FINANCIAL STATEMENTS – FACT, FICTION OR FANTASY?
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MUMBAI

SUMMARY OF DISCUSSIONS

CONTEXT SETTING

In the light of an increasing number of corporate failures, and with many of them being attributed to perceived inadequacies in accounting and auditing, trust in the financial system has been considerably dented. This is no new phenomenon. It maybe recalled that the setting up of the Cadbury Committee in UK nearly three decades ago also owed itself to incorrect financial statements and the accompanying loss of faith in the accounts presented. There have been changes in accounting standards and accounting policies, and a heightened awareness that auditing should better address the shortcomings that have been noticed.

With changes in accounting standards, a significant change in the presentation of audit reports, and the setting up of the NFRA for tighter regulation of the auditing profession, the time has come to examine whether the systems and safeguards put in place are adequate.

DISCUSSIONS

- With a number of scams being unearthed, the focus on financial statements has increased. Sadly, changes in Indian laws and regulations are kneejerk reactions, which are counterproductive in most cases.
- The sanctity of financial statements is being questioned. Whom are the statements prepared for? What purpose do they serve? What information do they give? Who are the users of these statements? Are there improvements to the statements in the pipeline?
- The dividing lines between business failure, financial failure and audit failure are blurred.
- The earlier simpler version of financial statements based on "true and fair" has been discarded. The current statements and audit reports come with a number of caveats, which makes it difficult to comprehend them. Unless one is an analyst, it is difficult to understand the financial statements now.

ARE FINANCIAL STATEMENTS A SOURCE OF INFORMATION FOR THE STOCK EXCHANGES?

- There was a study done in the US, where stock price was checked for 60 years, to find whether there was any correlation in the movement of the stock price when the financial statements were made public by companies. It was found that there was no correlation between the timing of the financial statement and the top line, bottom line or gross profit. It was concluded that market gets the information that it wants from sources other than the financial statements, since these statements do not provide the information that the market needs.
- Arthur Levitt, former Chairman of Securities and Exchange Commission (SEC) said, post the Enron scam, that the financial statements in the US had incorrect numbers. He gave pointed examples of categories in financial statements where numbers were not correct (such as in reserves etc).
- In analyst calls too, questions are not asked on the financial statements.

FINANCIAL STATEMENTS SHOULD BE CHECKED FOR

- Relevance
  - What is the purpose of the financial statements?
    - It is unclear whether financial statements are for holding a company accountable or for decision making. If they are for accountability, the focus should be on conformity, while if they are for decision-making, the focus should be on predicting value.
  - Who is the user of the financial statements? Statements should focus on the user to provide the information that she/he may require.

- Content – There is a huge gap in content in these statements. For example, vital information such as sensitivity analysis for foreign exchange movement is not given.
  - Another area where a gap exists is in non-GAAP information, some of which can help in making the statements more comprehensive.
- Reliability
  - Do these statements lie?
  - These statements do not lie, but they do not tell the truth also because they are made across different frameworks. Within each framework too, there are multiple choices.
    - Should there be one framework across the world? Should there be one framework for India? Should the choices within each framework be done away with since final numbers in these statements would depend on individual choices that were made?
  - Information that is critical is missing. Within the Standards themselves, a number of intangible factors/ assets do not get captured.
  - As a result, financial statements have moved away from fact to opinion.
- Integrity
  - There has been a lot of improvement in India. An increasing number of companies understand the spirit behind what is to be done because the market rewards them.
  - While there is a consistent base/ framework now, there is a need to create/ strengthen regulations around this. Earlier, the framework itself had not been implemented. Regulations will help in better implementation of the framework/ standards. Added to this, auditors too will help in improving the implementation of these standards.

ACCOUNTING STANDARDS

- Changes from the old to new standards have been good.
- However, frequent changes/ revisions in accounting standards has caused, and continues to cause, disruption in business. As a result of changes in the standards, the ratios of companies can change overnight since the same business would be measured differently. This can have a huge impact. For example, in mark to market, change in foreign exchange can have a huge impact on the numbers.
- The standards have moved from focussing on prudence to focussing on fairness. Earlier, when the focus was on prudence, a number of items were not considered and accounted for.
- Standards have to be a mix of principles and rules. If they are only principles based, there is a possibility of opinion shopping.
- Standards should have a sunset clause so that they are reviewed after a fixed time period.
- Companies in the US have an advantage because the standards are different.
- However, there are some questions that do not have easy answers -
  - Should standards be flexible, or should they be very tight?
  - Due to the flexibility, are all the numbers notional? How does one sift through the information that is available?
  - Is accounting so complex, that it is creating a web?
  - Are more ratios needed in addition to the ones prescribed by SEBI?

ACCOUNTING

- Accounting is a discipline.
- The problem is the use of accounting. Accounting can be as pure as the persons who are doing it decide it be to. For example, if RPTs are done strictly as per definition, the company could be law abiding, but it is possible that the spirit would not be respected.
- Since the definitions are elastic, the same company can quote different numbers for the same item within the same industry/ sector/ country.
- A number of financial transactions do not either get entered or are understated/overstated.
- Financial statements ultimately depend on the quality, culture and integrity of the management. Their accountability and integrity are very important. However, this is never spoken about.

  - Who should certify the reliability of data to auditors?
- While auditors are held responsible in the case of a problem, management and accountants within the company are not held responsible for the data that they provide to the auditors. Focussing only on auditors and Directors is not correct.
  - In the Satyam scam, the problem was not the auditor/ accounting standard, but the management.
  - Kneejerk reactions by way of changes in law is not the solution.
- With the same standards, there is a lot of difference in Indian companies when compared to their counterparts in the advanced countries.
- Some of the possible ways of dealing with these problems are -
  - Whistle blower – If used properly, any wrong/fraudulent accounting practice can be brought to the attention of the right persons with the use of this mechanism. Auditor cannot continuously sniff around for problems. If this mechanism is strengthened, it can greatly help auditors too. This would also help in quickly holding the concerned persons accountable. Strengthening of whistle blower mechanism should come from the Boards. At present, a number of Boards and ACs do not take anonymous complaints seriously, even if the complaint is of a verifiable nature.
  - Different treatment in the same company for the same item should be highlighted.

INTEGRATED REPORTING

- There is a need to focus on the future, and not just on the past. As a result, there is a need to move beyond financial reporting to integrated reporting which in addition to financial capital, focuses on manufactured capital, intellectual capital, human capital, social and relationship capital and natural capital.
- However, there would be problems in valuation of the other five kinds of capital.
- There should be a shift from a confrontational way of handling accounting to a cooperative way of handling accounting.
- Systems, processes and analytics should be seen holistically, which is not the case at present.

FREQUENCY OF FINANCIAL REPORTING

- Should financial reporting be annual/ quarterly or real time (using technology)?
- Quarterly reporting of results is excessive. A CEO cannot continue to show improvements every quarter. As a result, there is a temptation to resort to manipulations.

WHO IS THE END USER OF FINANCIAL STATEMENTS?

- There are a number of different end users, some passive and some active, each looking for different information from the same set of statements. However, the same set of statements cannot give all information to all users.
- As a result, the end user gets confused with these statements.
- There is a lot more information now, but less substance. A number of important items which helped the user earlier, have been removed from the financial statements.
  - However, possibly the only persons who read the complete set of financial statements are the auditors and the CFO.
- For institutional investors, there is a problem of standardisation. The existing disclosures have not been standardised, and different companies cannot be compared on the same parameters.
- For investors, the assumptions and the subjectivity behind each statement is too high to help them take a decision on the basis of the information available in these statements.
- Is it possible that different types of information be given in a report to the stakeholders, not necessarily in a statutory auditor's report or the balance sheet, by some person who understands the business of the company?

   - The statutory auditor may not be able to give this information since he may not have the right background for this. Relevant persons, with the right background, would have to be hired for this.
   - This information should be stated in simpler language, with no caveats. For example, the financial statements at present do not have a governance lens. One possible information that these statements can give could be on major findings of internal audit.
   - This information should be both reliable and intelligible.

MANIPULATION IN STATEMENTS

- The root cause of all manipulations is the high amounts of incentives being given and this is not being addressed.
- Pressures of quarterly reporting can force some persons to manipulate statements. This innovation should be dis-incentivised. Disclosures can help create awareness, but creating safeguards could be a challenge.

AUDITORS AND AUDIT REPORTS

- The involvement of auditors is increasing, but the essence is reducing.
- The profession is becoming like any other business. Further, perceived / real rivalry between audit firms also comes with its set of issues.
- The discharge of the role is more defensive because there is increased scrutiny of their action.
- Earlier, the access to Board and AC was limited, or was not there, but now it is increasing.
- Standards on reporting on governance is improving, which is a positive sign.
- Reporting and comfort from reporting, even though it has improved, can be further improved.
- However, the capacity and quality of accounting professionals is not upto the mark in a number of cases. There should be some standardisation, which is lacking at present.
- Financial statements are a snapshot of a moving object in a changing environment. Refinement to these statements is always possible. However, financial statements and auditors have limitations.
- The quality of an audit report depends upon the talent of an auditor. There is no substitute for the quality of service that a true audit professional can offer.
- Audit report is not a speaking report and so it is difficult to find what an auditor has done.
- What stops an auditor from saying that he is not happy with the accounts? Why cannot the language be simpler?
   - How much can an auditor look into the future?
   - The report is based on assumptions which are supported by the Board and the AC. These assumptions are not questioned because the AC agrees with them.

AUDIT COMMITTEE

- Audit Committee has a vital role to play in the audit process. It needs to deep dive into various challenges which are being faced by the auditor.
- In performing this role, the composition of AC is important. However, most companies in India do not have a qualitatively strong AC.
- Further, AC should work with the auditor and the management to ensure that auditor gets the support required.

AUDITOR AND MANAGEMENT

- The management and the auditor should constructively challenge each other. This will help strengthen financial statements.
- The AC should ensure that the management and the auditor have a healthy working relationship.
- Technology can help. But capacity both within the company and in audit firms will have to be built.

AUDITOR RESIGNATION

- The number of auditor resignations have reduced, which is a positive sign. They are trying to make changes since resignation is not a solution.
- When Boards and ACs do not take the concerns of auditors seriously, they do not have an option but to resign. A lot depends on the composition of the AC, and ultimately the Board. For example, if CEO is a member/ permanent invitee to AC, it is not correct.
- However, auditor resignation should be taken seriously. In addition to stating the true reason, the auditor who has resigned should come to the next AGM to explain to the shareholders why she/he quit since his appointment was made by the shareholders.
- ICAI has come up with a guidance note for auditors on what they should do when they are resigning.

INTERNATIONAL SITUATION

- Internationally, financial statements are equally complex.
- However with the same standards, the quality of reporting in India and in advanced countries is vastly different.
- The regulators take adverse media reports also seriously. This helps in prevention of any possible mistakes.
- The quality of information given in the US is far superior. The Form 10-K gives an overview of the industry and the company. This is information in public domain. Such information is not provided in India at present.

WAY FORWARD

- If the underlying numbers are correct, then the quality of audit report can be judged on the basis of whether it is a speaking report or not. Standardisation of text should be avoided. Some items can be added to help improve the perception of audit report and the financial statements.
    - Importance of cash flow should not be undermined; integrity of data should be checked, possibly with the aid of technology; transparency in disclosure for improved corporate governance is important.
- Governance lens should be introduced. With newer governance issues coming to the forefront, it is obvious that this is lacking at present.
    - If the intention of the management is wrong, there are limitations to what an auditor can do, but giving up is not the solution.
- Quality of professionals and value system of both the management and the auditor are important. Both of them have weaknesses, but implementation has to be strengthened to check for the newer situations.
- Auditor rotation is a good step but the comments of auditors should not be sugar-coated. They should be such that a layman can understand them.
- Capacity building of auditors is important.
- There is a need for initiating layman's understanding of accounting standards.
- There has been an improvement in auditor empowerment. Regulators have the right to question auditors if they go wrong, but it should not be kneejerk and should be done in a timely manner.
- IDs have a role in the quality and quantity of disclosure, and their correctness. But it is not clear whether IDs are equipped to play this role.
- Regulatory oversight is missing. In the US, SEC scrutinises financial statements and disclosures, and sends letters to companies if something is amiss. This keeps the companies in check. In India this is not done because SEBI does not have enough accounting professionals.
    - Who can make changes?
        - For listed entities, SEBI and RBI.
        - For larger universe of companies, MCA.

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Excellence Enablers Private Limited (EEPL) is an initiative that focuses on implementation of better corporate governance practices, improvement of Board performance, including audit and evaluation, training of directors and engagement with stakeholders of governance. It is founded on the firm belief that the gap between performance and potential can, and must, be bridged. Consistent with that belief, all our offerings are tailor-made to the specific needs of the organisation or the individuals concerned.

Given that our founder, Mr. M. Damodaran, introduced Clause 49 of the Listing Agreement, dealing with corporate governance in India, and has been a part of both public sector and private sector Boards, as well as performing and underperforming Boards, we offer experience based consultancy and courses on the journey from compliance through governance to performance. Further, given his success in turning around organisations that had been written off, we are uniquely positioned to offer courses on leadership, organisational transformation, and building winning teams.

EEPL has a number of highly experienced and renowned consultants and faculty members who have helped, and continue to help, us deliver programmes that have been well received.