pay for the resources it uses and to meet its other obligations, can the enterprise provide those goods or services.

To managers, the cash flows of a business enterprise are a significant part of their management responsibilities, including their accountability to directors and owners. Many, if not most, of their decisions have cash flow consequences for the enterprise. Thus, investors, creditors, employees, customers, and managers significantly share a common interest in an enterprise's ability to generate favourable cash flows. Other potential users of financial information share the same interest, derived from investors; creditors, employees, customers, or managers whom they advise or represent or derived from an interest in how those groups (and especially shareholders) are fair. Some of the potential users listed above may have specialised needs but also have the power to obtain the information needed. For example, the information needed to enforce tax laws and regulations are specialised needs. However, although the taxing authorities often use the information in financial statements for their purposes, they also have statutory authority to require the specific information they need to fulfill their functions, and do not need to rely on information provided to other groups. Some investors and creditors or potential investors and creditors may also be able to require a business enterprise to provide specified information to meet a particular need. For example, a bank or insurance company negotiating with an enterprise for a large loan or purchase of securities can often obtain desired information by making the information a condition for completing the loan transaction. Some users of financial information can obtain more information about an enterprise than others. This is clearly so for managers, but it also holds true for others, such as large scale equity shareholders and creditors. Financial statements are, it is argued, especially important to those who have limited access to information and limited ability to interpret it.

The True-blood Report states "An objective of financial statements is to serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities."

Financial Accounting Standards Board (USA) does not agree with True-blood's concept of users for financial reporting. According to FASB, financial reporting information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. FASB argues, "Individual investors, creditors, or other potential users of financial information understand to varying degrees the business and economic environment, business activities, securities markets, and related matters. Their understanding of financial information and the way and extent to which they use and rely on it also may vary greatly. Financial information is a tool and, like most tools, cannot be of much direct help to those who are unable or unwilling to use it or who misuse it. Its use can be learned, however, and financial reporting should provide information that can be used by all—non-professionals as well as professionals—who are willing to learn to use it properly. Efforts may be needed to increase the understandability of financial information. Cost benefit considerations may indicate that information understood or used by only a few should not be provided Conversely, financial reporting should not exclude relevant information, merely because it is difficult for some to understand or because some investors or creditors choose not to use it".

In India, the basic purpose of financial reporting (as per Indian Companies Act, 1956) is to provide shareholders of the company, financial statements and other related information. In India, shareholders, especially the existing shareholders, are the primary users of financial reporting. However, there are other potential users also who are equally interested in financial reporting information for making economic decisions. Therefore, the purpose of financial reporting in India should be to serve not only existing investors but prospective investors and creditors, and other external users and stakeholders as well.

12.6 GENERAL PURPOSE FINANCIAL REPORTING

Generally speaking, the term ‘financial reporting’ is used to mean general purpose external financial reporting. Often it is said that the purpose of financial reporting is the preparation of general purpose reports for external users. Despite the fact that financial reports are mainly intended (legally) for shareholders, they can be, and are, used by a number of other external users. The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their different needs for information. These needs include the following:

a. **Employees:** Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.

b. **Lenders:** Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

c. **Investors:** The providers of risk capital and their advisors are concerned with the risk inherent in, and return, provided by their investments They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the enterprise to pay dividends.

d. **Suppliers and other trade creditors:** Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuation of the enterprise as a major customer.

e. **Customers:** Customers have an interest in information about the continuance of an enterprise, especially when they have a long-term involvement with, or are dependent on, the enterprise.

f. **Governments and their agencies:** Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises, determine taxation policies and as the basis for national income and similar statistics.

g. **Public:** Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities. While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy. The management of an enterprise has the primary responsibility for the preparation and presentation of the financial statements of the enterprise. Management is also interested in the information contained in the financial statements even though it has access to additional management and financial information that helps it carry out its planning, decision-making and control responsibilities. Management has the ability to determine the form and content of such additional information in order to meet its own needs. The reporting of such information, however, is beyond the scope of this framework. Nevertheless, published financial statements are based on the information used by management about the financial position, performance and changes in financial position of the enterprise. It is still debatable whether a single set of financial statements could serve the interests of all external users. It is possible that some users may find the financial reports more useful than the others. However, it has been forcefully argued and empirically proved that all external users have something in common while making investment decisions and fulfilling their needs. Therefore, although the users may be of different types, they have certain similar information needs. The question of similar information needs of investors and creditors is best understood in terms of their economic decisions, i.e.., investment decision and credit decision.

Investment decision concerns the decision to buy, to sell or to hold a share. An investment decision is a complex one because of intervention of investment market. An investor in a buying decision determines the ability of an enterprise to pay dividends, currently, prospectively or even at liquidation. In an investment market share prices rise and fall with changes in investors' expectations about the ability of an enterprise to pay further dividends. In a credit decision, the lender knows the amount of loan requested and the terms of repayment of principal and interest. The lender receives a definite amount of interest or return. The lender seeks to determine the borrower's ability to repay principal and interest. The borrower's ability to pay is not subject to precise measurement and in most situations, no single set of information can provide the lender with an assured measure of the borrower's ability to repay. Thus, the credit decisions like other economic decisions, require an assessment of risk. Therefore, adequate information is needed by the lender to be selective among borrowers (to reduce his risk) and to make predictions based on his preferences for amount, timing, and uncertainty of cash returns. Lenders also need information about borrowers to determine the degree of control or influence they wish to impose through such loan provisions. All investors and creditors measure sacrifices and benefits in terms of the actual or prospective disbursement or receipt of cash. The distinction between an investment and a credit decision, often, is not sharp. Thus, the information needs of creditors and investors are essentially the same. Both groups are concerned with the enterprise's ability to generate cash flows to them and with their own ability to predict, compare, and evaluate the amount, timing, and related uncertainty of these future cash Flow.

The Statement of Financial Accounting Concept No. 1 of FASB (USA) also states that "general purpose external financial reporting is directed toward the common interest of various potential users in the ability of an enterprise to generate favourable cash flows". It is also contended that investors and creditors and their advisers are the most obvious prominent external groups who use the information provided by financial reporting. Their decisions and their uses of information are usually studied and described to a much greater extent than those of other external groups, as their decisions significantly affect the allocation of resources in the economy. In addition, information provided to meet investors' and creditors' needs is likely to be generally useful to members of other user groups who are interested in essentially the same financial aspects of business enterprises as investors and creditors.

Management as user of information is interested in information about assets, liabilities, earnings, and related elements as external users are, and need, generally, the same kind of information about these elements as external users. Thus, management is major user of the same information that is provided by external financial reporting.

However, management's primary role in external financial reporting is that of communicating information for use by others. For that reason, it has a direct interest in the cost, adequacy, reliability, and, understandability of external financial reporting.

12.7 SPECIFIC PURPOSE REPORTING

Financial reporting objectives in accounting literature so far has focused on general purpose financial reporting which aims to satisfy the information needs of all potential users. Company law provisions in almost all countries of the world have consistently accepted the utility of general purpose financial reporting. Due to this, the separate (specific) needs of specific users have been largely ignored on the assumption that general purpose reports can satisfy the information needs of all external users. However, a reasoning has also been made suggesting that the needs of specific users may be better served by presenting specific purpose reports to help them in their separately identifiable decision functions. For instance, financial reports submitted to obtain credit or loans, or government, or financial reports given to trade and industry, may not satisfy other users' needs and expectations. However, the proposal of specific purpose reports in company financial reporting is criticised on some counts.

Firstly, the cost of the developing 'specialised reports to satisfy special requirements of specific users may exceed the benefits when the company financial reporting policy is determined in its totality.

Secondly, specialised needs of specific users cannot be ascertained with any degree of certainty.

Thirdly, issuing multiple reports about the financial results of an enterprise can create confusion among various users. Multiple reports increase the perceived complexity of the environment. Such changes in perceived environment complexity induce changes in decision-makers' cognitive processing capabilities and, in turn, can decrease the effectiveness of decision-making by users.

Fourthly, multiple reports may not be desirable and practicable from the standpoint of information economics.

To conclude, company financial reporting, in future, will continue to adhere to general purpose reporting system to aid investors, creditors, and other external users in their economic decisions. Meanwhile, in order to achieve the objectives of financial reporting (through general purpose reports) there is a continuous need to investigate many vital aspects relating to general purpose financial reports such as identifying potential users and user groups, identifying information needs of such users, determining the feasibility of providing general purpose information to meet these needs, determining the manner of reporting such information, and having a feedback from the users regarding the use and relevance of general purpose information.

12.8 SUMMARY

To sum up, we can say that financial reporting information contributes much towards better investment decision making, promoting understanding and creating an environment to cooperate. Financial reporting generates confidence and has favourable effect on the company's cost of capital. In the long run, financial reporting can retain its credibility only if it does what it is designed to do provide society with relevant and reliable information about economic events and transactions and does not attempt to move the economy in one direction rather than another.

12.9 GLOSSARY

- **FASB-** Financial Accounting Standard Board
- **CICA-** Canadian Institute of Chartered Accountant
- **Investment Decision Making-**Capital Expenditure Decision
- **Trueblood Report-** Report submitted by Study Group under the chairmanship of M Robert Trueblood.
- **Manager's Decisions-**The accounting data published in financial reports which may have economic effects on the behaviour of the managers of corporate enterprises.

12.10 SELF ASSESSMENT QUESTIONS (SAQ)

Q1. What is Stamp Report?

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Q2. What do you man by General Purpose Report?

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Q3. Explain Specific Purpose Report.

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12.11 EXAMINATION ORIENTED QUESTIONS

1. State the objectives of corporate financial reporting developed by Trueblood Report.

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2. Discuss the objectives of corporate financial reporting developed by Stamp Report.

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3. How Trueblood Report is different from Stamp Report? Discuss.

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12.12 SUGGESTED READINGS

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UNIT-III **M.Com 1st Semester**

Course No. M.Com-C150 **Lesson No. 13**

CORPORATE ACCOUNTING

REPORTING BY DIVERSIFIED COMPANIES : SEGMENT REPORTING-NATURE, OBJECTIVES AND PROBLEMS; DISCLOSURE REQUIREMENTS OF DIFFERENT USERS GROUPS OF SEGMENT REPORTING

13.1 INTRODUCTION

13.2 OBJECTIVES

13.3 REPORTING BY DIVERSIFIED COMPANIES / SEGMENT REPORTING

13.4 TYPES OF SEGMENTS

13.5 TERMINOLOGY OF SEGMENT REPORTING

13.6 OBJECTIVES OF SEGMENT REPORTING

13.7 DISCLOSURE REQUIREMENTS OF DIFFERENT USERS GROUPS OF SEGMENT REPORTING

13.8 NATURE OF SEGMENT REPORTING

13.9 PROBLEMS IN SEGMENT REPORTING

13.10 SUMMARY

13.11 GLOSSARY

13.12 SELF ASSESSMENT QUESTIONS

13.13 EXAMINATION ORIENTED QUESTIONS

13.14 SUGGESTED READINGS

13.1 INTRODUCTION

The basic goal of a country's economy is to maximise the economic and social welfare of its citizens through an efficient allocation of resources. In developing economies, chartered by inadequate resources, capital is the scarcest and most important productive factor. To obtain their capital at a lower cost, the business enterprises and companies in particular, go to the capital market. Since capital owners and investors, like the business enterprises, also attempt to maximise their own economic returns, they require information in order to make sound economic decisions. The quality of information available to them would, in turn, lead to a more efficient allocation of resources in a country's economy.

In the absence of meaningful information, capital owners, investors, creditors and others are likely to make investment decisions based on tips, hunches, guess work and unreliable news leading to an inefficient allocation of resources in the economy.

13.2 OBJECTIVES

After going through this lesson, you will be able to understand-

- the meaning of segment reporting;
- objectives of segment reporting;
- benefits of segment reporting; and
- problems in segment reporting.

13.3 REPORTING BY DIVERSIFIED COMPANIES OR SEGMENT REPORTING

The concept of segment reporting is applicable to a diversified enterprise. A diversified company may be defined as a company which has diversified operations, i.e., activity or operations in different industries and/or foreign operations and sales where those activities (or operations) are significant in terms of sales revenue, profit or losses generated or assets employed. It is also true that segmentation along industry and geographical lines subject to different profitability, different risks and different growth prospects are likely to be found in most diversified companies. The diversified companies and their operations in different industries, activities and geograph-ical areas raise questions as to whether modifications are necessary to the existing framework of corporate accountability and financial reporting practices.

Are consolidated financial statements meaningful where company's operations comprise a number of activities in different geographical areas with different profitability, risk and growth characteristics? Although a business enterprise's total or aggregated financial information is useful, the financial 'statements users find segment information more valuable in assessing an enterprise's standing—its past results and future pros-pects.

Segment reporting is the reporting of the operating segments of a company in the disclosures accompanying its financial statements. Segment reporting is required for publicly-held entities, and is not required for privately held ones. Segment reporting is intended to give information to investors and creditors regarding the financial results and position of the most important operating units of a company, which they can use as the basis for decisions related to the company.

Under Generally Accepted Accounting Principles (GAAP), an operating segment engages in business activities from which it may earn revenue and incur expenses, has discrete financial information available, and whose results are regularly reviewed by the entity's chief operating decision maker for performance assessment and resource allocation decisions. Follow these rules to determine which segments need to be reported:

- Aggregate the results of two or more segments if they have similar products, services, processes, customers, distribution methods, and regulatory environments.

- Report a segment if it has at least 10% of the revenues, 10% of the profit or loss, or 10% of the combined assets of the entity.
- If the total revenue of the segments you have selected under the preceding criteria comprise less than 75% of the entity's total revenue, then add more segments until you reach that threshold.
- We can add more segments beyond the minimum just noted, but a reduction must be considered if the total exceeds ten segments.

The following information must be included in segment reporting:

- The factors used to identify reportable segments
- The types of products and services sold by each segment
- The basis of organization (such as being organized around a geographic region, product line, and so forth)
- Revenues
- Interest expense
- Depreciation and amortization
- Material expense items
- Equity method interests in other entities
- Income tax expense or income
- Other material non-cash items
- Profit or loss
- The segment reporting requirements under International Financial Reporting Standards are essentially identical to the requirements just noted under GAAP.

The **AJCPA** has defined a segment of business as "Component of an entity whose activities represent a separate major line of business or class of customer.

A segment may be in the form of a subsidiary or division or a department, and in some cases a joint venture or other non-subsidiary investee, provided that its assets, results of operations and activities can be clearly distinguished, physically and operationally and for financial reporting purposes from the other assets, results of operations and activities of the entity."

13.4 TYPES OF SEGMENTS

The various types of segments are as under:

a. Business segment:

Business segment is a distinguishable part of an enterprise that is involved in providing an individual product or service or a group of related product, or services and that is subject to risks and returns that are different from those of other business segments.

b. Geographical segment:

Geographical segment is a distinguishable part of an enterprise that is involved in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments.

c. Reportable segment:

Reportable segment is a business segment or a geographical segment identified based on the foregoing definition for which segment information is required to be disclosed.

13.5 TERMINOLOGY OF SEGMENT REPORTING

a. Segment revenue:

Segment revenue reported in the statement of profit and loss of an enterprise that is directly attributable to a segment and the relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, whether from sales external customers or from transactions with other segments of the same enterprise. Segments revenue does not include:

- Extraordinary' items.
- Interest or dividend income, including interest earned on advances or loans to other segments, unless the operations of the segment are primarily of a financial nature.
- Gain on sales of investments or gains on extinguishment of debt. Unless the operations of the segment are primarily of a financial nature.

b. Segment expense:

Segment expense is an expense resulting from the operating activities of a Segment that is directly attributable to the segment and the relevant portion of an expense that can be allocated on a reasonable basis to a segment, including expenses relating to sales to external customers and expenses relating to transactions with other segments of the same enterprise. Segment expense does not include :–

- Extraordinary items.
- Interest; including interest incurred on advances or loans from other segments unless the operations of the segment are primarily of a financial nature.
- Losses on sale of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature.
- Income tax expense.
- General administrative expenses, head office expenses, and other expenses that arise at the enterprise level and relate to the

enterprise as a whole. However costs are sometimes incurred at the enterprise level on behalf of a segment such costs are segment expenses if they relate to the segment's operating expenses and if they can be directly attributed or allocated to the segment on a reasonable basis.

c. **Segment result:**

Segment result is segment revenue less segment expenses.

d. **Segment assets:**

Segment assets are those operating assets that are used by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

e. **Segment liabilities:**

Segment liabilities are those operating liabilities which result from the operating activities of a division and either are directly attributable to the division or can be allocated to the division on a reasonable basis.

f. **Segment accounting policies:**

Segment accounting policies are accounting policies framed for preparing and presenting the financial statement of the enterprise as well as those accounting policies that relate specifically to segment reporting.

13.6 OBJECTIVES OF SEGMENT REPORTING

Segment reporting is the reporting of the operating segments or units of a company in its financial statements. Segment reporting is required for publicly held entities, but not required for privately held ones. The following are the main objectives of segment reporting:

a. **To ensure transparency:** The key objective of segment reporting is transparency. Analysts, potential investors and other stakeholders need complete information to evaluate the sustainability and growth of a company and to monitor the performance of its management.

b. **To assess risk and return:** The risk for investment in equity of a company that discloses complete information is lower than a company that withholds information. Greater disclosure should therefore bring down the cost of capital for a firm.

c. **To enable investors to make informed judgement:** Segment reporting also allows financial statement users to get a better sense of the fluctuations that might affect overall numbers for each segment. If a business shows much higher earnings than expected, for example, segment reporting shows where those earnings are coming from. A stakeholder can look at the same report to determine if the numbers are sustainable.

d. **To inform investors and creditors:** The objective of segment reporting is to provide information to investors and creditors regarding the financial results and position of the most important operating units of a company, which they can use as the basis for decisions related to the company. Further, users can benefit from an enhanced degree of comparability with other enterprises.

13.7 DISCLOSURE REQUIREMENTS OF DIFFERENT USERS GROUPS OF SEGMENT REPORTING

A remarkable feature of modern business in India as well as abroad has been the growth of diversified enterprises that carry on activities in two or more lines of business. This widespread movement towards diversification has led to a need for information about the various segments of an enterprise in addition to consolidated financial statements about its overall performance. Diversified companies present a peculiar and special problem for investment decision-making. The progress and success of a diversified company are composites of the progress and success of its several segments. Proponents of segment reporting contend that information about separate segments contributes to investor evaluations of diversified companies.

a. **Investors:** Segment reporting provides investor's information about profitability risk and growth of various segments of enterprises operations. Investors will be in better position to assess accurately a firm's future earnings. Investor's uncertainty about company's prospects will thus be reduced with the help of segment reporting.

b. **Employees:** Employees and trade unions are also interested in the performance and prospects of the enterprise from the stand point of wage negotiations and job security. Segment reporting helps them as it helps investors.

c. **Management:** Segment reporting is also helpful to the management while taking various important managerial decisions. Management while taking policy decisions may need for information on segmental performance. Lack of information on segmental performance may lead to misunderstanding between management and workers.

d. **Government Agencies:** Government agencies at national and international level in the case of multinational companies, are becoming more concerned by the activities of large companies and the balance; of payments. Segment disclosures by the geographical location seem likely to promote a better understanding of corporate strategy and its impact.

e. **Consumers:** The interests of consumers and the general public may also be promoted by segmental disclosures in the sense that social responsibility in terms of the removal of price discrimination could be encouraged by segment disclosures regarding profits.

13.8 NATURE OF SEGMENT REPORTING

Information reported in a business enterprise's financial statements constitutes an important input to financial statement analysis which is generally made in investment and lending decisions. Investors and lenders analyse information relating to a business enterprise to evaluate the risk and return associated with an investment or lending alternative. **Financial Accounting Standards Board of the USA** states: "The purpose of the (segment) information is to assist financial statement users in analysing and understanding the enterprise's financial statements by permitting better assessment of the enterprise's past performance and future prospects."

Segment information helps users of financial statements in the following way:

(a) Better understand the performance of the enterprise;

(b) Better assess the risks and returns of the enterprise; and

(c) Make more informed judgments about the enterprise as a whole.

Information about the different types of products and services an enterprise produces and the different geographical areas in which it operates would be useful to the respective users. The following points will explain the nature of segment reporting:

1. **Allocation of resources:** Segment information, if disclosed to parties outside the enterprise, would play an important role in improving the allocation of scarce resources in an economy. Non-availability of information creates uncertainty in the investment market and thereby makes the investment market inefficient.

   The disclosure of information removes the imperfections in the investment market and causes the market to function properly. This may influence management performance and encourages them to work in the interest of society and investors. It helps in checking corporate abuses related to matters such as fraud, unfair pricing policy and trade practices.

2. **Investment and credit decisions:** Segment information enables the financial statement users to better analyse the uncertainties surrounding the timing and amount of expected cash flows—and therefore, the risks—related to an investment or a loan to an enterprise that operates

in different industries and markets. Since the progress and prospects of diversified enterprise are composites of the progress and prospects of its several parts, financial statement users regard financial information on a less than total enterprise basis as also important.

In credit decisions, creditors like shareholders, are interested basically in profitability and cash flows of a debtor company. Profits are the source of funds for paying interest and principal of loans. In making short-term loans decisions the banker aims to forecast short-period cash flow as an indicator of a customer's ability to meet maturing financial obligations.

A banker is interested in segment information for short-term loans to disclose areas of weakness such as unprofitable products or markets that absorb rather than produce funds for meeting debts. It should be noted, however, that bankers have power to demand more information from a client than the investors.

It has been found that security analysts are able to make more accurate earnings projections after access to segmented data and therefore concluded that segmented or line-of-business reporting would benefit users. Thus, segment information enhances investors' ability to understand a diversified company and to make accurate and useful forecast about the profitability of segments as well as the company as a whole.

3. **Equilibrium in share prices:** The segment disclosures would tend to adjust the prices of company shares according to information released. Researchers have examined the influence of segment data on company share prices. They took into account both changes in risk and changes in expected return resulting from segment profit disclosure. Results revealed a reduction in the cost of equity capital for firms disclosing segment profit data for the first time.

4. **True and fair view:** An important provision of the Companies Act in India (and abroad) is to reveal a true and fair view of the results of operation and financial position. Segment disclosures may be greatly required in terms of the true and fair criterion established in the Companies Act. This has encouraged provision for disclosure of segmented information in the legislation of certain countries of the world such as the USA and Canada.

   Also, segment disclosures are advocated by international agencies like the UN and the OECD. In some countries, the accounting bodies have prepared guidelines for the disclosure of segment information in company annual reports.

For example, the **Financial Accounting Standards Board of** USA has issued **Statement No. 14,** Financial Reporting for Segments of a Business Enterprise in December 1976. An Australian study argues that an auditor may be held legally responsible in certain circumstances if he gives an unqualified report on overall financial statements which do not reveal, where they exist, significant disparities in segment results.

To conclude, we can say that the above-mentioned benefits associated with segment disclosure point out that segment reporting is desirable in published annual reports of diversified companies to present true and fair results of their business activities, and to help investors in making proper investment decisions.

13.9 PROBLEMS IN SEGMENT REPORTING

The difficulties involved in segment reporting are, truly speaking, the problems of implementation. However, there are some difficulties of which company managements and investment community are aware and which must be resolved if segment information is to be disclosed in company annual reports. Some of the major problems in implementing segment reporting proposal are listed below:

a. **Basis of segmentation:** How a diversified company should be fractionalized for reporting purposes is a problem in segment reporting. Basically, there are three questions involved in this vital problem-

- **Firstly,** the improbability of developing a single uniform system which would permit segmentation of all companies on a reasonable basis.
- **Secondly,** development of a system which will realistically reflect the operations of the companies concerned.
- **Thirdly,** misunderstandings that are likely to result from attempting to view parts of a total company as if they were independent units subject to independent valuation.

The greatest problem in segmenting a diversified enterprise lies in the fact that diversification may exist in different forms such as, industry, product lines, individual products, markets and geographical areas. Each type of diversification may create segments that vary significantly in terms of profitability, growth and risk.

Besides, more than one type of diversification may be found in an enterprise simultaneously. Also, terms like industry, product, location and market are not very precise. Some argue that it is difficult to evaluate a segment separate from the rest of the company. It should be noted that the purpose of segmentation is to provide information which will help financial statement users to judge the future success of the company. Therefore, segments selected should be realistic and viable from the operating point of view.

In other words, segment(s) selected in a diversified company for financial reporting purposes should represent the company and company operations, reflect the difference within the company regarding rate of profit, degrees of risk and potential for growth.

b. **Allocation of common costs:** Common costs for the purpose of preparing segment reports need to be apportioned between different products (segments). In some cases, common costs are apportioned on a basis which may be classified as reasonable and reliable. For example, factory rent is a common cost which can be divided among different segments on the basis of the area occupied by them. Similarly, the expenses pertaining to a central accounting department may be apportioned among different segments without much difficulty if details about the time devoted to the accounting matters of each segment by the company accounting department is available.

But the expenses of planning department (established at the company level) may be very difficult to apportion as no direct relation between the services provided by the planning department and the benefits accruing to different segments may be visible. If a common cost is apportioned on a basis which does not reflect a rational relationship, the basis, being totally unjustified, would produce inaccurate and unreliable segment figures. It may be concluded that common costs have to be grouped in terms of how easily they can be apportioned among different segments.

The problem of allocating common items (common assets and liabilities) is greater for some items than for others. It is particularly great for assets, liabilities, and equity so that reporting for business segments is suggested less often for information from the balance sheet, statement of shareholders' equity and funds statements than for information from the income statement.

Thus, some common costs can be allocated on a rational basis; some may be distributed on a basis which may even reflect whim or bias. Because of the diversity of methods employed, cross- company comparisons of similar segments are likely to be misleading, and the reliability of segment operating results varies depending on how closely the basis of allocation approximates results that would have been produced by market transactions.

c. **Pricing of inter-segment transactions:** The segments in a diversified company may or may not have substantial amounts of inter-segment transactions. A diversified company having disparate segments may have very few inter-segment transactions. On the contrary, a diversified enterprise may have closely integrated segments which would surely have very substantial transactions among themselves.

Indeed, there may be segments which have no outside transactions under any circumstances. As compared with the apportionment of common costs, it is relatively easy to price inter-segment transactions. Internally, a company will price its transactions between its segments in order to hold the various segments responsible for their activities and operations.

An important secondary purpose of the pricing, however, may be to motivate employees, or actually to measure the success of the several segments as accurately as possible.

The market price for pricing inter-segment transactions may be more useful for external users as it provides accurate revenue data based on the transactions approach and the realisation concept. Although market values result in a more accurate determination of segment profitability, they are often difficult to determine as no readily available open market transactions exist as a standard against which to measure the price used. The use of marginal cost (variable costs) tends to understate the revenue of supplying segment. In full cost plus profit margin or negotiated price based on full cost techniques, revenue is recognised by the transferring segment before an outside sale takes place. Sometimes, it leads to an inaccurate and premature measure of segment performance.

In case the full cost method is used, the profit of the transferring segment happens to be understated because the profit margin likely to be earned on the transfers is not considered. The inclusion of profit margin is possible only when market price technique is used.

No single accounting method is available which may be classified as the most appropriate. If market values are difficult to determine, full cost of the product or a negotiated price is considered an acceptable alternative. Additional research is needed with regard to determination of a suitable method of intersegment transfers. However, segment reporting should not be withheld simply because an appropriate method is not available.

d. **Comparability of segment data:** There is the question of comparability of the data disclosed when

- apparently similar segments, in different firms may be identified differently;
- the treatment of inter-segment transfers may differ, and common costs may be allocated on different bases.

Problems concerning the technical feasibility of segmental reporting may limit its current usefulness in practice, but do not necessarily undermine its potential relevance. Secondly, comparability between segments is not, in any case, an essential goal of segmental reporting.

The main aim is to promote a more informed evaluation of the performance and prospects of each firm, including the prediction of profits and cash flows, so that comparisons can be made at the firm rather than at the segmental level.

e. **Degree of integration in segment activities:** A more significant argument against segmental reporting can be made where a firm is highly integrated. In the case of a vertically-integrated firm, the recognition of external markets for intermediate goods may not always be warranted.

Similarly, in the case of a horizontally-integrated firm, there may be circumstances where there is a substantial amount of interdependence between activities which are coordinated by management to an extent that the recognition of separate activities cannot be supported.

Where a firm's operations are highly integrated and closely coordinated, then it seems unlikely that meaningful segmental reports will result. The problem is how to determine the critical point at which disaggregation no longer becomes justifiable, or segmental reports valuable.

f. **Costs of segment disclosure:** Further arguments against segmental reporting are concerned with the costs of disclosure. The provision of additional information will, undoubtedly, increase a firm's operating costs in terms of the costs of collection, processing, audit and dissemination. A further potential cost is where the company's management control system needs to be adapted to allow the relevant data to be collected.

Much will depend on the quantity and quality of data required and the nature of the company's existing control system. It seems likely that, in many instances, management will already be gathering relevant segmental data for its own internal purposes, and it may well be that this can be readily adapted for its external users.

The level of disaggregation required seems likely to be an important cost consideration. It can be argued that there must be some limit to the number of segments disclosed and to their related information content. There is also the question of information overload to be taken into account which even in the case of sophisticated investors may eventually have dysfunctional consequences.

Another important cost argument relates to the increased competition that may result from segmental disclosures. It is argued that the disclosure of profitable segments will attract competitors, whilst loss-making segments may become the subject of take-over bids or put pressure on management to sell them off, with the purpose of improving profits in the short-term and to take on less risky projects.

A competitive disadvantage may also occur where foreign companies are not required to provide segmental reports. In addition, government scrutiny may also be encouraged, especially in the case of multinational companies with possible regulatory or tax consequences.

Against these arguments is the public interest in the form of competition as a means to a more efficient allocation of resources in the economy taken as a whole.

A key question is, of course, the extent to which competition is seen to be a desirable goal, and the extent to which regulation of disclosure is seen to be necessary to achieve it. This is likely to vary across countries according to the balance of value judgments at any point in time concerning the costs and benefits involved.

g. **Management conservatism:** Another argument is that, where there is no regulatory provision to disclose segmental reports, voluntary disclosures are likely to be perceived by managements to be beneficial only in certain instances; for example, where management believes that the company's attractiveness to investors will be enhanced and the costs of finance reduced.

Few companies are likely to take voluntary action that may benefit their competitors or reveal weaknesses.

Further, where regulations exist but gives too much discretion to management, it tends to be largely ineffective as either there is no disclosure, or where there is, it is of questionable value owing to "conscious manipulation or inadvertent discrimination" in the identification of the segments to be reported.

In nutshell, we can say that there are a number of valid arguments in favour of segment reporting which, in the case of investors, are supported to some degree by empirical research findings. On the other hand, there are situations where segmental reporting may not be meaningful, where there is little stimulus for disclosures to be made, and where the costs may outweigh the benefits.

A fundamental problem concerns the evaluation of costs and benefits especially where social objectives inevitably intrude. Any decision to provide or require segmental disclosures must also involve consideration of a further set of problems, including the identification of reportable segments as well as issues of materiality, content, measurement, presentation and audit.

13.10 SUMMARY

Information reported in a business enterprise's financial statements constitutes an important input to financial statement analysis which is generally made in investment and lending decisions. Investors and lenders analyse information relating to a business enterprise to evaluate the risk and return associated with an investment or lending alternative. The key advantage of segment reporting is transparency. Analysts, potential investors and other stakeholders need complete information to evaluate the sustainability and growth of a company and to monitor the performance of its management. The objectives of segment reporting are described as under – a. To provide a better understanding of the performance and evaluation of the results of the organization. b. To provide the information to the stakeholders about the important units of the organization to evaluate and make decisions about the investment. c. To make the accounts more transparent and understandable. d. To make better decisions by taking in mind the business from different segments. e. For a better analysis of the risk and returns of the organization. f. To analyze the most profitable or Loss-making units.

Segmental reporting is important for the organization, its investors, and the stakeholders in the following way: a) It provides investors the complete details about the units, their profitability, etc. They can analyze and decide upon the investment in the organization. b) It helps the organization in better decision making as the planning about expansion or diversification is to be done based on the result of the segment. c) It helps the creditors to decide the credit terms based upon the analysis of each segment separately. d) It helps the shareholders to decide whether to retain the shares or to sell the shares. e) It helps management to decide whether to expand the segment or sell off the segment. f) Segmental Reporting gives a better understanding of the financial statements. g) The profit-making and loss-making units can be easily identified with the help of segmental reporting. h) It helps in the optimum utilization of resources and better presentation. i) It helps potential investors in better investment decisions.

But it is also not free from limitations. There are many disclosures required in the case of segmental reporting; hence it is a time-consuming process. The data presented can be misinterpreted by the investors or creditors. Method of reporting Inter-segment transactions are different for each organization. The base of the segment is also different as some organization divides the segment based on geographical location, and some organizations divide based on product-wise. The common costs are sometimes difficult to allocate.

13.11 GLOSSARY

- **Segment revenue-** Segment Revenue reported in the statement of profit and loss of an enterprise that is directly attributable to a segment.
- **Segment expense-** Segment Expense is an Expense resulting from the operating activities of a Segment that is directly attributable to the segment.
- **Segment result-** Segment result is Segment revenue less segment expenses.

- **Segment assets-** Segment Assets are those operating assets that are used by a segment in its operating activities and that either are directly attributable to the segment.
- **Segment liabilities-** Segment Liabilities are those operating liabilities which result from the operating activities of a division and either are directly attributable to the division or can be allocated to the division on a reasonable basis.
- **Segment accounting policies-** Segment accounting policies are accounting policies framed for preparing and presenting the financial statement of the enterprise as well as those accounting policies that relate specifically to segment reporting.

13.12 SELF ASSESSMENT QUESTIONS

Q1. What is segment reporting?

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Q2. State the objectives of segment reporting.

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Q3. Discuss the benefits of segment reporting.

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13.13 EXAMINATION ORIENTED QUESTIONS

1. What do you mean by segment reporting? Explain the benefits and limitations of segment reporting.

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Q2. Discuss the problems in segment reporting.

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13.14 SUGGESTED READINGS

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CORPORATE REPORTING

INTERIM REPORTING-NATURE, OBJECTIVES, PROBLEMS AND SUGGESTIONS FOR IMPROVING INTERIM REPORTING

14.1 INTRODUCTION

14.2 OBJECTIVES

14.3 MEANING OF INTERIM REPORTING

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14.13 SUGGESTED READINGS

14.1 INTRODUCTION

In a self-motivated business environment, with the increased scope and complexity of business enterprises, annual data are insufficient to evaluate developments in general economic, industry and company activities and making or revising projections of earnings and financial position as a basis for investments decisions. Investment decisions are made on the basis of information disclosed in company annual reports. These economic decisions are made throughout the year rather than at year-end reporting dates. Although annual reporting has been accepted by accountants and/or law, investment decisions based on financial data are made daily and require current financial information. No doubt the annual report will continue as a report on management's stewardship for the full year and a benchmark for measurement of financial progress over several years. But neither the dynamics of the internal organisation, nor outside economic forces stop and start over at each new accounting year. Therefore, it is suggested that financial reporting should continuously measure and report on the firm's progress and information on a less than annual basis for the benefit of shareholders and other rural users.

14.2 OBJECTIVES

After going through this lesson, the students will be able to understand-

- the meaning of interim reporting;
- objectives of interim reporting;
- problems of interim reporting; and
- suggestions for improving interim reporting.

14.3 MEANING OF INTERIM REPORTING

Interim reporting is the financial reporting made by a company on a less than annual basis, such as half yearly or quarterly financial reports. Annual data are insufficient to evaluate developments in general economic, industry, and company activities and making or revising projections of earnings and financial position as a basis for investment decisions.

Investment decisions are made on the basis of information disclosed in company annual reports. These economic decisions are made throughout the year rather than at year-end reporting dates. Although annual reporting has been accepted by accountants and/or law, investment decisions based on financial data are made daily and require current financial information.

No doubt the annual report will continue as a report on management's stewardship for the full year and a benchmark or measurement of financial progress over several years. But, neither the dynamics of the internal organisation, nor outside economic forces stop and start over at each new accounting year.

Therefore, it is suggested that company financial reporting should continuously measure and report on the firm's progress and provide information on a less than annual basis for the benefit of shareholders and other external users.

14.4 OBJECTIVES OF INTERIM REPORTING

Five basic objectives of interim reporting are identified, they are –

1. **Make projection:** Annual data proves to be insufficient in evaluating the progress and earnings projections of the company. Thus, interim reporting helps in making early projections regarding cash flows and other developments of the company.

2. **Estimate annual earnings:** Annual earnings can be estimated based on the reports of interim financials. Gain or loss in a quarter period helps in the proper estimation of profit or loss a company will incur at the end of the fiscal year.

3. **Identify turning points:** Major breakthrough in the company's performance can be estimated and identified using interim reporting.

4. **Evaluate management performance:** How well is the management of the company performing can be evaluated using the results of interim financial reports.

5. **Supplement annual report:** Along with the annual financial report, interim reporting helps in periodic evaluation of the financial performance of the company which forms a supplement for annual reports

14.5 PROBLEMS IN INTERIM REPORTING

Basically two problems-Accounting Problems and Conceptual Problems are involved in interim financial reporting.

I. Accounting problems:

Accounting problems are of the following types:

1. Inventory problems:

In a business enterprise, inventory is a major element in the generation of income. Inventory problem in interim reporting has three types of problems; determination of inventory quantities, valuation of inventories, and adjustments of valuation. The development of inventory data for interim reporting depends largely on the making of accurate physical counts and its costing procedure. However, the valuation problem is more important than the quantity problem.

It is almost invariably considered impractical to count and price the inventory every quarter or every month, so estimates of gross profit must be used to determine cost of goods sold. Alternatively, the company may have perpetual inventory records integrated with the accounting records, allowing direct determination of cost of goods sold, but the perpetual records may not be verified by cycle counts, and some interim allowance will be needed for annual physical inventory adjustments.

2. **Matching problem:**

Business operations are not similar and uniform throughout the year. Resources are acquired and output is done in advance of sales. Some costs related to current sales do not mature into liabilities or readily measurable expenses until a subsequent time. Because of various lead and lag relationships between cost and sales, difficulties are created in matching costs and revenues. The relationship between costs and revenues becomes unclear.

Interim accruals for various selling expenses, general and administrative expenses, allowances for doubtful accounts, and deferrals and contingencies are illustrations of items that normally require companies to rely heavily on estimates.

Many techniques and procedures are available in accounting for allocating costs between different periods. But the allocation procedures appear to be highly arbitrary which raise serious questions as to the reliability and usefulness of the results.

For example, depreciation and property taxes may be allocated to months on a time basis, but deducting a constant amount each period when sales fluctuate, tend to increase the amplitude of fluctuations in reported profits.

Some expenses to be incurred during a period may be uncertain at the time when revenues are reported, e.g., maintenance and repairs, employee vacations, various taxes, etc. Income tax is also a complex area in interim reporting requiring considerable attention. In order to calculate interim income taxes, a company must estimate such items as the annual pretax income, and other permanent differences for the full year.

3. **Extent of disclosure problem:**

There is a problem of deciding the quantity of disclosures in interim financial reports. Generally speaking, disclosure requirements applicable for annual reporting are not applicable to interim reporting. In the absence of mandatory interim disclo-sures, the interim disclosure practices are likely to vary.

There is a problem of determining materiality criteria for deciding the information to be disclosed in interim reports. The treat-ment to be given in respect of prior period adjustments, extraordinary items and earnings per share can create difficulties in interim reporting.

II. Conceptual issues:

The primary conceptual issue is whether the interim period is part of a longer period or is a period in itself. The former position is known as the integral view, the latter as the discrete view. Under the integral view, revenue and expenses for interim periods are based on estimates of total annual revenues and expenses.

The discrete view holds that earnings for each period are not affected by projections of the annual results; the methods used to measure earnings are the same for any period, whether a quarter or a year. As a practical matter some elements of both positions are recognized in current reporting practices.

Those who favour the second, the integral approach, view each interim period primarily as being an integral part of the annual period. Under this view deferrals, accruals, and estimates at the end of each interim period are affected by judgments made at the interim date as to the results of operations for the balance of the annual period.

Proponents of the discrete approach, on the other hand, argue that users are interested in a report of the actual realizations of the interim period itself in order to monitor management's performance during this period.

Consequently, they argue against any allocation of costs based upon annual results that would lead to a smoothing effect in which turning points and short- term fluctuations are obscured from investors. For the purpose of interim reporting, discrete approach is preferred for some items (issues) whereas integral view is suggested for the other items. This combination approach has been recognized by FASB (USA) when it states:

"Users may be interested both in making predictions for various future periods and in detecting changes in profit trend and liquidity. It may not be necessary to place emphasis on one of these or on other possible uses. The integral and discrete views may seem to have both advantages and disadvantages. Therefore, a more reasoned approach is to attempt to obtain the advantages and minimize the disadvantages of each of these views."

Interim period reporting is inevitably an attempt to ensure that report users have reliable information on which to base their decisions. Interim reporting presents particular problems in the context of audit. The urgency of timely reporting both precludes a full external audit, and increases the chance of the inaccuracies arising through estimations and allocations. Furthermore, narrative comments are less easily validated or assessed for accuracy and completeness than well-defined numerical disclosures.

14.6 INTERIM REPORTING IN INDIA

In India, earlier, the companies were required to provide financial information by way of annual reports to their shareholders. Recently it was felt that there is a wide time gap between the two annual reports and during this time gap investors do not get information to make sound investment and other decisions.

On the other hand, rational investment decisions cannot be made on the basis of rumors, hearsay, liking or disliking. The publication of the interim results of the companies may prove a reliable source to evaluate the strengths and weaknesses of the company.

14.7 NATURE OF INTERIM REPORTING

1. Reports on interim period activities are designed to materially assist users or achieve objectives.

2. Interim reports for general distribution are be directed towards meeting the needs of both current and prospective shareholders and important representatives of these groups.

3. Interim reports are designed so as to reduce the amplitude of those exchange price fluctuations that result from misinformation. Misinformation is used here to include failure to communicate and partial communication.

4. Substantial disaggregation of data are be reflected in reports for interim periods. Disaggregation should emphasise disclosure of information about the nature of the events which underlie the reported data.

5. Interim reports incorporates data developed with an emphasis on forecast-ability. Unusual events, the effect of which is material in size, should be separately disclosed in interim reports. Materiality should be based on the results of interim period activities. The accounting for and reporting of similar events in interim statements should be consistent for a given entity over time. Interim reports, should, in substance, articulate with annual reports.

6. Timeliness is emphasised in the reporting of information about interim period activities. Financial reports should be promptly distributed by publicly owned business firms to external users at least four times during each fiscal year, and usually following the end of each of three months period.

14.8 SUGGESTIONS FOR IMPROVING INTERIM REPORTS

Backer has given the following suggestions to enhance the usefulness of interim financial reports:

1. **Adopting fiscal period to operating cycle:**

   Accounting problems resulting from arbitrary cut-offs can be minimised by selecting a close date which coincides with a time of low activity in a company's natural operating cycle. Businesses which experience more than one distinct seasonal cycle within a year could improve the significance of quarterly statements by reporting for seasonal cycles rather than for calendar years.

   Reports for periods containing a uniform number of working days rather than for calendar months, and prorating costs on the basis of working days instead of months help to remove some erratic fluctuations in monthly and quarterly operating results.

2. **Smoothing income to minimise fluctuations:**

   Accounting techniques for smoothing interim income include accrual of anticipated expenses which relate to the whole year rather than reporting them when they arise. For example, provision for bad debts may be accrued monthly rather than only at the end of the year.

3. **Allocating annual costs to interim periods on basis of sales:**

   Reported profit tends to vary with sales when annual costs are allocated to interim periods on the basis of the period's portion of total annuals sales.

   To have interim period costs and profits vary with sales is advantageous to investors who are seeking to forecast annual profits because forecasts of sales can then more easily be translated into forecasts of profits. However, maximum benefits will result only where annual costs of both manufacturing and non-manufacturing functions are allocated to periods on the basis of sales.

4. To aid interpretations:

Disclosure to aid interpretations where material amounts of unusual items have been accrued or differed in accounting for interim income, disclosure of the procedures followed may help the users to interpret the results. Since investment decisions are based on future expectations rather than past performance, a view of management's expectations by interim periods would seem to be helpful.

Interim financial reporting, undoubted, is useful to managements and shareholders (existing and potential) since economic decisions are made by the investors throughout the year and not necessarily at the end of an accounting period.

The preparation of interim reports, say quarterly or half yearly, requires the solution of some accounting problems, e.g., matching problem, inventory valuation problem, besides probably the most important issue as to extent of disclosure in interim reports.

It is now argued that interim statement should be a complete financial statement—complete profit and loss account and balance sheet. Inadequate disclosure of interim information will not achieve the objectives underlying financial reporting.

The costs involved in gathering, preparing, developing and distributing the interim information is also an important factor and may act as a restraint in the objective of providing fuller interim information.

It has to be satisfied that benefits likely to be derived from interim reports are more than the costs involved therein. If costs of disclosure are within manageable limits, business enterprise should prefer to give interim data to the shareholders, investors and other interested users.

14.9 SUMMARY

Interim reporting is the reporting of the financial results of any period that is shorter than a financial year. Interim reporting is usually required of any company that is publically held, and it typically involves the issuance of three quarterly financial statements each year. These statements include:

- **Balance sheet:** As of the end of the current interim period and the immediately preceding fiscal year.
- **Income statement:** For the current interim period, and the fiscal year-to-date, and the corresponding periods for the immediately preceding fiscal year.
- **Statement of cash flow:** For the current fiscal year-to-date period, and the corresponding period for the immediately preceding fiscal year.

The precise format and contents of interim reports issued by publicly-held companies are defined by the SEBI. These reports are reviewed by a company's auditors, rather than undergoing a complete audit.

There are several factors to consider when constructing interim reports, which are:

- **Accounting changes.** If there is a change in accounting policy or accounting estimate, report the results of the change in the interim period when it occurred. You should restate the interim results of prior periods when there is a change in accounting policy, but not when there is a change in accounting estimate.
- **Accounting policies.** You should consistently apply the same accounting policies used for the construction of full-year financial statements to the construction of interim statements. If you plan to apply a new accounting policy to the full-year statements of the current fiscal year, then use them in the interim period, too.

- **Cost of goods sold.** It is acceptable to use an estimation method to arrive at the cost of goods sold for an interim period, if you have not conducted a physically inventory count.

- **Expense recognition.** You should charge an expenditure to expense in the period to which the cost is traceable. You may defer recognition of an expense if it affects more than one interim period, and recognize it over those periods.

- **LIFO layer liquidation.** If you liquidate a LIFO inventory layer during an interim period and expect to replace it before the end of the fiscal year, then include in the cost of goods sold for the interim period the sold units at the cost at which you expect to replace the liquidated LIFO layer.

- **Market declines.** If market prices decline for inventory items, recognize the related loss in the interim period. It is allowable to reverse this loss if there is a market price gain later in the fiscal year.

- **Materiality.** If an item is material to the interim period but not to the fiscal year as a whole, then disclose the item separately in the interim report.

- **Quantity discounts.** If you are granting quantity discounts to customers based on their annual purchases, you should accrue the discount in advance in each interim period, based on their probable annual purchases.

- **Retroactive adjustments.** As a general rule, do not retroactively adjust prior interim periods within a fiscal year. Exceptions are only allowed if the impact of the adjustment is material to the results of continuing operations for the full fiscal year, and a portion of the adjustment is tied to a specific interim period, and you could not have estimated the amount of the adjustment prior to the current interim period.

- **Seasonal or cyclical revenues.** You may only recognize seasonal or cyclical revenues when earned. You may not accrue or defer them in an interim period.
- **Transaction recognition.** You should base the recognition of an accounting in an interim period on what you expect for the company's results for the transaction entire year, not just for the interim period. For example, you should recognize an income tax expense in an interim period that is based on the expected weighted-average income tax rate for the entire year. This treatment may result in a series of accrual adjustments in later interim periods, as you refine your estimates.

14.10 GLOSSARY

- **SEBI**- Securities and Exchange Board of India
- **Balance sheet**- a statement of assets and liabilities
- **Income statement**- a statement of profit or loss during the financial year
- **Statement of cash flow**- statement of inflows and outflows of cash
- **LIFO**- Last-in-First-Out

14.11 SELF ASSESSMENT QUESTIONS

Q.1. What is interim reporting? Explain its relevance for the investors and other external users.

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Q2. Discuss problems involved in preparing interim reports.

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Q.3 What developments have taken place in the area of interim reporting.

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Q.4 Prepare a comprehensive note on interim reporting practices of Indian Companies.

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14.12 EXAMINATION ORIENTED QUESTIONS

1. Prepare a comprehensive note on interim reporting practices of Indian Companies. Do you think that there is scope for improvement in this area for the benefit of Indian investors.

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2. Suggest way to improve interim reporting of business enterprises.

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3. What are the problems in preparing interim financial reports by business enterprises? What is the position of interim financial reporting in India?

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4. What is the need for interim reporting? Explain the problems in interim reporting being by business enterprises.

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5. Discuss the recommendations of AS-25 with regard to disclosure of interim financial information.

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6. Discuss the SEBI's guidelines on interim reporting.

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HARMONISATION IN REPORTING- NATURE, NEED, BENEFITS AND OBSTACLES IN CONVERGENCE AND HARMONISATION; SUGGESTIONS FOR INCREASED CONVERGENCE AND HARMONISATION; CORPORATE GOVERNANCE REPORTING : VALUE ADDED REPORTING AND HR REPORTING

15.1 INTRODUCTION

15.2 OBJECTIVES

15.3 HARMONISATION IN REPORTING- MEANING

15.4 NEED FOR HARMONISATION IN REPORTING

15.5 MAJOR FORCES LEADING TO HARMONISATION IN REPORTING

15.6 BENEFITS OF HARMONIZATION IN REPORTING

15.7 DISADVANTAGES OF HARMONIZATION

15.8 OBSTACLES IN CONVERGENCE AND HARMONIZATION

15.9 SUGGESTIONS FOR INCREASED CONVERGENCE AND HARMONIZATION

15.10 CORPORATE GOVERNANCE REPORTING

15.11 VALUE ADDED REPORTING

15.12 HR REPORTING

15.13 SUMMARY

15.14 GLOSSARY

15.15 SELF ASSESSMENT QUESTIONS

15.16 EXAMINATION ORIENTED QUESTIONS

15.17 SUGGESTED READINGS

15.1 INTRODUCTION

Harmonization of financial statements refers to financial reporting that is based on international accounting standards that are accepted across the globe. The international business community recognized the need for uniform accounting standards. This has been necessitated by of the spectacular growth in the number and size of multinational companies, foreign investments and cross-border listings on the stock exchanges. To improve the comparability against domestic and international peers, harmonization of financial statements is advocated. Harmonization strives to enhance comparability between financial statements by setting restrictions on the alternative accounting treatments allowed for similar transactions. The comparability of financial statements becomes doubtful if similar transactions are accounted for differently in different countries. Investors and analysts benefit from enhanced comparability of financial statements.

15.2 OBJECTIVES

After going through this lesson, the students will be able to understand-

- the meaning of harmonization;
- need for harmonization;

- benefits of harmonization;
- obstacles in convergence and harmonization; and
- suggestions for increased convergence & harmonization.

15.3 HARMONISATION IN REPORTING- MEANING

Harmonization refers to the process of eliminating areas of difference in accounting practices throughout the world. It is a process of increasing the compatibility of accounting practices by fixing the limits to their degree of variation. It carries a wider meaning than standardization although it is sometimes being used inter changeably.

Christopher and Robert in their book "Comparative International Accounting" have defined the term Harmonisation as 'a process of increasing the compatibility of accounting practices by setting bounds to their degree of variation while standardization appears to imply the imposition of a more rigid and narrow set of rules. In a simplest way harmonisation means not only bringing out uniformity by reducing alternatives and differences in procedures by setting specific bounds, but embraces a blending and combining the elements of accounting practices of various countries into an orderly structure. There is pressure for harmonisation of divergent accounting practices not only from the users of financial statements but also from those who regulate and prepare them. Pressures come from the investors and financial analysts to facilitate investment and credit decisions.

The financial analysts are of the view that international diversity in accounting practices has enough potentiality to destroy the international flow of capital. The Investors are also putting pressure for harmonisation as they desire that financial information should not only be intelligible but comparable also.

Increased number of multinational corporations on global arena also calls for increased harmonisation. Lack of harmonisation in different accounting standards developed by different countries also imposes financial burden on multinational corporations. Hennessy who is chairman of credit issue has observed that the cost of converting to US accounting standards is at least S 1 million for a major Japanese or British Company.

Accounting professionals also put pressure for harmonisation as it will lead to the internationalization of their profession. Universal accounting principles would enable professional accountants to operate with ease in different countries. Pressures for harmonisation also come from governments and revenue agencies particularly in developing nations.

Harmonization is aimed at reducing differences in financial reporting processes around the world. The goal is to achieve some level of comparability in the way financial statements are prepared and presented. When international harmonization occurs, the difficulties for companies and individuals considerably decrease in presenting the financial statements and their interpretations. There are several organizations that have been trying to eliminate the differences between financial reporting standards and achieve international harmonization. If international harmonization is achieved, many countries would benefit from it as it would improve the access to the international financial markets and improve the confidence and knowledge of investors which may even trigger an increase in future investments.

Harmonization, as being different from standardization, is the process of creating a similar set of procedures by establishing boundaries as to how much they can differ globally. However, standardization is the process of unifying the reporting standards to make them the same. However, this is almost impossible to achieve. Therefore, harmonization has been implemented considering the facts that even the harmonization can not eliminate the international differences in reporting standards. Garrido, León, and Zorio, 2002 stated that the globalisation has been one of the main drivers of moving towards harmonization by eliminating differences. This has been increasingly important in the case of multinational companies when operating internationally and using different sets of reporting standards which made it less efficient to compare the financial statements. Another importance for harmonization has been an increasing focus on investors as they benefit from new IFRS due to investor oriented approach.

The accounting and auditing processes were developed by governments and regulatory bodies all over the world according to the specific needs of those countries. However, as mentioned by Roussey (1994) the need for one set of international reporting standards have increased even more as the businesses are going global and growth in cross-border financing are creating an environment that would benefit from greater harmonization of accounting standards at both international and national levels. To achieve harmonization, the parties such as investors, business analysts, corporations, organizations, government bodies should work in cooperation.

There are several organizations that promote the harmonization of IFRS globally. These are just a few of them:

- European Union
- International Organization of Securities Commissions
- International Federation of Accountants
- World Trade Organization
- International Monetary Fund
- World Bank

15.4 NEED FOR HARMONISATION IN REPORTING

1. Harmonisation ensures high quality financial reporting.
2. Harmonisation ensures a reliable financial reporting and disclosures.
3. Harmonisation enables a systematic reviews along with evaluation of performance of a multinational corporate unit having subsidiaries in various countries where in each country has its own set of GAAP.

4. Harmonisation adds to the global credibility of a corporate unit.

5. Harmonisation makes the comparison of the corporate unit against the domestic and international peers more easier.

6. Harmonisation provides a level of playing ground where no country is advantaged or disadvantaged by its GAAP.

7. Sometimes Harmonisation can prove to be crucial to the economic development of a country.

15.5 MAJOR FORCES LEADING TO HARMONISATION IN REPORTING

Emergence of MNCs:

This is primary and single factor responsible for the need of harmonisation. MNCs share more than 1/3 of world output. So every nation of the world is directly or indirect affected by MNC's.

Increased need of harmonisation is there because of the following:

(i) MNC's desire for foreign capital.

(ii) MNC's desire for reducing accounting and reporting costs.

Regional, Political and Economic Harmonisation:

Regional, Political and Economic Harmonisation is also compelling accounting professionals for the need of increased harmonisation in accounting practices. Unification of Germany, United Europe are the examples of regional, political and economic co-operation.

Developed Countries like USA, Japan look in developing nations like India for Capital investment. Undeveloped countries approach developed nations for financial help. Due to economic dependence business has increased manifold. Every country is trying for political and economic harmonisation.

Global Integration of Capital Markets:

International flow of capital has given rise to the concept of global investors. On the other hand listing of foreign companies in domestic stock exchanges has given birth to the global integration of capital market. Global investors are interested in cross border financial reporting. Informational needs of global investors have compelled accounting professionals and institutes to work for harmonisation.

It has therefore, been a long felt need that companies world over communicate using a common accounting language. Country specific principles are so varied that the aspiration for a globally integrated capital market can be fulfilled only through a uniform financial reporting code.

For instance, the US, the U.K., Japan. Australia and the European Union should accept the same set of accounting standards, audit rules, disclosures and capital market regulations.

The impetus for changes in accounting practice has come from the needs of the business community and governments. With the expansion of international business and global capital markets, the business community and governments have shown an increased interest in the harmonization of international accounting standards.

Suggested problems caused by lack of harmonization of international accounting standards include:

1. A need for employment of key personnel in multinational companies to bridge the "gap" in accounting requirements between countries.

2. Difficulties in reconciling local standards for access to other capital markets.

3. Difficulties in accessing capital markets for companies from less developed countries.

4. Negative effect on the international trade of accounting practice and services.

International interest in harmonization of international accounting standards has been especially strong since the early 1970s. In 1973, nine countries, including the United States, formed the International Accounting Standards Committee (IASC). IASC includes approximately 100 member nations and well over 100 professional accounting bodies. The IASC is the only private sector body involved in setting international accounting standards.

The IASC's objectives include:

1. Developing international accounting standards and disclosure to meet the needs of international capital markets and the international business community.

2. Developing accounting standards to meet the needs of developing and newly industrialized countries.

3. Working toward increased comparability between national and international accounting standards.

The IASC does not have authority to enforce its standards, but these standards have been adopted in whole or in part by many countries.

IASC follows a due-process procedure similar to that of the FASB. This includes exposure drafts and a comment period. All proposed standards and guidelines are exposed for comment for about six months.

The United Nations (UN) has shown a substantial interest in harmonization of international accounting standards. The UN appointed a group tostudy harmonization of international accounting standards in 1973. This has evolved into an ad hoc working group. Members of the working group represent governments and not the private sector. The working group does not issue standards but rather facilitates their development. The UN' sconcern is with how multinational corporations affect the developing countries.

Domestic accounting standards have developed to meet the needs of domestic environments. A few of the factors that influence accounting standards locally are:

1. A litigious environment in the United States that has led to a demand for more detailed standards in many cases.
2. High rates of inflation in some countries that have resulted in periodic revaluation of fixed assets and other price-level adjustments or disclosures.
3. More emphasis on financial reporting / income tax conformity in certain countries (for example, Japan and Germany) that no doubt greatly influences domestic financial reporting.
4. Reliance on open markets as the principal means of intermediating capital flows that has increased the demand for information to be included in financial reports in the United States and some other developed countries.

The following have been observed to have an impact on a country's financial accounting operation:

1. Who are the investors and creditors—the information users—as (individuals, banks, the government).
2. How many investors and creditors are there?
3. How close the relationship is between businesses and the investor / creditor group?

4. How developed the stock exchanges and bond markets are?

5. The extent of use of international financial markets.

With this back drop of fragmentation, it will be difficult in the short run, if not impossible, to bring national standards into agreement with a meaningful body of international standards.

In the United States, the FASB did not show a critical interest in harmonization of international accounting standards until the early 1990s. The FASB now actively participates in the harmonization of international accounting standards. This includes cooperating with the IASC and the UN.

15.6 BENEFITS OF HARMONIZATION IN REPORTING

The first and most important advantage of harmonization of reporting standards is to achieve comparability in financial statements. Due to different sets of financial reporting standards, the way financial statements prepared and presented are different from each other which make it complicated to compare them. This is even more noticeable in multinational companies when they operate in more than just one country. If international harmonization is achieved, the level of international comparability also increases making it easier for companies to prepare the financial statements under one set of rules; investors who understand the financial statements due to the nature of IFRS and make well thought investment decisions.

There will be increased auditing efficiency and money saving as companies has to use only one set of reporting standards. This also serves to reduce trade barriers among countries allowing more access to international capital markets.

Another advantage worth noting is the consistency to be achieved under IFRS as it was one of the objectives of IFRS as a single reporting standard. The consistency also contributes to better understanding between investors, lenders and other businesses as there will be the nature of predictability in place. Moreover, companies operating in different countries also can use their expertise and systems in all countries they are operating due to consistency of the reporting standards. Another benefit that derives from consistency is the time scale needed to implement in new countries as there will be no need to learn and adapt to new county specific rules except minor adjustments.

15.7 DISADVANTAGES OF HARMONIZATION

As mentioned by Ketz (2004), information will be difficult to obtain from domestic accounting standards. He further states that according to critics of international accounting systems, with different social and economic institutions, political approaches, tax implications, laws and business practices, a single set of rule which is IFRS is hard to be achieved and even if achieved, it will be less useful than it has been expected. This indicates that even if international harmonization is achieved it will be impossible to eliminate every single difference in international reporting standards.

Another disadvantage of harmonization is when there exists different economic environment as harmonization could be considered useless. If a particular country has its own practice in place, and even though they adapt to use one of the international reporting standards, it could be more harmful to the country rather than make anything good. This is because the irrelevant element of the new reporting standard may be of no use and therefore may even introduce ambiguity and complication to that country's reporting standards.

The differences make it difficult to distinguish changes in the performance from the effects arising from the use of different accounting requirements. The aim of accounting harmonisation is to make the financial statements of companies comparable with the financial statements of companies in other countries. On the simplest level, harmonisation is the process of bringing international accounting standards into some sort of agreement so that the financial statement from different countries are prepared according to a common set of principles of measurement and disclosure.

The desirability of uniform accounting has been apparent throughout the lifetimes of many people, however only in the last twenty years or so has the ease for it become irresistible. One factor mentioned by Alexander and Nobes (2008), has been the increasing globalisation of businesses. Because the globalisation pushing large companies go multinational, those companies are operating internationally and following different accounting standards depending on the requirements of the local government.

The successful completion of Uruguay Round of GATT, leading to the establishment of the World Trade Organization and expansion of European Union further creates multinationals that require a uniform accounting reporting standards.

Alexander and Nobles (2008), claimed that if businesses are multinational in scope, it is likely that they will wish and need to raise their capital in many different countries. And they are assisted in this by increasing competition among the capital markets, each anxious to increase its share of world business. Indeed, competition among the capital markets may the strongest factor in encouraging a change of attitude by national regulators towards International Accounting Standards. And the strongest capital markets see the ability to accept International Accounting Standards as enabling them to compete more effectively: the need to prepare extra accounts to have a cross-border about the desirability of allowing domestic companies to use international standards for domestic companies may be content with the stock exchange quotations in other countries and see no need for a quotation on the domestic exchange.

15.8 OBSTACLES IN CONVERGENCE AND HARMONIZATION

Many difficulties have been faced in the harmonization programmes commenced by international agencies, especially by IASC (now IASB) which are as follows:

1. **Difficulties in the development of standards:**

   The main difficulties in establishment of an internationally uniform system of accounts and the standardisation of accounting procedures are the following:

(i) Provincialism:

Many countries hold provincial outlook in many spheres. As long as people believe that their own views are superior to those of others, known or unknown, it is hardly possible to reach agreement on a common solution. Although this provincialism is absent among the (IASC) Board members, it is present very often in their countries.

(ii) Differences in economic and social environment:

Harmonization is adversely affected by the differences in economic and social environment, in which accounting has a role to play. In different countries, there is a different view on what is, or should be, the primary purpose of financial statements. In some countries, and the USA is one of them, the investor and his decisions are considered to be most important. In others, such as Germany, it is the creditor.

In France, the information needs of Government play a major role. In some countries, it is believed companies have a public accountability to a great variety of interest groups. These differences in purposes which are in the minds of accountants lead to different views on what is appropriate accounting treatment. Some operate from an environment of extreme conservatism, others from an environment that borders on creative accounting.

(iii) Diverse accounting practices:

Another difficulty is that at the present time, there are wide divergences in world-wide accounting practices. Each practice may have its own justification and we'll be understood in the national environment. Obviously, it is the task of IASC to try and narrow these areas of divergence. However, variation in accounting practices hampers harmonization. IASC is operating in an environment of conflict between ideals and practicality.

The IASC has, first, to outlaw practices that are clearly misleading or allow management too much latitude; and then should try to eliminate options that do not contribute to fairness and usefulness in financial reporting.

(iv) Gaps between developed and developing countries:

In many areas, developing countries differ from those of developed. In fact most developing countries had little chance to evolve accounting systems which truly reflected the needs and circumstances of their own societies. Their existing systems are largely extensions of those in developed countries.

In this situation, the benefits of their being more deeply integrated into systems that predominantly suit developed countries become questionable. Briston comments that instead of recognising the inadequacies of the UK and US system and attempting to make it more relevant and integrated, UK and US accountants are gradually imposing that outmoded system upon developing countries.

On the contrary, developing countries must create their own systems before this adverse influence has reached an irreversible stage. Briston has studied the spread of western accounting ideas throughout the world. British influence is very long-standing in many old colonial countries. He points out that once a reporting system and nucleus of an accounting profession has been established, it becomes very difficult to modify the system.

The result is that these countries have adopted accounting principles and systems which originally evolved to meet the needs of UK capitalism.

2. Difficulties in enforcement of standards:

After establishment of international standards, difficulties may emerge at enforcement level. These obstacles have to be overcome in order to achieve adoption of and compliance with International Accounting Standards.

Such difficulties are listed as follows:

(i) Tax laws:

Harmonization faces problems due to differing tax laws. In many countries of the world, enterprise are required to draw up one set of financial statements only serving both tax purposes and financial reporting purposes. Government has an overriding interest in profit as computed for fiscal purposes; tax laws often prescribe in detail how profit should be measured. In this framework, it is unavoidable that business is more concerned about tax saving than it is about accurate determination and reporting of financial performance. And equally unavoidable is the consequence that International Accounting Standards are judged primarily by these tax implications, the government opposing standards that would reduce profits and business opposing standards that would boost profits. Due to these reasons local standards and international standards differ and, where they differ, local standards prevail and international standards tend to be ignored. Clearly, we cannot hope for improvement and harmonization of financial statements unless all ties between tax accounting and reporting to the public are cut completely. This would be the single most important contribution that governments are able to provide to the cause of international harmonization.

(ii) Disclosure laws:

Another difficulty is, again, the law-not the tax law but laws regulating financial reports to shareholders and the public. In some countries, this law provides great details both on disclosure and on measurement. In this environment, the notion of 'true and fair reporting' loses importance and the primary purpose of preparers and auditors comes to comply with law and regulations.

For IASC, this situation means that in such a country International Accounting Standards will not be adopted unless they are incorporated in the disclosure laws. This requires changing the relevant law which is itself a tiresome and time-consuming task. In most countries lawmakers are not leaping to their feet to do this job because company reporting is not a hot political issue. And if it is, even worse, because then politicians will handle the issue with strong political overtones.

(iii) Existence of local standards:

Difficulties may evolve from the activities of the national standards-setting bodies. In more and more countries, accounting standards have been found established by the profession or government agencies or jointly by both.

Seen on the national level, this may have merits. But seen from an international viewpoint, problems arise. If many countries have detailed rules on many subjects, there is bound to arise conflict between these national systems. This is unfortunate for international enterprises who address their reports to users both at home and abroad, and it reduces the credibility of their statements abroad. At the same time, once there are national standards, it appears to be rather difficult to adopt them to international consensus. As soon as there is a national standard, national positions become entrenched, and it is hard to exchange that position for one that is considered second rate.

Apart from that, national standards-setters have to weigh carefully the feelings and environment prevailing in their own countries. That means that often standards-setters are unable to compromise even if they would wish to do so.

(iv) Competition among international standards-setting agencies:

There is found a potential competition between international standards-setters. As it is clear, apart from IASB, the UN and the OECD are now engaged in the field of company reporting, especially by multinational enterprises.

OECD has made it clear that it does not want to go into setting of standards, but wishes to restrict itself to clarifying the guidelines for disclosure of information, and to energizing in some way or other, the process of international harmonization.

In the UN, on the other hand, it is quite clear that a number of countries wish the UN to develop and issue enforceable standards for reporting by multinationals. In such situations, there is a serious danger of incompatible and conflicting sets of international standards. It is also rightly said that the UN exercise has strong political overtones.

(v) Unhelpful corporate attitudes:

Standards are basically meant for business enterprises. They are expected to comply with International Accounting Standards, and if they do not, they are an obstacle in getting compliance.

Amongst the enterprises that are reluctant to formally adopt international accounting Standards, two broad categories can be made:

(a) Those whose affairs are purely domestic, and that hold the view that international standards are none of their business. The vast majority of companies in countries of the world belong to this category.

(b) Those whose affairs are international, that recognise there is a need for international harmonization, but are hesitant to back IASB as long as they are not sure IASB is a winning horse.

On the other hand, it should be noted that many companies do comply with International Accounting Standards for the simple reason that these do not require anything that is not already in their national standards.

3. Other difficulties:

There are many other difficulties which hinder the efforts towards international harmonization. These difficulties primarily relate to international standards-setting agencies. Daley and Mueller has analysed country representation on international standards-setting bodies. Of the countries who are represented on at least three of the bodies, seven are western developed nations, only one is from Africa, and none is from the Middle East. They point out that because of the 'western bias' of the IASC many of the developing nations criticize its work for 'being insensitive to their situation and needs'.

Daley and Mueller conclude that if private sector standards- setting is to continue as at present, with no enforcement powers, then it must become more internationally oriented. That is, more nations must be represented on the international committees than at present; it is then more likely that statements will be acceptable.

Mueller gives three major reasons why the IASC may be viewed as an ineffective and inappropriate agency for setting international standards. First, there is the potential conflict between the standards set by IASC and those set by the national bodies. Second, in many countries accounting standards need to be incorporated in law and set by political procedures.

Third, there is no political and diplomatic recognition of IASC by national governments or international agreements. The IASC does, however, participate in the discussion on standards by the appropriate UN and OECD groups.

Burggraaff discusses the political pressures on IASC. He differentiates between political pressure coming from various interest groups in the private sector and political pressure from government bodies, and government agencies who are interested in international standards.

The pressure that the various interest groups, from time to time, bring on the LASB, places the Board in an uncomfortable dilemma. The pressure means that the committee decision-making process either has to be based on consensus and compromise or on resorting to underlying concepts. It is also argued that the IASB (IASC) has no real authority to implement its recommendations and has to rely on the best efforts of individual members which most often are not the accounting standards-setting bodies of these countries.

15.9 SUGGESTIONS FOR INCREASED CONVERGENCE AND HARMONIZATION

There is no doubt that harmonization of company's annual reports would be beneficial to all countries of the world and would achieve the goal of comparability in international financial reporting. Although many international agencies and bodies are working towards harmonization in financial reporting, the International Accounting Standards Board (IASB), earlier IASC, plays (and would play) an important role in harmonization programme.

Some suggestions have been given here to enable harmonization in published company annual reports at the international level:

1. **Enlarge representation on IASB:** At present, IASB is seen by many as an organisation heavily influenced by Western accounting profession. The effective representation of third world countries is not found in IASB. The IASC has to be 'International' in real terms. That is, more countries, especially the developing countries, must be represented on the IASB than at present. In that situation IASB's statements will have world-wide acceptance and compliance.

2. **Avoid political pressures on IASB:** Generally political pressures on IASB come from various interest groups in the private sector and government agencies who are interested in international standards. Developing useful international standards requires that all kinds of pressures from any quarter should be eliminated in the decision- making process applied in the development of international standards. If international standards are the result of pressures exercised by vested interests, the IASB will not be able to function in an objective and purposeful manner.

3. IASB should **publicize standards developed** by it and for this should try to get support of the accounting profession, member countries and corporate managements all over the world. IASB should encourage member bodies to adopt IFRSs or phrase or rephrase their rules in such a way that they are in line with IFRSs.

4. Each country should pass legislation to the effect that as and when an international standard is set or amended by IASB, local standards, if they exist, should be brought into line; if local standards do not exist the IFRS should be adopted. Legislation of this character would enjoy the necessary degree of flexibility.

5. UN should recognise IASB as the **body qualified to set up international standards**. The UN should then use its authority to hasten universal

acceptance of such international standards. IASB should be formally recognised by governments as an international standards setting body.

6. The governing bodies of the accounting profession should formally acknowledge that it is their task, among many others, to apply disciplinary procedures when bad professional work, including the non- observance of standards, is brought to their notice.

7. In each country the local stock exchange should cooperate in taking appropriate action against companies which failed to comply with standards.

8. And finally, continuous research is needed to ascertain why the differences arise and to determine what will be the economic effects of some countries changing practices. We should study the reasons for the continued existence of national differences in accounting principles and practices. Emphasis should be upon investigation, analysis and education rather than upon undue haste in speeding the process of promulgating further International Accounting Standards. Convergence and Harmonization, in fact, can only be achieved if there is mutual international understanding both of corporate objectives and rankings attached to them. The research results of various studies of economic effects of market reaction to pronouncements can provide feedback to policy-makers which will assist them in their deliberations.

15.10 CORPORATE GOVERNANCE REPORTING

Concept of Corporate Governance:

Corporate governance refers to the accountability of the Board of Directors to all stakeholders of the corporation i.e. shareholders, employees, suppliers, customers and society in general; towards giving the corporation a fair, efficient and transparent administration.

Need for Corporate Governance:

The need for corporate governance is highlighted by the following factors:

(i) Wide Spread of Shareholders:

Today a company has a very large number of shareholders spread all over the nation and even the world; and a majority of shareholders being unorganised and having an indifferent attitude towards corporate affairs. The idea of shareholders' democracy remains confined only to the law and the Articles of Association; which requires a practical implementation through a code of conduct of corporate governance.

(ii) Changing Ownership Structure:

The pattern of corporate ownership has changed considerably, in the present-day-times; with institutional investors (foreign as well Indian) and mutual funds becoming largest shareholders in large corporate private sector. These investors have become the greatest challenge to corporate managements, forcing the latter to abide by some established code of corporate governance to build up its image in society.

(iii) Corporate Scams or Scandals:

Corporate scams (or frauds) in the recent years of the past have shaken public confidence in corporate management. The event of Harshad Mehta scandal, which is perhaps, one biggest scandal, is in the heart and mind of all, connected with corporate shareholding or otherwise being educated and socially conscious. The need for corporate governance is, then, imperative for reviving investors' confidence in the corporate sector towards the economic development of society.

(iv) Greater Expectations of Society of the Corporate Sector:

Society of today holds greater expectations of the corporate sector in terms of reasonable price, better quality, pollution control, best utilisation of resources etc. To meet social expectations, there is a need for a code of corporate governance, for the best management of company in economic and social terms.

(v) Hostile Take-Overs:

Hostile take-overs of corporations witnessed in several countries, put a question mark on the efficiency of managements of take-over companies. This factors also points out to the need for corporate governance, in the form of an efficient code of conduct for corporate managements.

(vi) Huge Increase in Top Management Compensation:

It has been observed in both developing and developed economies that there has been a great increase in the monetary payments (compensation) packages of top level corporate executives. There is no justification for exorbitant payments to top ranking managers, out of corporate funds, which are a property of shareholders and society. This factor necessitates corporate governance to contain the ill-practices of top managements of companies.

(vii) Globalisation:

Desire of more and more Indian companies to get listed on international stock exchanges also focuses on a need for corporate governance. In fact, corporate governance has become a buzzword in the corporate sector. There is no doubt that international capital market recognises only companies well-managed according to standard codes of corporate governance.

Corporate Governance Reporting

The underlying objective of good corporate governance is to promote transparency and public accountability. The disclosure of "corporate governance" practices not only provides investors, with information about corporations' ownership structure, management structure, management composition and auditing and internal control but also enables the managers of the corporations to release information about how they execute their responsibilities. One of the key aspects of corporate governance reporting is what **Sinclair** refers to as discharging “public accountability”. “Public accountability” according to **Sinclair,** is a form of accountability in which managers and organizations become “more accountable to the public, interested community groups and individuals”. **Coy and Dixon** argue that public accountability requires open disclosure to all citizens and stakeholders, who have an opportunity to make criticisms. **Coy et al. (2001)** advocate the need for public accountability-based disclosure in order to meet the information needs of a broad range of stakeholders who have a legitimate economic, social and political interest in the reporting organization.

Transparency” is another aspect that is regarded as a key element of “good” corporate governance. **Barth and Schipper (2008)** argue that “transparency” is the extent to which financial reports reveal how corporations’ managers discharge their responsibilities in a way that is readily understandable by those using the financial reports. **Parker (2007)** points out that corporate governance reporting involves more than compliance with legal requirements. It incorporates, he adds, the voluntary disclosure of information related to wider organizational issues such as management processes, investors’ rights, ownership structure and any other information that discharges corporate management responsibilities. It can be argued that the underlying ethos behind corporate governance reporting relies on public accountability and transparency. Corporate governance reporting, as **Parker (2007)** argues, involves more than compliance with regulatory requirements.

15.11 VALUE ADDED REPORTING

Meaning and Definition of Value Added

Value added is an alternate performance measure to profit. Generally users of financial statements believe that profit is the only indicator of the prosperity of any organisation. But value added is a superior performance measure as it attracts the attention on inputs controllable by managers.

Value added is defined as “The wealth created by the reporting entity by its own and employee’s efforts and comprises salaries and wages, fringe benefits, interest, dividend, tax depreciation and net profit retained”. It has also been defined as “The increase in market value resulting from an alteration in the form, location or availability of a product or service excluded the cost of goods and services purchased from outside”.

Thus, (i) Value added term focuses on the creation and distribution of value added.

(ii) Value added may be termed as gross value added or net value added.

(iii) Gross value added is the term used for the excess of gross sales and income from services over the cost of purchase in material and services.

(iv) Net value added is the term used for the annual charge of depreciation deducted from gross value added.

Value Added Analysis:

‘Value Added’ is very important measure to judge the performance of any organisation, It indicates the wealth created by the organisation during a particular period, Value added analysis had assumed a great importance as a tool to measure performance of any entity which is the result of collective efforts of employees, management and shareholders.

The concept of value added has a direct link with the concept of social responsibility. Value Added Analysis is the analysis of wealth creation and application of wealth by any enterprise. If any enterprise in which investments have been made by various provider of finances like shareholders, debenture holders, financial institutions does not create wealth (i.e. value added), it means that enterprise is misusing the public funds.

Financial reporting, now a day is being done by keeping in view the interest of stake holders not only of shareholders. The value added concept also aligns corporate financial reporting with National Income Accounting, as value added is included while computing gross domestic product. Figure indicating concept of value added in case of a company form of organisation.

Concept of Value Added Reporting:

CONCEPT OF VALUE ADDED

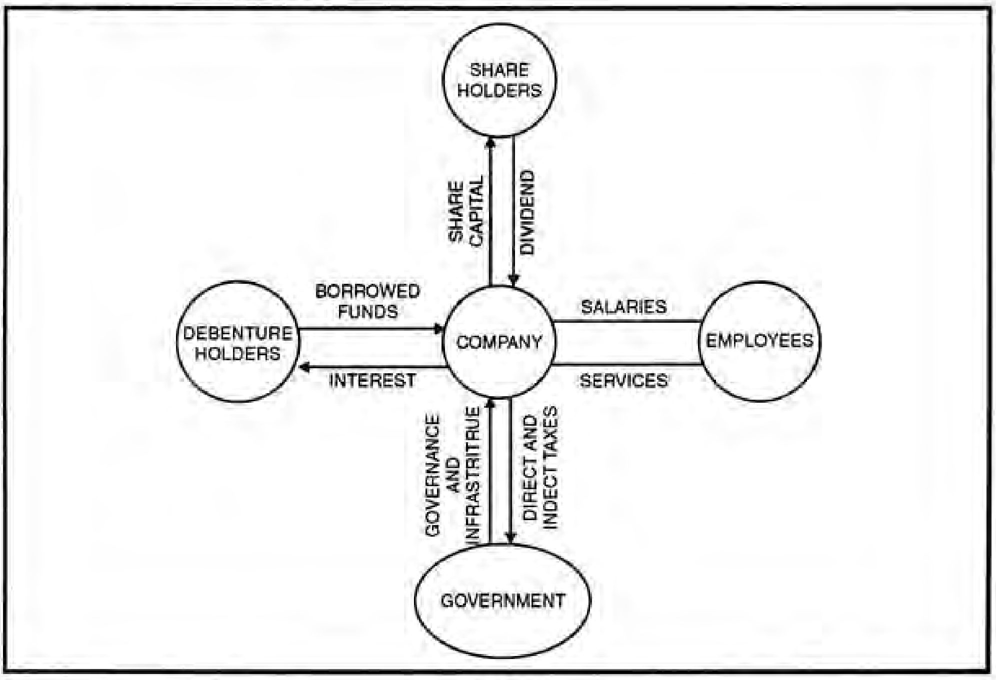

TABLE-I
Transaction Incomes

	Firm-X ₹	Firm-X ₹	Firm-Z ₹	Firm-A ₹
Final purchase price				10,000
Raw Materials	Nil	2,000	6,000	
Add Outside purchases	200	400	400	
	200	2,400	6,400	
Add Labour and				
Fixed Cost	1,600	3,000	2,600	
	1,800	5,400	9,000	
Add Profit	200	600	1,000	
Sales Value	2,000	6,000	10,000	
Gross Income	2,000	6,000	10,000	
Less Raw material	nil	2,000	6,000	
Less Outside purchases	200	400	400	
	1,800	3,600	3,600	

Value added represents net income. In the basic law of economics, the value of all incomes are equal to the value of all outputs. Table I depicts the income generated from a series of transactions between four firms X, Y, Z and A. Firm X extracts iron ore from ground and converts it in to pig iron and sells it to Firm Y. Whereas Firm Y uses it as a basic raw material and converts it in to steel and sells it to Firm Z

Now Finally Firm Z fabricates the steel into a washing machine which it sells to Firm A. To begin with Firm X to convert iron ore, pig iron and steel into a product like washing machine in the chain all the three firms X, Y and Z use the services of external agencies in the form of tools, repairs and power etc.

If we go through table I we find that the combined income of the firms X, Y and Z (₹1800 + ₹3600 + ₹3600 = ₹9000) is not equal to their combined sales volume (₹2,000 + ₹6,000 + ₹10,000 = ₹18,000). The reason is obvious. The sales volume received by firm Y ₹6,000 includes an amount of ₹2,000 owed to firm X which in turn is partly from X's income 1,800) and partly the income of A's outside suppliers (₹200). Now if we included the amount of 2,000 in firm Y's income, we would have counted it twice. Similarly with the sales volumes received by firm Z from A (? 10,000)

Further verification of table-I shows clearly that net income of firms X, Y, Z is ₹1,800. ₹3,600 and ₹3,600 respectively, this sum of ₹9,000 represents the total operating costs and profits of three firms. We can conclude from above discussion that the sales volume received by any firm is not entirely an income for example firm Z's income of ₹10,000 contains an amount of ₹6.400 which firm Z owes to its creditors. Financially it would make no difference if firm Z would issue two bills to firm A one for ₹3,600 and other for ₹6,400 to pay to firm Z and to firm Z's creditors. Only when the creditors of raw material other services are paid, the original creditor can use the remaining sum of money to pay for his own operating cost and if anything is left makes a profit, thus this residual income is called value added.

Value Added Statement:

Value added statement is considered as a part of social responsibility reporting. It is a statement particularly prepared as a routine part of management information system. The value added statement is just a re-arrangement of information contained in the trading and profit and loss account. No doubt, this rearrangement of income statement helps us in understanding the contribution of an organisation to the society in a better way. It has been recognized that the activities of an enterprise have both economic and social impacts on the users of financial statements. An enterprise is accountable to the society as it uses common assets of the community at large such as railways, harbour roads and other facilities.

Conceptual issues involved in preparation of Value Added statement:

In the absence of any guidelines provided by various financial institutions for the preparation of value added statements. There have been divergent practices exist so as to the treatment of depreciation and taxation and style of format to be used.These conceptual issues are discussed as under:

A) Depreciation:

Basically there are three ways of treatment of depreciation.

(i) Gross value added:

The value added by firm is not reduced by the amount of depreciation under this approach. Depreciation is treated as reinvested in business. Depreciation is treated as an application for expansion of the business and shown as amount of retained earnings.

(ii) Net value added:

The charge of depreciation is included in the purchase of materials and services. In this approach depreciation is deducted like other items on the assumption that value of fixed assets diminishes with the passage of time.

(iii) Eliminate depreciation charge:

This is the third way of treatment of depreciation. In this approach, we eliminate the charge of depreciation altogether. This is done by showing the cost of all fixed assets purchased in a year as a part of the purchase in materials and services. This approach is inconsistent with the accrual concept of accounting.

(B) Taxation:

Another conceptual issue is taxation particularly, how to deal with indirect taxes like sales tax and excise duty etc. The main problem arises regarding treatment of these items. The common opinion is that the taxes paid less subsidies if any, should be shown in the share of Government, while the sales tax and excise duty paid on material and services purchased from outside can be considered as a part of these materials and services. The same treatment can be done with sales and excise duty collected on the products sold may be included from the sales revenue thus from value added.

Approaches to Compute Value Added Reporting:

Basically there are two approaches to compute value added by the enterprise while performing its operations during a particular accounting period.

(i) Additive Approach:

This approach concentrates on adding of all the values which are created by an enterprise. Thus interest, depreciation salaries, wages, rent, taxes, insurance employee welfare, overhead expenses and PBT all are added to give the sum of value added.

(ii) Subtractive Approach:

In this approach Raw material, bought in components, sub contract processing consumable stores, loose tools repairs and maintenance of plant and machinery and other purchased services are deducted from sales revenue and some items are added or subtracted as the case may be, increase or decrease in labour and relevant overhead in stocks.

Creation of Wealth:

Every enterprise while performing in a society should create wealth (i.e. value added). Which is an excess of turnover plus income from other services over the cost of purchase in materials and services. Turnover refers to sale of goods and sales tax and excise duties and also deducting various rebates, returns, commissions discounts and goods used for self consumption. Whereas the word income from services refers to income from dividends, royalties and rent received.

Cost of material purchased and services includes the cost of material consumed, other materials like consumables, packing fuel oil etc. Cost of services includes audit fees, insurance payments, rent and rates paid arid other expenses like postage and telegram, printing charges. By incurring these expenses an enterprise creates value added. Sometime enterprises also incur some non operating expenses like granting donations for national disasters etc.

Distribution of Wealth (Value Added) for Value Added Reporting:

The main shares of this wealth which has been created by an enterprise as value added is shared by usually three members of society.

(i) Government

(ii) Employees

(iii) Providers of finances.

Employees receive their share in value added in form of salaries, remuneration, contribution towards provident fund, E.S.I, and other benefits. They also enjoy staff welfare facilities created by an enterprise.

Government receives its share in form of custom duty, excise duty, sales tax, wealth tax and other tax from an enterprise.

Providers of finances also receive their own share in value added in form of interest on bank borrowings, interest on term loans, interest on debentures and dividends to shareholders.

Whatever is left, after providing shares in value added generated to employees, government and providers of finances, is reinvested in enterprise itself in form of depreciation and retained earnings.

Value Added Statement of M/s Sheetal Ltd.

Particulars	Detail	Amt.	Particulars	Detail	Amt.
Generation of value added			**Application of value added**		
(A) Sales of goods	××		**(A) Employees**		
(inclusive of sales tax)			*Salaries*	××	
	××		*Remuneration*	××	
Less Sale Returns	××		*Contribution*		
Les Allowances	××	××	to E.S.I.	××	
(B) Income from			*Staff welfare*	××	
services			**(B) Government**		
Dividend		××	*Custom duty*	××	
Interest	××		*Excise Duty*	××	
Royality Recd.	××		*Sales Tax*	××	
Other Income	××	××	*Wealth Tax*	××	
(C) Cost of bought in			**(C) Providers of**		
material and services			**Finances**		
Raw Material	××		*Interest on*		
Packing	××		*Borrowing from*	××	
Stationary	××		Bank	××	
Fuel oil	××		*Interest on*		
Electricity	××	××	*Term Loan*	××	
(D) Cost of Services			*Interest on Debentures*	××	
Audit fees	××		**(D) Re-inveted in**		
Insurance	××		*Business*		
Printing		××	*Retaind*		
Other expenses	××	××	*Earnings*	××	××
Added Value generated		××	*Added Value distributed*		××

Problems in Preparation of Value Added Statements:

The accountants generally face hurdles while preparing value added statements as given under:

(i) The accountants face problem while treating pay roll costs. Should there be the actual cost incurred in the period or the costs which are related to the sales achieved? Most of the corporate simply show the total payroll costs for the period.

(ii) The second problem which accountants face is, the treatment of work in progress and stocks. In corporate financial accounts, work in progress and stocks are valued at market price or cost whichever is less. In case of long term work in progress, the valuation will include elements of profit, however if true value added is an increase in value created, change in stocks and work in progress should be included at market value.

(iii) The last hurdle which corporate accountants face is the treatment of investment income in corporate company; which is having income from associated company or royalties, should that income be added to the turnover in the same section of the value added statement? The alternate treatment is to add it to turnover or to find out a value added calculation from sales less purchase and then add the other income.

Economic Value Added Statement (EVA):

The term EVA is a registered trade mark of Stern Stewarts Co. U.S.A. The recent change which took place in the minds of the thinkers is that EVA is a true measure of corporate surplus. As already discussed, profit is no more an only indicator of prosperity of any business entity. Every business entity should earn sufficient to cover not only its cost of capital rather sufficient surplus to grow. Any profit earned over and above the cost of capital is economic value added. The statement in which calculations regarding economic value added are shown is called Economic Value Added Statement.

Measurement of EVA

EVA is the corporate surplus and is the barometer of economic efficiency of an enterprise. In traditional ownership concept, compensation of labour and management and even cost of debt is charged to income statement. Only dividend is treated as an appropriation of profits. But in economic terms profit is the surplus to the corporate after clearing the cost of equity. In introducing EVA concept Stewart used net operating profit after tax. Depreciation is charged for arriving at net operating profit after tax.

EVA = [ROOC – WACC] x Capital

Where

EVA = Economic Value Added
ROOC = Return on Operating Capital
WACC = Weighted Average Cost of Capital

For Calculation of ROOC following formula can be applied

$$\text{ROOC} = \frac{\text{NOPAT} + \text{Cost of Debt}}{\text{Operating Capital}} \times 100$$

Where NOPAT = Net Operating Profit After tax

For calculation of WACC following formula can be used

$$\text{WACC} = \frac{E}{C_E} \times Ke + \frac{P}{C_E} \times Kp + \frac{CTB}{C_E} \times Kd$$

Where

E = Equity
P = Closing Preference share capital
LTB = Long term Borrowing (Cl. Balances)
Ke = Cost of eqiuty
Kp = Cost of preference share capital
Kd = Cost of long term borrowings

15.12 HUMAN RESOURCE (HR) REPORTING

Today, HR reporting is crucial. HR reports provide both quantitative and qualitative information on employees, HR practices, and company trends. This information is vital for informed decision making because it is almost impossible to make informed business decisions when HR stakeholders lack insight into their own organization. HR reporting solves this problem, producing the key metrics required to gain insights into the state of the organization and uncover where improvements need to be made. Regular HR reporting enables both HR and management to keep their fingers on the organization's pulse by tracking key workforce metrics. For example, the sales department may be struggling with high turnover rates or high time-to-hire rates, indicating that more emphasis needs to be placed on retaining employees. But if the organization's HR reporting is inadequate, then such a problem may only reveal itself after it's too late – when the sales department is so undertrained and understaffed that sales (and thereby revenues and profits) are plummeting through the floor.

With HR reporting, new trends and opportunities can be spotted early on, and emerging problems can be addressed before they significantly impact the business. As well as identifying employee turnover patters, HR reporting helps companies make better hiring decisions, forecast hiring requirements, track employee performance, discover the root causes key issues (including high turnover rates and poor employee performance), as well as issues pertaining to costs – cost of absence, cost of labor, training costs, and, of course, recruitment costs.

HR Reporting Metrics

To deliver value from HR, it's important to track the right metrics. Most companies will do some form of standard HR reporting, recording things like average length of employee placements, average salaries, average number of vacation days per employee, average number of unpaid leave days per employee, number of new starters, etc. These metrics are easy to measure – which is why most companies measure them. However, they don't really deliver much in the way of business-critical insights that have a direct link to organizational strategy.

The following is the list of reports that companies must need to deliver value from HR

Effective HR reporting should illustrate precisely how HR is contributing to the rest of the organization, which means that the metrics tracked should measure how successful HR is in realizing the organization's business goals.

Revenue Per Employee

An organization's workforce should bring in enough revenue to justify employment. Loosely, this can be calculated by dividing the organization's total revenue by total number of employees. However, this is rather crude calculation that doesn't factor in things like cost per hire, training costs, etc. As such, more thorough HR reporting needs to be completed to arrive at the true figure.

Profit Per Employee

Beyond revenue, profit per employee should also be measured for effective HR reporting. Calculated by dividing business profit by total number of employees, profit per employee can help you determine if your over or understaffed. For example, the organization may have taken on extra sales staff to improve revenue, but are they really adding dollars to your bottom line, or is increased staffing simply eating into profits?

Cost Per Hire

This measures what a company pays to recruit and onboard each new employee. The average cost per hire is about $4,000, according to recent studies, but it is required to determine precisely what it is at a particular organization. To do so, we must factor in everything from the costs of an applicant tracking system to man-hours spent interviewing candidates, training, and onboarding costs.

Time to Fill

This is the number of days between a position becoming available and a candidate accepting that position. The longer it takes to fill a position, the more money it costs the organization – and the longer the organization suffers in terms of lost productivity.

Training Spend Per Employee

How much are you spending on employee training? Course fees, travel costs, the cost of your learning management system, the time spent administering employee training, productivity losses due to training time – it all adds up to determine its cost.

Training ROI

Are your training investments paying off? This is not an easy thing to calculate, but training ROI can be worked out by dividing the cost of employee training by the value of increased performance. Performance metrics will of course vary depending on the department the employee hails from. For example, the performance of customer service reps may be measured in terms of number of customer complaints, time spent handling routine issues, etc. Salespeople will of course be measured in terms of sales performance, and marketing in terms of leads generated. Comparing before and after training results will allow you determine whether training is paying off, and thereby whether or not you need a new strategy.

Time to Productivity

This is another important HR reporting metric, for it allows you to determine how long it takes for new hires to reach full productivity. For example, let's say a fully-productive salesperson generates $1,000 a day in revenue. How long does it take (and how much does it cost) to bring a new hire up to that standard – and how can you shorten that timeframe (and reduce the associated costs)?

Employee Turnover

Another important metric for effective HR reporting – not only for purposes of predicting how many new hires you'll need to make, but also in determining whether your employees are happy or not. Turnover is at an all-time high, according to a recent report from Salary.com – standing at 19.2% for the average US company. A good goal to strive for would be about half that – with the high costs of new hires, high turnover is expensive.

But not all employee turnover is created equal, of course. As such, turnover should be broken down into revealing categories. What is your involuntary (employer-led) turnover rate, for example, compared to your voluntary (employee-led) turnover rate? And what is your unwanted turnover rate? Not all turnover is negative – such as when bad performers leave. Unwanted turnover rate is the number of good performers that leave, expressed as a percentage of overall performers.

And what about your 90-day and 360-day quit rates? This is the number of new hires that leave within three months or a year. It is of course HR's job to recruit the right people, and if your HR reporting reveals big 90- and 360-day quit rate percentages, this will be a key indicator that something is going wrong with the recruitment process.

Quality of Hire

This is the percentage of new hires that are given a good rating by their manger during their early performance reviews. Quality of hire is important for HR reporting as it is another indicator of how effective HR is in selecting and recruiting the right candidates. Only by consistently maintaining a high quality of hire will the organization reach its strategic goals.

Employee Satisfaction and Engagement

Both of these metrics can be measured through employee attitude and engagement surveys. Dissatisfaction is a leading cause of employee turnover, while high engagement predicts higher productivity, better customer service, lower turnover, and more.

Absenteeism

Another hugely important metric for meaningful HR reporting. Calculated by dividing an employee's workdays missed by total workdays scheduled, absenteeism is another measure of employee satisfaction and engagement – unhappy employees take more time off.

Absence Cost

How much is absenteeism costing your company? Loss of productivity, sick pay, replacement costs – what are the figures, and how can they be brought down?

The above list is by no means exhaustive. Other HR reporting metrics that must be considered are:

- Internal promotion rates
- Length of service (how long the average employee stays at your organization)
- Health care and benefits costs per employee
- Cost of HR per employee (how much you pay the HR team vs. how many employees you have)
- Above average performance ratio (how many employees are performing at a high level)
- Innovation (number of successful product or process ideas vs. total number of employee suggestions)
- Ghost rate (number of new hires that don't show up for first day of work)

The list could indeed go on and on – and it all produces valuable data that can be analyzed to reveal those crucial business insights that allow HR to make informed business decisions.

Data-Driven HR

The whole purpose of HR reporting is to enable data-driven HR. HR teams can use real data generated by HR reporting to make better HR decisions, better understand and evaluate the business impact of people, make HR processes more effective and efficient, and improve the overall wellbeing and effectiveness of the organization's employees. All of this can have a huge impact on a company's ability to achieve its strategic goals – which is precisely why HR reporting is so valuable.

However, data-driven HR requires specialized tools – HR analytics and HR dashboard tools that allow teams to visualize HR data and use it to predict the future (such as when employees might be at risk of quitting) and take action.

Thus, Effective HR reporting using powerful HR analytics tools gives HR the invaluable ability to not only describe what has happened, but predict what will happen in the future. And this is what makes HR reporting so crucial – it provides the insights needed to make informed business decisions and drive performance across the whole organization. Tracking the right metrics is the first step – and for different companies, different data will be relevant – and using the right tools to make sense of it all is the second. HR dashboards are crucial for realizing the full potential of HR reporting – with intelligent, data-driven HR, opportunities for HR teams to add more value to the organization open up. Data, indeed, is one of the most valuable assets at HR's disposal today, and HR teams everywhere need to start doing more with it.

15.13 SUMMARY

The goal is to achieve some level of comparability in the way financial statements are prepared and presented. When international harmonization occurs, the difficulties for companies and individuals considerably decrease in presenting the financial statements and their interpretations. There are several organizations that have been trying to eliminate the differences between financial reporting standards and achieve international harmonization. If international harmonization is achieved, many countries would benefit from it as it would improve the access to the international financial markets and improve the confidence and knowledge of investors which may even trigger an increase in future investments.

15.14 GLOSSARY

- **Harmonisation-** It means maintaining uniformity in accounting practices through out the world.
- **IASC-** International Accounting Standard Committee
- **IASB-** International Accounting Standard Board
- **FASB-** Financial Accounting Standard Board

- **IFRS-** International Financial Reporting Standard
- **NYSE-** New York Stock Exchange
- **GAAP-** Generally Accepted Accounting Principles

15.15 SELF ASSESSMENT QUESTIONS

Q.1 What is meant by harmonization ?

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Q.2 What are the benefits of harmonization in reporting?

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Q3. Explain the need for harmonization in financial reporting.

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15.16 EXAMINATION ORIENTED QUESTIONS

1. What do you understand by Harmonisation in financial reporting? Discuss the need for harmonization in financial reporting.

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2. Explain the major obstacles in convergence and harmonization in financial reporting.

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3. Explain briefly the benefits of harmonization in financial reporting. Discuss the suggestions to be offered for increased convergence and harmonization.

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UNIT-IV M.Com 1st Semester

Course No. M.Com-C150 Lesson No. 16

DEVELOPMENT IN FINANCIAL REPORTING

CREATIVE ACCOUNTING-BASICS, METHODS, TYPES AND IMPORTANCE

16.1 INTRODUCTION

16.2 OBJECTIVES

16.3 CREATIVE ACCOUNTING BASICS–MEANING, DEFINITIONS

16.4 TYPES OF CREATIVE ACCOUNTING

16.5 IMPORTANCE OF CREATIVE ACCOUNTING

16.6 METHODS OF CREATIVE ACCOUNTING

16.7 LIMITATIONS OF CREATIVE ACCOUNTING

16.8 SUMMARY

16.9 GLOSSARY

16.10 SELF ASSESSMENT QUESTIONS

16.11 EXAMINATION ORIENTED QUESTIONS

16.12 SUGGESTED READINGS

16.1 INTRODUCTION

One of the problems of accounting problems is not the non-availability of solution to the problems but the availability of more than one solution to each of a few major accounting problems. Inventory valuation, annual depreciation, accounting treatment of goodwill, overtime premium, idle time costs, research and development costs, etc., are some of the examples for the accounting problems with alternative solutions. What is more important is that these diverse accounting treatments are considered as based sound accounting principles and as sound accounting practices by the professional accounting bodies. Further, the corporate enterprises are allowed to use any of these accounting methods. These diverse accounting treatments are acting as the avenues for few industrial enterprises to manipulate their financial results and financial position. -

Another important problem is, for few emerging accounting problems, there is objective and generally accepted accounting solution. In other words, for some accounting issues, no single generally accepted solution is available. That means, there are few suggested methods as to how to account for certain new kinds of accounting problems. Consequently, the corporate enterprises which have the freedom to use any one of these suggested methods can manipulate their accounting figures to suit their requirements. As a result, the users of accounting information and reports, more particularly the external parties, are deprived of objective, comparable and reliable information.

It is very well known that the financial reports which comprise of, among others, the financial statements (viz., Profit and Loss A/c, and Balance Sheet) are expected to possess the valuable information content. These reports should contain relevant, material, and objective facts and figures. This assumes importance as most of the users of annual reports, more particularly the external parties, are not in a position to find out whether any information in the report is distorted by the companies intentionally. Further, they may not be able to quantify the extent to which the distortion has affected the operating results and/or the financial position. Therefore, it is the responsibility of the companies to report the truth/facts. Unfortunately, few organizations are intervening in the financial reporting process and manipulating their accounts for one reason or the other, both knowingly and unknowingly.

16.2 OBJECTIVES

After going through this lesson, the students will be able to understand-

- the meaning and definitions of creative accounting;
- methods of creative accounting; and
- types and importance of creative accounting.

16.3 CREATIVE ACCOUNTING – BASICS MEANING

Different terminologies are used in different parts of the world to denote Creative Accounting which is a preferred term in Europe. Though focus of one terminology differs from others the end result is same viz to present the financial statements in such a way which the company intends to see its financial statements. As the base for analysis of different dimensions of Creative Accounting, a few definitions are presented below.

a. **Kamal' Naser (1993)** has defined Creative Accounting as, "the process of manipulating accounting figures by taking advantage of the loopholes in accounting rules and the choices of measurement and disclosure practices in them to transform the financial statements from what they should be, to what the preparers would prefer to see reported and the process by which transactions are structured so as to produce the required results rather than reporting transactions in a neutral and consistent way."

b. Creative Accounting is also defined as the one which makes use of regulations to escape from regulatory control without actually violating the regulations.

c. It (i.e., Creative Accounting) is also defined as the one which makes use of accounting methods which, though not illegal, aim at creating a position of profitability or financial position which is not totally valid but either illusory or misleading.

d. **Barnea A, Ronen J and Sadan J (1976)** have defined Creative Accounting as the deliberate dampening of fluctuations about 'some level of earnings considered to be normal for the firm'.

e. **Copenland (1968)** also viewed Creative Accounting as, "involving the repetitive selection of accounting measurement or reporting rules in a particular pattern the effect of which is to report a stream of income with a smaller variation from trend than would otherwise have appeared."

f. **Merchant and Rockness (1990)** felt, any action on the part of management which affects reported income and which provides no true income advantage to the organization and may in fact, in the long term, be detrimental.

However, an analysis of the above definitions provides a greater insight into the meaning and basics of Creative Accounting which are presented below.

a. Creative Accounting is basically a process of manipulation of accounting figures relating to financial performance and financial position. It is concerned with the actions on the part of the companies to manipulate financial performance and position in a skillful manner, or in a clever or unscrupulous way. Hence, it is an intentional or deliberate attempt on the part of the companies to manipulate the accounting figures.

b. The purpose as to why the companies resort to manipulation is to transform their financial statements from what they are or should be, to how the companies prefer to see their financial statements to look like. For example, a company which has earned only 2 crore profit for 2021-22 may resort to manipulation of its accounts to report 3 crore profit (for 2021-22). It may be noted here that though the entity earned only 2 crore profit, it reports 3 crore profit.

c. The firms may also resort to manipulation of their results to report a stream of profit with a smaller variation from one year to another than would otherwise have appeared. For instance, a business entity has succeeded in earning and reporting a continuously increasing (say, at 10%) profit year after year. If for-the current year, the rate of increase in the profit may be lower than 10% (when compared the immediately preceding year. In this case the company may resort to manipulate its accounts in such a way that results in reporting a profit for the current year which is 10% (or slightly higher than 10%) than the previous year's profit. The objective, here, is to report profit at some level which is considered to be normal for the business entity.

For the purpose of manipulation of accounts, the firms may utilize the diverse accounting treatments permitted by the accounting regulations for certain transactions They take advantage of the loopholes in accounting regulations and the choices of measurement permitted in the accounting regulations. Since (i) diverse accounting treatments are suggested by the accounting regulators (ii) firms are permitted to use one of these suggested treatments, and (iii) firms are allowed to shift from one method to another (of course for justifiable reasons and disclosure in the financial reports together with its impact on the items of financial statements), the entities are able to manipulate their accounting figures to report what they intend to report. It may be noted here that it is not a violation of accounting regulations and therefore, they are not subject to regulatory penalty. This is because of the loopholes in the accounting regulations.

Even if the companies resort to manipulation of their accounts, it does not provide any income advantage to the companies in the real sense. For example, a firm was able to report 3 crore for 2021-22 though it has earned only 2 crore. In this case, there is no real increase in the profit by 1 crore as it has not earned. If this type of manipulation continues for long, it may act as detrimental to the business entity. The reason is there are certain obligations which depend upon the reported profit (e. g income tax dividend to shareholders, bonus to employees etc). This results in the payment of higher amounts (of taxes dividends bonus etc) than what the company is liable/able to pay. As a result, the company may move towards insolvency.

Anyhow Creative Accounting deals with the manipulation of accounting figures with the help of loopholes in the accounting regulations to report operating results which the company intends to report instead of reporting the actual amount of profit earned. This applies even to the Balance Sheet items also.

16.4 TYPES OF CREATIVE ACCOUNTING

The different terminologies used for creative accounting are as follow:

1. Income smoothing
2. Earning smoothing
3. Earning management
4. Disclosure management
5. Financial engineering
6. Cosmetic accounting
7. Innovative accounting.

Michael Jameson (1988) views the accounting process consists of dealing with many matters of judgment and of resolving conflicts between competing approaches to the presentation of the results of financial transactions. This flexibility provides opportunities for manipulation, deceit and misrepresentation. These activities have come to be known as creative accounting.

The reasons as to why the business enterprises resort to manipulation of accounting figures differ from one enterprise to another and also from one year to another. These reasons can also be considered as the motives behind, or objectives of, Creative Accounting. The experts have identified many types of creative accounting which are summarized below.

a. **Income-based Taxation System:** The business entities are required to pay tax on their profit at rate specified by the government. As known, the tax liability of an entity for an accounting period depends upon two important variables viz., taxable income and applicable tax rate.

For example, if the taxable profit for 2021-22 is 2 crore and the tax rate is 40%, then the amount of tax payable works out to 80 lakh (i.e., 2 crore x 40%). Normally, the companies prefer to reduce their tax liability. Hence, it is necessary to reduce either the taxable profit (which the companies do not prefer) or tax rate (which is not in the hands of the companies) or both. Therefore, the companies wish to reduce their tax liability by reporting lower amounts of profit (of course, not by earning lower amounts of profit) through the manipulation of their taxable profit. Therefore, income-based taxation system is one of the reasons as to why the companies resort to Creative Accounting. Of course, this reduction in the tax liability is only in the short-run and not a permanent one. The firm may have to pay higher amount of tax in the next years.

b. **Income Smoothing:** The business entities prefer to report a steady and consistent growth in the profit when compared to widely fluctuating profits from one year to another. One of the reasons for this is the fact the investors are normally ready to pay a premium for stocks of the companies which have the record for steady and predictable earnings streams than for the stocks of the companies which report volatile profits fluctuating from one year to another. Methodology of - income smoothing is in the form of post-poning the recognition of revenue to the next year which is predicted to be a difficult year. It may also include post-poning the accounting for certain expenses of the current year which is a difficult year to the next year which is expected to improve in the next year. However, with the intention of reporting steady and consistently improving profits, the companies resort to manipulation of their accounts.

c. **Big Bath Accounting:** It is a technique of earnings management wherein a business entity makes a one-time charge against its current year income with the objective of reducing its assets. It may be noted here that the reduction in the assets value during the current year lowers the expenses in the subsequent years. No doubt write-off reduces the assets value in the books of account and results in lower net profit for the year in which this write-off was made as it increases the charge against the current year revenue. But this results in lower expense in the future which in turn improves the profit of future periods. The primary objective of taking one big bath (i.e., in a single year) is to see that the company reports higher amounts of profit in subsequent years. This objective can also be achieved by recognizing in one year (i.e. in the current year) the future cash costs of expected plant shut-down or employee layoffs. The purpose is to take all these loses at once so that in future years, the company can report (higher) profit. Normally this technique is used in a bad year which is very bleak (e.g., sales are very low due to external non-controllable factors and the company is left with no other alternatives except reporting loss and the companies even wait for a bad year to take one big bath to clean up the Balance Sheet.

d. **Matching Reported Profit to Profit Forecast:** Based on their past performance and also predictions about the future, the companies forecast their profit for the ensuing year. This forecasted profit is also made public. In this type of cases, the companies usually prefer to report, more or less, the same amounts or rates of profit as forecasted prior to or at the commencement of accounting period. As lower than forecast profit, the stakeholders may infer to the effect that the management is inefficient and ineffective. And the capital market may respond adversely. For all these reasons, among others, the companies prefer to report an amount of profit which was forecasted. Hence, they resort to manipulation of accounting figures.

e. **Matching reported profit with analysts predictions:** Financial Analysts, an- import of member of financial intermediaries, make certain predictions (based on the past performance and predictions about the future) about the profits of certain companies and these analysts' predictions become the base, in certain cases, for investment decisions by the general public. These analysts also indirectly advice the general public about the companies whose scripts can be purchased. And the general public, in certain cases, act on the predictions made by the analysts. Further analysts predictions influence the market prices of equities. If the company's actual profit is lower than analyst's prediction, one can expect an adverse impact on the market price of its share. The general public (who bought the shares of this firm on the analysts' predictions) may not take the analysts' predictions seriously in future. This affects the reputation of the analysts who may not advice their customers to go in for the shares in future. With the objective of avoiding all these adverse implications, business entities try to match their reported profit with the analysts predictions by manipulating their accounts

f. **Profit-based managerial remuneration :** Some business entities pay remuneration to their managerial personnel on the basis of the profit earned. Even the Companies Act provides for the payment of managerial remuneration based on the profit. This acts as motive for the managerial personnel to manipulate their accounts to report higher amounts of profit than earned so that they can receive higher amounts of remuneration. Therefore, profit-based managerial remuneration is another source of inspiration for the management to resort to manipulation of their accounting figures.

g. **Insider trading :** Insider trading is the trading of a public company's stocks or other financial instruments by the individuals who have easy access to non-public information about the company's performance such as profit possible rate of dividend declaration etc. As the persons who are working in the company (i.e. insiders) have easy access to company's key information which is not made public, they are able to take right decisions about the buying and selling of shares of the company. It may be noted here that the definition of insider is very wide and it covers not only the insiders themselves but also others who are related to them like brokers, associates members of their families etc. Any person with easy access to non-public information and who trades on the basis of price (the market price of share) sensitive information is called insider trading. However, the insider trading is considered as unfair to other investors who do not ha easy access to this type of key information. Therefore, it is considered as illegal. Anyhow, the intention of management to engage in insider trading encourages them to resort to manipulation of their accounts. For example, a key officer of a company owns some shares (either directly or indirectly say in the name of members of his family) which are traded at present at higher price in the market. It is assumed that this company for the current year is expected to incur and report loss instead of profit as expected by the market. The key officer who receive this price sensitive information much earlier (i.e., before it is made public) sells his shares at the current higher market price. When the company reports loss for the current year, the capital market reacts adversely i.e., the market price of shares of this company starts to declining. The investors who bought the shares at higher price are put to loss.

h. **To maintain or boost share price:** Usually, the capital market is forward looking as the stock prices are established on the basis of the expectations of the investors (both the present and prospective) about the future earnings capability of the business entity. As is known, the future earnings capability of any business entity depends upon the interaction among many factors pertaining to the economy, industry, company, etc. Estimated profit embodies investors' perception about various factors such as growth in sales demand for the goods and services of the firm, competitive structure, industry environment, profit margins, cost management, etc. Whenever these determinants change, one can find the stock prices adjusting to reflect the kind of change. If the change is favourable (say, in the form of increase in the amount and rate of profit), market price of equity may increase or may remain constant without registering a downward change. Hence, the companies use the profit as an effective tool either to maintain its share price or to boost the same to higher level. For the purpose of achieving this objective (i.e., for maintaining or boosting stock price), the companies resort to manipulation of their accounts to create appearance of good profit trend

i. **Distracting stakeholders attention from unwelcome News:** Any unwelcome news about the company certainly affects the market price of its equity as the shareholders may act immediately on the receipt of the unwelcome news The news that the company is going to lose its industry leader position shortly or the news that there has been a substantial fall in the market share of the company are examples to unwelcome news about the company If this made known to the shareholders they start disposing off their present equity holdings with fewer takers which results in the fall in the market price of its equity. In this type of situation, the companies resort to profit inflating measures to distract the attention of stakeholders from the unwelcome news. Through the manipulation of accounts the companies report inflated or overstated profit which is sufficient enough to distract the attention of stakeholders' attention from the unwelcome news.

j. **To increase the borrowing capacity:** Usually, the borrowing capacity of the business entity is linked to its capital and reserves. When the company's borrowing amount is nearing the maximum permissible limit (based on the aggregate of its capital and free reserves), it resorts to manipulation of its accounts to report higher profit and retain major portion of it in the company itself which ensures in the increase in amount of reserves. The increase in the amount of reserves increases the aggregate of its capital and reserves thereby increasing its borrowing capacity. This is, therefore, another reason for manipulation of accounting figures.

k. **Price revision policy of government undertakings:** In the case of public sector undertakings) - more particularly in the case of public utilities such as passenger transport undertakings, power distribution corporations, etc), it is necessary (in some cases) to obtain the prior permission from the government/s to revise (i.e., to increase) the prices of their goods and services. Normally, the governments do not allow their undertakings to increase the prices unless it is very essential and there are no other alternatives. Therefore, the government undertakings resort to manipulation of their accounts to report lower profits or more loss to obtain the permission from the governments to revise the prices for their goods and services upwardly.

To conclude, we can say that, there are a number of reasons as to why the companies resort of managing their earnings to report at the desired level. For ensuring this purpose, the companies make use of creative accounting.

16.5 IMPORTANCE OF CREATIVE ACCOUNTING

The companies find a number of opportunities or avenues to manage, their accounts to suit their intended use and purpose. In other words, the companies use different methodologies or techniques for manipulation of their accounts. Hence, these procedures can be termed as techniques of Creative Accounting. These techniques can also be considered as modus operandi as they deal with the method of manipulation of accounting results. However, **Oriol Amat and Catherine Growthorpe** have identified six major areas as the, sources of inspiration for Creative Accounting. They are identified below follow by a brief analysis of the same

a. **Flexible regulations.** In a few cases of business transactions and events the accounting regulations provide for diverse accounting treatment Further the accounting regulations permit the companies to choose one or other from permitted alternatives. They also allow the companies to shift from accounting treatment to another (of course, for justifiable reasons). This type of environment provides avenues for the companies to manipulate their accounting figures by using suitable accounting method and or by shifting from permitted method to another permitted method to manipulate their reported profit and other results. Hence, the presence of flexible accounting regulations is one of the factors which motivates the companies to manipulate their financial statements And the companies make use of flexibility provided in the accounting regulations as one of the techniques for manipulating the reports results.

b. **Dearth of regulations:** In spite of substantial development in the accounting discipline including Accounting Standards,- still there are few area which not fully regulated. In other words, for certain issues, regulators have not yet developed the relevant Accounting Standards and therefore, one can find the dearth of regulations in this type of accounting issues. For example, human resource accounting, environmental accounting, social accounting, accounting for changes in price level, etc., are certain area wherein no concrete procedure has so far been evolved. Therefore, the companies enjoy the freedom to use any method which suits them. Hence, the dearth of accounting is another important avenue for the companies to manipulate their accounting results.

c. **Estimation in discretionary area:** In certain area, the management has considerable scope for estimation of the financial implications. Therefore, the management utilizes this opportunity to estimate the amount either at higher level or lower level depending upon their requirements. In the case of credit sales, for example, the amount due from customers (to whom the company sold its goods and services on credit basis) is recognized in the books of account as Accounts Receivable (i.e., debtors and/or bills receivable). The amount of accounts receivable, therefore, represents the value of credit sales for which payment is yet to be received. In this case, one may find some difference between the amount due and the amount received. The reasons may differ from one case to another- a customer (who purchased goods from the company on credit basis) may become insolvent, he may face certain cash flow difficulties. In this type of situation, the accounting regulations require the companies to make provision for the estimated doubtful portion of accounts receivable. This provision is purely an estimation of the possible loss of either a portion or full amount of accounts receivable. As is known, the initial provision is charged to Profit and Loss Account making necessary adjustment to accounting payable in the Balance Sheet. This type of area (i.e., the area like the estimation of provision for doubtful debts) provides considerable scope for management to manipulate their accounts by estimating the amounts at lower level (if they want to report higher amounts of profit) or higher level (if they want to report lower amounts of profit).

d. **Artificial transactions:** The companies use the artificial transactions to manipulate their accounts- to manipulate both the Balance Sheet items and to move profit amounts between accounting years. This is possible when a company is able to enter into few artificial transactions with a third party who obliges this type of artificial transactions. For instance, sale of a machine to its banker and lease it back for the remaining useful life of the machine. And the selling price may be recognized in the books of account of the company either at higher level or lower level that its (i.e., machine) current value depending upon the company's intention (of course, the difference is adjusted through higher or lower lease rent). This way, the companies use the artificial transactions to manipulate their accounts.

e. **Timing of genuine transactions:** Companies having investments in other entities can use them for the purpose of reporting higher profit. Usually, realizable value of investment is normally higher than its historical cost. Whenever the company finds that its profit for a particular accounting year is not reasonable, it can sell its investments (during that year) for higher value than its historical cost. This enables the company to report the profit at the desired level. It may be noted here that the company has full freedom. to decide about the time selling its investments. Therefore, freedom to sell investment and other similar transactions provides opportunities for the companies to manipulate their revenue, profit, etc.

f. **Re-classification of items of financial statements:** Re-classification of items of financial statements provides an opportunity for the companies to manipulate the accounting figures. For example, by re-classifying an item of short-term liability into a long-term liability, it is possible to improve the Liquidity Ratios viz., Current Ratio and Acid Test Ratio. Similarly, by reclassifying an item of chargeable expense into capital expenditure it is possible for the company to inflate the amount of reported profit. In other words, by following aggressive capitalization and extended amortization period, it is possible to overstate the amount of profit. Hence, few companies are making use of this opportunity to manipulate the accounting figures.

   To conclude, we can say that, the business entities can manipulate their financial statements to report the financial results and position at the desired level.

16.6 METHODS OF CREATIVE ACCOUNTING

Though it is very difficult to eliminate the manipulation of accounts completely some measures may be taken by the appropriate authorities to minimize the manipulation of accounts. Of course authorities such as IASB Ministry of Corporate Affairs of Government of India etc have taken certain measures. In this background, it is necessary to look into the possible measures for the minimization of manipulation. **Oriol Amat John Blake** and **Jack Dowds** have suggested four measures in this regard as summarized below.

a. Availability of diverse permitted accounting -solutions to few important accounting problems is one of the sources of motivation for the companies to resort to the manipulation of their accounts. Hence, it is necessary to reduce the number of permitted choices so the firms are left with only one way accounting for-the business transactions and events.

b. Another major area for manipulation of accounts is the scope, in certain cases, for estimation. By reducing the scope for estimation, it is possible to minimize the scope for manipulation of accounts by the companies.

c. Substance over form is one of the important accounting principles which required to be used to ensure the financial statements to provide complete view of the business transactions and events. This ensures the presentation of overall financial reality- of the business entity rather than the legal form of transactions and events. It may be noted here that the primary objective of accounting is to measure- and report the monetary impact of business transactions and events rather than their legal form. Therefore, this principle is key to prepare and present reliable and useful financial statements and reports. By adhering to this principle, it is possible to minimize the manipulations of accounts more particularly recognition of artificial transactions.

d. One of the avenues for the companies to manipulate their accounts is the revaluation of assets.

   By specifying the revaluation methods and the procedures, it is possible to avoid the manipulation of accounts through revaluation.

16.7 LIMITATIONS OF CREATIVE ACCOUNTING

Attempts of companies to manipulate their financial statements are criticized many on a number of grounds. The important objections against Creative Accounting are summarized below:

a. **Against the principle of true and fair:** Accounting regulations and also the applicable Laws require the Boards of Directors of business entities to approve their accounts only after stating that they present a true and fair view. This principle of true and fair view is the foundation of accounting. Even the IFRSs (issued by IASB) and Ind ASs (of India) require the fair presentation of financial statements which is equivalent to true and fair view.

When the financial statements are manipulated to present them in way in which the companies intend to see them do not present the true and fair view. Manipulated accounts distort the operating results and the financial position. Therefore, Creative Accounting is certainly against the spirit of true and fair view.

b. **Leads to industrial sickness:** When a business entity resorts to manipulation of its accounts to report higher amount of profit (than actually earned) year after year, it results in payment of certain expenses and/or appropriations out of reserves and capital. As a result, one can find the erosion in. the reserves base and also capital erosion which is an indication, of industrial sickness. It may be noted here that the sick industrial company is defined [(2nd Amendment) Act, 2002] as a unit which has,

   i. Accumulated losses in• any financial year which are equal to 50% or more of its average net worth during four years immediately preceding such financial year or

   ii. Failed to repay its debt within any three consecutive quarters on demand made in writing for its repayment by a creditor or creditors of such company.

   Therefore, it is not desirable even from the point of view of companies to resort to the practice of manipulating their accounts and to report distorted-profit and financial position.

c. **Violation of consistency principle:** When the companies shift from one accounting treatment to another for the purpose of manipulation of accounting results, it results in the violation of consistency principle. As is known, consistency requires the companies to use the same principles, procedures, etc., for the purpose of preparing and presenting financial statements. This facilitates the comparison of performance of different periods of the same company. On the other hand, if different accounting procedures are followed for different years while preparing the financial statements, the results of two periods lack comparison as they were based on different procedures. Therefore, Creative Accounting violates the spirit of convention of consistency

d. **Misleading users of accounting information:** Use of techniques of Creative Accounting (for the purpose of manipulating the accounting results) distorts the accounting results When these distorted accounting results are presented to the external users of accounting reports/information, they mislead the external users This is because the external parties base their decisions on the information provided by the companies through their annual reports and take wrong decisions as they had no idea that these results are manipulated by their companies. Hence use of Creative Accounting misleads the users of accounting information.

Therefore, there is no justification for deliberate manipulation of accounting figures with sole objective misleading the external parties to behave in the way expected by the companies. Creative Accounting for reasons like big bath accounting insider trading boosting share price etc. is not only undesirable but also unjustifiable. However, manipulation of accounts for reasons like income smoothing is not much harmful to the external parties and the companies. Still, it should not be encouraged. Hence, it is necessary to look into the motives behind resorting to manipulation It is therefore necessary to measures by the appropriate authorities to minimize/eliminate manipulation of accounting results.

16.8 SUMMARY

External parties including the shareholders (who are owners of the companies) have no access to detailed accounting reports and statements. They have to contend with whatever information the companies provide them with the annual reports. The external parties use these reports for the purpose of taking their decisions hoping that the reports contain accurate and true information. But few companies, for one or the other reasons, are involved in the manipulation of their accounts as a result of which the results are distorted which is not made known the external users. This defeats the very purpose of reporting to the external parties. Hence, it is necessary for the companies not to manipulate their accounts to deceive their stakeholders. It is also necessary for the regulators to look into this issue.

16.9 GLOSSARY

- **Big Bath accounting-** It is a technique of earnings management wherein a business entity makes a one-time charge against its current year income with the objective of reducing its assets.
- **Insider trading-** Insider trading is the trading of a public company's stocks or other financial instruments by the individuals who have easy access to non-public information about the company s performance such as profit possible rate of dividend declaration etc.
- **Income smoothing-** The business entities prefer to report a steady and consistent growth in the profit when compared to widely fluctuating profits from one year to another.
- **Income-based taxation system**- The business entities are required to pay tax on their profit at rate specified by the government.

16.10 SELF ASSESSMENT QUESTIONS

Q1. Define Creative Accounting and explain its salient features.

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Q2. Critically examine the motives behind companies resorting to manipulation of their accounts.

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Q3 Write notes on Big Bath Accounting and Insider Trading.

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16.11 EXAMINATION ORIENTED QUESTIONS

Q1. What do you mean by Creative Accounting? Why do the companies manipulate their accounts?

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Q2. What is meant by Earnings Management? Discuss the reasons as to why companies manipulate their earnings figures.

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Q3. What are the techniques of Creative Accounting? Discuss them briefly.

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Q4. Define Creative Accounting and discuss how the companies manipulate their accounts.

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Q5. What are the objections against Creative Accounting? Discuss.

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Q6. What is Creative Accounting? What measures do you suggest to minimize the scope for manipulation of accounts by the companies?

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DEVELOPMENT IN FINANCIAL REPORTING

FORENSIC ACCOUNTING–NATURE AND ESSENTIALS; FUNCTIONAL AREAS OF FORENSIC ACCOUNTING AND FORENSIC ACCOUNTING IN INDIA

17.1 INTRODUCTION

17.2 OBJECTIVES

17.3 MEANING OF FORENSIC ACCOUNTING

17.4 NATURE OF FORENSIC ACCOUNTING

17.5 ROLE AND FUNCTIONS OF FORENSIC ACCOUNTANT

17.6 NEED FOR FORENSIC ACCOUNTING

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17.12 SELF ASSESSMENT QUESTIONS

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17.1 INTRODUCTION

Contemporary Accounting is no longer confined to mere Bookkeeping exercise reflecting the factual statement of affairs and is actually an instrument of control and a tool of various management functions. Various types of accounting such as financial accounting, cost accounting, management accounting, inflationary accounting, etc. are already in place in the field of accounting. But the one that has gained importance in recent past is Forensic Accounting.

The Forensic Accountant has to look beyond the number reveals and comprehend the underlying circumstances with analytical mind set. The job of forensic accounting is the job of an intelligent accountant who is the blood hound trying to sniff out frauds, criminal financial transactions and financial scams associated with big corporates and the capital market, securities, misuse of financial outlay in general through documentary evidence. Forensic Accounting awareness thus, enhances creditability of the accounting performance as the purpose of this accounting is to reduce the likelihood of fraud remaining un-deducted in business entities in-spite of statutory audit.

As the complexity and scope of commerce has expanded throughout the world, the need to track money and financial information has grown. Forensic accounting is a rapidly growing area of accounting concerned with the detection and prevention of financial fraud and white-collar criminal activities. George A. Manning in his book “Financial Investigation and Forensic Accounting” defines Forensic Accounting as the science of gathering and presenting financial information in a form that will be accepted by a court of jurisprudence against perpetrators of economic crimes. The integration of accounting, auditing, and investigative skills yields the specialty known as Forensic Accounting which focuses very closely on detecting or preventing accounting fraud. The word ‘Forensic’ means “suitable for a court of law". "Forensic", according to the Webster's Dictionary means, "Belonging to, used in or suitable to courts of judicature or to public discussion and debate." The word accounting is defined as "a system of recording and summarizing business and financial transactions." The term 'forensic accounting' refers to financial fraud investigation which includes the analysis of accounting records to prove or disprove financial fraud and serving as an expert witness in Court to prove or disprove the same. Thus, basically, forensic accounting is the use of accounting for legal purposes.

Increasing number of cyber crimes, failure of regulatory agencies to track security scams, series of co-operative bank bursting, invisible cracks in Accounting Information Systems, all have led to growing awareness of the need of accounting and financial professionals to acquire special skill to identify and act upon indicators of poor corporate governance, mismanagement of corporate affairs, deliberate misstatements, frauds and unethical behaviour.

Enron, an energy trading company of U.S.A. was given 7th rank in 500 Fortune companies, faced major disaster in the form of the largest bankruptcy to ever filed in U.S.A. Even Satyam Scam in India also poses a big question mark on the credibility and authenticity on certification of certified auditors on audit reports. "Auditor should be watch dog and not the blood hound". It was a popular saying that every auditor should know. But after having major disasters like Enron and Satyam, auditors are supposed to be the blood hounds rather than be the just watch dogs. Otherwise need may arise for some sort of investigating accountant having a thorough knowledge of investigating accounting which could help to sniff out frauds and criminal transactions recorded in books of accounts.

17.2 OBJECTIVES

After going through this lesson, the students will be able to understand the

- meaning of forensic accounting;
- essentials of forensic accounting;

- need for forensic accounting;
- role of forensic accountant;
- functional areas of forensic accounting; and
- forensic accounting in India.

17.3 MEANING OF FORENSIC ACCOUNTING

Forensic accounting is the application of accounting knowledge and investigative skills to identify and resolve legal issues. It is the science of using accounting as a tool to identify and develop proof of money flow. These tools and techniques can be valuable for fraud and forensic accounting investigators. Because employee and management fraud, theft, embezzlement, and other financial crimes are increasing, accounting and auditing personnel must have training and skills to recognize those crimes.

The wave of financial crisis primarily caused by corporate misconduct and fraudulent financial activities eroded public trust and investor confidence in financial reports and audit services and need was felt to look beyond the conventional accounting function which only fulfilled the compliance requirements i.e. company's books of accounts are kept in accordance with rules and regulations. In view of the increasing number of financial frauds committed by conspiracy with complex accounting records manipulation, it was felt that a new class of Accountants is needed to detect the financial fraud in companies with their accounting, auditing, and investigative skills and also assist in legal matters. This area of accounting came to be known as 'forensic accounting'. There is a global awareness to fight the cases of financial frauds. Though many strategies have been formulated and many actions have been taken to fight against it, the problem still persists.

One of the major hindrances in fighting financial crime cases is lack of quality forensic analysis of the financial statements and records due to lack of forensic accounting professionals. Quality forensic accounting experts can facilitate timely and accurate investigation of the intricate financial crimes and unearth the complex modus operandi adopted by the fraudsters who are themselves in some cases highly qualified financial professionals. Weak law enforcement is another one of the major reasons for rampant increase in white collar financial crimes.

Forensic means "suitable for use in court of law". When this word is related with accounting, then it means accounting which is suitable for use in court of law. Forensic Accounting is an application of a specialised knowledge and specific skills to stumble upon the evidence of economic transactions. It is a specially practice area of accountancy that describes engagements that results from actual or anticipated disputes or litigation. In simple words Forensic Accounting is an accounting that is suitable for legal review. Forensic Accounting is focused upon both the evidence of economic transaction and reporting is contained within an accounting system and the legal frame work which allows that evidence to be suitable for the purpose of establishing accountability.

Forensic accounting includes the use of accounting, auditing and investigative skills to assist in legal matters and to obtain legal evidence for the arrived at results. A Forensic Accountant gathers a lot of information and undertakes detailed analysis producing irrefutable evidence in the court of law. It is a branch of accounting that uses investigative skills to determine the accuracy of a company's financial statements specifically in a legal dispute. It consists of two major components; litigation services that recognize the role of an accountant as an expert consultant, and investigative services that use a forensic accountant's skills and may require possible courtroom testimony.

According to the definition developed by the AECPA's Forensic and Litigation Services Committee, forensic accounting may involve the application of special skills in accounting, auditing, finance, quantitative methods, the law and research. It also requires investigative skills to collect, analyze, and evaluate financial evidence, as well as the ability to interpret and communicate findings.

17.4 NATURE OF FORENSIC ACCOUNTING

Forensic accounting encompasses litigation support, investigation and dispute resolution and, therefore, is the intersection between accounting, investigation, and law. Fraud examination is a methodology for resolving fraud allegations from inception to disposition including obtaining evidence, interviewing, writing reports, and testifying. The fraud examiners also assist in fraud prevention, deterrence, detection, investigation, and remediation. Like most forensic sciences, fraud and forensic accounting may include using financial information to piece together or reconstruct past events in instances where that reconstruction is likely to be use in some judicial proceeding (e.g., criminal or civil court, deposition, mediation, arbitration, or settlement negotiation).

Fraud and forensic accounting is a broad area that includes occupational fraud, corruption and abuse, financial statement fraud, and civil litigation matters. Thus,

- Forensic Accounting emphasises on suitability for use of evidence in court of law.
- Forensic Accounting is an application of a special knowledge and skill to find out the evidence of economic transaction.
- Forensic Accounting is focused on reporting which is contained within an accounting system and legal framework.
- Forensic Accounting emphasises on establishing accountability of the guilty for misstatement or mismanagement of corporate affairs.

17.5 ROLE AND FUNCTIONS OF FORENSIC ACCOUNTANT

Forensic accountants look beyond the numbers and deal with the business realities of situations. Analysis, interpretation, summarisation and the presentation of complex financial and business related issues are prominent features of the profession. A forensic accountant will also be familiar with legal concepts and procedures. Public practice or insurance companies, banks, police forces and government agencies are major employers of forensic accountants.

Activities usually carried out by the forensic accountants involve:

- Investigating and analysing financial evidence.
- Developing computerised applications to assist in the analysis and presentation of financial evidence.
- Communicating their findings in the form of reports, exhibits and collections of documents.
- Assisting in legal proceedings, including testifying in courts, as an expert witness and preparing visual aids to support trial evidence.

17.6 NEED FOR FORENSIC ACCOUNTING

A forensic accountant has to analyse, interpret, summarise and present complex financial and business-related issues for investigation. Forensic accountant carries out investigative accounting and provides litigation support. The services of forensic accountants are in great demand in the following areas:

1. **Detection of fraud committed by employees:** Where the employee indulges in fraud, forensic accountants are engaged. They detect fraud, trace the asset (if any) created out of fund embezzlement, gather and review the evidence, and interview the employee alleged to have embezzled the funds.
2. **Criminal investigation:** Where the matter under investigation involves financial implications, the services of a forensic accountant are availed of by the investigation department, law society, etc. The report of an accountant is very much useful in preparing and presenting evidence.
3. **Settlement for retiring partner:** When the retiring partner feels that he has been unjustly settled with, he can challenge the settlement with the help of a

forensic accountant, who can correctly assess the value of assets and liabilities due to his client.

4. **Cases relating to professional negligence:** Forensic accountants also take up cases relating to professional negligence. Whenever there is a breach of generally accepted accounting practices (GAAP) or auditing practices or ethical codes of any profession, forensic accountants are required to quantify the loss resulting from such professional negligence or deficiency in service.

5. **Arbitration service:** Forensic accountants render arbitration and mediation services for the business community, since they undergo special training in the area of alternative dispute resolution.

6. **Facilitating settlement regarding motor vehicle accident:** As the forensic accountant is well acquainted with intricacies of laws relating to motor vehicles, and other relevant laws in force, his services become indispensable in measuring economic loss when a vehicle meets with an accident.

7. **Settlement of insurance claims:** Insurance companies engage forensic accountants to have an accurate assessment of claims to be settled. Similarly, policyholders seek the help of a forensic accountant when they need to challenge the claim settlement as worked out by the insurance companies. A forensic accountant handles the claims relating to consequential loss policy, property loss due to various risks, fidelity insurance and other types of insurance claims.

8. **Dispute settlement:** Business firms engage forensic accountants to handle contract disputes, construction claims, product liability claims, infringement of patent and trade marks cases, liability arising from breach of contracts and so on.

9. **Matrimonial dispute cases:** Forensic accountants entertain cases pertaining to matrimonial disputes wherein their role is merely confined to tracing, locating and evaluating any form of asset involved.

17.7 FUNCTIONAL AREAS OF FORENSIC ACCOUNTING

The following are the functional areas of forensic accounting :–

(i) Fraud Detection

(ii) Expert within testimony

(iii) Discovery assist

(iv) Royalty Audits

(v) Damage computations

(vi) Claim Analysis

(vii) Determination of Compliance

These are explained below in detail :–

(i) Fraud detection :

The main task which is assigned to a Forensic Accountant is fraud detection Electronic Business has also enhanced the number of cyber frauds Forensic Accountant acts like a detective so as to find out frauds committed by employees of an organization. He is always in a better position to detect frauds committed in routine affairs

(ii) Expert with testimony :

Forensic Accountant has to focus upon the evidence of economic transaction. He has to detect and interpret the evidences of both normal and abnormal introduced into the books of accounts. He has to act like an expert or specialist with testimony

(iii) Discovery assistance :

Forensic Accountants also provide discovery assistance Forensic Accountants are specialist Certified Public Accountants that specialize in those types of engagements where there is need for such evidence. They offer independent assistance and assurance in such diverse areas as audit committee advisory services mergers investment analyst research and organisation risk management.

(iv) Royalty audits :

Forensic Accountants also provide assistance in doing royalty audits They use to have dispersed knowledge of auditing and internal control.

(v) Damage computation :

Detective agencies generally go for analysis of fingerprints and the narcotics but what about the digital evidence analysis, whenever any fraud or crime takes place in an organisation particularly in corporate entity. It may cause internal as well as external damages. Forensic Accountant may help in damage computation.

(vi) Claim analysis :

Forensic Accountants being specialist may be specialised in insurance claims, personal injury claims, fraud construction etc. They offer their specialised services for claim analysis. Insurance companies can hire Forensic Accountants for examining and analysing fake claims made by insured.

(vii) Determination of compliance :

Number of national standards in the field of accounting and auditing have been developed and issued by ASB of ICAI in India and most of them have been made mandatory in nature. Number of corporate laws are there in the field of taxation may be direct or indirect. What about their compliance? Forensic Accountants can help law enforcement agencies in determination of compliance of standards as well as laws.

17.8 ESSENTIALS OF FORENSIC ACCOUNTING

- The Base of Forensic Accounting is accounting knowledge. The success of Forensic Accounting will largely depend upon thorough knowledge of accounting itself.
- The knowledge of auditing is another pillar of Forensic Accounting. Forensic Accountants generally work 'like Forensic auditors. Risk assessment and fraud detection is another essential, which is must for introduction of forensic accounting in an organisation.
- Basic understanding of legal environment is must for introducing Forensic Accounting because Forensic Accountant has to perform within legal framework and accounting system established.
- Knowledge of investigating methods and procedures is also necessary for the success of Forensic Accounting.
- Analytical mind set of the all other employees is must who are working in forensic department.
- Knowledge of system methodology for investigation is other requirement

  Forensic Accounting is basically a team work. Forensic accountant has to work with Forensic researchers fraud examiners as they are to find out financial discrepancies and to determine who what where how when and why these discrepancies arose

17.9 FORENSIC ACCOUNTING IN INDIA

In India there is a serious fraud examination office Creation of that office is a landmark for the Forensic Accountants In India. Forensic Accountants are most required in the wake of growing frauds The detective agencies and law enforcement officers are the experts of analysing finger prints. But whenever the needs of digital analysis arises then the needs of a Forensic Accountant is also felt. ICAI 'in India, has decided to equip chartered accountants with adequate tools to detect white collar crimes and identify malpractices like rooting terrorist funds. President of ICAI said "Forensic Accounting" will help professionals to deal with new problem in the corporate world. He said Forensic Accounts will encompass the use of accounting and auditing skills and will use computers as an audit tool. Chartered Accountants will be trained in Forensic' Accounting.

17.10 SUMMARY

Forensic Accounting has been growing in stature. High expenses incurred in technology advancement, bulk purchase, software procurement, cross border transactions, explode of Information Technology, etc. provide ample opportunities for the forensic accountant to tread on and furrow for the wrong doings. The functions of forensic accountant are akin to the blind man entering a dark room during mid-night in search of a black hat that may be there, as he has to go beyond the figures and statements.

Forensic Accounting is a fast emerging field in the World of Accounting. Forensic accounting in India has come to limelight recently due to rapid increase in corporate scandals and scams especially after scam of Satyam. Another reason for forensic accounting gaining importance is the belief that our law enforcement agencies do not have adequate expertise as well as the time to uncover frauds. It also helps in :–

- **Detection of fraud committed by employees**- Where the employee indulges in fraud, forensic accountants are engaged to detect fraud.
- **Criminal Investigation**: Where the matter under investigation involves financial implications, the services of a forensic accountant are availed of by the investigation department, law society, etc.
- **Settlement for retiring partner**- When the retiring partner feels that he has been unjustly settled with, he can challenge the settlement with the help of a forensic accountant, who can correctly assess the value of assets and liabilities due to his client.

- **Cases relating to professional negligence**-Forensic accountants also take up cases relating to professional negligence.
- **Arbitration service**-Forensic accountants render arbitration and mediation services for the business community, since they undergo special training in the area of alternative dispute resolution.
- **Facilitating settlement regarding motor vehicle accident-** As the forensic accountant is well acquainted with intricacies of laws relating to motor vehicles, and other relevant laws in force, his services become indispensable in measuring economic loss when a vehicle meets with an accident.
- **Settlement of insurance claim-**Insurance companies engage forensic accountants to have an accurate assessment of claims to be settled.

17.11 GLOSSARY

- **Forensic reporting :–** evidence in court of law.
- **Fraud detection :–** to detect fraud.
- **Forensic accountant :–** familiar with legal concepts and procedures.

17.12 SELF ASSESSMENT QUESTIONS (SAQ)

Q1. What is Forensic Accounting ?

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Q2. Explain the role and function of Forensic Accounting.

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Q3. Discuss the need for Forensic Accounting.

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17.13 EXAMINATION ORIENTED QUESTIONS

1. What is forensic accounting. Discuss the functional areas of forensic accounting.

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2. Give the main characteristics a Forensic Accounting should possess.

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3. Discuss the position of Forensic Accounting in India.

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4. What do you mean by Forensic Accounting? Discuss its essentials.

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5. "Forensic Accountant is blood hound o book keeping" Discuss.

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6. Write a note on Forensic Accounting in India.

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UNIT-IV M.Com 1st Semester

Course No. M.Com-C150 Lesson No. 18

DEVELOPMENT IN FINANCIAL REPORTING

ENVIRONMENTAL ACCOUNTING-MEANING AND NATURE

18.1 INTRODUCTION

18.2 OBJECTIVES

18.3 ENVIRONMENTAL ACCOUNTING - MEANING

18.4 DEFINITIONS OF ENVIRONMENTAL ACCOUNTING

18.5 NATURE OF ENVIRONMENTAL ACCOUNTING

18.6 LIMITATIONS OF ENVIRONMENTAL ACCOUNTING

18.7 OPPORTUNITIES IN ENVIRONMENTAL ACCOUNTING

18.8 ENVIRONMENTAL ACCOUNTING IN INDIA

18.9 SUMMARY

18.10 GLOSSARY

18.11 SELF ASSESSMENT QUESTIONS

18.12 EXAMINATION ORIENTED QUESTIONS

18.13 SUGGESTED READINGS

18.1 INTRODUCTION

Today companies all over the world have started to adopt environmental accounting. As our planet is in great danger and the world is dealing with a lot of problems. The world is heating up because of global warming, corals and other marine life are dying because of oil spills and water pollution, and people with asthma are both dying and decreasing because of air pollution. But what would an accountant do? Auditing, Financial Statement, Taxation and Bookkeeping from mere looking at it, it's all about accounting. Every professional and non-professional including accounting student knows that. But has everybody know about Environmental Accounting? It is well said that, businesses are formed to deliver services or produce products in order to earn a profit. In the present era accounting goes beyond the bottom line of black or red – it includes "green", too. With the growing green consumer awareness, companies are more than ever expected to align its business strategies with environmental initiatives. Environmentally conscious companies have already discovered that they can generate business strategies to help them reduce their carbon footprint, minimize their environmental impact, make the best use of natural resources, become more energy efficient, reduce costs, and exhibit social responsibility-all at the same time Companies who are ready to become an integral part of President Obama's Green Economy through governmental initiatives will need to expand their accounting staff by hiring accountants who specialize in "green" or environmental accounting. The term, green or environmental accounting, has been around since the 1980s, and is known as a management tool used for a variety of purposes, such as improving environmental performance, controlling costs, investing in "cleaner" technologies, developing "greener" processes and products, and forming decisions related to their business activities.

18.2 OBJECTIVES

After going through this lesson, the students will be able to understand the

- meaning and definitions of environmental accounting,

- benefits of environmental accounting,
- features and limitations of environmental accounting

18.3 ENVIRONMENTAL ACCOUNTING – MEANING

Environmental Accounting is a type of accounting that attempts to factor environmental costs into the financial results of operations. This term was first brought into common use by Economist Professor Peter Wood in the 1980's. Environmental Accounting involves putting a value on a country's natural resources, like forests and seas, in order to have a more complete "snapshot" of a country's economic performance. Under this type of accounting. countries modify their System of National Accounts (SNA) to reflect the use and depletion of natural resources. Data from the SNA are the basis of major economic indicators, like GDP and gross national product (GNP). In having data that show the contribution of the environment to the economy, as well as the costs of pollution and environmental degradation, governments can come up with policies tackling natural resource management and sustainable development. While various countries have already experimented with environmental accounting, there has been no international consensus on a standardized method on Environmental Accounting yet. Accounting is required to submit various types of user information on the financial position and performance of entities in the management of resources at their disposal. In recent decades a growing number of entities give great importance to environmental issues and their reflection by accounting, either under the influence of administrative regulations or because of their information needs.

Environmental Accounting has been around for two decades. In simple words, Environmental Accounting is kind of managerial accounting tool that tries to factor the environmental costs within the financial outcome of the operations of a business. Environmental Accounting entails the estimation of prices for all national assets, including natural and human capital assets, and their inclusion in the 'financial statement' of the nation. It is not an easy task. 'Environmental Accounting' is a methodology for capturing 'externalities' of 'conventional' economics (which include material and unaccounted changes in natural capital, human capital, and social capital) by estimating their stock or net asset values, and thus bringing them within a common framework of value accounting for the nation. An externality occurs in economics when a decision (for example, to pollute the atmosphere) causes costs or benefits to individuals or groups Other than the person making the decision.

Environmental Accounting involves an array of quantitative estimations, modeling and valuing the non-marketed services of environmental assets such as forests, calculating the value of education as a generator of future incomes, present-valuing future liabilities in the form of pollution abatement costs and healthcare costs, etc.

Environmental Accounting also undertakes measuring and tracking of carbon dioxide equivalent levels that will not be emitted into our atmosphere due to the Kyoto Treaty. There are approximately more than 3,000 companies globally who have taken to the practice of documenting and reporting GHG emissions. This process is very similar to how businesses use financial reports to judge operational performances. This new area of expertise can be recognized as Enterprise Carbon Accounting (ECA) and many companies already have in place expert accountants who use GHG emissions reporting to oversee their sustainability performance.

18.4 DEFINITIONS OF ENVIRONMENTAL ACCOUNTING

Environment accountants are held responsible to identify and track green costs often times working with site, research and development, and production managers when planning their budgets. In the past, such costs were buried in overhead preventing a clear picture of the cost savings and benefits to the product, process, system or facility responsible for the green initiatives.

Environment accountants help management recognize that the tax benefits, rebates and lower costs of being environmentally friendly add up to a real bottom-line reward for doing the right thing.

“Public environmental, social and sustainability reporting is the main route through which corporate accountability and integrity can be demonstrated,” claims the London-based Association of Chartered Certified Accountants in its report, "Environmental, Social and Sustainability Reporting on the World Wide Web."

Environmental Accounting also referred as green accounting is defined as an important tool for understanding the role played by the environment in the economy. Environmental accounting prepares accounts that exhibit the cost of environmental conservation during the normal course of business. These costs can include costs to clean up or remediate contaminated sites, environmental fines, penalties and taxes, purchase of pollution prevention technologies and waste management costs. Environmental Accounting generates, analyses and uses financial and non-financial information to support management.

According to **Bennett** and **James**, "It is a complementary management accounting approach to the financial accounting approach. Key application fields for EA are assessment of annual environmental costs/expenditures, product pricing, budgeting, investment appraisal, calculating costs and savings of environmental projects, or setting quantified performance targets".

EMA is broadly defined as the identification, collection, analysis, dissemination, and use of physical flow information (materials, energy and water flows), environmental cost information, and other monetary information for both conventional and environmental decision-making within an organisation. This definition of EMA is similar to the definition of conventional management accounting, but has several key differences:

EMA places particular emphasis on identifying environmental costs, including the costs of producing waste; EMA includes information on physical flows and use of materials, water, and energy, as well as cost information; EMA information is particularly useful for activities and decisions with environmental impacts.

18.5 NATURE OF ENVIRONMENTAL ACCOUNTING

Environmental Accounting is an important function that provides firms with a means to incorporate information with business decision making and business operations.

Environmental accounting is the growing body of evidence indicating that environmental costs can make up a much larger proportion of costs than firms realize. Environmental accounting will also serve as a solid foundation for an Environmental Management System (EMS), or increase the effectiveness of an existing one. In addition, having and environmental accounting system in place allows firms to:implications on their operations, products, and services. Even consumers and stakeholders are taking interest and ask to report on environmental behaviour. Apart from this EA provides data that results in cost and competitive advantage. Companies like good year scrap tyre and Ricoh Group are even implementing it. As the EA benefits the company so does it benefits environment. Implementing of EA results in increase in awareness among business, stakeholders and society as a whole. It helps to build an environment friendly business culture. Companies incur costs in pollution prevention and waste disposal equipments that saves environment. The following points explain the nature of environment accounting :

1. Environmental Accounting enable governments to evaluate choices better without a bias against future generations, or a bias in favour of man-made assets as against natural assets. It would present in a different & holistic economic light choices such as conserving precious ecosystems rather than surrendering them at throwaway prices.
2. Environmental Accounting is to adjust traditional measures of growth and to re-cast them as measures of sustainable growth. There it could be fair and true measure of the national' wealth.

3. It improves environmental performance, controlling costs, and promote sustainability.

4. It encourages the government as well as the corporate to investing in cleaner and efficient technologies.

5. It helps in developing “greener” processes, and products.

6. It facilitates forming informed decisions related to their business activities.

18.6 LIMITATIONS OF ENVIRONMENTAL ACCOUNTING

Following are the main limitations of Environmental Accounting:

1. Environmental Accounting is an evolving science and still under study. For the concept to become fully implemented, lot of study is required.

2. There is no standard accounting method because Environmental Accounting is yet to develop.

3. Comparison between two firms or countries is not possible if methods of accounting are different.

4. It is not possible to ‘value every component of natural capital or human capital in a manner which is accurate, consistent and widely accepted as a norm by expert academic opinion.

18.7 OPPORTUNITIES IN ENVIRONMENTAL ACCOUNTING

Environmental Accounting is a great career choice with a big impact. Instead of figuring out how the corporate giants of the world can make impressive profits, a Environmental accountant analyzes external and internal costs of what happens to the environment. Once a Environmental accountant has identified an environmental cost, then this information can be used by companies or government to calculate carbon edits etc. Environmental Accounting goes beyond whistle-blowing and government-sponsored studies. Many private companies hire environmental accountants to evaluate the costs of cutting pollution, including adding in benefits of tax relief for following government regulations or tax credits for utilizing government-approved equipment or methods. More the number of Environmental cost saved or carbon credit saved, more will be the relief from government.

18.8 ENVIRONMENTAL ACCOUNTING IN INDIA

India is beginning to recognise that protecting biodiversity and ecosystems is a critical national priority. Mr Jairam Ramesh, the former environment minister, advocated greening India's national accounts by 2015 and encouraged policy makers to recognise the trade-off between pursuing high growth economic policies against the extensive impact they could have on India's natural capital." One organisation that is already leading the way is the Environmental Indian States Trust (GIST) which, in ' unleashed a series of environmentally adjusted accounts under the Environmental Accounting for Indian States Project. According to their results, the loss of forest ecological services (i.e. soil erosion prevention, flood control and ground water augmentation) over three years (2001-03) due to declining dense forests was estimated at an astounding 1.1 per cent of GDP. Breaking it down by States, they showed that for native forest-rich states such as Arunachal Pradesh, Assam, Himachal Pradesh, Jammu and Kashmir and Mizoram, the loss of these services was significantly high as a proportion of their net state domestic product (NSDP) an estimated 6 per cent. For instance, if we look at Assarn where forest cover decreased by 0.28 million hectares over three years, the value of effective flood control alone was at a loss of Rs 800 million. Following up on the initial study, GIST performed another round of accounting for the period 2003-2007 and the results speak loudly. Although the FSI claims an increase in overall forest cover in India, native dense forest cover is still declining rapidly. According to GIST's latest results, the North-Eastern states continue to be most affected, particularly Arunachal Pradesh and Mizoram where the loss of forest ecological services is more than 12 per cent of their NSDP.

18.9 SUMMARY

The environmental-Environmental Accounting is an emerging aspect of accounting science that will influence, in the near future, the enterprises. The adoption of basic elements of environment accounting will portray the role of environment in the economy as well as render easier the analysis of macroeconomic questions with the help of accounting information systems and thus, lead the economy to a viable path.

To further address the need and rationale for Environmental Accounting, the European Environment Agency (EEA) and its partners have been developing techniques consistent with national accounts methods to record the contribution of ecosystems to society's welfare. The methods, collectively known as ecosystem accounts, comprise both physical and monetary accounts of stocks, material and energy flows and services.

The EEA's basic approach entails quantifying the level of investments needed to ensure that ecosystems continue to provide the same level of services. This takes account of a variety of 'indicators of ecological potential', accounting for the state of the landscape, ecosystem production, biodiversity, water, absorption of external inputs and the capacity to support healthy populations.

Environmental Accounting must be viewed as a dynamic and ongoing process rather than a one-time activity. Environmental Accounting is a growing movement that has the backing not only of environmentalists but some top global corporations. To greatly simplify it, Environmental Accounting puts a rupee value on natural resources in order to help business and political leaders to make more informed decisions.

In the last sixty years, GDP has come to be seen as the primary indicator of the state of national economies and social wellbeing and a key guide to policymakers and investors. It reflects about the growth made by the nation. However, experts all over the world have started questioning the wisdom of using GDP as the true measure of the nation's wealth and more significantly, its economic sustainability.

Although a variety of criticisms can be leveled against GDP From a sustainability perspective the key concern is that it measures what an economy produces, not the state of capital stocks that support that output Such stocks include manmade capital but also other resources-natural, social and human-which together determine how much a society can produce

GDP growth does not reflect many vital aspects of national wealth and well-being, such as changes in the quality of health, the extent of education, or the quantity and quantity of natural resources Thus GDP accounts are inadequate to evaluate the trade-offs encountered by India's policy makers, and in the absence of an appropriate sustainability yardstick, the concept of 'sustainable development' in India remains at best an elusive dream Visible symptoms of unsustainable development include large and persistent disparities in wealth levels between rural and urban communities, inadequate public investment in health and education, rapid natural resources depletion, and a widespread incidence of the "vicious cycle" of chrome poverty and environmental degradation in forest-dependent co

High GDP growth usually supported by investment in physical infrastructure, which places mounting pressure on the country's environment and natural resources However, there is an asymmetry between manmade and natural capital as the depreciation in the fumier reflects in (WP accounts but the deprec c the natural capital is not taken into account while calculating GDP Recognizing that GDP growth is too narrow a measure of economic growth and not a measure of national wealth, experts have proposed a "Environmental Accounting" framework for India and its States and Union Territories.

At the micro level, of course, accounting practice does acknowledge the importance of manmade capital Business accounts have always included an element of depreciation to reflect the decreasing value of a firm's productive capital over time. The rationale is that sustained output is only possible if a firm invests in maintaining its capital stock

However, governments and international institutions pay less attention to the fundamental robustness of the economy when calculating national accounts In GDP, 'G' stands for 'gross', which means 'before subtracting capital depreciation'

Even when calculating net domestic product the depreciation only reflects changes in manmade capital, not those public goods that are not produced but play a vital role, in determining economic output for example nature.

By focusing only on flows of outputs, GDP provides misleading signals to policymakers. Activities that maximise production in the short term need not preserve the capital stocks that are central to long-term prosperity. Indeed, focusing just on GDP as a measure of economic health can be misleading. Robert F. Kennedy also noted, "It measures everything; in short, expect that which makes life worthwhile."

India must also take into consideration the costs of development and not self-cannibalize its rich natural capital wealth and jeopardise the very future of the people it is trying to secure. Ultimately not recording the cost of reinvestments to sustain healthy ecosystems creates and conceals ecological liabilities. This distorts our perception of the future when restoring ecosystem services will demand that the future generations repay the debts.

Decision-makers need the right indicators to ensure that policies and investments maximise wellbeing for current and future generations. Equally, citizens need access to such information to hold their governments to account for robust and transparent information which is a prerequisite for public empowerment and engagement

This means that there is a need to develop systems of national accounting that fully incorporates the capital stocks that determine our earnings Better macroeconomic and societal indicators are needed to reflect the contribution of biodiversity and ecosystem services to human well-being

One approach that is gaining momentum across the globe is "Environmental Accounting" whereby national accounts are adjusted to include the value of nature's goods and services.

Clearly, this poses conceptual and practical difficulties. From the environmental perspective, the key challenge lies in defining, quantifying and valuing natural capital. Whereas economic activity is quantified in monetary terms and recorded in business accounts. There are very few systems to measure the scale and cost of our impact on the environment.

18.10 GLOSSARY

- **Green Accounting-** It is also known as environment accounting
- **EMA-** Environment Managerial Accountant
- **Environmental accounting-** Environmental Accounting also referred as green accounting is defined as an important tool for understanding the role played by the environment in the economy.
- **EEA-** European Environment Agency
- **EA-** Environmental Auditing
- **ERA-** Environmental Risk Assessment

18.11 SELF ASSESSMENT QUESTIONS

Q1. What is Environmental Accounting?

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Q2. What is the criticism for using GDP as true and fair measure of economic wealth?

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Q3. State the features of Environmental Accounting.

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18.12 EXAMINATION ORIENTED QUESTIONS

Q1. Explain the concept of Environmental Accounting. Why do experts in accounting believe What it is a better tool for measuring GDP than the existing system?

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Q2. "Environmental Accounting is a dynamic and ongoing process rather than one-time process" Comment briefly explaining the benefits and limitations of Environmental Accounting.

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Q3. Briefly comment on the status of Environmental Accounting in India.

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UNIT-IV **M.Com 1st Semester**

Course No. M.Com-C150 **Lesson No. 19**

DEVELOPMENT IN FINANCIAL REPORTING

ENVIRONMENT ACCOUNTING-NEED, SCOPE, FORMS, ELEMENTS, ADVANTAGES AND MECHANISM

19.1 INTRODUCTION

19.2 OBJECTIVES

19.3 NEED FOR ENVIRONMENTAL ACCOUNTING

19.4 SCOPE OF ENVIRONMENT ACCOUNTING

19.5 FORMS OF ENVIRONMENTAL ACCOUNTING

19.6 ADVANTAGES OF ENVIRONMENTAL ACCOUNTING

19.7 ELEMENTS OF ENVIRONMENTAL ACCOUNTING

19.8 MECHANISM OF ENVIRONMENTAL ACCOUNTING

19.9 SUMMARY

19.10 GLOSSARY

19.11 SELF ASSESSMENT QUESTIONS

19.12 EXAMINATION ORIENTED QUESTIONS

19.13 SUGGESTED READINGS

19.1 INTRODUCTION

There is growing awareness and concern of the impact of human activity on the ecosystem. This concern at global level about the impact of the human activities on the environment and the need for mitigating the effects led to codification of 'soft law' on environment which began with the United Nations Stockholm Conference on Human Environment and the launch of UN environmental programme in 1972. The principles such as Polluter Pays, Absolute Liability, No Fault Liability, Precautionary Principle, Inter generational Equity and 'Good neighbour hoodness' began to take roots into international and national environmental regulations. Increasing danger to environment, extinction of many species of plants and animals, depletion of the ozone layer and global warming due to indiscriminate use of fossil fuels emitting Green House Gas has become a reality. States which are considered as trustees of the environment for future generations are increasingly adopting the path of sustainable development in their planning process and formulating tougher regulations for industry based on the soft law developed internationally.

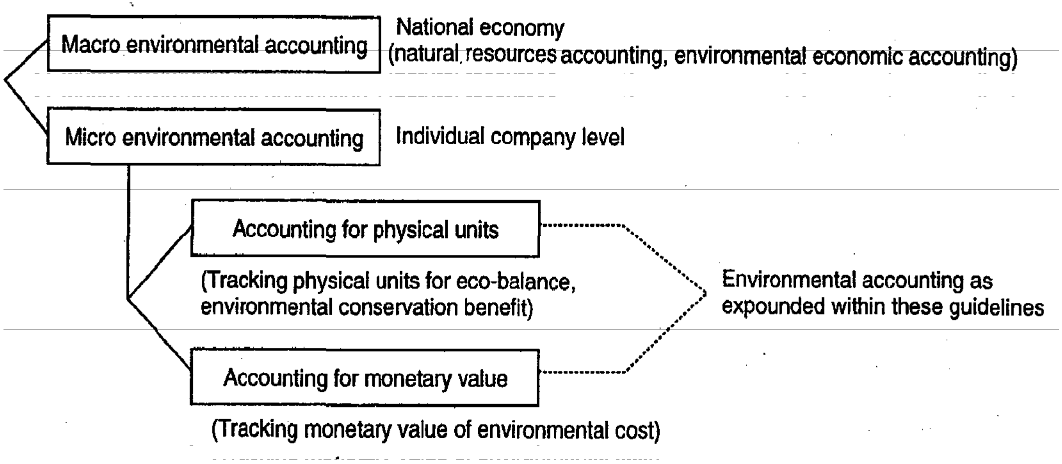
The Brundtland Commission report states "humanity has the ability to make development, sustainable to ensure that it meets the needs of the present without compromising the ability of future generations to meet their own needs."

There is an increasing trend to judge an enterprise in relation to the community in which it operates, just as a responsible citizen is judged by his actions in relation-to the community in which he lives. The impact of the activities of the organisations on the environmen reference to pollution of water, air, land and abuse of natural resources are coming under the scrutiny of governments, shareholders and citizens.

Unless proper accounting work is done either by the individual organisation or by the Government itself, it cannot be determined that both have been fulfilling their responsibilities towards environment. Therefore, the need of environmental accounting has emerged. In the early 90's, the UNEP and the World Bank set out to examine the feasibiily of physical and monetary accounting in the area of natural resources and the environment and to develop alternative macro indicators of environmentally adjusted and sustainable income and product. Simultaneously, the statistical division of the United Nations (UNSTAT) also developed methodologies for a system of Integrated Environmental and Economic Accounting (IEEA) and issued as an SNA handbook on Integrated Environmental and Economic Accounting.

Environmental accounting at organisation level aims to address the needs of organisation to measure the economic efficiency of its environmental conservation and the business activities of the company as a whole.

There are a variety of concepts within environmental accounting. These guidelines cover environmental, as shown in the diagram below:



Environmental accounting within the context of these guidelines mainly targets companies and other organisations. It is the framework for integrating the accounting concepts of both physical units and monetary values, and addresses the issue of cost performance (cost versus benefit).

In addition, it consists of environmental resource accounting which attempts, as best as possible, to consistently and comprehensively record information on environmental pollution and natural resources using an accounting framework. Environmental accounting also encompasses eco-balance, in which a table of input and output data for environmental impacts is created to measure and report the amount.

19.2 OBJECTIVES

After going through this lesson, you will be able to understand-

- the need of environmental accounting,
- the scope of environmental accounting,
- the forms of environmental accounting,
- the elements of environmental accounting, and
- the advantages and mechanism of environmental accounting,

19.3 NEED FOR ENVIRONMENTAL ACCOUNTING

Environmental accounting at the corporate level helps the management to know whether corporate has been discharging its responsibilities towards sustainable development while meeting business objectives. Environmental accounting addresses the following:

- Meeting regulatory requirements;
- Operate its factory in a way that environmental damages do not occur;
- Promote a culture and attitude of environmentally safe working amongst its employees;
- Disclosure to shareholders the amount and nature of the preventative measures taken by the management;
- Ensures safe handling and disposal of hazardous waste;

19.4 SCOPE OF ENVIRONMENT ACCOUNTING

The scope of Environmental Accounting (EA) is extensive and includes corporate, national & international level.

The following aspects are included in environmental accounting :

1. The direct investments made by a corporate for minimisation of losses to environment. It Includes investment made into the equipment/devices that help in reducing potential losses to the environment. This can be easily monetised. -
2. Indirect losses due to business operations. It mainly includes
   - Degradation and destruction such as loss of biodiversity, air and water pollution, hazardous waste including bio medical waste, coastal marin etc.
   - Depletion of non-renewable natural resources
   - Deforestation and land uses (measuring and monetising them can b and complex)

19.5 FORMS OF ENVIRONMENTAL ACCOUNTING

(a) **Environmental Management Accounting (EMA):** In EMA there is a particular focus on material and energy balance aspects and environmental cost information. This type of accounting is further classified into:

- **Segment Environmental Accounting:** This is an internal environmental accounting tool to select an investment activity, or a project, related to environmental conservation from among all processes of operations, and to evaluate environmental effects for a specified period.
- **Eco-Balance Environmental Accounting:** This is an internal environmental accounting tool to support PDCA for sustainable environmental management activities.

- Corporate Environmental Accounting: This is a tool to inform the public of relevant information compiled in accordance with the Environmental Accounting. This could be referred to as Corporate Environmental Reporting. For this purpose the cost and effect (in quantity and monetary value) of its environmental conservation activities are used.

(b) **Environmental Financial Accounting (EFA):** Environmental Financial Accounting concentrates on reporting environmental liability costs and other significant environmental costs.

(c) **Environmental National Accounting (ENA):** In national level accounting the particular focus is on natural resources, stocks & flows, environmental costs & externality costs, etc.

19.6 ADVANTAGES OF ENVIRONMENTAL ACCOUNTING

Following are the advantages of introducing environmental accounting for both the company which implements environmental accounting and for the society at large:

(1) Merits for the Company

(a) Merits from the Standpoint of Management (Internal Functions of Environment Accounting)

The functions of environmental accounting which supports corporate management are what are known as the internal functions of environmental accounting. By using the environmental accounting tool, companies can monitor factors such as environmental conservation cost, environmental conservation benefit, economic benefit associated with environmental conservation activities. Through the analysis of these factors, a company can realise the appropriate allocation of management resources to environmental conservation activities, thereby making efficient use of management resources.

Examples of how environmental accounting can be of assistance to internal management, is that it allows management to monitor account balances to reduce waste disposal cost and recycling expenditure, is to review account balances model for managing expenditures for environmental conservation projects and investment decisions, abets risk management to avoid lawsuits, becomes an integrated part of the environmental management system, and provides examples or models for use in environmental management of performance management. In addition, by reporting the results obtained from environmental accounting procedures, a company can achieve several goals such as heightening their employees' cost awareness and widely implanting a correct recognition of environmental issues, thereby has the benefit of deepening workers understanding of the company itself and increases an employee's perception of belonging to an environmentally conscious company.

(b) Merits of External Reporting (External Functions of Environmental Accounting)

Through the reporting of its environmental accounting results, a company promotes environmental communication. By enhancing environmental communications, it is possible for a company to build trust with its external stakeholders. Through these efforts, a company becomes recognised as an environmentally conscious corporation and can differentiate from other companies within the same sector (industry). As a result, a company can see benefits in a diverse range of areas. For example, it can give a company the advantage in developing its sales strategies. The company can also become selected as a constituent in a "green" mutual fund. In this manner, it serves as a positive catalyst in building up company's stock price. From the standpoint of employing personnel, owing to society's growing interest in environmentally conscious corporations, environmental reporting can work to a company's advantage.

(2) Merits to Society

The increase in the number of companies reporting on their environmental accounting can help to nurture stakeholders interested in environmentally conscious companies, contribute to the establishment of an environmentally conscious social system, and promote environmental conservation activities throughout the society at large.

19.7 ELEMENTS OF ENVIRONMENTAL ACCOUNTING

The fundamental elements of environmental accounting are environmental conservation cost, environmental conservation benefit and economic benefit associated with environmental conservation activities.

(1) Incurring environmental conservation cost:

Environmental conservation cost is in consideration of the capital (goods or service) and human resources (labour) that a company uses to implement environmental conservation activities.

(2) Environmental conservation benefit realised:

Environmental conservation benefit is the improvement in environmental performance indicators as a result of progress made by implementing environmental conservation activities.

(3) Economic benefit associated with environmental conservation activities realised:

Economic benefit associated with environmental conservation activities is the contribution to a company's economic profit as a result of progress made by implementing environmental conservation activities.

19.8 MECHANISM OF ENVIRONMENTAL ACCOUNTING

Environmental accounting is mechanism for quantitatively analysing environmental conservation activities. However, in addition, qualitative data, which has been deemed necessary, is incorporated into the results or quantitative data. Each constituent element of environmental accounting is measured using either monetary value or physical units. However, for data which cannot be described using physical or monetary units, it is possible to express it in qualitative terms.

The table below shows how each constituent element can be expressed as quantitative data or as qualitative data.

Constituent Elements	*Quantitative Data*	*Qualitative Data*
Environmental conservation cost	Monetary value	Details of activities
Environmeniai conservation benefit	Physical units	Details of benefits
Economic benefit associated with environmental conservation activities	Monetary value	Details of benefits

In environmental accounting, explanation of basic key items or the results obtained from accounting procedures are also categorised as qualitative data.

Environmental conservation benefit is measured in physical units. However, by assessing the economic value of environmental conservation benefit measured in physical units, the same data can then be expressed in monetary value as well. For example, this method can be used to assess the economic value of lower health risk resulting from a reduction in air pollutant emissions.

Meanwhile, economic benefit associated with environmental conservation activities is measured in monetary value. These benefits are reflected in profits a company records on its financial statements.

In this manner, both the assessment of the economic value of environmental conservation benefit and the economic benefit of environmental conservation activities are measured in monetary value but the essential content of these two elements differs. The former expresses the benefit to overall society in monetary terms, while the latter depicts the benefit to a company's business operations.

19.9 SUMMARY

The value of environmental accounting has long been recognised by leading international environmental organisations and many countries as an important policy design and resource management tool for creating a sustainable future. In recent years, it has become increasingly viewed as particularly relevant for many of the world's paramount environmental challenges most notably climate change and as an important aide in helping governments better devise defensible, measurable, and practical solutions to respond to them. Environmental accounting as a discipline, however, is still evolving. Environmental accounting covers complex and diverse topics, some of which are still subject to debate. In particular, valuing some natural assets, such as clean air and water, is complicated by the fact that these goods are generally not traded in markets and alternative techniques for establishing their prices face conceptual and empirical challenges.

19.10 GLOSSARY

- **Environmental accounting-** It is the framework for integrating the accounting concepts of both physical units and monetary values, and addresses the issue of cost performance (cost versus benefit).
- **Segment environmental accounting-** This is an internal environmental accounting tool to select an investment activity, or a project, related to environmental conservation from among all processes of operations, and to evaluate environmental effects for a specified period.

- **Eco-balance environmental accounting**- This is an internal environmental accounting tool to support PDCA for sustainable environmental management activities.

- **Corporate environmental accounting**- This is a tool to inform the public of relevant information compiled in accordance with the Environmental Accounting.

19.11 SELF ASSESSMENT QUESTIONS

Q1. What is environment accounting ?

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Q2. What are the aims and functions of environmental accounting?

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Q3. What are the main components of environmental accounting?

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19.12 EXAMINATION ORIENTED QUESTIONS

Q1. What is meant by environmental accounting? Discuss the need for environmental accounting.

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Q2. Discuss the forms and elements of environmental accounting. Discuss the advantages of environmental accounting.

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Q3. What is method of measuring the constituents of environmental accounting?

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DEVELOPMENT IN FINANCIAL REPORTING

SOCIAL ACCOUNTING: NATURE, FEATURES, NEEDS AND BENEFITS; SOCIAL ACCOUNTING AND AUDIT PRACTICES IN TATA

20.1 INTRODUCTION

20.2 OBJECTIVES

20.3 MEANING AND DEFINITIONS OF SOCIAL ACCOUNTING

20.4 NATURE OF SOCIAL ACCOUNTING

20.5 NEEDS OF SOCIAL ACCOUNTING

20.6 NATURE OF SOCIAL ACCOUNTING

20.7 BENEFITS OF SOCIAL ACCOUNTING

20.8 SCOPE OF SOCIAL ACCOUNTING

20.9 DIFFICULTIES OF SOCIAL ACCOUNTING

20.10 HISTORICAL BACKGROUND OF SOCIAL ACCOUNTING IN INDIA

20.11 SOCIAL ACCOUNTING AND AUDIT PRACTICES IN TATA

20.12 LEGISLATIVE SUPPORT AVAILABLE TO SOCIAL AUDIT IN INDIA

20.13 SUMMARY

20.14 GLOSSARY

20.15 SELF ASSESSMENT QUESTIONS

20.16 EXAMINATION ORIENTED QUESTIONS

20.17 SUGGESTED READINGS

20.1 INTRODUCTION

Every business organization whether big or small not only provides products and services to us, but they are also damaging natural resources. Every industrial unit has certain responsibilities towards the society in which it operates. The users of financial statements i.e., investors, creditors, money lenders, Government agencies, suppliers, research scholars and consumers are also part and parcel of this society in which the business firm has to operate. Traditional financial accounting mainly focuses on the measurement and reporting of business transactions between two or more business enterprises. Statements prepared under accountings are basically prepared for the use of investors and management. Interaction between firm and social environment is practically ignored. Business enterprises particularly involved in manufacturing operations are damaging social environment in form of damaging the air, water and soil. The traditional financial statements do present financial and operating results but do not present any information on social performance of reporting entity. This nature of financial statements has led to a debate that business enterprises should conform to the socially desirable goals for example, product safety, environmental protection, employee's welfare, employment to minorities. On the other hand, business organisations are not going to leave their basic goal of earning profits because any business running into losses may become a sick unit with the passage of time and cannot fulfill any social goal. Earning profits is not harmful if some part of profits is being utilised for meeting social goals.

20.2 OBJECTIVES

After going through this lesson, the students will be able to understand-

- the meaning of social accounting;
- features of social accounting;
- needs of social accounting; and
- benefits of social accounting.

20.3 MEANING AND DEFINITIONS OF SOCIAL ACCOUNTING

The term 'social accounting' was first introduced into economics by J.R. Hicks in 1942. In his words, it means 'nothing else but the accounting of the whole community or nation, just as private accounting is the accounting of the individual firm'. Social accounting, also known as national income accounting, is a method to present statistically the inter-relationships between the different sectors of the economy for a thorough understanding of the economic conditions of the economy.

It is a method of studying the structure of the body economic. It is a method of studying the structure of the body economic. It is a technique of presenting information about the nature of the economy with a view not merely to get an idea of its prosperity, past or present, but also to get guidelines for state policy to influence or regulate the economy.

The term 'social accounting' is of recent origin and many other terms like, 'social audit', 'socio-economic accounting', 'social cost benefit analysis', 'report on corporate social policies', 'social information system', 'social accounting', 'social responsibility accounting' etc. are often interchangeably used for this. Now-a-days it is being realized that commercial evaluation of business units is not sufficient to justify commitment of funds to a business unit. Rather evaluation will be complete only if it takes into consideration social cost and benefits associated with them.

DEFINITIONS OF SOCIAL ACCOUNTING

In order to gain understanding of the term social accounting, various points-of view given by some eminent accounting authorities are reproduced below:

Elliot uses the term social responsibility accounting which, according to him, "is a systematic assessment of and reporting on those parts of a company's activities that have a social impact. Social responsibility accounting, therefore, - describes the impact of corporate decisions on environment pollution, the consumption of non-renewable resources, and ecological factors; on the rights of individuals and groups; on the maintenance of public services ; on public safety; on health and education and many other such social concerns."

According to **G.C. Maheshwari,** social accounting is "identification, measurement, -recording and reporting of corporate activities which may permit informed decision-making with respect to social activities of the firm having direct or indirect effect on the very fabric of the society at large, while 'social audit' would mean enquiry into the corporate social accounting records by an outside agency that can opine with a view to attestation and authentication of such records and reports."

In the words of **Kohlar,** "Social accounting is the application of double entry book keeping to social economic analysis".

This is an orthodox definition as it is based on application of book keeping principles rather than sophisticated techniques of management accounting to the national socio-economic situation.

Ralph defines social accounting as, "the measurement and reporting, internal and external, of information concerning the impact of an entity and its activities on society." He viewed social accounting as an independent discipline which is to measure and report the activities of an entity in so far as they effect the society.

According to **Leonard Spacer,** "Social accounting as the means by which the effects of social programmes are attempted to be expressed in some type of quantitative terms".

Salivary says, "Social accounting is the expansion of the existing boundaries of the accounting beyond the normal economic consequences".

20.4 SOCIAL AUDIT

Social Audit is a tool with which government departments can plan, manage and measure non financial activities and monitor both internal and external consequences of the department/organisations social and commercial operations.

The process of evaluating a firm's various operations procedures, code of conduct and other factors to determine its effect on a society. The goal is to identify what, if any, actions of the firm have impacted the society in some way. A social audit may be initiated by a firm that is seeking to improve its cohesiveness or improve its image within the society. If the results are positive, they may be released to the public. For example, if a factory is believed to have a negative impact, the company may have a social audit conducted to identify actions that actually benefit the society.

"Social audit is a process in which people work with the government to monitor the planning and implementation of the policies/programme which are intended for the beneficiaries (people)".

It is also defined as an in-depth scrutiny and analysis of the working of any public utility vis a vis (in relation to) its social relevance.

The underlying ideas of a social audit are directly linked to the concept of democracy and participation. In Social Audit, it examines the impact of specific governmental activities on certain sections of the society within are in contact with government agencies. It is an important tool in the Management of National Affairs.

The following are the objectives of social audit :

1. Assessing the physical and financial gaps between needs and resources available for local development.

2. Creating awareness among beneficiaries and providers of local social and productive services.
3. Increasing efficacy and effectiveness of local development programmes.
4. Scrutiny of various policy decisions, keeping in view stakeholders interests and priorities, particularly of rural poor.
5. Estimation of the opportunity cost for stakeholders of not getting timely access to public services.

Principles of Social audit:

The foremost principle of social audit is to achieve continuously improving performances relative to the chosen social objectives. Eight specific key principles have been identified from Social Auditing practices around the world.

1. Multi-perspective: It aims to reflect the views (voices) of all those people (stakeholders) involved with or affected by the organization/department/ programme.

2. Comprehensive: It aims to (eventually) report on all aspects of the organization's work and performance.

3. Participatory: It encourages participation of stakeholders and sharing of their values.

4. Multidirectional: Stakeholders share and give feedback on multiple aspects.

5. Regular: It aims to produce social accounts on a regular basis so that the concept and the practice become embedded in the culture of the organization covering all the activities.

6. Comparative: It provides a means whereby the organization can compare its own performance each year and against appropriate external norms or benchmarks; and provide for comparisons to be made between organizations doing similar work and reporting in similar fashion.

7. Verified: It ensures that the social accounts are audited by a suitably experienced person or agency with no vested interest in the organization.

8. Disclosed: It ensures that the audited accounts are disclosed to stakeholders and the wider community in the interests of accountability and transparency.

These are the pillars of social audit.

20.5 NATURE OF SOCIAL ACCOUNTING

The salient features of social accounting are as under :

i. Social accounting is an expression of a company's social responsibilities.

ii. Social accounting is related to the use of social resources.

iii. Social accounting emphasizes on relationship between firm and society.

iv. Social accounting determines desirability of the firm in society;

v. Social accounting is application of accounting on social sciences.

vi. Social accounting emphasizes on social costs as well as social benefits.

vii. It includes community services and community involvement programmes.

vii. It covers activities relating to the well beings of employees including job enrichment and promotional policies.

viii. It includes conservation of resources and protecting environment, air and water, quality control and appropriate disposal. of waste.

ix. It deals with the impact of a company's products or services on the society, advertising, packaging, product safety and warranty policies.

20.6 FEATURES OF SOCIAL ACCOUNTING

Social accounting is commonly used in the content of business, or corporate social responsibility. It can be used in conjuction with community based monitoring (CBM).

Social accounting challenges conventional ?????, in particular financial accounting, for giving a narrow image of the interaction between society and organisations, and thus artificially constraining the subject of accounting.

The following are the features of social accounting :

1. Social accounting is an expression of a company's social responsibilities.
2. Social accounting is related to the use of social resources.
3. Social accounting determines desirability of the firm in society.
4. Social accounting is an application of accounting on social sciences.
5. Social accounting exphasize on relationship between firm & society.
6. Social accounting emphasizes on social costs as well as social benefits.

20.7 NEED OF SOCIAL ACCOUNTING

Social accounting helps in understanding the structure of an economy and relative importance of the different sectors and flows. It is a key to the evaluation and formulation of government policies both in the present and future. Social accounting is needed because of the following reasons:

(1) To classify transactions:

Economic activity in a country involves innumerable transactions relating to buying and selling, paying and receiving income, exporting and importing, paying taxes, etc. The great merit of social accounting lies in classifying and summarising these different kinds of transactions properly, and deriving from these such aggregates as national income, national expenditure, saving, investment, consumption expenditure, production expenditure, government spending, foreign payments and receipts, etc.

(2) To understand economic structure:

Social accounting helps us to understand the structure of the body economic. It tells us not only about the national income but also about the size of production and consumption, the level of taxation and saving and the dependence of the economy upon foreign trade.

(3) To understand different sectors and flows:

Social accounts throw light on the relative importance of the different sectors and flows in the economy. They tell us whether the contribution of the production sector, the consumption sector, the investment sector or the rest of the world sector is greater than the other sectors in the national accounts.

(4) To clarify relations between concepts:

Social accounts help in clarifying the relationships between such related concepts as net national product at factor cost and gross national product at market prices.

(5) To guide the investigator:

Social accounts are a guide for the economic investigator by indicating the type of data which might be collected for analysing the behaviour of the economy. Such data might relate to gross national product, government expenditure on goods and services, private consumption expenditure, gross private investment, etc.

(6) To explain trends in income distribution:

Variations in the components of social accounts are a guide to the trends in income distribution within the economy.

(7) To explain movements in GNP:

Movements in gross national product valued at constant prices and expressed per head of population indicate changes in the standard of living. Similarly, changes in the level of productivity can be measured by relating gross national product valued at constant prices to working population per head.

(8) To provide a picture of the working of economy:

Social accounts provide an ex post picture of the working of the economy. "They can also be used as a framework for drawing up an ex ante forecast of the likely outcome of the economy in the future. Thus, social accounts ensure consistency of forecasts, both internally and in relation to other known facts."

(9) To explain interdependence of different sectors of the economy:

Social accounts also provide an insight into the interdependence of the different sectors of the economy. This can be known from a study of the matrix of social accounts.

(10) To estimate effects of government policies:

The importance of social accounts lies in estimating the effects of government policies on different' sectors of the economy and in formulating new policies in keeping with changes in economic conditions, as revealed by national income accounts.

Their main function is to help the government judge, guide or control economic conditions and to formulate economic policies which aim at maximisation of national income, keeping employment at a high level, reducing inequalities of income and wealth, preventing undue rise in prices, conserving foreign exchange, etc.

(11) Helpful in big business organisations:

Social accounts are also used by big business houses for assessing their performance and to improve their prospects on the basis of the statistical information about the various sectors of the economy.

(12) Useful for international purposes:

Social accounting is also useful for international purposes. A comparative study of the social accounts of different countries of the world helps in the categorization of countries into underdeveloped, less developed and developed. It is on the basis of social accounts that the various agencies of the United Nations make provisions for aid to poor countries of the world.

(13) Basis of Economic Models:

Social accounts form the basis for economic models for the purpose of analysing the behaviour of the economy as a whole, of economic forecasting and of illuminating problems of economic policy.

20.8 BENEFITS OF SOCIAL ACCOUNTING

The important benefits of social accounting are as follows :

(1) A firm fulfils its social obligations and informs its members, the government and the general public to enables everybody to form correct opinion.

(2) It counters the adverse publicity or criticism levelled by hostile media and voluntary social organisations.

(3) It assists management in formulating appropriate policies and programes.

(4) Through social accounting the firm proves that it is not socially unethical in view of moral cultures and environmental degradation.

(5) It acts as an evidence of social commitment.

(6) It improves employee motivation.

(7) Social accounting is necessary from the view point of public interest groups, social organisations investors and government.

(8) It improves the image of the firm.

(9) Through social accounting, the management gets feedback on its policies aimed at the welfare of the society.

(10) It helps in marketing through greater customer support.

(11) It improves the confidence of shareholders of the firm.

20.9 SCOPE OF SOCIAL ACCOUNTING

The scope of social accounting is very large since, it can be applied to many areas of social activities. In the absence of clear definition of corporate social responsibility by legislation, individual firm must decide for themselves the nature and cope of their social responsibility. However, with a view to facilitate corporate accountability, Brummet (1973) has find five possible areas in which corporate social objectives may be found and each area of contribution of corporate social activities may be measured and reported.

1. Net income contribution:

The basic objective of business is to earn profit. The growing attention towards social activities of the firm will not reduce the importance of profit to the firm. The corporate should ensure that the profit is earned within legal framework that is “profit in a socially acceptable manner”.

2. Human resource contribution:

It reflects the effect of organization on the human resource of the organization. The organizational activities include: recruitment policies and practices, training, experience building, job enrichment, wage and salary, Congruence of employees and organizational objectives, job safety and Occupational health.

3. Public contribution:

It reflects the impact of organizational activities on individuals generally outside the organization. The organizational activities include: General Philanthropy, General volunteer community activities, Training and employment of handicapped persons.

4. Environmental contribution:

It reflects the impact of corporate activities on the environment.

5. Product or service contribution:

This area relates to the qualitative aspect of the organization’s product or service. It includes product utility, durability of product, product safety, and serviceability as well as the welfare role of the product or service. It also includes customer satisfaction, honesty in advertising their products etc.

20.10 DIFFICULTIES OF SOCIAL ACCOUNTING

The preparation of social accounts presents the following difficulties:

1. Imputations:

In preparing social accounts, all incomes and payments are measured in money. But there are many goods and services which are difficult to impute in terms of money. They are services of the housewife in her home, painting as hobby by an individual, a teacher teaching his children at home, etc. Similarly there are a number of non-traded or non-marketed products and services.

They are vegetables produced in the kitchen garden and consumed by the family itself, rental value of house occupied by the owner himself, a portion of farm produce retained by the farmer for personal consumption, etc. All such non-market transactions which cannot be assessed in money terms present problems in preparing social accounts accurately.

2. Double counting:

The greatest difficulty in preparing social accounts is of double counting. It arises from the failure to distinguish between final and intermediate products. For instance, flour used by a bakery is an intermediate product and that by a household the final product.

Similarly, ‘the purchase of a newly constructed building by the government is taken under consumption output of the economy. On the other hand, the purchase of the same building by a private firm becomes gross investment for the year’. Thus the same product is shown as consumption and investment in social accounts. Such problems lead to difficulties in preparing social accounts.

3. Public services:

Another problem is of estimating a number of public services in social accounts. They are police, military, health, education, etc. Similarly, the contributions made by multipurpose river valley projects cannot be fitted into the social accounts because of the difficulty of assessing their numerous benefits in monetary terms.

4. Inventory adjustments:

All inventory changes whether negative or positive are adjusted in the production accounts by inventory valuation adjustment. But the difficulty is that firms record inventories at their original costs and not at their replacement costs.

When prices rise, there are gains in the book value of inventories. But when prices fall, there are losses in the value of inventories. So, for correct calculation of inventories in business accounts under social accounting, inventory valuation adjustment is required which is a very difficult thing.

5. Depreciation:

Another problem in business accounts under social accounting is of estimating depreciation. For instance, it is very difficult to estimate the current depreciation rate of a capital asset whose expected life is very long, say fifty years. The difficulty increases further when prices of assets change every year. Unlike inventories, it is very difficult to have depreciation valuation adjustment in social accounts.

20.11 HISTORICAL BACKGROUND OF SOCIAL ACCOUNTING IN INDIA

It initially concentrated on British corporate social reporting strategies in India. But it was eventually influenced by the International Professional Group. The Indian Companies Act 1956 played a vital role in the development of business annual reports. The contract journalist should have a profit and loss account in accordance with Section 165 of the 1956 Indian Corporations Act, the Balance Sheet Director's publication, as well as the auditors ' survey. It has also been observed that the Indian profit and loss report and Indian balance log are not so imaginative and less instructive.

The Indian economic statements are usually prepared in the legal structure to meet the legal duty. None of these are the problems of corporate social reporting pursuant to chapter 227(4A) of the Indian Companies Act of 1956 needing the auditor to advise and express his view as to whether the Corporate Profit and Loss Account and the balance sheet have the company's "true and sincere" opinions. Obviously, Indian financial information is harmful and not accessible to the public. It includes only statutory and non-statutory reports that Indian corporations are not prepared for. Multiple ignored factors are the real resources of the organization, private accountability, etc. in the Indian equilibrium panel. Required and recorded in the form and structure of the law. The Committee suggested several elements of documents, auditing, private responsibility, etc.

The Committee suggested incorporating the past information into the Director's research:

1. The company has taken measures in separate fields with a perspective to practicing its social responsibility for the different sectors of culture, as far as possible and under economic circumstances.

2. The commission should also recommend on the future plans of the company to meet its private duties and duties.

According to these allegations, the business should show various financial accountability to the distinct parts of culture and monetarily.

It is necessary to disclose any information that is useful to the business. And the most significant item is that the organisation should create its prospective systems for social security. "In the light of modern economic development, the operation of the company is no longer separated. Profit stays vital but has no primary goal. The company requires to recognize obligations in order to be socially responsible and to offer the community a wider benefit."

If a business encounters customers, staff, shareholders and society's private needs, its private accountability will be properly practiced otherwise. In the

1981 research carried out by 202 companies ' Indian Institute of Chartered Accountants, 123 of these 202 companies revealed their directors ' dedication to a business in the areas of social responsibility.

Tata Iron and Steel Company Limited was the first company to generate corporate social reporting in India, which published its survey on' financial audit' in 1979-1980. The main objective of the social inspection is to investigate the extent to which the company has achieved its cultural and private objectives towards investors, community and the local community.

The Sachaar Committee therefore suggested that the company aims not only the company but also the financial goal and exclude cultural goals. Profit is indeed the most significant variable in commercial organisations ' financial performance in this vibrant age, but more significant than that are social obligations as both companies and groups complement each other.

The Audit Committee first described the concepts and explained its dedication to Jamshedpur Pollution Control, employer-staff interactions, clients, investors, community and economic growth, regional growth programs, etc. This has been discussed by the audit committee.

Despite being critical of the research and praised for being highly comprehensive and not responsible. Second, only those details given for putting the company in an advantageous position.

Furthermore, there are many large companies, as well as for India's Cement Corporation and India's Metals and Minerals Trading Corporation, both in public and in the private sectors. The Oil and Natural Gas Commission, the Indian Steel Authority Ltd., Bharat Heavy Electrical Ltd., etc., released their private output without uniform design in their annual report.

The Public Works Office has now been changed to the Public Enterprise Department, which requires social transparency and thus requires the transparency of their private expenses for each public enterprise. As a consequence, most companies are preparing their private records in order to conform with legal and other conditions.

A variety of company issues prepare their personal accounts, but according to distinct plans and designs. Nearly all issues are adopting corrective action in their quarterly accounts to reveal their personal obligations to community.

Several techniques in both qualitative and quantitative models were acknowledged in developed countries in creating social accounting for businesses in other nations. Companies in Australia are noted to disclose information on personal accountability in the framework of environmental, power, human resources, utility and involvement in culture, etc. Also essential for business climate reporting are the United States, United Kingdom, Germany, France, Japan, New Zealand, Rolland, Sweden and Spain.

Several techniques in both qualitative and quantitative models were acknowledged in developed countries in creating social accounting for businesses in other nations. Companies in Australia are noted to disclose information on personal accountability in the framework of environmental, power, human resources, utility and involvement in culture, etc. Also essential for business climate reporting are the United States, United Kingdom, Germany, France, Japan, New Zealand, Rolland, Sweden and Spain.

Several big businesses in Great Britain are publishing a value-added statement. The French government has made it legally mandatory to reveal social responsibility to companies. Dills and Weygant's Annual Social Responsibility Report (SRAR), Saidler's Social Income Statement (SIS), Linowcs ' Socio-Economic Operating Statement (SEOS) and Abt's model include a range of the country's techniques and models. Also included in the social audit is social audit

Some big commercial firms release private accounts in Great Britain as a value-added statement. The French government has made it legally compulsory for companies to reveal their private responsibilities. Dills and Weygant's model, also known as Social Responsibility (SRAR), Social Revenue Statements (SIS), Linowcs ' Socio-Economic Operating Statement (SEOS), and Abt's model, also include social audits, are the various methods and designs used in overseas nations.

20.12 SOCIAL ACCOUNTING AND AUDIT PRACTICES IN TATA

Experiments have been going on in various countries as to the programme to be adopted for social audit, but till now no standard procedure has been fixed up. Different persons have expressed their opinions differently. But, all are in the opinion that the programme for audit should be framed in such a way that it will be possible to evaluate financially and quantitatively the different activities of the concern. For this, a group of people have advocated to prepare statements concerning socio-economic activities along with the financial statements. On the basis of time, different methods have been evolved to measure the performance of the concern. At the same time, the appraisal of that performance has become necessitated. The statement should disclose expenditure incurred by the concern towards social activities as well as the monetary value of the social benefits evolved out of activities. Similarly, if due to the activities of the concern, social welfare is hampered, it should be expressed in monetary value. However, the activities for which evaluation can be made are given bellow: (i) Contribution towards handicapped employees, (ii) Contribution towards other employees, (iii) Contribution towards other backward community, (iv) Contribution towards creation of employment opportunities, (v) Contribution towards proper conservation of resources, (vi) Contribution towards prevention of environment pollution, (vii) Contribution towards the consumers, (viii) Contribution towards adoption of welfare measures for the employees, (ix) Contribution towards rural development.

In order to evaluate various programmes in respect of discharging social responsibility, a special method of accounting is needed. But no standard method or system of social accounting acceptable to all has been established so far.

Once any standard method is introduced, there arises the necessity of proper examination and verification of such accounting. In different countries, specially in U.S.A., a good number of business undertakings have been disclosing various information, with the submission of annual report in respect of discharging social responsibilities. In India, the Tata Iron and Steel Company Ltd.(TISCO) released in July 1980 the Report of the Social Audit Committee which went the question whether the company had fulfilled the objective contained in clause 3(a) of its Articles of Association regarding its social and moral responsibilities to the consumers, employees, shareholders, society and the local community. The report is largely a descriptive analysis of the performance of the company in the field of discharging its social responsibility. It does not attempt to give a socio-economic operating statement. It cannot be denied that it is a remarkable event in case of social accounting and audit in our country. But, the report has now ceased to be published. Apart from this, in 1978 the Indian Textile Corporation brought out a statement of social accounting as well as social audit. The Cement Corporation of India has been publishing since 1979-80 social income statement and social balance sheet along with the annual report. In Kerala, the state government has taken a decision to introduce Social Audit for local bodies. In this context, it can be mentioned that by virtue of section 227 (4-A) of the companies Act, the central govt. has enforced the Manufacturing and Other Companies (Auditor's Report) Order, 1988.

20.13 LEGISLATIVE SUPPORT AVAILABLE TO SOCIAL AUDIT IN INDIA

Social Audit gained significance especially after the 73rd Amendment of the Constitution relating to Panchayat Raj Institutions. It has empowered the gram sabhas to conduct Social Audits in addition to its other functions, and it was by far the only legislative reference to the concept of Social Audit.

Right to information Act, 2005: This is also a key pillar of support for Social Audit system in India. This was enacted by Parliament of India to provide for setting out the practical regime of the right to information for citizens. The Act applies to all states and union territories of India, except the state of Jammu and Kashmir. This Act also requires every public authority to computerize records for wide dissemination and to proactively publish certain categories of information so that the citizens need minimum resources to request for information formally. This is again a support for Social Audit system in India.

National Rural Employment Guarantee Act, 2005 (NREGA): Section 17 of this Act provides for regular "Social Audits" so as to ensure transparency and accountability in the scheme. It is the responsibility of the state government to conduct the Social Audit. The state government will conduct the Social Audit according to the pre-designed "Schedule of Social Audit". The state government has to ensure that the agencies for conducting Social Audit are well equipped and trained.

The Draft "NREGA Transparency and Public Accountability Rules" lay down detailed guidance for conducting Social Audit. The government has been instrumental in establishing an independent Social Audit Society for carrying out the Social Auditing of NREGA in the state. This society is called "Society for Social Audit" Other social sector programmes also laid down provisions and procedure for "Social Audit". For example: The ministry of Housing and Urban Poverty alleviation has laid down Social Audit methodology and operational guidelines for various schemes.

Governments are facing an ever-growing demand to be more accountable and socially responsible and the community is becoming more assertive about its right to be informed and to influence governments' decision-making processes. Both Social Audit and Social Accounting are the tools through which business world can plan, manage and measure non-financial activities and monitor both internal and external consequences of the departments' social and commercial operations. Social Audit gained significance in India after the 73rd Amendment of the Constitution relating to Panchayat Raj institutions. The approach paper to the Ninth Five Year Plan (1997-2002) emphasizes Social Audit for the effective functioning of the Panchayat Raj institutions and for achieving the goal of decentralization in India. In Kerala, the state government has taken a decision to introduce Social Audit for local bodies. Social responsibility has been assuming increasing importance and there is a growing awareness among the corporate sector these days that every company should contributes positively towards the social goals. At present, almost all the countries of the business world including India have started to think of discharging their social responsibilities efficiently. This type of thinking is essential for maintaining long term existence of the organization.

20.14 SUMMARY

Social audit is a strong tool to check, monitor, evaluate and report the social performance of programmes and projects led by the government and business organizations. In India, it is specifically being used for the evaluation of the social performance of government schemes and programmes. It could effectively be used in private sector also to monitor the performance of the private organizations. In India, it is being implemented since many years as a tool to eradicate corruption with a due support from legislations. It is based on the principle that democratic local governance should be carried out, as far as possible, with the consent and understanding of all concerned. Although facilitated and duly supported by government agencies and officials, social audits, as a process still needs to be strengthened- A Long Way to Go Ahead.

The concept of 'Social Accounting' has gained importance as a result of high level industrialization which has brought prosperity as well as many problems to the society. It has necessitated the corporate sector, with huge amounts of funds at their disposal to invest substantial amounts in social activities so as to nullify the adverse effects of industrialization. In modern times, accounting efforts have been extended to the assessment of the state of society and of the social progrmames not for the satisfaction of any individual or group but for the application of evaluative procedures in the allocation of resources towards better social well being as a whole. Social accounting is concerned with the study and analysis of accounting practice of those activities of an organisation. The concept of socialistic pattern of society, civil rights movements, environmental protection and ecological conservation groups, increasing awareness of society towards corporate social contribution etc. have contributed towards the growing importance of social accounting.

Social Accounting, also known as Social Responsibility Socio-Economic Accounting, Social Reporting and Social Audit, aims to measure and inform the general public about the social welfare activities undertaken by the enterprise and their effects on the society. As per **F.E. Perry's Dictionary** of banking, social accounting is the reporting of the cost incurred in employing with anti-pollution, safety and health and other societal beneficial requirements and, more generally the impact of business entity on the endeavor to project society its amenities and the environment. In the words of **Richard Dobbins** and **David Fanning**, social accounting is "the measurement and reporting of information concerning, the impact of an entity and its activities on society." The National Association of Accountants (NAA) Committee defined social accounting as 'the identification, measurement, monitoring and reporting of the social and economic effects of an institution on society." It is thus clear that social accounting is concerned with the internal and external reporting of social costs and benefits both in quantitative as well as qualitative terms by a business enterprise.

In India, there is no legal obligation on companies to provide information on social costs and social benefits in their annual statements, but some progressive companies like Cement Corporation of India, Bharat Heavy Electricals Ltd., Minerals and Metals Trading Corporation of India and the Tata Iron and Steel Company Ltd. are giving by means of supplementary information, the details of the social costs and social benefits as a result of their operations.

20.15 GLOSSARY

- **Social accounting-** it is concerned with the identification, measurement, monitoring and reporting of the social and economic effects of an institution on society."
- **Human resource contribution -** it reflects impact of enterprises policies on human resources.
- **Public contribution** – it reflects enterprise's policies impact on individuals which are outsiders for the organization.
- **Environmental contribution-** includes activities directed towards reducing deterioration of water, air and soil. Installation of air purifiers, disposal of wastes, reduction in noise pollution are also included in this contribution.
- **Product or service contribution-** includes product safety, Product quality, packaging, product promotion, advertisements, service facilities, product durability, customer satisfaction, completeness and clarity of labeling.
- **NAA-** The National Association of Accountants
- **CBA-** Cost benefit analysis
- **CSR-** Corporate social responsibility
- **Social income-** excess of social benefits over social overheads as social income.
- **Social constituents-** all different social groups which are likely to be affected due to the operations of an enterprise are regarded social constituents.
- **Social equity-** total claims of all social groups over firm as social equity.

20.16 SELF ASSESSMENT QUESTIONS (SAQ)

Q1. Do you think that the concept of social accounting of business is inconsistent with the profit objective of business?

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Q2 Explain the meaning of social accounting and give its approaches.

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Q3. Explain the concept of social cost benefit analysis.

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20.17 EXAMINATION ORIENTED QUESTIONS

1. What do you understand by Social Accounting? Discuss its procedure, advantages and weaknesses.

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2. Discuss the importance and problems in social accounting.

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3. Discuss the legal, social and environmental factor which affect the business operation from country to country.

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4. Explain social accounting and audit practices in TATA.

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5. What is the position of social cost benefit analysis in India?

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