CHAPTER II

THEORY OF DISCLOSURE

Corporate financial disclosure through published annual reports plays an important role in the efficient allocation of limited resources of a country. Also, financial reporting connotes communication of published financial statements and related information from an enterprise to third parties including shareholders, creditors, governmental agencies and the public. Thus financial reporting is, in fact, a subject of the communication component of accounting. It is a process of providing to a wide variety of users certain financial information relevant to their data-needs concerning the performance of specific entities. It may, however, be emphasized that the financial reporting does not imply unidirectional and unlimited flow of all kinds of information. In fact, it is an effective communication of accounting information.
The entire annual report needs to be studied in order to evaluate management's obligation to report to various interested parties properly. Hence, the following aspects are discussed in this Chapter:

I  CONCEPT OF DISCLOSURE

II  QUALITATIVE CHARACTERISTICS IN DISCLOSURE

I  CONCEPT OF DISCLOSURE

Disclosure can be defined as a process through which a business enterprise communicates with the external parties. There are three concepts of disclosure generally proposed viz., Adequate, Fair and Full Disclosure. Of these three, the most commonly used is Adequate Disclosure. Fair and Full are more positive concepts. Fair disclosure implies an ethical objective of providing equal treatment to all potential financial statement readers. Full disclosure implies the presentation of all relevant information.\(^1\) However, it is contended that there is no difference among these concepts.\(^2\)

Disclosure of information significant to investors and other users should be adequate, fair and full so that it can help them in making economic decisions in the best possible way.

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2 Ibid.
Adequacy of disclosure cannot be tested accurately and precisely since no definite test to measure it exists in financial reporting. But when information is reported outside the business enterprise, adequacy of disclosure can be tested. The basis of the test is the extent to which the items of information are helpful to users in making economic decisions. The quantum and quality of information will vary according to the needs of the users. The scope of adequate disclosure can be explained in terms of the following five interconnected questions:

01 User
02 Purpose
03 Quantum
04 Mode
05 Timing

Financial accounting information is used by a variety of groups and for diverse purposes. Some users have direct interest in reported information. Such users are owners, creditors, suppliers, management, tax authorities, employees, and customers. Owners want to know whether to relinquish, retain or further acquire shares in that company; employees and workers about continuity in employment and future prospects; management to judge the...
efficiency and performance; creditors to judge its credit status; customers about regular supplies at reasonable prices including good quality of products.

Besides these, there are other groups of users having indirect interest in the financial affairs of Co. publicly held corporations like financial analysts and advisors, stock exchange brokers, financial press and reported agencies, trade-associations, labour unions. These user-groups having direct/indirect interest have different objectives and diverse informational needs. The emphasize in financial accounting has been an all-purpose report, catering to the needs of all and not intended to satisfy any specialised needs of individual users.

"Financial accounting presents all purpose financial information that is designed to serve the common needs of owners, creditors, managers, and other users, with primary emphasis on the needs of present and potential owners and creditors."  

This dependence on all-purpose information is based upon the logical assumption that a significant number of users need similar information. Also, this practice is in use because of lack of knowledge of requirements of specific users.


5 Ibid., p. 47.
Special purpose reports satisfy specialised or particular needs of individual users. Information in a special-purpose report cannot be expected to serve other needs well.

Issuing separate reports for different users is not feasible. The cost of developing specialised reports to satisfy special requirements of users may exceed the benefit when the corporate disclosure policy is examined in its totality. Secondly, it also complicates the matter. Being required to serve the various different groups of interests, they will comprise different materials and different figures. Specialised needs of large number of users cannot be ascertained with any degree of certainty.

It is, therefore, suggested that financial reports should be all-purpose reports with special emphasis on shareholders. To meet this objective, the existing statements (under the existing law) primarily meant for shareholders should be adequately expanded and should include the details to serve the needs of others also—debenture-holders, creditors, employees, customers, suppliers, analysts etc.

At present it is observed that no company issues either special-purpose reports even a comprehensive all-purpose report. Most of the companies are confining

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themselves to bare legal minimum requirements and are presenting a picture which caters to the needs of the most immediate readers—the shareholders. Only a few companies, like Dunlop, Associated Cement, Hindustan Lever, Phillips, Tata Iron and Steel, Tata Chemicals etc. provide a mass of data for everyone—from the shareholders to the buyers of the company's products and beyond; and include a number of paragraphs disclosing certain other matters, e.g., employer-employee relations, effect of taxation on profits, decentralisation of shareholdings, field of operations, photos of the products, future plans, contribution to nation's economy, and so on.

**Purpose**

The concept of adequate disclosure involves identifying the purpose for which information is to be disclosed. Where users do not know the objectives or goals, accountants cannot decide what information is to be communicated to them. Identification of target by the user-group leads to the user's purpose of financial information.

There are many views available in literature about the purpose of information to be disclosed in annual reports. Traditionally, information has been used in (i) making investment decisions and (ii) in making exercise of
investors' control over management. From management's point of view, measuring past performance is the primary purpose of financial reporting.

In today's investment market, the primary purposes to which the information is directed are, to assist in evaluation for the extension of credit, to aid in investment decision-making and to judge the quality of management's performance in the past.

The purpose of the concept of disclosure in financial statements is based on relevant economic information. Of these purposes, the following are quite significant:

i) To provide information useful to investors and creditors for predicting, comparing and evaluating potential cash-flows in terms of amount, timing and related uncertainty;

ii) to provide information to users for predicting, comparing and evaluating the earning power of the enterprise;

iii) to supply information useful in judging management's ability to utilize the resources effectively in achieving the primary goals of the enterprise;

iv) to report on those activities of the enterprise which are important in its social environment.

Since the investor is the dominant or primary user group; the primary purpose of information in disclosure is

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to facilitate investment decisions. Besides, other user groups also use annual reports. Although information in annual report is to serve primarily the investor, both existing and potential, yet it should meet the information needs of others as well.

03 Quantum

The quantity and quality of information depends on needs and expectations of users and the degree of uncertainty prevailing in the investment market. The basic determinants of the quantity of information to be reported are primarily dependent upon a critical assessment of the information needs which are relevant to a specific set of users.

Degree of uncertainty in users' decision-making is also a significant factor in deciding how much to disclose in annual reports. The type and amount of accounting disclosure needed in investment market may depend upon the degree of uncertainty under which decision-makers are operating. The greater the uncertainty of the economic decision maker, the greater is the amount of information needed by him. When he is almost certain or has even decided what to do, little information need be provided. A large number of suggestions and recommendations have been given by various writers, committees and accounting bodies for improving the quantity and quality of disclosure in corporate annual reports. The Accounting
Board\textsuperscript{3} has suggested various disclosures in addition to balance-sheet and income statement, separate disclosure of the important components of the financial statements, disclosure of components of working capital, disclosure of notes necessary for adequate disclosure, contingent liabilities, important long term commitments, changes in accounting principles and practices, information on terms of owners' equity and long term debt, earnings per share, disclosure of subsequent events, and consolidated financial statements of subsidiaries.

An AICPA Study\textsuperscript{9} states that accounting reports should not be misleading. Financial statements prepared on the basis of generally accepted accounting principles would be considered to be not misleading and would show fair presentation of financial position and results of operations of business enterprise. It has further recommended disclosure of following items of information to fulfill the objectives which would have inescapable effect on disclosure practices in future:

1) Basic underlying assumptions with respect to matters subject to interpretation, evaluation and prediction;

2) transactions and other events that are part of incomplete earning cycle;

\textsuperscript{8} Accounting Principles Board, \textit{op.cit.}, pp.91-98.

iii) changes in the value reflected in successive statements; and

iv) financial forecasts, when enhance the reliability of users' predictions.

The significance of reporting different types of information in annual reports is stressed. However, it has also been argued that disclosing too much information which is extraneous to user requirements should be discouraged. Excessive details may cause confusion in the mind of users. Thus, the annual report will contain only those items of information which are useful in economic decisions and needed by users for their purposes.

04 Mode

The question of adequacy of disclosure is not only identifying the users and determining the information and their purpose, but it also signifies the method of disclosing information. The method of disclosure determines the usefulness of information.

The suitability of any method of financial reporting in any circumstance should be judged by its success in furthering the objectives of that financial report. Form of presentation should be so designed as to enhance the users' understanding of the data and minimise the possibility of misrepresentation.

All information disclosed in financial statements must be organised and grouped in some logical manner.
Classification, arrangement and summarization of information should be done for the purpose of indicating similarity, dissimilarity, relative importance and inter-relationship among the data.

Disclosure should be made in the body of formal financial statements to the extent it is practical. If financial statements are unable to absorb essential information, they can be modified to include more data. To promote full understanding of users, disclosure can be made through supporting schedules and notes annexed to financial statements. There is a relation between the disclosure and information in financial statements and notes. If more disclosure is made in financial statements, less would be in the form of notes and vice-versa.

Significant information should be presented at a place in annual report which may not be overlooked easily. Due care should be taken in placing those items which are relevant and material and thus useful for making economic decision. Notes to the financial statements and related schedules represent a great potential for aiding full and fair disclosure of financial information.

No particular form of presenting the information is presumed better than others for all purposes, and thus, several forms are used.
Timing

Timely reporting is an essential element of adequate disclosure. The value of reported financial data for the decisions of investors depends upon its usefulness and timeliness. West\textsuperscript{10} argues that "timely disclosure is fundamental to good investor relations". A major consideration in timely disclosure is the responsibility to report promptly and accurately any corporate news which may materially affect value of the security or influence investors' decisions. Thus, it is amply clear from the above discussion that corporate annual report is a vital source of information which is available to company shareholders.

\textbf{II QUALITATIVE CHARACTERISTICS IN DISCLOSURE}

Information, that is reported to facilitate economic decisions, has several characteristics. Such attributes or characteristics make financial information useful. The qualitative objectives of disclosure are ethical goals of truth, justice and fairness that are generally accepted as desirable goals by society as a whole. However, these qualities are less abstract and they can be applied more directly to information in financial accounting. There are also "generalisations that require judgement in using them.

to evaluate and improve accounting principles". These attributes denote the quality of information and hence satisfy users' needs. These would help in achieving the concept of adequate disclosure in financial reporting.

These characteristics may be listed as follows:

01 Relevance
02 Materiality
03 Understandability
04 Comparability
05 Consistency
06 Reliability
07 Freedom from bias.

Relevance

Relevance is closely and directly related to the concept of useful information. Relevance implies that all those items of information should be reported that may aid the users in making economic decisions.

American Accounting Association defines relevance as "the primary standard and requires that information must bear upon or be usefully associated with actions it is designed to facilitate or results desired to be produced".

The committee set up by the American Accounting Association prepared a statement of Basic Accounting Theory and pointed out that none of the other recommended standards (verifiability, freedom from bias and quantifiability) has

this position of primacy. The Accounting Principles Board also holds 'relevance' as a primary qualitative objective of financial accounting information. Thus, both the authorities (AAA's Committee on Basic Accounting Theory and Accounting Principles Board) have listed 'relevance' as the most important characteristics. Shawayder also explains relevance as a characteristic of the property which should be considered by the user of information system. For example, the net income figure is a relevant statistic (a relevant property of the firm) to readers of the financial statements. Although relevance has been defined in accounting literature, yet no satisfactory set of relevant items of information has been suggested. In this regard, an important task is to determine the needs of users and the items of information should be relevant to attain the target of the user(s).

The question of relevance arises after identification of the purpose for which the information will be used. It means that information relevant for one purpose may not be necessarily relevant for other purposes. Information that is not relevant, is useless because that will not aid users in making decisions. Relevant information also reduces decision maker's uncertainty about future acts.

A necessary test of the relevance of reportable data is their ability to predict events of interest to statement users.

The objective of relevance helps in selecting items of information that will facilitate economic decision, especially the investment decisions of investors. In today's complex financial accounting environment, an all-purpose report attends the common needs of users so that information may be relevant to all users. In judging relevance of an all-purpose information, attention is focused on the common needs of users and specific needs of particular users will not be considered in this 'relevance' judgement.

It is difficult to prepare an all-purpose report which may command universal relevance. However, this has been recognised a potentially satisfactory solution.

Thus, relevance is the dominant criterion in making decision regarding information disclosure.

02 Materiality

According to Accounting Standard-I, it is required that financial statements should disclose all "material" items, i.e. all those items should be disclosed in annual report which are likely to influence the economic decisions of the users. Thus the concept of materiality implies that not all financial information should be disclosed in an annual report—only material information should be reported.

Thus materiality is that piece of financial information which is absolutely essential in the context of a decision to be made by the user. However, the materiality of an item depends not only upon its relative
size, but also upon its nature or combination or both, that is, on either quantitative and/or qualitative characteristic. It means that some items may be material although smaller in size or quantity.

Materiality involves the use of judgement. No generally accepted guidelines have been established for judging materiality. Basically, materiality judgements should relate to the significance of information and its impact on user's economic decisions. The effect on earning is the primary standard to evaluate materiality in a specific case. Still materiality decisions are highly subjective and the judgement of accountant is a strong factor in making a materiality decision. No single materiality criterion is appropriate or applicable to all situations.

It may be emphasized here that there is a need to establish more objective standards to judge materiality. Bernstein, a strong advocate of objectivity asserts "that we establish definite standards, which given similar circumstances, will help accountants to arrive at meaningfully similar conclusions regarding question of materiality". The Institute of Chartered Accountants of India has an important role to play in this regard. The institute can establish guidelines to help the accountant make his materiality decisions.

Relevance generally refers to the nature of the item with respect to specific or general uses of financial reports, while materiality refers to the significance of a specific item in a specific context. Materiality places a restriction on how much should be disclosed. That is, it determines an upper limit on the amount of information that companies can meaningfully disclose. Because of human limitations in information processing ability, it is argued that there is a point beyond which further disclosure only confuses the decision maker. However, it has yet not been able to specify where this critical point lies.

03 Understandability

Information in annual report should be presented in a way which can be understood by reasonably well-informed as well as by sophisticated users. Presenting information which can be understood only by sophisticated user and not by others, create a bias which is inconsistent with the standard of adequate disclosure. Presentation of information should not only facilitate understanding but also avoid wrong interpretation of financial statement. Thus, understandable financial accounting information presents data that can be understood by users of the information and is expressed in a form and with terminology adopted to the users' range of understanding.

The criterion of understandability requires that the users have some understanding of the economic activities
of the enterprise, the financial accounting process and technical terminology used in financial statement. (Understandability does not necessarily mean simplification of the data in annual reports, since there is a limit beyond which business complexities cannot be described in a simple way. This characteristic only requires that information be expressed as simply as permitted by the nature and circumstances of what is being communicated.)

In deciding understandability of the item of information, all relevant users' needs should be considered. That is, accounting information should not be limited to the interests of the average investor or sophisticated user but, in fact, information should be ordered and arrayed to serve a broad range of users.¹⁵

Comparability

Economic decisions require making choice among possible courses of actions. In making decisions, the user will make comparisons among alternatives facilitated by financial information. Comparability implies the reporting of like things in a similar fashion and unlike things reported differently. Primary objective of comparability should be to facilitate the making of predictions and financial decisions by creditors, investors and others.

Comparative financial accounting information presents similarities and differences that arise in the enterprise

or enterprises and their transactions and not merely from differences in financial accounting treatment. Information, if comparable, will assist the decision maker to determine relative financial strengths and weaknesses and prospects for the future, between two or more firms or between different periods in a single firm.

Financial reports are not able to achieve comparability because of differences in business operations of companies, management's viewpoint in respect of their transactions, and due to different accounting practices to describe basically similar activities. Two corporate managements may view the similar risk, uncertainty, benefit or sacrifice in different fashions and thus would lead to different implications of financial statements. With all information that facilitates interpretation, users are able to compare and assess the results of similar transactions and other events among enterprises.

Efforts, therefore, should be directed towards developing accounting standards to be applied in appropriate circumstances to facilitate comparison and interpretation of data. Areas of differences in accounting practices, which are not justified by differences in circumstances, should be narrowed.

Consistency

Consistency of a method over a period of time is a valuable adjunct to comparability. Consistency is an
important factor within a single enterprise. The qualitative standard of fair presentation in financial statements depend in part, on consistency of method. Although financial accounting practices and procedures are largely conventional, consistency in their use permits comparison over time. It is relatively unimportant to the investor what precise rules or conventions are adopted by a company in reporting its earnings, if he is assured that it is followed consistently from year to year. Lack of consistency produces lack of comparability.

In accounting, consistency has been used to refer to the use of same accounting procedures by a single firm or accounting entity from period to period, the use of similar measurement concepts and procedures for related items within the statement of a firm for a single period and the use of same procedures by different firms. If a change in procedure is made, disclosure of the change and its effects permits some comparability, although users can rarely make adjustments that make the data completely comparable.

Although consistency is an important criterion in making information disclosure decisions, it should not prove a bottleneck for bringing about improvements in accounting policies, practices and procedures. Users' needs may change over a time which would require a change in accounting objectives as well as in accounting standard
and methods. These improvements are needed to serve users' needs in changing circumstances. When it is found that current practices or presentation being followed are not fulfilling users' purposes, a new practice or procedure should be adopted. However, consistency is desirable, until a need arises to improve practices, policies and procedures.

06 Reliability

Reliability of financial information is an important characteristic. Reliable information is required to form judgements about the earning potential and financial position of a firm. Reliability differs from item to item. Some items of information presented in an annual report may be more reliable than others. For example, information regarding plant and machinery may be less reliable than certain information about current assets because of difference in uncertainty of realisation.

It is the responsibility of the management to report reliable information in annual reports. The goal of reliable information can be achieved by management if it applies generally accepted accounting principles, appropriate to the enterprise's circumstances, maintains proper and effective system of accounts and internal control and prepares adequate financial statements. If corporate managements decide to disclose uncertainties and assumptions in annual reports, they will increase the value of the information expressed therein.
There are many factors affecting the reliability of information. Possibility of error in measuring information and business events may create difficulty in attaining high degree of reliability. Thus, measurement constraints in accounting place restrictions on the accuracy and reliability of information. Adequate disclosure in annual reports however, requires that users should be informed about the data limitations and the magnitude of possible measurement errors. Non-disclosure of limitations attached with information will mislead the users. It can be mentioned here that the most reliable information may not be the most significant for users in making the economic decisions.

07 Freedom from Bias

As the purpose of information in an annual report is to serve the different users needs in decision-making process, there should be no purposeful bias in reporting i.e. for favouring any group. Information, free from bias, that is, objective and fair, would enhance the relevance of information to selected purposes and users. Freedom from bias means that facts have been impartially determined and reported. Objectivity in accounting as a quality which should exist when financial data are presented in a manner to establish connection between the events taking place in a given business entity and the mental image created in the user's mind about those events. Objectivity in financial presentations is attained by the individual
practitioners through the competent and ethical exercise of professional judgement in conjunction with reference points (procedure and principles) socially prescribed by the members of the profession as a corporate body.

Accounting information should not concentrate at a few users to the detriment of others who may have opposing interests. Information would be free from bias if financial statement representation in annual report have been made exactly according to transactions and events in the business enterprise. Complete reporting about business facts and situations, accounting practices followed, judgements and assumptions made and degree of uncertainty in transaction increases the objectivity and fairness of the information.

To sum up, the above mentioned characteristics (relevance, materiality, understandability and freedom from bias), make reportable information useful. Financial information that meets the above qualitative objectives also meets the reporting standard of adequate disclosure. They are based, "largely upon the needs of users of the statements". However, there are three constraints on full achievement of the qualitative characteristics:

i) Conflict of objectives;

ii) Environmental influences; and

iii) Lack of complete understanding of the objectives.

The pursuit of one characteristic may work against the other characteristics. It is difficult to design financial statements which may be relevant to user needs on the one hand and also free from bias towards any particular user group. The qualitative objectives should be arranged in terms of their relative importance. Desirable trade-off among them should be determined. In this way emphasis can be given to those objectives which deserve emphasis in information disclosure decision. About relevance, both preparers and users agree that it is the most important characteristic. However, both the parties are not in agreement over the relative significance of other qualitative objectives.

Some environmental factors such as difficulty in measuring business events, limitations of available data, users' diverse requirements affect accounting and thus put constraints on achieving objectives. Constraints also arise because users have different level of competence to handle large masses of data or to interpret summarised data in making prediction. Anticipated benefits from proposed changes in reportable information to achieve the qualitative objectives must be weighed against the additional cost involved. Thus, for improving disclosure in annual reports, a clear understanding of the nature of qualitative characteristics and their implications in corporate reporting is required.