FINANCIAL STATEMENT ANALYSIS

Study Material for Session 1 - 10

UNDERSTANDING OF FINANCIAL STATEMENTS

Introduction:

Financial statements are compilation of financial data, collected and classified in a systematic manner according to the accounting principles, to assess the financial position of an enterprise as regards to its profitability, operational efficiency, long and short-term solvency and growth potential. Financial statements are the report card of business. Financial statements comprise a number of statements prepared at the end of each financial year to assess the various financial activities and strength of an enterprise. It should give a true and fair view of the state of affairs of the company as at the end of the financial year. A company's financial statements are a window into its financial health.

A complete set of financial statements normally consists of a Balance Sheet, a Statement of Profit and Loss and a Cash Flow Statement together with notes, statements and other explanatory materials that form integral parts of the financial statements.

The major information contents of different components of financial statements are explained as below:

i) **Balance Sheet** portrays value of economic resources controlled by an enterprise. It also provides information about liquidity and solvency of an enterprise which is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due.

ii) **Statement of Profit and Loss** presents the result of operations of an enterprise for an accounting period, i.e., it depicts the performance of an enterprise, in particular its profitability.

iii) **Cash Flow Statement** shows the way an enterprise has generated cash and the way they have been used in an accounting period and helps in evaluating the investing, financing and operating activities during the reporting period.

iv) **Notes** and other statements present supplementary information explaining different items of financial statements. They include various other disclosures such as disclosure of accounting policies, segment reporting, related party disclosures, earnings per share, etc.

Nature of Financial Statements:

The American Institute of Certified Public Accountants (AICPA) stated: “they (financial statements) reflect a combination of recorded facts, accounting conventions and personal judgment, and the judgments and conventions applied affect them materially.”

Therefore the nature of financial statements is:

- **Recorded facts:** The original cost or historical cost is the basis of recording transactions.
- **Accounting Conventions:** The use of accounting conventions makes financial statements comparable, simple and realistic.

- **Postulates:** Financial statements are prepared on certain basic assumptions (pre-requisites) known as postulates such as going concern postulate, money measurement postulate, realisation postulate, etc.
- **Legal implications:** Financial statements are the summarised reports of recorded facts and are prepared the following accounting concepts, conventions and requirements of Law.
- **Personal judgment:** Personal opinion, judgements and estimates are made while preparing the financial statements.

Objectives of Financial Statements:

i) The primary objectives of financial statements are to present the true and fair value of the state of affairs of the firm with the help of its various statements.

ii) To supply necessary information to the users and analysts for taking decisions which will be formulated in future.

iii) To provide information about economic resources and obligations of a business.

iv) To provide information about the earning capacity of the business.

v) To provide information about cash flows.

vi) To judge effectiveness of management.

vii) To provide information about activities of business affecting the society.

viii) To Disclosing accounting policies.

Characteristics of Financial Statements:

Four qualitative characteristics of the financial statements:

- **Understandability**: The financial statements should present information in a manner as to be readily understandable by the users with reasonable knowledge of business and economic activities and accounting.
- **Relevance**: The financial statements should contain relevant information only.
- **Reliability**: To be useful, the information must be reliable; that is to say, they must be free from material error and bias.
- **Comparability**: Comparison of financial statements is one of the most frequently used and most effective tools of financial analysis. The financial statements should permit both inter-firm and intra-firm comparison.

Uses of Financial Statements:

- They provides necessary information about the financial activities to the interested parties
- They reveal the right and proper position of a business
- They provides necessary information about the efficiency or otherwise of the management, regarding the proper utilization of the scarce resources
- They provide necessary information for predictions (financial forecasting)
- They help to evaluate the earning capacity of the firm by supplying a statement of financial position, a statement of periodical earnings together with a statement of financial activities to the various interested persons

- They facilitate decisions regarding the changes in the manner of acquisition, utilization, preservation and distribution of the scarce resources
- They facilitate decisions regarding replacement of fixed assets and expansion of the firm
- They provide necessary data to the government for taking proper decisions relating to duties, taxes and price control, etc. and for some legal and control purposes
- They device remedial measures for the deviations between the actual and budgeted performances
- They also provide necessary data and information to the managers for internal reporting and formulation of overall policies
- They also help to safeguard the interest of shareholders who are not allowed to go through the day-to-day affairs of the firm
- They help the credit rating agencies to determine the rating of the Company

Users of Financial Statements:

There are many users of the financial statements produced by an organization. Two primary users of accounting information are there, internal users and external users. Each group uses accounting information differently, and requires the information to be presented differently.

Internal users are people within a business organization who use financial information. Examples of internal users are owners and managers.

External users are people outside the business entity (organization) who use accounting information. Examples of external users are suppliers, banks, customers, investors, potential investors, government and tax authorities. The external users may be classified further into users with direct financial interest – owners, investors, creditors; and users with indirect financial interest – government, employees, customers and the others.

Limitations of Financial Statements:

Financial statements are not free from limitations. They provide only aggregate information to satisfy the general purpose needs of the users. They are technical statements understood by only persons having some accounting knowledge. They reflect historical information but not current situation, which is essential in any decision making. In addition, one can get idea about the organisation's performance in terms of quantitative changes but not in qualitative terms like labour relations, quality of work, employees' satisfaction, etc. The financial statements are neither complete nor accurate as the flow of income and expenses are segregated using best judgement apart from accepted concepts. Hence, these statements need proper analysis before their use in decision-making.

Form and Content of Financial Statements:

As per section 133 of the Companies Act, it is mandatory to comply with accounting standards notified by the Central Government from time to time. As per section 129 of the Companies Act, 2013, Financial statements should give a true and fair view of the state of affairs of the company or companies and comply with the accounting standards notified under section 133 and should be in the form or forms as may be provided for different class or classes of companies in Schedule III under the Act.

Schedule III to the Companies Act, 2013 provides the manner in which every company registered under the Act shall prepare its Balance Sheet, Statement of Profit and Loss and notes thereto. The requirements of the Schedule III however, do not apply to companies as

referred to in the proviso to Section 129 (1) of the Act, i.e., any insurance or banking company, or any company engaged in the generation or supply of electricity or to any other class of company for which a form of Balance Sheet and Statement of Profit and Loss has been specified in or under any other Act governing such class of company. Presentation of the financial statements of non-banking finance companies would be governed by Schedule III.

The Schedule III (and earlier, the Revised Schedule VI) prescribes only the vertical format for presentation of Financial Statements. Current and non-current classification has been introduced for presentation of assets and liabilities in the Balance Sheet. Unlike the Old Schedule VI, the Schedule III (and earlier Revised Schedule VI) lays down a format for the presentation of Statement of Profit and Loss. The Schedule III (and earlier, the Revised Schedule VI) has specifically introduced a new requirement of using the same unit of measurement uniformly across the Financial Statements.

The Structure of Schedule III is as under:

I. General Instructions

II. Part I – Form of Balance Sheet

III. General Instructions for Preparation of Balance Sheet

IV. Part II – Form of Statement of Profit and Loss

V. General Instructions for Preparation of Statement of Profit and Loss

VI. General Instructions for the Preparation of Consolidated Financial Statements

The General Instructions for the preparation of the Consolidated Financial Statements were not included in Revised Schedule VI and is now a part of the Schedule III.

Provided that the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement.

THE SCHEDULE III TO THE COMPANIES ACT, 2013:

https://www.mca.gov.in/SearchableActs/Schedule3.htm

http://kb.icai.org/pdfs/PDFFile5b27859a90bfc7.83429474.pdf

FINANCIAL REPORTING AND REGULATIONS

Introduction to USGAAP:

Generally Accepted Accounting Principles (GAAP or US GAAP) are a collection of commonly-followed accounting rules and standards for financial reporting. The specifications of GAAP, which is the standard adopted by the U.S. Securities and Exchange Commission (SEC), include definitions of concepts and principles, as well as industry-specific rules. The purpose of GAAP is to ensure that financial reporting is transparent and consistent from one organization to another.

US GAAP Standards:

GAAP is merely a set of standards. Although its principles work to improve the transparency in financial statements, they do not provide any guarantee that a company's financial statements are free from errors or omissions that are intended to mislead investors.

The SEC has stated that it intends to move from GAAP to the International Financial Reporting Standards (IFRS). But the latter differ considerably from GAAP and progress toward adoption or convergence has been slow. (See International Financial Reporting Standards (IFRS).)

While GAAP itself is not government-regulated, it exists because of the combined efforts of government and business. The use of GAAP is not mandatory for all businesses, but SEC requires publicly traded and regulated companies to follow GAAP for the purpose of financial reporting.

Companies that issue stock are held to this standard by SEC, which requires yearly external audits by independent accountants, but companies without external investors are not obliged to follow this standard. Despite the mandate, the SEC is not responsible for the standards associated with GAAP. Instead, the Financial Accounting Standards Board (FASB) actively influences any changes in financial reporting standards used at the corporate level. The FASB Advisory Council (FASAC) advises the FASB on all matters that may influence GAAP rules.

Government entities, on the other hand, are influenced by a set of standards that are slightly different from GAAP. The Government Accounting Standards Board (GASB) manages those standards. Other countries have their own GAAP rules, which differ from those in the United States. Each country's own version of the FASB, such as the Canadian Institute of Chartered Accountants (CICA), creates these rules.

In 2008, the Securities and Exchange Commission issued a preliminary "roadmap" that may lead the United States to abandon GAAP in the future, and to join more than 100 countries around the world in using the London-based International Financial Reporting Standards (IFRS).

FASB and IASB Convergence:

As of 2010, the convergence was underway with the FASB meeting routinely with the International Accounting Standards Board (IASB), which administers IFRS. The SEC expressed at that time its desire to fully adopt IFRS in the U.S. by 2014. (See International Financial Reporting Standards (IFRS).)

With the convergence of the U.S. GAAP and the IFRS accounting systems, as the highest authority, the IASB is becoming more important in the United States.

Although convergence efforts have stalled since FASB and IASB completed projects that better align accounting rules in U.S. GAAP and IFRS in February 2013—including revenue recognition, leases, and credit losses on financial instruments—former SEC Chair Mary Jo White said in January 2017 just prior to her departure that collaboration between the two

boards should continue. She called for renewed emphasis on global accounting standards that would best serve investors through collaboration between FASB and IASB.

Indian Accounting Standards:

Accounting Standards are written policy documents issued by expert accounting body or by the government or other regulatory body covering the aspects of recognition, measurement, treatment, presentation, and disclosure of accounting transactions in financial statements.

The main objective of Accounting Standards is to standardize the diverse accounting policies and practices. These Accounting Standards were implemented to eliminate the non-comparability of financial statements and the reliability to the financial statements.

The Institute of Chartered Accountants of India (ICAI), to harmonize the diverse accounting policies and practices, constituted at Accounting Standard Board (ASB) on 21st April 1977. Accounting Standards in India are issued by the Institute of Chartered Accountants of India (ICAI).

The role of ICAI is recognised as a standard-setter under Indian law (section 133 of Companies Act, 2013):

"The Central Government prescribes the standards of accounting or any addendum thereto, as recommended by the ICAI, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority (NFRA)."

The Ministry notifies the standards under the Companies Act by publishing them in The Gazette of India. Notified standards are authoritative under Indian law. For non-corporate entities, Accounting Standards are issued by the ICAI.

The Indian Accounting Standards (Ind AS), as notified under section 133 of the Companies Act 2013, have been formulated keeping the Indian economic & legal environment in view and with a view to converge with IFRS Standards, as issued by and copyright of which is held by the IFRS Foundation. Notwithstanding anything contained in the above para, Ind AS notified under the Companies Act 2013 are governed by the provisions of Indian Copyright Act, 1957 and the copyright in Ind AS vests in Government of India.

Indian Accounting Standards (Ind AS) are based on and substantially converged with IFRS Standards as issued by the Board. India has not adopted IFRS Standards for reporting by domestic companies and has not yet formally committed to adopting IFRS Standards.

IFRS (International Financial Reporting Standards):

A London based board IASB (International Accounting Standards Board) formed the IFRS (International Financial Reporting Standards). Moreover, the motive behind the IFRS formation is to provide a uniform accounting standard worldwide. Further, they are guideline based standards that draw the standards and guidelines for financial reporting.

At present, our worldwide economy is incredibly integrated. Organizations raise capital from over the globe. They likewise market and sell their items in different nations. This outcome results in having tax liabilities in different nations too. Thus this has prompted an interest for a worldwide standard for accounting.

A definitive objective of the IFRS is to standardize accounting by giving a typical worldwide language to worldwide business. So if an organization has dealings in a few nations it just distributes one lot of financial reports that satisfy the statutory prerequisites of the nations it

works in. Likewise worldwide standard at that point it turns out to be a lot simpler for clients of these financial reports to analyze them.

Comprehensively the IFRS comprise of the accompanying:

28 – IAS (which were issued before the IFRS)

13 – IFRS

15 IFRIC Interpretations

9 SIC Interpretations

IASB keep on refreshing these worldwide standards to stay aware of the cutting edge exercises. A definitive objective is a worldwide convergence however they have begun by concentrating on Europe. Today there are roughly 120 nations that have acknowledged the IFRS as their accounting standards. 90 of these nations are completely integrated with the IFRS. Among these 120 nations are Australia, the UK, Japan, Canada and so forth.

IFRS and Convergence with AS:

ICAI's Accounting Standard Board (ASB) is the one who formulates Indian Accounting Standards as per the Ministry of Corporate Affair. These standards are furnished keeping the financial condition and practices of India in mind. They are made to suit the Indian organizations and the divulgence necessities of the Indian government.

On the contrary, IFRS are framed as per the worldwide standards and condition. Convergence would mean crossing over any barrier between the two, i.e. the IFRS and the Indian AS. Convergence will include an arrangement of the two sets of standards. The trade-off is finished by embracing the policies of the IFRS either completely or in a part.

Procedure for Issuing/Setting/Formulating of Accounting Standards in India:

- First, the ASB will identify areas where the formulation of accounting standards may be needed
- Then the ASB will constitute study groups and panels to discuss and study the topic at hand. Such panels will prepare a draft of the standards. The draft normally includes the definition of important terms, the objective of the standard, its scope, recognition and measurement principles and the representation of said data in the financial statements.
- The ASB then carries out deliberations of the said draft of the standard. If necessary changes and revisions are made.
- Then this preliminary draft is circulated to all concerned authorities. This will generally include the members of the ICAI, and any other concerned authority like the Department of Company Affairs (DCA), the SEBI, the Central Board of Direct taxes (CBDT), Standing Conference of Public Enterprises (SCPE), Comptroller and Auditor General of India etc. These members and departments are invited to give their comments.
- Then the ASB arranges meetings with these representatives to discuss their views and concerns about the draft and its provisions
- The exposure draft is then finalized and presented to the public for their review and comments
- The comments by the public on the exposure draft will be reviewed. Then a final draft will be prepared for the review and consideration of the ICAI

- The Council of the ICAI will then review and consider the final draft of the standard. If necessary they may suggest a few modifications in consultation with ASB
- Finally, the Accounting Standard on the relevant subject is then issued under the authority of the council.

List of converged Indian Accounting Standards (IND ASs):

https://www.icai.org/post.html?post_id=7543

List of IFRS standards:

https://www.ifrs.org/issued-standards/list-of-standards/

FINANCIAL STATEMENTS

Schedule III:

Preparation of Balance Sheet and Statement of Profit and Loss of a Company:

PART I — BALANCE SHEET

Name of the Company……..

Balance Sheet as at …….

(Rupees in……)

Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
1	2	3	4
I. EQUITY AND LIABILITIES			
(1) Shareholder's Funds			
(a) Share Capital			
(b) Reserves and Surplus			
(c) Money received against share warrants			
(2) Share application money pending allotment			
(3) Non-Current Liabilities			
(a) Long-term borrowings			
(b) Deferred tax liabilities (Net)			
(c) Other Long term liabilities			
(d) Long term provisions			
(4) Current Liabilities			
(a) Short-term borrowings			
(b) Trade payables			
(c) Other current liabilities			
(d) Short-term provisions			
TOTAL			
II.Assets			
(1) Non-current assets			
(a) Fixed assets			
(i) Tangible assets			
(ii) Intangible assets			
(iii) Capital work-in-progress			
(iv) Intangible assets under development			
(b) Non-current investments			
(c) Deferred tax assets (net)			
(d) Long term loans and advances			
(e) Other non-current assets			

(2) Current assets *(a)* Current investments *(b)* Inventories *(c)* Trade receivables *(d)* Cash and cash equivalents *(e)* Short-term loans and advances *(f)* Other current assets			
TOTAL			

PART II – STATEMENT OF PROFIT AND LOSS

Name of the Company…….

Profit and loss statement for the year ended …….

(Rupees in……)

	Particulars	**Note No.**	**Figures as at the end of current reporting period**	**Figures as at the end of the previous reporting period**
	1	**2**	**3**	**4**
I	Revenue from operations		xxx	xxx
II	Other income		xxx	xxx
III	Total Revenue (I + II)		xxx	xxx
IV	Expenses: Cost of materials consumed Purchases of Stock-in-Trade Changes in inventories of finished goods work-in-progress and Stock-in-Trade Employee benefits expense Finance costs Depreciation and amortization expense Other expenses Total expenses		 xxx xxx xxx xxx	 xxx xxx xxx xxx
V	Profit before exceptional and extraordinary items and tax (III - IV)		xxx	xxx
VI	Exceptional items		xxx	xxx
VII	Profit before extraordinary items and tax (V - VI)		xxx	xxx
VIII	Extraordinary items		xxx	xxx
IX	Profit before tax (VII- VIII)		xxx	xxx

X	Tax expense: (1) Current tax (2) Deferred tax		 Xxx Xxx	 Xxx Xxx
XI	Profit (Loss) for the period from continuing operations (VII-VIII)		xxx	xxx
XII	Profit/(loss) from discontinuing operations		xxx	xxx
XIII	Tax expense of discontinuing operations		xxx	xxx
XIV	Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)		xxx	xxx
XV	Profit (Loss) for the period (XI + XIV)		xxx	xxx
XVI	Earnings per equity share: (1) Basic (2) Diluted		 xxx xxx	 xxx xxx

STATMENT OF CHANGES IN EQUITY

Name of the Company.....

Statement of Changes in Equity for the period ended.....

A. Equity Share Capital

Balance at the beginning of the reporting period	Changes in equity share capital during the year	Balance at the end of the reporting period

B. Other Equity

	Share application on money pending allotment	Equity component of compound financial instrument	Reserve and Surplus				Debt Instrument through other Comprehensive Income	Equity Instrument through Other Comprehensive Income	Effective portion of Cash Flow Hedges	Revaluation Surplus	Exchange difference on translating the financial statement	Other items of Other Comprehensive Income (Specify nature)	Money received against share capital	Total
			Capital Reserve	[9][Securities Premium]	Other Reserve (Specify nature)	Retained Earning								
Balance at the beginning of the reporting period														
Changes in accoun														

ting policy or prior period errors														
Restated balance at the beginning of the reporting period														
Total comprehensive														
Income for the year														
Dividends														
Transfer to retained earnings														
Any other change (to be specified)														
Balance at the end of the reporting period														

Measurement of Elements in Financial Statements:

Historical cost	Acquisition price
Current Cost	Assets are carried out at the amount of cash or cash equivalent that would have to be

	paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
Realisable (Settlement) Value	For assets, amount currently realisable on sale of the asset in an orderly disposal. For liabilities, this is the undiscounted amount expected to be paid on settlement of liability in the normal course of business.
Present Value	Assets are carried at present value of future net cash flows generated by the concerned assets in the normal course of business. Liabilities are carried at present value of future net cash flows that are expected to be required to settle the liability in the normal course of business.

As per Section 2(40) of Companies Act, 2013, Financial Statement in relation to a company, includes –

(i) a balance sheet as at the end of the financial year;

(ii) a profit and loss account, or in case of company carrying out activity not for profit, an income and expenditure account for the financial year;

(iii) cash flow statement for the financial year;

(iv) statement of changes in equity, if applicable; and

(v) any explanatory note annexed to, or forming part of, any document referred to sub-clause (iv) stated above.

Provided that the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement.

The Schedule III (and earlier, the Revised Schedule VI) prescribes only the vertical format for presentation of Financial Statements. Current and non-current classification has been introduced for presentation of assets and liabilities in the Balance Sheet. Unlike the Old Schedule VI, the Schedule III (and earlier Revised Schedule VI) lays down a format for the presentation of Statement of Profit and Loss. The Schedule III (and earlier, the Revised Schedule VI) has specifically introduced a new requirement of using the same unit of measurement uniformly across the Financial Statements.

THE ANNUAL REPORT

An annual report is a financial summary of a company's activities during the year along with management's analysis of the company's current financial position and future plans. Annual reports are prepared at the end of the fiscal year for external users to gain financial information about the inner workings of the company and what management plans to do in the future.

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."

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

- Providing information to the management of an organization which is used for the purpose of planning, analysis, benchmarking and decision making.
- Providing information to investors, promoters, debt provider and creditors which is used to enable them to male rational and prudent decisions regarding investment, credit etc.
- Providing information to shareholders & public at large in case of listed companies about various aspects of an organization.
- 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.
- Providing information as to how an organization is procuring & using various resources.
- Providing information to various stakeholders regarding performance management of an organization as to how diligently & ethically they are discharging their fiduciary duties & responsibilities.
- Providing information to the statutory auditors which in turn facilitates audit.
- Enhancing social welfare by looking into the interest of employees, trade union & Government.

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 why financial reporting framework is important –

- In help and 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 the backbone for financial planning, analysis, benchmarking and decision making. These are used for above purposes by various stakeholders.
- Financial reporting 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, labour contract, government supplies etc., organizations are required to furnish their financial reports & statements.

Indian Financial Reporting System:

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.

Role of the SEBI:

The Securities and Exchange Board of India (SEBI) is the regulatory authority in India established under Section 3 of SEBI Act, 1992. SEBI Act, 1992 provides for establishment of Securities and Exchange Board of India (SEBI) with statutory powers for

(a) protecting the interests of investors in securities

(b) promoting the development of the securities market and

(c) regulating the securities market.

SEBI has used its power to order changes in listing agreement. SEBI has imposed a number of disclosures and other requirements through this route. Some important requirements are as follows:

♦ Dispatch of a copy of the complete & full annual report to the shareholders.

♦ Disclosure on the Y2K preparedness level.

♦ Disclosure of Cash Flow Statement.

♦ Disclosure of material developments and price sensitive information.

♦ Compliance with Takeover Code.

♦ Disclosure of interim unaudited financial result

♦ Disclosure regarding listing fee payment status and the name and address of each stock exchange where the company's securities are listed.

♦ Corporate governance report.

♦ Compliance with Accounting Standards issued by the ICAI.

The initiative to introduce the Cash Flow Statements (as a principal financial statement) in India was taken by the SEBI and it has used its power under section 11 of the SEBI Act, 1992 to direct all recognized stock exchange for a requirement of appending an audited Cash Flow Statement (CFS) (prepared only as per Indirect method as prescribed in AS 3 or Ind AS 7) as a part of annual accounts. As per the SEBI mandate, the requirement of providing a CFS is mandatory for listed companies from the financial year 1994-95 i.e., year ended 31st March 1995. When the SEBI mandate was issued, there was no accounting standard issued by the ICAI as regard preparation and presentation of a CFS. The ICAI issued a revised accounting standard (AS 3) on the subject by replacing its standard on Fund Flow Statement in March 1997. After introduction of ICAI standard the SEBI has directed a change in the Listing Agreement to provide that CFS shall be prepared in accordance with the ICAI standard. Earlier in the Companies Act, 1956, there was no requirement for preparing the cash flow

statement. However, the new Companies Act, 2013 has mandated the Level I entities to prepare the Cash flow statement as one of the main part of its Financial Statements.

The process of the SEBI has resulted in a changed regime for imposition of financial disclosure requirements that is quick and does not require lengthy process of legislative changes. By virtue of the provisions contained in the Listing Agreement, listed companies are now under legal compulsion to comply with all the accounting standards issued by the ICAI.

The Companies Act, 2013:

The Companies Act, 2013 lays down the detailed provisions regarding the maintenance of books of accounts and the preparation and presentation of annual accounts. The Act also prescribes the mechanism for issuance of accounting standards by National Financial Reporting Authority (NFRA). It specifies the roles and responsibilities of directors and also the matters to be reported upon by them in the annual reports of the companies. Under the provisions of the Act, audit of annual accounts is compulsory for all companies registered under it. The Act extensively deals with the qualification, appointment, removal, rights, duties and liabilities of auditors and provides contents of auditors' report. In case of delinquency/ default by the management or auditor, penal provisions are prescribed. However, despite providing for detailed requirements in respect of maintenance of books of account, preparation and presentation of financial statements and audit of annual accounts, the main thrust under the Companies Act is upon the presentation of a 'true and fair view' of the state of affairs and operating results of the reporting companies.

As the preparation of financial statements contained in annual reports presupposes the existence of a recording procedure of transactions of the reporting entities, the requirements as to the maintenance of books of accounts are also mentioned. As per Section 129 of the Companies Act, 2013, at the annual general meeting of a company, the Board of Directors of the company shall lay financial statements before the company:

Financial Statements as per Section 2(40) of the Companies Act, 2013, inter-alia include -

(i) a balance sheet as at the end of the financial year;

(ii) a profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;

(iii) cash flow statement for the financial year;

(iv) a statement of changes in equity, if applicable; and

(v) any explanatory note annexed to, or forming part of, any document referred to in sub-clause (i) to sub-clause (iv):

Provided that the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement.

Disclosure by Listed Companies:

1. Balance Sheet, Profit and Loss Account and Directors' Report: Please, refer para given above.

2. Cash Flow Statement: Cash flow statements are prepared as per AS 3. Students are advised to refer AS 3 for details.

3. Related Party Disclosure: Transactions between related parties may not be at arm's length. Hence, companies are required to make appropriate disclosures in respect of such

transactions so that users of financial statements can make their own assessment. Such disclosures have to be made in annual reports in compliance with the accounting standard on Related Party Disclosure (AS 18) issued by the ICAI.

4. Disclosure to be made by Holding Companies and Subsidiary Companies in respect of Loans, Advances and Investments: Disclosures are required as per section 129(3) of the Companies Act, 2013.

5. Management Discussion and Analysis Report: Management Discussion and Analysis (MD & A) report is a very important document through which management of a company can express its views and opinions on various aspects of a company like performance, success or failure, future plan of the company, forward looking information, etc.

The MD&A complements and supplements the financial statements, but does not form part of the financial statements. The objective in preparing the MD&A should be to improve the reporting company's overall financial disclosure by providing a balanced discussion of the results of operations and financial conditions. The MD&A serves the laudable purpose of giving investors important disclosures about a company's operations. Although this section contains useful information, investors must heed caution, as the section is unaudited.

By virtue of the provisions contained in the Listing Agreement, the company has to provide a MD & A report to the shareholders. This report may be presented as part of the directors' report or as an addition thereto. It should include discussion on the following matters within the limits set by the company's competitive position:

(i) Industry structure and developments.

(ii) Opportunities and threats.

(iii) Segment-wise or product-wise performance.

(iv) Outlook.

(v) Risks and concerns.

(vi) Internal control systems and their adequacy.

(vii) Discussion on financial performance with respect to operational performance.

(viii) Material developments in Human Resources/ Industrial Relations front, including number of people employed.

6. Corporate Governance: In India the first attempt was made by the Confederation of Indian Industries (CII) to codify Corporate Governance. But the genesis of the provisions on Corporate Governance contained in the Listing Agreement is the Report of Kumar Mangalam Birla Committee. On 7th May 1999, the SEBI had set up a committee under the chairmanship of Sri Kumar Mangalam Birla to formulate the code of Corporate Governance. The SEBI in its meeting held on 25th January, 2000 accepted the recommendations made by the committee and suggested incorporation of certain matters in the Listing Agreement.

The following disclosures shall be made in the section on the corporate governance of the annual report.

(1) A brief statement on listed entity's philosophy on code of governance.

(2) Board of directors:

(3) Audit committee:

(4) Nomination and Remuneration Committee:

(5) Remuneration of Directors:

(6) Stakeholders' grievance committee:

(7) General body meetings

(8) Means of communication

(9) General shareholder information

(10) Other Disclosures

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 most common:

♦ Notice of annual general meeting

♦ Director's report

♦ Management discussion & analysis

♦ Risk Management Report

♦ Audited Standalone financial statements

♦ Audited Consolidated financial statements

♦ Corporate governance report

♦ Shareholders Information

♦ Auditor's report on financial statements

♦ C & AG'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.

WINDOW DRESSING

Window Dressing in Accounting refers to the manipulation done by the management of the company intentionally in the financial statements in order to present a more favourable picture of the company in front of the users of the financial statement before the same is released in the public.

Purpose of Window Dressing in Accounting:

- Shareholders and Potential shareholders will be interested in investing in the company if the financial look is good.
- It is useful to seek funds from investors or to obtain any loan.
- The stock price of the company will shoot up if the financial performance is good.
- Tax avoidance can be done by showing poor financial results.
- To cover up the poor management decisions taken.
- It improves the liquidity position of the business;
- To show a stable profit and results for the company.
- It is done to reassure the financial stability of the company to money lenders.
- It is done to achieve targeted financial results.
- It is done to showcase a good return on investment.
- To increase the performance bonus to the management team based on the overstated profits.
- To cover up the actual state of business in case the business is nearing insolvency.

Top Methods of Window Dressing in Accounting:

- Cash/Bank: Postponing the payment to suppliers so that at the end of the reporting period, the cash/bank balance will be high. Selling off the old assets, so that the cash balance will improve and show a better liquidity position, at the same time fixed assets balance will not differ much since it is an old asset with more accumulated depreciation.
- Inventories: Changing the valuation of inventories to increase or decrease profits.
- Revenue: Companies sell products at a discounted price or gives special offers to boost up the sales at the year-end so that the financial performance of the company looks better.
- Depreciation: Changing the depreciation method from accelerated depreciation to the straight-line depreciation method so the profits will be improved.
- Creation of Provisions: As per the concept of prudence in accounting, it requires recording expenses and liabilities as soon as possible but revenue only when it is realized or assured. If an excess provision is created, it can reduce the profits and reduce the corresponding tax payment.
- Short Term Borrowing: Short term borrowing is obtained to maintain the liquidity position of the organization
- Sale and Leaseback: Selling off the assets before the end of the financial year and uses the money to fund the business and maintain the liquidity position and leasing it back for a longer term for the business operations.
- Expenses: Presenting the capital expenditure as revenue expenditure to understate the profits.

Ethics of Window Dressing:

The entire concept of window dressing is clearly unethical, since it is misleading. Also, it merely robs results from a future period in order to make the current period look better, so it is extremely short-term in nature.

Recent Scandals in Financial Reporting:

- **WorldCom –** Worldcom case is one of the most infamous examples of window dressing, which was done by inflating earnings through improper capitalization of expenses. WorldCom declared bankruptcy in July 2002. Chief Accounting and finance executives charged with securities fraud.
- **Enron Scandal** – Enron Corporation was a US energy, commodities, and services company based out of Houston, Texas. In one of the most controversial accounting scandals in the past decade, it was discovered in 2001 that the company had been using accounting loopholes to hide billions of dollars of bad debt, while simultaneously inflating the company's earnings. The scandal resulted in shareholders losing over $74 billion as Enron's share price collapsed from around $90 to under $1 within a year.
- **Lehman Brothers Scandal** – Lehman Brothers was a global financial services firm based out of New York City, New York. It was one of the largest investment banks in the United States. During the 2008 financial crisis, it was discovered that the company had hidden over $50 billion in loans. These loans had been disguised as sales using accounting loopholes. According to an SEC investigation, the company had sold toxic assets to banks in the Cayman Islands on a short-term basis. It was understood that Lehman Brothers would buy back these assets. This gave the impression that the company had $50 billion more in cash and $50 billion less in toxic assets. In the aftermath of the scandal, Lehman Brothers went bankrupt.
- **Satyam Scandal** – Satyam Computer Services was an Indian IT services and back-office accounting firm based out of Hyderabad, India. In 2009, it was discovered that the company had inflated revenue by $1.5 billion, marking one of the largest accounting scandals. An investigation by India's Central Bureau of Investigation revealed that Founder and Chairman, Ramalinga Raju, had falsified revenues, margins, and cash balances. During the investigation, Raju admitted to the fraud in a letter to the company's board of directors. Although Raju and his brother were charged with breach of trust, conspiracy, fraud, and falsification of records, they were released when the Central Bureau of Investigation failed to file charges on time.
- **American International Group (AIG) Scandal** – American International Group (AIG) is a US multinational insurance firm with over 88 million customers across 130 countries. In 2005, CEO Hank Greenberg was found guilty of stock price manipulation. The SEC's investigation into Greenberg revealed a massive accounting fraud of almost $4 billion. It was found that the company had booked loans as revenue in its books and forced clients to use insurers with whom the company had pre-existing payoff agreements. The company had also asked stock traders to inflate the company's share price. AIG was forced to pay a $1.64 billion fine to the SEC. The company also paid $115 million to a pension fund in Louisiana and $725 million to three pension funds in Ohio.