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

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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.

USERS

- Direct Interest
  - Owners
  - Lenders
  - Suppliers
  - Creditors
  - Employees
- Indirect Interest
  - Lawyers
  - Labor Unions
  - Trade Associations
  - Business Researchers
  - Financial Consultants
  - Public at Large
- Special Interest
  - Economists
  - Regulatory Authorities
  - Taxation Authorities

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