

Role of Financial Reporting & Disclosures in Corporate Governance

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Background

A financial reporting system supported by good governance, high quality standards and sound regulatory framework is the key to economic development of a country. Financial reporting system, providing essential financial information about the company to its shareholders and other stakeholders, needs to be reliable, free from bias and should enable comparison on the basis of common benchmarks. This, in turn, necessitates an appropriate financial reporting system that incorporates sound accounting principles and reflects a true and fair view of the financial health of the company while ensuring legally enforceable accountability. In a globalised world, such a system should also be uniform across borders so that there is comparability on the basis of common benchmarks.

The growing inter-linkages in the world economy and the recent global financial meltdown has thrown up important challenges that the world community must meet jointly. In the aftermath of the financial crisis, there is growing realization across the world of the need for enabling a single set of high quality global Accounting Standards, which would be based on common accounting principles while providing reliable and comparable financial information. With this in view, G-20 had called upon the international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards within the context of their independent standard setting-processes; and complete their convergence projects by 2011. International Financial Reporting Standards (IFRS), issued by the International Accounting Standards Board (IASB), are increasingly being recognized as global accounting standards, and are in use in over 100 countries with about 40 more countries (including India) being in the process of converging with them.

Accounting and disclosure requirements mechanism for companies in India

Accounting standards have been in use in India for preparing accounts for several decades. The Institute of Chartered Accountants of India had constituted the Accounting Standards Board on 21st April, 1977, to formulate Accounting Standards applicable to Indian enterprises with a view to harmonise the diverse accounting policies and practices in use in India. Initially, the Accounting Standards were recommendatory in nature. After gaining sufficient experience, the Institute gradually started making the Accounting Standards mandatory for its members, i.e.,

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requiring its members to report on whether an enterprise subjected to audit had followed a mandatory Accounting Standard as part of their professional conduct.

After the avowed adoption of liberalisation and globalisation as the corner stone of Indian economic policies in early '90s, and the growing concern about the need of effective corporate governance of late, the accounting standards have increasingly assumed importance.

With the amendment of the Companies Act, 1956 through the Companies (Amendment) Act, 1999, accounting standards as well as the manner in which they were to be prescribed, were provided a statutory backing. The accounting and disclosure requirements for companies are regulated under the Companies Act, 1956. Under section 211(3A) of the Act, every profit and loss account and balance sheet of the company shall comply with the accounting standards. Under Section 211(3C), accounting standards are to be notified by the Central Government after consulting National Advisory Committee on Accounting Standards (NACAS), based on the recommendations of ICAI. The Act also provides a transition provision from the date of amendment of the Act in 1999, in the form of *deemed accounting standards* (standards of accounting issued by ICAI), till accounting standards are notified by the Government based on the procedure laid down in Section 211(3C).

The the Accounting Standards issued by the ICAI, in the form of deemed accounting standards till the standards were notified by the Government, ensured that i) there was **continuity** in the standards of accounting followed by the companies; ii) the **expertise** in developing accounting standards by the ICAI over the past so many years was retained; and iii) a suitable **platform** was created for convergence of Indian accounting standards with the IFRS.

In India, subsequent to Companies (Amendment) Act, 1999, when the Central Government was vested with the powers to notify Accounting Standards, the process of harmonization with International Accounting Standards (now IFRS), was taken up. While the Companies (Accounting Standards) Rules, 2006, notified in December 2006, which now contain the accounting standards applicable to companies in India, are substantially harmonized with IFRS following the process adopted by the ICAI, NACAS and the Central Government, there are, however, still some deviations from the IFRS. While some deviations are consequences of legacy issues arising from the accounting practices generally applied in the country, in other cases, the deviations have also arisen because of the provisions of the Act which cannot be overruled by the Rules.

Convergence of Indian accounting standards with IFRS

In the year 2007, ICAI developed a Concept Paper on Convergence with IFRS in India with the objective of exploring the approach and strategy for achieving convergence with IFRS.

In 2008, the Government announced the policy that the Indian Accounting Standards are expected to be fully convergent with IFRS wef April 1, 2011. While some countries have adopted the IFRS without modifications, others have tailored the IFRS to their country-specific conditions during the process of convergence. India decided to go in for 'convergence' rather than 'adoption'. Convergence with IFRS would allow India to consider local economic conditions and business environment while preparing converged accounting standards, thus enabling an orderly transition while safeguarding the interests of Indian enterprises and providing them enough time for transition. Government of India has been following a consultative approach for the purpose of achieving convergence of national accounting standards with IFRS.

In July 2009, with a view to designing a definitive roadmap for convergence with IFRS and co-ordinating the process, a Core Group was set-up under the Chairmanship of the Secretary, Ministry of Corporate Affairs with participation from Ministry of Finance, C&AG, RBI, SEBI, IRDA, PFRDA, ICAI, NACAS and industry representatives.

In January 2010, the Ministry of Corporate Affairs, Government of India announced the roadmap for convergence, according to which the Indian Accounting standards converged with IFRS shall be applied to specified classes of companies, in phases, beginning with the financial year 1.4.2011 to 2014.

Roadmap for convergence of Indian accounting standards with IFRS

As per the roadmap announced by the Ministry of Corporate Affairs, there will be two separate sets of Accounting Standards u/s 211(3C) of the Companies Act, 1956. First set would comprise of the Indian Accounting Standards which are converged with the IFRS which shall be applicable to the specified classes of companies. The second set would comprise of the existing Indian Accounting Standards and would be applicable to other companies, including Small and Medium Companies (SMCs).

The first set of Accounting Standards (i.e. converged accounting standards) will be applied to specified classes of companies, in phases, beginning with the financial year 1.4.2011 to 2014 as per following schedule:-



<ul style="list-style-type: none"> NSE – Nifty 50 BSE – Sensex 30 Whose shares or other securities listed outside India Whether listed or not, having networth in excess of Rs. 1000 Cr. <p>(Excluding Banking, Insurance and NBFCs)</p>	<ul style="list-style-type: none"> All insurance companies 	<ul style="list-style-type: none"> Listed or not, having a networth of more than Rs. 500 Cr. but not exceeding Rs.1000 Cr. (Excluding Banking, Insurance and NBFCs) 	<p>Listed and having a networth of Rs 500 Cr. or less</p> <p>(Excluding Banking, Insurance and NBFCs)</p>
		<ul style="list-style-type: none"> All scheduled commercial banks 	
		<ul style="list-style-type: none"> Urban Co-operative Banks having networth in excess of Rs.300 Cr. 	<p>Urban Co-operative Banks having networth in excess of Rs.200 Cr. but not exceeding Rs.300 Cr.</p>
		<p>NBFCs being:</p> <ul style="list-style-type: none"> NSE – Nifty 50 BSE – Sensex 30 Whether listed or not, having networth in excess of Rs. 1000 Cr. 	<p>All listed NBFCs and those unlisted NBFCs having networth in excess of Rs.500 Cr. but not exceeding Rs. 1000 Cr.</p>

Notes:

- When the accounting year ends on a date other than 31st March, the conversion of the opening Balance Sheet will be made in relation to the first Balance Sheet which is made on a date after 31st March.
- Companies which do not fall in the above categories including the Small and Medium Companies (SMCs) and Regional Rural Banks will not be required to follow the IFRS converged Indian Accounting standards, though they may voluntarily opt to do so, but need to follow only the notified Indian Accounting Standards which are not converged with IFRS.

Accounting Standards and responsible corporate governance

While the movement towards common accounting standards is gaining strength across the world, equally strong is the concern at the need for ensuring sound and responsible corporate governance. Failures of businesses in which deficiencies of financial reporting and corporate disclosure have figured prominently are not new phenomena. The collapse of Business Empires and the related auditor issues are seen by many as the event that initiated the changed perception of the reliability of financial reporting. It might be better to consider such failures as the event that confirmed a trend and, by its sheer size, awoke many issues that had been significant for some time. Failures of large global corporations gave the issues greater visibility. Almost all the high profile failures are the result of the combined effect of failures in business, failures in governance and failures in reporting. The business issue that should be communicated to the users of financial statements is not properly disclosed, governance structures fail to prevent or detect this, and a reporting failure results. As an entity moves closer to business failure, the incentive to distort reporting increases and, therefore, the chance of reporting failure increases.

Corporate entities, today, are of an unprecedented size with operations spanning the entire globe. They are raising and utilizing resources at levels that could affect the common future of all mankind in the days to come. Therefore today, the concern is towards the triple bottom line- people, profits and environment. Therefore, while promoting confidence in corporate reporting is vital to the healthy functioning of business entities and capital markets and makes a significant contribution to the overall economic growth, and, while strong connections exist between corporate governance, corporate financial reporting and auditing, this synergy needs to be further developed so that it can build faith in the actions of the business entities and also protect our common future. The responsibilities of the Company Boards to ensure credible governance has increased in view of the expansion of the definition of ownership from the shareholders to the stakeholders. Stakeholders beyond the shareholders including workers communities etc. are becoming increasingly vocal about the issues related to the responsible business governance. The added responsibilities for the Board arise from the issues of sustainability and sustainable development which is engaging various stakeholders including governments during the last few years. A regulatory regime in which high standards of corporate reporting and governance are intelligently and diligently applied, would underpin the healthy functioning of markets to the benefit of business, investors and other stakeholders alike.

One of the basic features of IFRS is that they are *principle-based* and not rule-based. IFRS involve extensive use of judgement in selection of appropriate accounting policies and alternative treatments, including at the time of adoption. Also, IFRS require fair valuations and future forecasts, which will involve use of estimates, assumptions and management's

judgements. It has been observed that the combination of all these factors can have a significant impact on the reported earnings and financial position of an enterprise. The audit committees and board members will have to handle this challenge in an effective manner and specifically focus on how well companies are geared for the transition to IFRS.

Another challenge is in the field of accounting for derivatives. The Institute of Chartered Accountants of India, in co-ordination with the Reserve Bank of India, has been working on devising standards on this. ICAI has already issued accounting standards dealing with accounting of derivatives but these are yet to be notified by the Government of India. Leaders of the G-20 had called upon accounting standard setters to take action to reduce the complexity of accounting standards for financial instruments by end of 2009. The IASB had planned to address the G-20 Leaders call through development of three new standards, based on exposure drafts issued in 2009. The IASB had, in November 2009, issued a new IFRS on the classification and measurement of financial assets. Publication of the IFRS represented completion of the first part of a three-part project to replace IAS 39 Financial Instruments: Recognition and Measurement with a new standard – IFRS 9 Financial Instruments. It is expected that once the IASB finalizes its position, the relevant accounting standards would also be notified in India in accordance with the schedule of convergence with IFRS. But, all this may pose further challenges for the regulatory bodies and others in terms of risk assessment and mitigation strategies of the enterprises.

Following the widespread international adoption of IFRS, it has been observed that various stakeholders, including regulators, preparers & users of financial statements and auditors continue to encounter practical implementation challenges. These challenges typically relate to issues of institutional development, enforcement and the capacity for technical implementation. Apart from financial reporting issues, convergence to IFRS in India will have implications in terms of taxation, compliance and enforcement, level of preparedness of the Indian industry and professionals etc.

The process of transition involves substantial efforts, particularly by preparers of financial statements and their auditors. A key message to the preparers of accounts is that it is never too early to start the transition process. It is a major change management project for organizations, requiring a broad range of changes to systems, processes and people which must be carefully managed, and they need to learn from the experience of Indian and global companies who have already transitioned to IFRS reporting and how organizations can capitalize on opportunities to improve operational excellence and overcome critical business challenges. A robust project plan from the outset would be a pre-requisite for a smooth transition to IFRS.

As a convergence of the statutory application of the new accounting standards, the financial results of the companies, as reflected in their statutory financial statements, may undergo a change. Normally, such changes arising out of changes in law are treated as neutral for tax purposes. There are significant tax issues, in addition to accounting and other business issues, needing to be resolved especially, in view of the phased approach for transition. CBDT and ICAI have constituted a joint study group to identify and address taxation issues arising out of convergence with IFRS in India.

In view of the phased approach of moving towards IFRS converged accounting standards in India, suitable taxation provisions that allow appropriate treatment for two sets of accounting standards that would increasingly be applied during the transition process are needed to be explored. As per IFRS requirements, there are many items in the profit & loss account which are treated differently and would need tax clarifications in the Indian context. On transition to IFRS, certain one-time adjustments would also have to be recorded in the financial statements and the taxation authorities need to clarify tax implications of such adjustments.

Conclusion

In the aftermath of the global financial crisis, it is particularly important that along with a common understanding on accounting principles and standards, there should also be strong and effective corporate governance. More so, since the IFRS are principle based and will require exercise of judgment by the company management. In doing so, there will be a need for managements to exercise their judgment in the best interest of the stakeholders. On the other hand, companies also need to be given enough time to understand and assess the impact of the change, proposed to be brought about by the IFRS based accounting standards, and consider it for communication with the stakeholders like the Government agencies, lenders etc. All the regulatory bodies involved in the implementation of the roadmap for convergence with IFRS must also, well in time, establish the necessary legal and regulatory environment that sets the direction for and enables convergence with IFRS in order to meet the set deadlines. Ensuring tax parity on non-converged and converged accounts also holds the key to the effective implementation of the whole convergence exercise. It is hoped that clarity on the above issues would come within time and the Indian corporate sector and professionals would be able to achieve convergence well in time.