FINANCIAL REPORTING AND ANALYSIS

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"Financial statements are like fine perfume; to be sniffed but not to be swallowed."

– Abraham Brilloff

PREFACE

Accounting is not only the language of business but also its scorecard. It translates a firm's diverse activities into an appropriate set of objective numbers that provide information about the performance, problems and prospects of an enterprise. Accounting and financial reporting has been debated and discussed in the accounting literature with a view to provide satisfactory solutions to many aspects of vital importance in this area.

The skills of financial reporting and analysis are very important to a wide range of users such as investors, creditors, regulatory authorities, general public, etc. But nowhere are they more important than within the firm. Business managers who have these skills are able to diagnose their firm's problems, suggest useful solutions and anticipate the economic consequences of their actions. Like a ball player who cannot keep a score, a business manager, who does not fully understand accounting and finance functions is under a great handicap. In order to understand, financial reporting and analysis, we need a book, which can provide a comprehensive and updated discussion of the subject matter in a clear, concise and logical manner. The present text, ***Financial Reporting and Analysis***, is an attempt to enrich students and other readers with adequate and latest knowledge about skills of financial analysis.

The book is divided into five units.

First unit – Introduction gives Financial Reporting: An Overview and Conceptual Framework.

Second Unit – Understanding Financial Statements discusses Basic Financial Statements and Additional Disclosure Statements.

Third Unit – Elements of Financial Statements covers Inventory, Assets, Liabilities, Revenues, Expenses, Gains and Losses.

Fourth Unit – Analysis and Interpretation of Financial Statements deals with Financial Statements Analysis, Ratio Analysis, Expanded Analysis.

And lastly the fifth unit – Accounting Standards presents discussion on Accounting Standards and Convergence with IFRSs.

The text, Financial Reporting and Analysis, is meant for B.Com. (Hons.) and B.Com. Programme students of Indian Universities under CBCS. This book is also meant for business and accounting students and non-financial executives interested in the practice of financial reporting and analysis. It introduces standard techniques and recent advances in a practical, intuitive way.

We welcome any suggestions and opinions to further improve the quality of the book.

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UNIT I

INTRODUCTION

CHAPTER 1

Financial Reporting : An Overview

LEARNING OBJECTIVES

After reading this chapter, you should be able to

- *explain the concept of financial reporting.*
- *describe the objectives of financial reporting.*
- *explain the users of financial reporting information.*
- *comment critically on general and specific purpose reports.*
- *highlight the benefits and constraints of financial reporting.*

Development of a sound conceptual base along with understanding of practical applicability is an indispensible precondition towards preparation of financial statements reflecting "true and fair" view of a concern. This chapter intends to introduce the concept of financial reporting along with underlying objectives, users and essential qualitative characteristics of useful financial information.

CONCEPT OF FINANCIAL REPORTING

Financial reporting may be defined as communication of published financial information and related information from a business-enterprise to third parties (external users) including shareholders, creditors, customers, government authorities and the public. It is reporting of financial information of an entity (individual, firm, company, government enterprise) to a user or group of users.[1] The ambit of financial reporting covers the company as issuer (preparer); the investors and creditors as primary users, other external users; the accounting professionals as measurers and auditors; the company law regulatory or administrative authorities as statutory bodies governing the entire process.

FINANCIAL REPORTING AND FINANCIAL STATEMENTS

Financial statements essentially provide duly audited relevant accounting information for the perusal of stakeholders and public at large. Although financial reporting and financial statements are governed by the same objectives, some useful information is better provided by financial statements and some is better provided, or can only be provided, by means of financial reporting other than financial

statements. The term financial reporting doesn't merely restrict itself to communication of information contained in financial statements. As the two concepts are interlinked, watertight distinction is not possible, it is however an accepted fact that the scope of financial reporting is wider and more comprehensive than financial statements which are only a means of conveying information about enterprise's financial performance.

FASB (USA)[2] has described some major characteristics of financial reporting and financial statements in its Concept No. 1 to highlight the distinction between the two:

1. Financial statements are a central feature of financial reporting. They are the principal means of communicating accounting information to those outside an enterprise. Financial statements may also contain information from sources other than accounting records. However, accounting systems are generally organized on the basis of the elements of financial statements (assets, liabilities, revenues, expenses, etc.) and provide the bulk of information for financial statements. The financial statements now most frequently provided are (a) balance sheet or statement of financial position, (b) income or earnings statement, (c) statement of retained earnings (d) statement of other changes in owners' or stockholders' equity, and (e) statement of changes in financial position (statement of sources and applications of funds).
2. Financial reporting includes not only financial statements but also other means of communicating information that relates, directly or indirectly, to the information provided by the accounting system— that is, information about an enterprise's resources, obligations, earnings, etc. Management may communicate information to those outside an enterprise by means of financial reporting other than formal financial statements either because the information is required to be disclosed by authoritative pronouncement, regulatory rule, or custom or because management considers it useful to those outside the enterprise and discloses it voluntarily. Information communicated by means of financial reporting other than financial statements may take various forms and relate to various matters. Corporate annual reports, prospectuses, and annual reports filed with the Securities and Exchange Commission are common examples of reports that include financial statements, other financial information, and nonfinancial information. News releases, management's forecasts or other descriptions of its plans or expectations, and descriptions of an enterprise's social or environmental impact are examples of reports giving financial information other than financial statements or giving only nonfinancial information.

3. Financial statements are often audited by independent accountants for the purpose of enhancing confidence in their reliability. Some financial reporting by management outside the financial statements is reviewed but not audited, by independent accountants or other experts, and some is provided by management without audit or review by persons outside the enterprise.

Also as per the ICAI's Framework for the Preparation and Presentation of Financial Statements (2000):

"Financial statements form part of the process of financial reporting. A complete set of financial statements normally includes a balance sheet, a statement of profit and loss (also known as 'income statement'), a statement of cash flows, and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about industrial and geographical segments and disclosures about the effects of changing prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report."

Hence, it's quite evident that financial reporting encompasses various other reports along with presentation of financial statements and serves a larger purpose.

OBJECTIVES OF FINANCIAL REPORTING

Financial reporting is not an end in itself but a means to attain certain objectives. Though development of universal consensus over objectives of financial reporting is still underway, the following are primarily accepted as primary purposes served by financial reporting:

(a) Investment decision making

(b) Management accountability

Investment Decision Making

According to Framework for the Preparation and Presentation of Financial Statements issued by ICAI (India) in 2000, 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. These users have different set of needs and all of them do not have direct access to all relevant information required for their decision making. General-purpose financial statements published by the companies meet many of these needs. The role of financial reporting sets in at this juncture. The primary objective of financial reporting is to provide relevant and useful financial information and aid the decision making process of stakeholders. These decisions concern the efficient allocation of investible funds amongst the available investment opportunities.

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

- 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. 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 amount, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Since investors and creditors' cash flows are related to enterprise cash flows, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.
- Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change its resources and claims to those resources.

Hence, it's quite evident that the objectives of financial reporting stem out of the needs of external parties. Moreover, these users left with no choice but to rely on information communicated by the company to them. This information largely pertains to financial transactions that have taken place in the past and their impact on the enterprise by evaluating financial performance of the enterprise. Present or prospective investors may utilize this information to serve multiple objectives.

(a) They may evaluate the past performance of the enterprise and calculate expected returns in terms of dividend or capital appreciation.

(b) They may predict future earnings on the basis of past performance.

(c) They may conduct a risk analysis of the company and take a buy, hold or sell decision.

Financial reporting necessarily attempts to provide relevant financial information. However, the analysis, estimations, predictions and decisions are sole discretion of the investor.

Management Accountability

Apart from investment decision making, financial reporting also provides information on management accountability. As the shareholders and various impacted parties do not have direct control over the daily affairs of the business, it is the responsibility of the management to ensure that true and fair state of affairs of the

company are reported. It is the obligation of the management to safeguard the resources of the enterprise and to meet stakeholder expectations. Hence, providing information on management accountability to judge management's effectiveness in utilizing the resources and running the enterprise is another significant objective of financial reporting. Management is periodically accountable to the owners not only for the custody and safekeeping of resources, but also for their efficient and profitable use. Additionally, it's their duty to protect them to the extent possible from unfavorable economic impacts of factors in the economy such as technological changes, inflation or deflations.

Management accountability is of great interest to both existing and prospective shareholders along with creditors and other 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 are intended to play a major role in this regard.

It is worth mentioning here that accountability is a broad term that encompasses stewardship. Stewardship traditionally refers to the safe keeping of resources and the execution of plans for conserving and utilizing them. Management accountability extends beyond the element of stewardship involved in the safekeeping of assets. In the more recent times, it includes efficiency and effectiveness with respect to company's performance, future activities, budget forecasts, capital expenditure proposals, etc. Accountability spans beyond the companies' legal responsibilities to stakeholders. It includes the interests of persons other than existing shareholders. In this way, financial statements not only inform but also protect the interests of various stakeholders.

However, as we move into a deeper analysis of both the objectives, we find that these two objectives are exercisable in different perspectives. While decision making objective emphasizes more on reliability of information, accountability on the other hand stresses on the need of using the correct system and procedures used in deducing financial results. Secondly, decision making assumes that the accountant must aim to serve the decision makers to help them in sound financial decisions, whereas, stewardship objective has dual aspects. It has to balance the conflicts of interest from the point of view of accountor and accountee.

Nevertheless, the accounting profession has increasingly emphasized accounting as information provider. The AICPA (USA)[3] 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, individuals, enterprises and government regard the informational role of accounting as a crucial link in the efficient allocation of society's resources.

To conclude, the above two basic objectives associated with company financial reporting contribute in making wise economic decisions and determining the economic performance. Both the objectives lead to the accomplishment of broader societal goal of efficient allocation of resources amongst multiple avenues. Hence, they influence capital formation and flow of funds and perform a vital role in successful functioning of an economy.

USERS OF FINANCIAL INFORMATION

As stated earlier, 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 conduct of business and economic activities. Thus, the users are potentially interested in the information provided by financial reporting. The users in financial reporting may be classified on the basis of their respective information needs.

1. Those contemplating direct economic interests:

(a) Potential users including owners, creditors, employees are most directly concerned with a particular business enterprise and its ability to generate favorable cashflows because their decisions relate to amount, timing and uncertainties of expected cashflows. These users get cash in the form of interest, dividends, market price appreciations, repayment of borrowing, payment of goods and services, or salaries or wages.

(b) Customers have a direct interest in a business enterprise in terms of goods and services. They usually keep a watch over the capability of the enterprise to utilize the resources and provide a continuous flow of goods and services.

(c) Managers and directors who are charged with managing the enterprise in the interest of owners also have a direct interest. They use the financial reporting information in their decisions and deciding managerial responsibilities, including their accountability to directors and owners.

2. Those contemplating indirect economic interests: Users such as financial analysts and advisors and labor unions have indirect interests because they advise, protect or represent a large section of direct interest bearers. Financial analysts analyze reports and propose recommendations to their clients. Labour unions protect the interest of labor class and bargain with management for pecuniary and non-pecuniary benefits on the basis of financial performance of the company.

3. Users with specialized needs: Regulatory authorities like SFBI keep a hawk's eye on financial reporting to protect investors' interest and for judicious use of public money. Lawmakers and tax authorities often use this information in financial statements for their statutory purposes. They also have the power to seek additional information for their perusal.

Some users of financial information can obtain more information about an enterprise than others. This is the 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 liability to interpret it. In India, the basic purpose of financial reporting as per Companies Act 2013 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. 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. Figure 1.1 displays different types of users of financial reports.

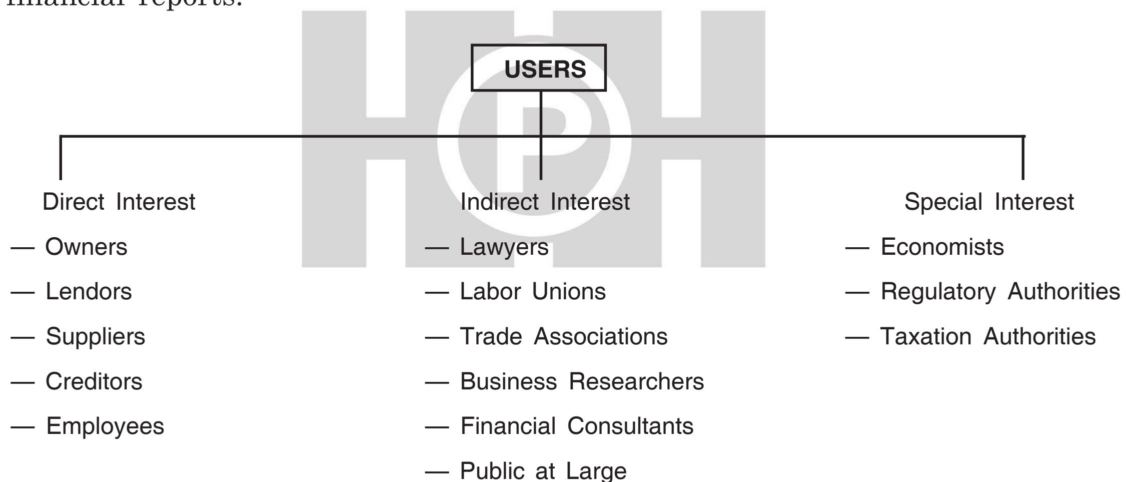

FIG. 1.1. Different Types of Users

GENERAL PURPOSE FINANCIAL REPORTING

In common parlance, the term 'financial reporting' is used to mean general purpose 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 external users.

As discussed in the previous sections, the users of financial statements include present and potential investors, employees, lenders, suppliers, and other trade

creditors, customers, government, 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*) *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 that enables them to assess the ability of the enterprise to pay dividends,

(*b*) *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.

(*c*) *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.

(*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 the members of the public in 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 financial statements cannot meet all of the information needs of these users, there are needs that 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 the other users that financial statements can satisfy.

Management as a user of information is interested in the 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 a 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.

SPECIFIC PURPOSE REPORTS

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 criticized on following counts:

(*a*) Number of Reports: Lack of consensus on an exhaustive list of specific purpose reports. It is virtually impossible to have an exhaustive list of special purpose reports satisfying specialized needs of specific users.

(*b*) Cost Benefit Analysis: In certain instances, the cost of acquiring and reporting certain information may outweigh the prospective benefits. Such scenarios make the concept of special purpose reports questionable.

(*c*) Increased complexity: Multiple reports pertaining to financial performance of an enterprise may create confusion among users. Multiple reports may increase the complexity due to numerous inter-linkages and overlapping in the decision and environment.

(*d*) Duplication of effort: Multiplicity of reports is undesirable and impractical from economic point of view. It leads to wastage of time, money and resources.

To conclude, company financial reporting, in future, will continue to adhere to general purpose reporting system to aid investors, creditors, and 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 these 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.

BENEFITS OF FINANCIAL REPORTING

The following are the benefits of financial reporting:

1. Aids decision making: True and fair financial reporting provides a strong foundation to various decisions at macro and micro level.

(*a*) *Macro level decision making*

The two important economic decisions that influence allocation of resources and which external users usually make are (a) security investment (b) credit decision. Sound economic decisions require assessment of impact of current business activities and developments on the earning power of a company. Both economic decisions require detailed information to determine benefits (to be received) in lieu of sacrifices (resources given). Information about economic resources and obligations of business enterprise is also needed to form judgments about the ability of enterprise to survive, to adapt, to grow, and to prosper amid changing economic conditions.

Financial reporting can provide information important in evaluating the strength and weaknesses of an enterprise and its ability to meet its commitments. It can supply information about the transactions within the business and factors outside the company such as taxation policy, trade restrictions technological changes, and market potentialities etc., which affect the earning power of a business enterprise. The ultimate goal of any economy is maximize the social welfare for which an efficient allocation of resources is required. This goal is of particular significance in developing economies where resources are not plentiful. The availability of capital is one of the scarce and major productive factors needed to pursue economic activity and to achieve the goal of efficient allocation of resources. Companies compete in the securities market to secure an edge in raising capital. Since owners of capital like business enterprises, attempt to maximize their own wealth and well-being, they require information to help them in making sound economic decisions. This process is assumed to lead to broader social goal of efficient allocation of resources throughout the economy.

(*b*) *Micro level decision making*

Financial reporting serves as a guiding point for diverse users including owners, prospective investors, managers, consultants, suppliers, lenders, etc., to meet their direct or indirect objectives. Regulatory authorities also frame or amend laws based on information supplied through reporting mechanism.

2. Favourable impact on company's cost of capital

Adequate disclosure in annual reports increases trust and image of a business entreprise. It enhances market price of a company's share in the investment market in the long run. Higher prices of company shares resulting from the full disclosure lead to a favourable impact on the company's cost of capital. It also enhances the future marketability of subsequent issue of company's shares. Choi[4] argues that if analysts are kept well informed then, over the long run, an individual company's share price will be relatively higher. Higher security prices would mean that a primary security issue could be priced higher and that the net proceeds from the issue would be higher. Thus, the firm would experience larger receipt from a given issue and hence, experience lower a cost of capital.

A report for Arthur Andersen and Company stated:

"Consistently good financial reporting should have a favorable long run effect on the company's cost of capital. Over a period of time, good reporting leads to informed investors who, because they understand the company, will pay a fair price for its securities. Minimum or inconsistent reporting often leads to some loss of investors' confidence in the quality of company information and in the price they will pay in the market. Credibility is a subtle intangible of great importance to any company; corporate reporting practices have a major effect on it. We have often observed this connection between credibility, corporate reporting, and the cost of capital.... Good corporate reporting is a long-term policy applicable to good and bad times."[5]

Hence, a fairly consistent and transparent financial reporting is bound to leave a positive impact on cost of capital. However, some studies have expressed apprehensions in some scenarious. Manipulation and/or misrepresentation of financial data by managers and its subsequent disclosure may lead to increase in perceived risk about the company. This may in turn lead to an increase in cost of capital and reduction in price of securities.

3 Increase in stock market efficiency

Financial reporting helps in bringing transparency in the stock markets and leaves a positive impact on improving market efficiency. Such voluntary release of information by corporate houses reduce information asymmetry and share prices closely reflect firm's worth.

4. Reduction in share price fluctuations

Adequate disclosure will tend to minimize the fluctuations in companies' share prices. Fluctuations in share prices occur because of the ignorance prevailing in the investment market. Fluctuations show an element of uncertainty in investment decisions. If the securities market is in possession of full information, the ignorance

and uncertainty will be reduced and share prices will tend to maintain equilibrium. Besides, increased disclosures would prevent fraud and manipulations and would minimize the chances of their occurrences. Ethics in disclosure demands that there should not be a difference between sophisticated few and general public at large by corporate managements. Hence we can say that:

- More complete information reduces uncertainty
- Less uncertainly reduces risk for investors and creditors
- Reduced risk makes investors and creditors satisfied with a lower rate of a return.
- A lower rate of return for investors and creditors is a lower cost of capital for the firm and produces higher stock prices. Figure 1.2 summarises the axioms and the chain reactions between the information provided to the public and the company's security prices.

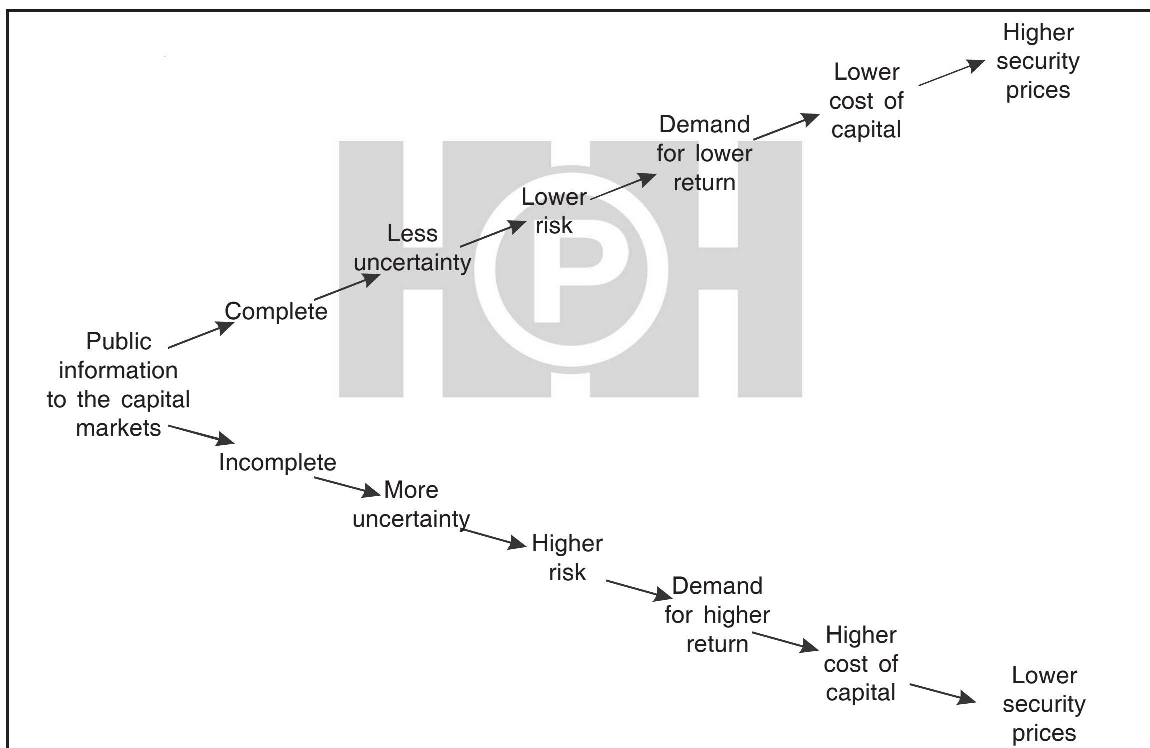

FIG. 1.2: The Links Between Information and Security Prices

Source: Paul B.W. Miller and Paul R. Bahson, *Quality Financial Reporting*, TMH, 2005, p. 8.

5. Affects employee perception

Employing decisions may be based on perceptions about a company's economic status acquired through financial statements. In particular, prospective and present

employees may use the financial reports to assess the risk and growth potential of a company and therefore, job security and future promotional possibilities. Labour unions and individual employees may use financial statement data as a basis for making contractual wage and employment benefit demands. Should this occur, data that incorrectly reflect the economic position and prospects of an enterprise may mislead employees into making or justiying unrealistic demands.

Furthermore, unionised companies showing large increases in earnings are likely to be faced with successfully negotiated demands for large wage increases. Hence, as regards employee decision, accounting techniques that result in greater fluctuations in reported earnings appear to be costly to shareholders, sharp increases in profits are likely to generate demands for large wage increases, while sharp decreases may lead to employee fears of bankruptcy or financial difficulties. Management also want to avoid charges of manipulation of net profit data. Thus, an apparently objectively determined series that tends not to change sharply is desirable. Historical cost based accounting meets these requirements.

6. Improves public image

The data presented in financial statements may affect the decision of a company's customers and hence, have economic consequences. Customers, like employees, may use financial statement data to predict the likelihood and/or timing of a firm going bankrupt or being unable to meet its commitments. This information may be important in estimating the value of a warranty or in predicting the availability of post sale supporting services or continuing supplies of goods over an extended period of time. Financial institutions may also use the financial statements to assess their present and future solvency and hence, the likelihood that they will be able to repay funds or meet promises as contracted. It is likely that the few informed customers will be able see through arbitrary or misleading accounting practices. However it may mislead uninformed customers.

7. Manager's decisions

The accounting data published in financial reports may have economic effects through its impact on the behaviour of the managers of corporate enterprises. The inclusion of accounting numbers in management compensation schemes or the fear of market misinterpretation of accounting reports may influence a manager's operating and financing decisions. Shareholders prefer accounting procedures that mirror economic events as closely as possible. However, shareholders also must be concerned that the managers might manipulate the reported data to increase their compensation. Therefore, shareholders, also want numbers that are reliable and objectively determined. To sum up, information contributes much towards better 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.

FUNDAMENTAL ACCOUNTING ASSUMPTIONS UNDERLYING FINANCIAL REPORTING AS PER ACCOUNTING STANDARD 1 ISSUED BY ICAI[6].

The following three assumptiours underly the preparation and presentation of financial reports.

1. Accrual basis

The effects of accounting transactions and events are recognized when they occur (instead when cash is received or paid) and are recorded and reported in the period to which they relate. Hence, revenues, expenses, profits and losses are recorded and reported on accrual basis.

2. Going concern

A business enterprise once set up is expected to continue business operations for the foreseeable future. Hence, it is presumed that business operations will continue uninterrupted without liquidation or material alteration in scale of operations. This assumption supports accrual basis of recording transactions. In the event of liquidation, the basis of preparation of financial statement changes and reporting also discloses a planned dissolution.

3. Consistency

Accounting policies used while preparing financial statements are consistently followed year after year. This ensures comparability of financial performance through time. Any change in accounting policy is made only after duly disclosing that change and its impact in the financial statements.

QUALITATIVE CHARACTERISTICS OF FINANCIAL REPORTING INFORMATION

Qualitative characteristics are qualities necessary for information to serve a major supporting role in the decision usefulness. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. Accounting information that is reported to facilitate economic decisions should possess certain characteristics or normative standards. The information must be useful in the formulation of objectives, the making of decisions, or the direction and control of resources to accomplish objectives. The utility of information lies in its ability to reduce uncertainty about the actual state of affairs of a business enterprise to the user. The characteristics make information a desirable commodity and guide the selection of preferred accounting policies and methods from among available alternatives. These characteristics have been viewed as a hierarchy of qualities with

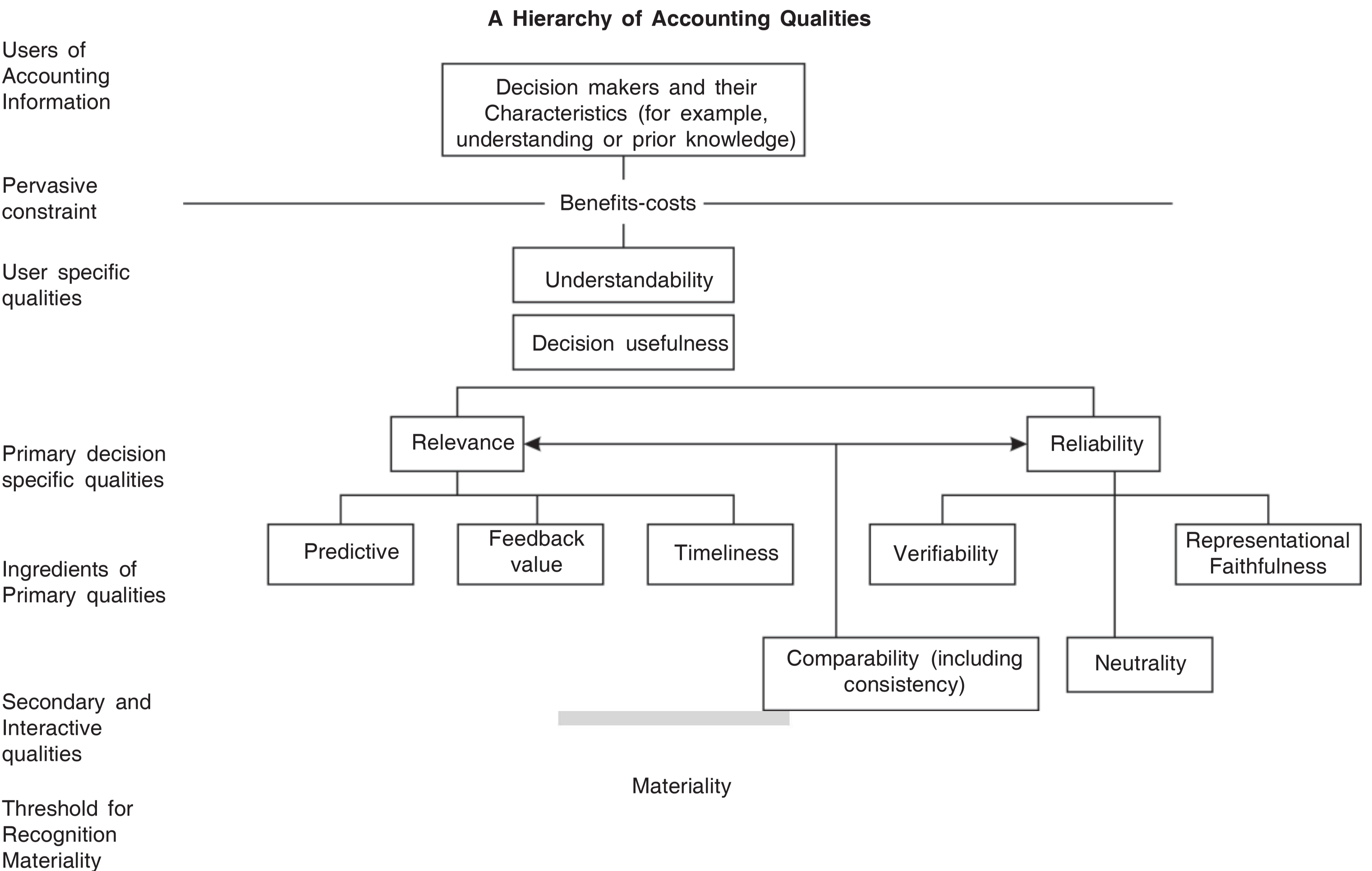

FIG. 1.3. A Hierarchy of Accounting Qualities

Source: Financial Accounting Standards Board, Statement of Financial Accounting Concept No. 2 Qualitative Characteristics of Accounting Information, Stamford FASB. p15

usefulness for decision making of utmost importance. The hierarchy of informational qualities which has been accepted by FASB (USA) in its Concept No. 2 Qualitative characteristics of accounting-information is displayed in Figure 1.3.

The 'Framework for the Preparation and Presentation of Financial Statements' issued by Accounting Standards Board of ICAI in 2002 has listed the following qualitative characteristics[7]:

1. Understanding

Financial reporting intends to provide a true and fair view of enterprise to its users. It is essential that information contained in financial statements is readily understood and correctly perceived by the users. Presenting information that can be understood only by sophisticated users and not by others, creates a bias, which is inconsistent with the standard of adequate disclosure. Presentation of information should not only facilitate understanding but also avoid wrong interpretation of financial statements. It is assumed that the users of financial information will have a reasonable knowledge of business and economic activities and study the accounting information with reasonable diligence.[7]

However, the quality of understandability should not be confused as providing only basic information or providing information in its elementary form. It must be ensured that all material information is disclosed and users are not confused by overflow of information. Understandability requires clear transmission of information from corporate enterprise to users to aid them in decision making. It should be determined in terms of broad classes of users (decision makers) rather than particular user groups. Since company financial reporting aims at general purpose external financial reporting, all relevant users needs should be considered in deciding the understandability of the information, and no decision should be based on specific circumstances of individual decision makers. That is, accounting information should not be limited to the interest of the average investor or sophisticated users but, in fact, information should be ordered and arrayed to serve a broad range of users.

2. Relevance

Relevance is closely and directly related to the concept of useful information. Relevance implies that all those items of information should be reported that might aid the users in making decisions and/or predictions. In general, information that is given greater weight in decision making is more relevant. Specially, it is information's capacity to make a difference that identifies it as relevant to a decision. Financial Accounting Standards Board in its Concept No. 1 (para 47, 1978) comments.

"Relevant accounting information must be capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present and future events or to confirm or correct expectations."

The question of relevance arises after identification and recognition for the purpose for which information will be used. It means the information relevant for one purpose may not be necessarily relevant for the other purposes. Information that is not relevant is useless because that will not aid users in making decisions. The relevant information also reduces decision makers' uncertainty about future acts. A necessary test of relevance of the reportable data is its ability to predict events of interest to the users. To say that accounting information has predictive value is not to say that it is itself a prediction. Users can be expected to favor those sources of information and analytical methods that have the greatest predictive value in achieving their specific objectives.

In today's complex financial accounting environment, a general purpose report aims to fulfill the common needs of users so that information should be relevant to all users. In judging relevance of general purpose information, attention is focused on the common needs of users and specific needs of particular users will not be considered in this relevance judgment. It is difficult to prepare a general purpose report that may provide optimal information for all possible users and which may command universal relevance.

To conclude, relevance is the dominant criterion in taking decisions regarding information disclosure. It follows that relevant information must be reported. Relevance has been defined in accounting literature, but no satisfactory set of the relevant items of information has been suggested. In this regard, an important task is to determine the need of users and the items of information that are relevant to target users.

3. Materiality

The concept of materiality permeates the entire field of accounting and auditing. The materiality concept implies that not all financial information need or should be communicated in accounting reports. Immaterial information should probably be omitted. Information should be disclosed in the annual report that is likely to influence economic decisions of the users. Information that meets this requirement is material.

Generally, the decision-makers see materiality in relation to actual assets or income. Investors see materiality in terms of the rate of change or change in the rate of change. Guidelines to test materiality include amount of the item, trend of net income, average net income for the series of years, assets, liabilities, trends and ratios that establish meaningful analytical relationship of information contained in annual reports. For instance, losses from bad debts that could be shrugged off as a routine by large business may become a cause of concern for a smaller enterprise. Another factor in materiality judgement is the degree of precision that is available in estimating the judgement item. For example accounts payable usually can be estimated more accurately than contingent liabilities arising from litigation.

4. Reliability

Reliability is described as one of the two primary qualities that make accounting information useful for decision making. Reliable information is required to form judgements about the earning potential and financial position of business firm. It differs from item to item. For example, information regarding plant and machinery may be less reliable than certain information about current assets because of differences in uncertainty of realization. Reliability is that quality which permits users of the data to depend upon it with confidence as a representative of what it purports to represent. Error free and bias free information leads to reliability. Users base their decision on information contained in financial statements. Hence, it is important that the information is reliable enough to be faithfully relied upon. FASB (USA) finds that it is not always easy to maintain a clear distinction between relevance and reliability, yet it is important to try to keep the two concepts apart. To explain this point, the FASB (Concept No. 2) illustrates further[8].

“Two different meanings of reliability can be distinguished and illustrated by considering what might be meant by describing a drug as reliable. It could mean that the drug can be relied on to cure or alleviate the condition for which it was prrescribed, or it could mean that a dose of the drug can be relied on to conform to the formula shown on the label. The first meaning implies that the drug is effective at doing what it is expected to do. The second meaning implies nothing about effectiveness but does imply a correspondence between what is represented on the label and what is contained in the bottle.”

There are many factors affecting the reliability of information such as uncertainties inherent in the subject matter and accounting measurements. Adequate disclosure in annual reports, however, requires that users should be informed about the data limitations and the magnitude of possible measurement errors. The reliability concept does not imply 100 per cent reliability or accuracy. Non-disclosure of limitations attached with information may mislead the users, it can be noted that the most reliable information may not be the most significant for users in making economic decisions and assessment of an enterprise’s earning power. It is the responsibility of the management to report reliable information in annual reports. The goal of reliable information can be achieved by management if it applies generally accepted accounting principles, appropriate to that enterprise’s circumstances, maintains proper and effective system of accounts and internal control and prepares adequate financial statements.

5. Comparability

Economic decisions require making choice among possible courses of action. In making decisions, the decision maker will make comparisons among alternatives, which is facilitated by financial information. Comparability implies to have like things reported in a similar manner and unlike things reported differently. An

important implication of the qualitative characteristic of comparability is that the users be informed of the accounting policies employed in preparation of financial statements, any changes in those policies and the effects of such changes. Users need to able to identify differences between the accounting policies like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Accounting Standards, including the disclosure of accounting policies used by the enterprise, helps to achieve comparability.

Comparable financial accounting information helps in understanding similarities and differences in the enterprise and their transactions and not merely the differences arising due to difference in financial accounting treatment. Financial reports of different firms which are not able to achieve comparability because of

- Difference in business operations of companies.
- Difference in management's viewpoint in respect of the transactions.
- Different accounting practices to describe similar activities.
- Different viewpoint for similar risk, uncertainty, benefit or sacrifice, in turn leading to different implications in financial statements.

With information that facilitates interpretation, users are able to compare and assess the results of similar transactions and other events.

6. Faithful Representation

Information contained in financial statements should faithfully represent the transactions and events of the enterprise. Representation of financial information may be subject to the risk of being less than faithful due to the difficulties attached with measuring the transactions and/or devising techniques used to recognize them. Accountants must ensure that information and messages intended to be conveyed by financial statements are duly conveyed. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognize items and to disclose the risk of error surrounding the recognition and measurement[9].

7. Substance over Form (Economic Realism)

Economic realism is not usually mentioned as a qualitative criterion in accounting literature, but it is important to investors. It is a concept, that seems easy to understand but hard to define because perceptions of reality differ. In essence, economic reality means an accurate measurement of the business operations, that is, economic costs and benefits generated in business activity. The definition problem arises from cash vs. accrual accounting, or the principle of matching costs with revenues. Accrual accounting is necessary for complex organizations, of course, but,

where accruals and estimates have a considerable degree of uncertainty as to amount of timing, cash accounting would seem to come closer to economic realism.

There have been tendencies in accounting for "the media to become the message", *i.e.,* for accounting numbers to become the reality rather than the underlying facts they represent. These may give the illusion of steady earning and both investors and management may feel better, but, in fact, there is considerable fluctuation in business activity. Investors need to know the facts about these fluctuations; if they find it useful to average earnings, they can do so themselves. The objective should be "to tell it like it is."[10]

8. Neutrality

Neutrality is also known as the quality of 'freedom from bias' or objectivity. It implies that primary concern-should be the relevance and reliability of the information and not the effect that the new rule may have on a particular interest or users(s). The objectives of (general purpose) financial reporting serve many different information users who have diverse interest, and no one predetermined result is likely to suit all users' interest and purposes. Therefore, accounting facts and accounting practices should be impartially determined and reported with no objective of purposeful bias towards any user or user group.

To say that information should be free from bias is not to say that standard setters or providers of information should not have a purpose in mind for financial reporting. In fact, information must be purposeful. Neutrality neither means 'without purpose' nor does it mean that accounting should be without influence on human behaviour. Accounting information cannot avoid affecting behaviour, nor should it. If it were otherwise, the information would be valueless and irrelevant. The predetermination of a desired result, and the consequential selection of information to induce that result, that is, the negation of neutrality in accounting. To be neutral, accounting information must report economic activity as faithfully as possible, without coloring the image it communicates for the purpose of influencing behaviour in some particular direction[11].

For a standard to be neutral, it is not necessary that it treats everyone alike in all respects. A standard could require less disclosure from a small enterprise than it does from a large one without having its neutrality impugned. Neverthless, in general, standards that apply differently need to be looked at carefully to ensure that the criterion of neutrality is not being violated.

9. Prudence

Financial statements are prepared in an environment of uncertainties attached to business and economy. These uncertainties may lead to some favourable and unfavourable impacts of financial performance of an enterprise. Prudence intends to adequately state net income and net assets while recognizing such uncertainties during preparation of financial statements.

Conservatism in financial reporting should no longer imply deliberate, consistent, understatement of net assets and profits. Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered. Thus, if two estimates of amounts to be received or paid in the future are about equally likely, conservatism dictates using the less optimistic estimates. However, if two amounts are not equally likely, conservatism does not necessarily dictate using the more pessimistic amount rather that the more likely one. Conservatism no longer requires deferring recognition of income beyond the time that adequate evidence of its existence becomes available, or justifies recognizing losses before there is adequate evidence that have been incurred.

10. Completeness

Financial statements should reflect complete state of affairs of the enterprise. Any omission of information can cause false representation of facts and lead to misrepresentation and confusion. Half-baked information may defeat all other qualitative characteristics including relevence and reliability.

Finaly, it can be concluded

That a balancing, or trade-off between qualitative characteristics is often necessary. Generally, the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is matter of professional judgement.

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QUESTIONS

1. For Investors, Creditors and others, what is meant by useful information?
2. What should be the objectives of financial reporting? In this connection, mention the steps taken recently in the developed countries.
3. Write notes on:
   (a) General purpose external financial reporting vs. 'Specific user' financial reporting.
   (b) Qualitative characteristics of financial statement.
4. Explain the relevance and reliability characteristics of financial accounting, and reporting.
5. What is a conceptual framework for accounting? List and explain the objectives of financial reporting.
6. What should be the basic objectives of 'financial reporting'? Explain with reasons.
7. "Company annual reports containing financial statements is the most important means of company finance reporting." Do you agree with this statement? Give reasons.
8. What do you mean by the term 'financial reporting'? Distinguish between 'financial reports' and 'financial statements.'
9. Discuss the relevance of general purpose report for external users. Do you think that general purpose report is an ideal solution in company financial reporting?
10. What is the specific purpose report? Explain why specific purpose reports are not yet prepared by companies.
11. Discuss the qualitative characteristics which make information useful. Is it possible to fix relative importance of these characteristics? Give arguments.
12. Discuss relevance and reliability as primary qualities of financial reporting information.
13. Discuss the problems arising in achievement of qualitative characteristics of accounting information. Give some suggestions to overcome these problems.
14. Make an outline of a company annual report to provide useful information to investors for making proper economic decision.
15. Do you think that company financial reporting practices in India are adequate and satisfactory? If not, what suggestions would you like to give to improve the financial reporting practices?
16. Explain clearly, the meaning of 'materiality' as a user constraint for disclosure of information to external user groups.
17. Discuss the steps taken recently in India towards greater disclosure of information in the financial statements of companies. What more should be done to make full disclosure?
18. Discuss the objectives of financial reporting.
19. Several qualitative characteristics of useful accounting information were identified in the chapter. Below is a list of these qualities as wall as list of statements describing qualities.

   A. Comparability
   B. Decision usefulness
   C. Relevance
   D. Reliability
   E. Predictive value
   F. Feedback value
   G. Timeliness
   H. Verifiability
   I. Neutrality
   J. Representational faithfulness
   K. Consistently
   L. Materiality

(i) Ability of measures to form a consensus that the selected accounting method has been without error or bias.

(ii) Having information available to decision makers before it loses its capacity to influence decisions.

(iii) Capacity to make a difference in a decision.

(iv) Overall qualitative characteristics.

(v) Absence of bias intended to influence behaviour in a particular direction.

(vi) Reasonably free from error and bias

(vii) Helps decision makers to correctly forecast

(viii) Validity

(ix) Interactive quality; helps identify and explain similarities and differences.

(x) Quantitative "threshold" constraint

(xi) Conformity from period to period

(xii) Helps decision makers to confirm or correct prior expectations.

Required. Place the appropriate letter identifying each quality on the line in front of the statement describing the quality.

20. What are two primary decision specific qualities of financial accounting information? Discuss in brief their role in decision usefulness?