CHAPTER - II
Theoretical Aspects of Financial Reporting

Introduction:

In today's world, financial strength is not enough to survive. The survival depends on the ability to adapt and shape up to challenges of ever changing conditions. One such thing is the firm's financial report.

It is the quality, reliability and objectivity of financial information, which stakeholders rely upon to make informed judgement and allocate resources efficiently has become the deciding factor. The demand for greater transparency and more effective financial reporting has placed renewed pressures on those preparing and attesting financial reports to comply with the accepted accounting standards and also ensure that these standards are properly applied.

The Institute of Chartered Accountants of India (ICAI), being the premier professional accounting body in India, plays a pivotal role in regulating the disclosure practices of the companies, both in the public and private sectors. It issues accounting standards, guidance notes and expert opinions and organizes a number of seminars, workshops and conferences on various dimensions of corporate disclosures. These standards encompass mechanisms for providing information about the financial condition, performance and importantly the risk profile of organizations to all potential users.
Meaning of Financial Reporting:

Before one delves into the meaning of financial reporting, one must consider the information value chain. First, business events create raw data; those data must then be organized into information to be useful. Information must be analyzed, then synthesized and managed so that it can be transformed into knowledge. And knowledge is the foundation of good decision-making. Figure 1 shows this value chain.

![Fig.1: Information value chain](image)

The term 'financial reporting' or 'corporate disclosure' connotes communication of accounting information of a corporate enterprise to its users. Financial reporting is not propaganda nor is it advertising. It is concerned with achieving a rapport or understanding between the organisation and its “public” who include share holders, analysts, employees, customers and the community. (01)

Financial reporting as defined by FASB, should provide information that is useful to present and potential investors and creditors and other users in making rational investments, credit and similar decisions.

The information should be comprehensible to those who have a reasonable understanding of business and economic activities and who are willing to study the information with reasonable diligence. Financial reporting depicts a clear picture of state of affairs in a logical manner as it could, to satisfy each and every user of financial statements.
Disclosure is a process of providing certain financial information to a wide variety of users, relevant to their data needs, concerning the performance of an entity. The extent of information disclosure, its adequacy, relevance and reliability are important characteristics of financial reporting practices prevalent in a country. So, in nutshell disclosure means to convey financial and non-financial information to various users that assist them in taking economic and financial decision of better quality.

Kohler's Dictionary for Accountants defines it as an explanation or exhibit attached to a financial statement or embodied in a report (e.g., Auditor's report) containing a fact, opinion or detail required or helpful in the interpretation of the statement of the report. It means the communication of material and relevant facts concerning financial positions and the results of the reporting concerns, to various users. The term disclosure has been used almost interchangeably with the word 'financial reporting' according to the author R.S. Agarwal. The word reporting is used when the person writing the same is offering his observations, which he is asked to comment.

When all the potential financial statement readers are equally treated, while disclosing the information, it is called 'Fair Disclosure'. When all relevant and all useful information is presented to all the potential users it is known as 'Full Disclosure'. Identifying the purpose of disclosure, needs of specific group of users, in sufficient quality, it is known as 'Adequate Disclosure'.

The general purpose of financial reporting & disclosure does not include all the relevant information for users. The specific purpose of financial reporting and disclosure satisfies particular needs of individual users. The multipurpose financial reporting and disclosure includes wide information for various user groups in a single set of information. It
includes all possible information for a wide range of users. Day by day the concept of disclosure is also changing. Now it does not mean disclosing immaterial, irrelevant and vague information.

Now emphasis is laid on the qualitative aspect of information which is relevant to informed investors for making economic decisions. The main reason for this emphasis is that full and complete disclosure is the corner stone to protect the rights of the stakeholders.

**Objectives of Financial Reporting:**

Financial reporting is not an end in itself but intended to provide information that is useful for making business and economic decisions. Financial reporting is affected by the economic, technological, legal, political and social environments in which businesses function.

The basic objective of financial reporting is to provide information useful to investors, creditors and other users in making sound investments decisions.

It includes not only financial statements but also other means of communicating information provided by the accounting system, that is, information about an enterprise’s resources, obligations, earnings, etc.

Financial reporting may, of course, provide information in addition to that specified by financial accounting standards, regulatory rules or custom.

In November 1978, the FASB of AICPA issued “Objectives of Financial Reporting by Business Enterprises” which laid down five objectives:

a) To provide information that is useful to investors, creditors and others in making rational decisions.
b) To assist investors and creditors in assessing future net cash flows of the enterprises in respect of amount, timing and uncertainty.

c) To identify entity resources (assets) and claims against resources, both, creditors (liabilities) and owners claims (owner equity).

d) To provide information about enterprise performance and earnings potentials.

e) To show how an enterprise obtains resources and how it uses them.

The objective of financial statements is to provide information about the financial position, the performance and the changes in financial position of an enterprise to enable a wide range of potential users in making economic decisions. In this way the main objective should always be not to present more information, but useful information. Attempt should be made to attain the quality of relevance, intelligibility, reliability and accountability. In essence, accounting information is not mere signal but communicator.

Necessity of Financial Reporting:

The presentation of corporate financial reporting has undergone vital changes from time to time. The micro and macro aspects of environmental forces have shaped the new face of corporate financial reporting in terms of issuing accounting standards and strengthening of corporate governance over corporations.

With the globalization of the Indian economy and the subsequent entry of Foreign Institutional Investors (FIIs), there has been a demand for disciplined financial reporting.

Accountants are simply measuring currently occurring events such as receipts, payments, purchases, sales using common - sense
methods and then reporting their results, using equally common - sense procedures for aggregating and classifying the data. (#8)

Preparing financial statements is not like a designing novel. It needs proper observation than generalization. Systematic structure of abstract propositions about the accounting world is an inevitable component of financial reporting practice.

The preparation of financial statements was carried out principally as a check on the accuracy of the book - keeping rather than to measure performance and position. (9)

The necessity for financial reporting arises to comply with the statutory requirements, public opinion and the logic of public accountability. The management as the trustee and custodian of public funds should make adequate corporate disclosures in an appropriate manner to investors, creditors, customers, the government and the public at a large. However, the accountability of government owned corporations is much greater because of the massive public money invested in them and the poor rates of return on investment.

The necessity of financial reporting is:

(a) For predicting, comparing and evaluating enterprise earning power.

(b) In judging management’s ability to utilize the resources effectively to achieve the primary goal of the enterprise.

(c) In providing information about the financial position, performance and changes in financial position of an enterprise.

(d) To show how an enterprise obtains resources and what it uses them for.

(e) Classifies assets and liabilities so as to delineate the
resource structure (assets) and financial structure (liabilities and ownership interest) of the entity. (10)
f) To enable the managers, for the purpose of accountability, to render a reliable amount of their activities to their owners.
g) To distinguish amounts that are affected in different ways by change in economic conditions or business activities.
h) To use accounting information to justify dividend payments linked to profitability and to liquidity.
i) To prepare segmental reports that disaggregate overall information covering the entity in its entirety into different areas of operation.

Though benefits from financial information are usually impossible to measure objectively as the information reflects the effects of transaction and events that have already occurred. The Financial Accounting Standards Board (FASB) of the AICPA has emphasized the practices of financial reporting. (11)

a) Financial reporting is useful to investors, creditors and others, in making rational decisions.
b) It assists investors & creditors in accessing future net cash flows to the enterprise performance and earning potential.
c) It shows how an enterprise obtains resources and uses them for.

Financial Reporting in SFCs in India:

SFCs were created as instruments of speedier economic development at the state level. They were developed just to bridge the
void created by development financial institutions (DFIs) at the national level. These DFIs met financial needs of larger and bigger enterprises leaving a large number of small and medium enterprises (SMEs) in the lurch. The SFCs were required just to meet the financial needs of these SMEs. The SFCs were promoted as state owned enterprises with the State being both a shareholder and lender.

The agencies became lenders of seed capital and other fixed capital requirements of SMEs and other tiny organisations.

Being State owned and established under a specific act, the disclosure practices of SFCs suffered from several limitations. The disclosures were done mechanically in pursuant to SFCs Act, 1951 and State Government guidelines. The principles of sound reporting were followed in contempt.

The disclosure of information in annual reports by the SFCs in India is less adequate and less investor oriented. Most of the SFCs publish what is minimum and in some cases even violate the provisions. But a few progressive SFCs like APSFC, DFC, UPFC, WBFC and so on are ahead of the law and have paved the way to progress for other SFCs. These SFCs provide the maximum information in an easily and readily intelligible form through schedules, charts and supplementary statements.

SFCs, now-a-day, are adopting “Virtual Reality” technique. This technique is sweeping aside traditional design, development and marketing tools because of its unrivaled capacity to convert complex data into easily understood images. Engineers no longer struggle to communicate ideas to their customers. The new visual language communicates to all people at all levels and has become a meeting place for the accountants, engineers and customers.
Rapid advance in graphics power and projection systems enable highly realistic walk through models to be viewed on personal computers or displayed larger than life at key presentations. The VR project will show the potential investor the total finished concept in a photorealistic detail. The VR centre will, through the internet, allow the concept to be viewed from anywhere in the world.

In the liberalized world, transparency of information and good corporate governance are the best policies. The traditional financial reporting model, developed during the industrial age, is no longer relevant in the information age. Disclosure of information through published annual reports play an important role in the efficient allocation of limited sources of SFCs. Financial disclosure, in fact, a subject of the communication component of accounting, helps in making the accounts transparent. It is considered to be the chief means of reducing uncertainty under which external users make decisions.

Users of financial statements are the best judges of their own needs. Users will ask for all the items with which they are familiar. Any particular study will, of course, identify a few items at the top the ranking but there is no solid basis for believing that the same items would be chosen by different group of users or by the same group at different time. Financial disclosures of SFCs are useful on account of the following users:

A. Employees:

Financial reporting by SFCs is significant from the point of view of employees:

a) To determine profitability of organization
b) To negotiate with the management regarding bonus, wages, etc.
c) To assess risk and growth potentials of SFCs along with job security, future promotional possibilities, etc.

B. Share Holders:

Financial reporting by SFCs is underlined from the point of view of share holders as below:

- To evaluate the ability of SFCs to take advantage of new business opportunities that may arise.
- To fulfill financial obligations of SFCs.
- To assess the ability of SFCs in making efficient & effective use of cash & equivalent resources.
- To know the plans of management for the future with the help of funds flow statement prepared by SFCs.
- To evaluate the ability of SFCs to meet the unexpected future obligations with the help of cash flow information.
- Pattern of shareholding to the level envisaged under the scheme of the SFCs Act would prompt these shareholders to take closer interest in SFCs, thereby changing qualitatively the Board functioning and nature of SFC’s accountability.
- To generate adequate cash flows.

C. Investors/Creditors / Lenders:

Financial reporting by SFCs carries more weight in the eyes of investors and creditors:

- Analysis of financial statement serves as a preliminary tool in the selection of investments from the point view of prospects, payments and protection.
Financial reporting provides information to investors, creditors and others to assess the amount, timing and uncertainty of prospective net cash inflows of SFCs. Cash receipts from interest on loans, etc., are to be assessed to meet its obligations when due to reinvest in operations.

It helps to assess the risk of the amounts or timing of the receipts that may differ from expectations.

Earnings information helps to evaluate management’s performance to estimate ‘earning power’, to predict future earnings, to assess the risk of investing in or lending to an SFC, etc. They may use information to conform, reassure themselves about or reject or change earlier predictions of assessments.

Financial reporting provides information about how an SFC obtains and spends cash, about its borrowings and repayment of borrowings and about other factors that may affect SFC’s liquidity or solvency. In evaluating the financial activities, assessing liquidity or solvency, financial reporting is more useful. (12)

Information about growth in the field of industrialization encourages the investors to build confidence and interest, among the investors in stimulating the development of capital market, etc.

It is useful in knowing the working of number of branches opened, staff appointed, etc.

It is useful in computing different financial ratios.
D. Managerial Point of View:

Management knows more about the SFC and its affairs than investors, creditors or other ‘outsiders’ and increase the usefulness of financial information by identifying the areas. The role of financial reporting is significant as it helps the managers and other responsible officers.

The practice of financial reporting provides different documents to evaluate the positions of the entity:

- It provides information about how management of SFC has discharged its responsibility to stakeholders for the use of resources entrusted.
- Financial reporting helps to know the role of management in the custody and safe keeping of SFC and also in the efficient and profitable use.
- Performance of an SFC is reflected and financial reporting reveals the efficiency of management.
- Financial reporting by SFCs helps the managers to take several vital and tactical decisions.

Financial reporting by SFCs is more important as it provides information about the financial position, the performance and the changes in financial position of SFCs, which is useful to a wide range of potential users in making economic decisions. IFRS (International Financial Reporting Standards), previously, known as International Accounting Standards clearly states that goal of financial reporting is “to create comparable, reliable and transparent financial statements that will facilitate greater cross border capital raising and trade”. (13)
Financial reporting by SFCs carries more importance as it achieves the following: (14)

- Complying with the statutory obligations.
- Putting before the interested parties, a record of the activities & achievements of SFCs for the period under review.
- Announcing clearly the policies and programmes of SFC.
- Indicating, in absolute term, the efficiency and skill with which the SFC has been working.
- Making the accounting (rule based) less cumbersome, transparent & consistent.
- Satisfying the informational needs of all parties interested.
- Identifying the areas of decision-making.
- Making the decision concerning the use of limited resources.
- Serving the various users of financial statements of SFCs like shareholders, creditors, government, management and others.

**Developments in Financial Reporting by SFCs:**

The Financial reporting by SFCs has improved tremendously since the turn of this century. Disclosure of informations through published annual reports plays an important role in the efficient allocation of limited resources of a country. It helps in making the accounts transparent. (15)

Design awareness has increasingly led SFCs to turn to illustrative material to make their reports more attractive and readable. Several SFCs provide a glossary of financial terms. Special purpose reports are sent not only to shareholders but also to analysts & employees. Use of graphic illustration & narrative explanation are made
by SFCs. Number and type of shareholders and the size of their holdings are included in the Financial reporting made by SFCs.

Provisions as per SFCs Act (Amendment) 6th Sept 2000:

The State Financial corporations Act (SFCs Act) was enacted by Parliament in 1951 to set up the institutional framework for financing medium and small scale industries in the states. SFCs (Amendment) Act 2000 came into force with effect from 6th Sept 2000. The State Financial Corporations were set up in the States in 1950s and early 1960s with the objective of promoting economic growth, encouraging balanced regional development and widening of entrepreneurial base by financing small and medium enterprises. The State Financial Corporations have been functioning for more than five decades in the country.

The SFCs Act had been under constant review and based upon the recommendations of several working groups / committees, set up from time to time, the SFCs Act was amended on ten occasions. The SFCs (Amendment) Act, 2000 had come into force with effect from 6th September 2000.

There was an imperative need to improve restricted provisions in the SFCs Act so that SFCs may be able to enjoy operational flexibility and functional autonomy. The major provisions of SFCs Act relating to accounts and audit are as follows:

- Clause 26 proposes to amend Sec. 37-A of the Act relating to inspection. As per the existing provisions the Development Bank with the approval of the Central Government and on being directed so to do by that government, shall cause an inspection of the working of any financial corporation of its books of accounts.
It is proposed to confer such power on the Small Industries Bank in place of Development Bank;

- It is proposed to confer powers upon the Board in respect of the form and manner in which balance-sheet and the accounts of the financial corporation shall be prepared; the maintenance of register of shareholders, particulars to be entered in such register, the safeguards to be observed in maintenance of the particulars of shareholders on computer floppies and diskettes, compact discs or any other electronic form, inspection and closure of register of shareholders;

- Under the existing provisions of the SFCs Act, SFCs are enjoined to keep their surplus funds in the form of deposits with SBI/RBI or to invest the same in Central/State Government securities;

- Every financial corporation shall have its own fund and all receipts of the financial corporation shall be carried there to and all payments by the corporation shall be made there from. All the money belonging to the fund shall be deposited in the Reserve Bank (or the State Bank of India or a subsidiary bank as defined in the State Bank of India Act 1959);

- The financial corporation may establish a special reserve fund, to which shall be transferred such portion of the dividend accruing to the Small Industries Bank on the shares of the financial corporation as may be fixed by agreement between the State Government, Development Bank and other Small Industries Bank;

- The financial corporation may invest its funds in accordance with applicable guidelines and prudential norms as may be prescribed and in such securities as the Board may decide from time to time;
• Annual general meeting shall be held annually, within the annual accounts of the financial corporation are closed, at a place, in a state where there is an office of the financial corporation;

• Audit - The accounts of the financial corporation shall be audited by auditors, duly qualified to act as the auditor under subsection (1) of section 226 of companies Act 1956; who shall be appointed by the financial corporation in annual general meeting of share holders out of the panel of auditors approved by the Reserve Bank of India for such terms and on such remuneration as the Reserve Bank may fix;

• Every auditor shall be supplied with a copy of annual balance sheet of the financial corporation and it shall be his duty to examine it together with the accounts and vouchers relating there to;

• The auditors shall make a report to the share holders on the annual balance sheet and accounts and in every such report they shall state whether in their opinion the balance sheet is a full and fair balance and properly drawn up so as to exhibit a true and correct view of the affairs of the State Financial Corporation;

• The State government may in consultation with Comptroller and Auditor General of India, at any time, issue directions to the auditors requiring them to report on the adequacy of measures taken by the financial corporation for the protection of its share holders and creditors or on the sufficiency of their procedure in auditing the affairs of the financial corporation and may enlarge or extend the scope of the audit or direct that different procedure in audit be adopted or direct that an examination be made by the auditors, if in its public interest so requires;
• The financial corporation shall send a copy of every report of the auditors to the Comptroller and Auditor General of India at least one month before it is placed before the share holders;

• Every audit report under subsection (6) shall be forwarded to the State Government and the Government shall cause the same to be laid before the Legislature of the State;

• Returns - The financial corporation shall furnish the statements and returns from time to time in required format, to the State Government, the Small Industries Bank, or the Reserve Bank; (16)

• The financial corporation shall furnish to the State Government, the Small Industries Bank and the Reserve Bank within four months of the close of each financial year, a statement in the prescribed form, the assets and liabilities at the close of the year, the auditors report and a report of the working of the financial corporation during the year and copies of the said statement, account and reports shall be published in the Official Gazette and shall also be laid before the legislative of the state;

Committee Recommendations:

From time to time, the Central Government, State Governments, IDBI, RBI, SIDBI, etc., have taken steps to improve the reporting practices of SFCs. Several committees have been constituted to improve upon the reporting practices of SFCs. The recommendations of many such committees were included in the SFCs Amendment Act, 2000. Committees were set-up to improve the reporting practices of banks, insurance companies, mutual funds, etc. Far – reaching recommendations were made by the Narasimhan Committee in 1991.
An attempt has been made to review the recommendations made by the important committees:

a) The Sachar Committee (Aug 1978)
b) Dr. Dave Committee (1984)
c) The Bureau of Public Enterprises (June 1986)
d) Dr. K. U. Mada Committee (Aug 1991)
e) The Narasimhan Committee (1991)
f) Jenkins Committee (1994)
g) Kapoor Committee (1998)
h) Khan Working Group Committee (24 April 1998)
i) G. P. Gupta Committee (30 Jan 2001)

a) The Sachar Committee (Aug 1978):

A High Powered Expert Committee on Companies and MRTP Acts, popularly known as Sachar Committee was appointed in August 1978. The committee has given certain suggestions for improving the disclosure of information in balance sheet, profit & loss account and the director's report, so that the annual report may provide useful information to the share holders and other users.

The committee has recommended that the balance sheet and profit & loss account should be prepared in vertical form and suggested a form for preparing balance sheet.\(^{(17)}\)

It is essential that the financial reporting of public enterprises should indicate the extent to which the enterprise is mindful of its social and moral responsibilities to consumers, employees, share holders and the government at large.

The Sachar Committee has suggested that director's report should indicate and quantify as precisely and clearly as possible the
various activities which have been carried out in the accounting year. The committee emphasized the objectives of a business should be the proper utilization of resources. Profit should not be the primary purpose for existence of the enterprise.

**Recommendations (Sachar Committee):**

1. Financial reports should state as to balanced regional development, provision of infrastructure facilities for the growth of the country’s economy, employment generation, etc.
2. They should highlight the economic and social benefits which have been rendered by the enterprises to the people of the region.
3. They should give a brief note on the welfare measures to their employees and also the amount spent on welfare per employee.
4. Graphs and diagrams should be used to show the trends of profitability, amount sanctioned, recovered, etc.
5. The auditors’ report should highlight in brief the ‘system of internal check and internal financial control’ along with necessary comments and suggestions for their improvement.
6. The financial reporting should also include a brief narration of the future policies and programs of the enterprise.

The above committee has given general recommendations. But item wise disclosure to be made, is not highlighted. Separation between financial and non-financial data is not emphasized.

**b) Dr. Dave Committee (1984):**

The IDBI appointed in 1984, a committee under the chairmanship of Dr.S.A.Dave, Executive Director of IDBI, to examine the financial structure and working of State Financial Corporations
(SFCs) and to suggest measures for strengthening their financial position.

The committee made specific recommendations for an appropriate resource mix, including the raising of resources, reducing arrears, developing a balanced portfolio through diversification into short / medium term financing, speedier utilization of special capital and upgrading of skills of personnel of SFCs.

IDBI accepted the recommendations and took the follow up measures for implementation. (19)

As a result of the Dave committee recommendations, RBI has given larger allocation of bond quotas to SFCs to enable them to mobilize a larger part of their requirements to improve their medium-term liquidity position.

c) The Bureau of Public Enterprises (BPE - June 1986):

The Bureau of Public Enterprises prescribes disclosure of additional information by the Central Public Enterprises (CPE) in their annual reports. BPE constituted a committee in June 1986 under the chairmanship of Mr. K. V. Ramkrishnan to review the accounting policies for these enterprises. After going into the details of various accounting standards, guidance notes and statements issued by ICAI, the committee has recommended the adoption of the accounting standards and guidance notes on specific topics, subject to certain additions and amplifications, which are necessary to be made in case of Central Public Enterprises. (20)

It is inevitable that the annual reports of public enterprises should be more informative with a view to bring out their salient features relating to their working and performance.
In this connection, the Bureau of Public Enterprises has laid down some guidelines, which should find a place in the annual reports of the enterprises.

The guidelines are:

1. A summary of financial results indicating the annual turnover, profit after depreciation and interest but before tax, provision for taxation, net profits, appropriations to reserves and provisions, proposed dividends, etc.
2. Information about the changes in the capital structure.
3. Important changes in pricing policy.
4. Changes in accounting methods, e.g. changes in the methods of depreciation, valuation of inventories etc.
5. Main events which have influenced the production or profitability of the company under report and outlook for the forthcoming years.
7. Export achievements or foreign exchange earnings together with future outlook.
8. Any significant achievements in import substitution / development of new products, etc.
9. Employer-employee relation, strikes, lock-outs, incentives schemes, training, etc.
10. Staff welfare activities, township, education, health facilities etc.
11. New projects or expansions, contemplated to increase or diversify the production and progress of the concern made so far.
The SFCs, being public enterprises, are expected to adopt these
guidelines in their financial disclosure practices.

d) Dr. K. U. Mada Committee (Aug 1991):

A Committee, under the chairmanship of Dr.K.U.Mada,
Executive Director, IDBI, was constituted in the year 1990 to review the
recommendations of the Dave Committee with particular reference to
resources-mix, shareholding pattern and other issues covering the whole
gamut of working of SFCs. (22)

Keeping in view the foregoing and also the emerging scenario
for the financial sector, the Mada Committee felt it necessary to review
the role and position of SFCs and to frame ground rules for improving
their viability to measure upto the international standards. The
committee noted that presently SFCs provide only term finance whereas
the international trend is towards single institution providing all the
facilities.

More important, SFCs will be under pressure to do away with
their dependence on protected funds and one could even visualize a
scenario where SFCs constitution would under go a change making
them independent business entities with possible privatization.

Recommendations - (Dr.K.U.Mada Committee):

1. The Board of Directors of SFCs should adopt and disclose
accounting policy statement, drawn in consultation with the apex
institutions and the State Governments (Chapter VI- para 2.1-
Mada Committee Report).
2. IDBI / SIDBI should assist SFCs in formulating accounting
policies and standardize the presentation of financial statement
and data by SFCs in conformity with the provisions of International Accounting Standard (IAS 30) (Chapter VI- para-5.1 -Mada Committee Report)

3. The practice of applying regulations of the Bureau of Public Enterprises (BPE) to SFCs should be discontinued. (Chapter VIII-para - 8 - Mada Committee Report).

3. The state level institutions (SFCs / SIDCs) should be brought within the ambit of the proposed legislation to set up special tribunals to deal exclusively with recoveries of the dues of institutions and banks. (Chapter IX - para14 - Mada Committee Report).

The Mada Committee recommended the following prudential norms and regulations as relevant for SFCs:

A] Balance sheet - Assets classification as standard, sub-standard, doubtful and loss assets should be made. Capital adequacy ratio calculations and asset-liability management should be emphasized.

B] Profit and Loss Account - Earning and income recognition, provision for bad and doubtful debt items should be distinctively shown. (23)

C] Operating aspects - Lending policies, exposure limits, recoveries, over dues, return on equity capital, administrative costs, etc., should be shown.

D] SFCs would have to equip themselves to face a situation where they have to mobilize resources in the capital market because of increasing liberalization and competition.

E] Accounting policies and standards would also have to confirm to the international standards.
The Mada Committee deliberated on the merits and demerits of the cash system vis-a-vis the mercantile system. SFCs should, over a period of time, fall in line with the practice followed by All India Financial Institutions and Banks. The committee recommended achieving greater degree of transparency in accounts and accounting policies. The committee also considered the provisions of the International Accounting Standards (IAS - 30) concerning disclosures in financial statements by banks and similar financial institutions.

The present format of balance sheet used by SFCs, broadly meets the requirements of the Mada Committee. The SFCs, especially the weaker ones, should be encouraged and assisted by IDBI in undertaking organizational reviews and restructuring, human resource development and strengthening of internal information systems.

At national level though financial reporting and disclosure practice is significant, much importance is not individually given in the report of above committee.

e) The Narasimhan Committee (1991):

The above committee was appointed by RBI in the year 1991 which made important recommendations with regard to treatment of income (Interest Received), asset classification, provisioning and capital adequacy, that have affected the State Financial corporations most. (24)

The major recommendations of Narasimhan Committee as to state level institutions (SLIs) are shown below:

a. Merger of SFCs, SIDCs and SSIDCs in each state into a single entity.
b. Strong SFCs to go public with State Government holdings gradually brought down to 50%.

c. Transfer of present share holdings of IDBI in SLIs to SIDBI.

d. Ownership of SIDBI to be transferred to RBI / Government on the same lines as NABARD.

e. There is a need to develop information and control system in several areas like better tracking of spreads, costs and NPAs for higher profitability, accurate and timely information for a strategic decision to identify and promote profitable products and customers, risk and asset liability management; and efficiency treasury management.

The Narasimhan Committee was appointed for banking sector reforms and for harmonizing the role and operations of DFIs and banks. Therefore recommendations as to financial reporting and disclosure practices were silent.\(^{(25)}\)

f) Jenkins Committee (AICPA’s Special Committee) (1994):

It is an international committee set up by FASB, USA in 1991. The committee was chaired by Ed. Jenkins, who later became chairman of the US Financial Accounting Standards Board. The committee prepared the report called “Improving Business Reporting - A Customer Focus”.\(^{(26)}\)

The AICPA first published the concept behind the now popular “Jenkins Report” in the year 1994. The Jenkins report describes investor information needs that go far beyond what is required by the traditional financial reporting model and includes non-financial information.
In February 1997, AICPA executive leaders and AICPA members with backgrounds in international matters met to discuss ways to better coordinate the AICPA's involvement with international standards setting and other international leadership activities and to develop a plan to position the AICPA to play a more influential role in the international standards-setting and policy-making arenas.

The current financial reporting model provides only limited disclosures relevant to understand risks and uncertainties. AICPA's special committee known as Jenkin's Committee submitted the comprehensive report on financial reporting to facilitate capital allocation decisions, to improve business-reporting model (27)

**Status and Role of AICPA:**

The role and influence of the AICPA is significantly understood through the efforts in the following four areas;

- International accounting standards
- International auditing and assurance standards
- International ethics standards and
- Assuring the quality of global practice.

The AICPA continues to provide valuable authoritative guidance, explanation, and clarification to its members and other financial statement preparers in specialized industries in the US and around the world. AICPA developed educational materials and financial reporting tools that are available on a worldwide basis. AICPA reporting model has been gaining value by:

a. Communicating the total picture with clarity and objectivity
b. Translating complex information into critical knowledge
c. Anticipating and creating opportunities and
d. Designing pathways that transform vision into reality.

Committee Report - Use in SFCs:

It is believed that strong international standards in accounting, auditing and assurance, ethics, and quality control, together with a strong foundation in education and training, constitute the bedrock of the profession on which new products and services can be built. An attempt is made to study the recommendations of AICPA and their impact on the reporting practices of SFC.

AICPA has identified materiality with information that is significant enough to affect evaluation or decisions. This item of materiality has helped the SFCs to determine the information to be presented in the financial statements.

AICPA has recognized the significance or relevance in corporate disclosure practices, which is the primary qualitative objective of financial accounting information. This item has influenced the SFCs to present only the relevant information in the annual reports.

AICPA has observed that an objective of financial statements is to report on the activities of the enterprise affecting the society and the activities that are important to the role of enterprise in its social environment.

AICPA argued that timeliness is or should be one of the qualitative objectives of accounting. This influences SFCs to make information available when it is needed and to enable future actions.

The item of consistency is underlined in AICPA report. Consistency makes the information comparable and thus helps the readers of the financial statements, of SFCs, in deriving important information for decision-making.
Thus, AICPA helps the SFCs to raise the level of information internationally without lowering it domestically.

The recommendations are as below:

1. To provide information with a forward-looking perspective, including management’s plans, opportunities, risks and measurement of uncertainties.
2. To focus more on the factors that create longer value, including non-financial measures indicating how key business processes are performing. (AICPA, 1994, 5)

In the international environment, changes in the dynamics of global capital flows have augmented the demand for the comparability in financial reporting among companies in different countries. Many recent reports, articles and studies conclude that cooperation between national and international accounting standard setters is necessary to facilitate the increasing number of cross-border transactions by the providers and seekers of capital.

A report recently issued by AICPA special committee on financial reporting recommends that US standard setters and regulators should continue to work with their non-US counterparts and International Accounting Standards. (28)

The AICPA special committee developed its model of business reporting as below:

I. Financial and Non-Financial Data
   a. Financial statements and related disclosures
   b. High level operating data and performance measurements that Management uses to manage the business.
II. Management’s Analysis of Financial and Non-Financial Data
   a. Reasons for changes in the financial, operating and performance related data and the identity and past effect of key trends.

III. Forward Looking Information
   a. Opportunities and risks, including those resulting from key trends.
   b. Management’s plans including critical success factors.
   c. Comparison of actual business performance to previously disclosed opportunities, risks and management’s plan.

IV. Information about Management and Shareholders
   a. Directors, management, compensation, major shareholders and transactions and relationships among related parties.

V. Background about the Company
   a. Broad objectives and strategies
   b. Scope and description of business and properties
   c. Impact of industry structure on the company.

**g) Kapoor Committee (1998):**

This committee was appointed in the year 1998. Majority of SFCs were plagued by low recoveries, indifferent management and political interference. Even though the managing directors are to be appointed by the respective State Governments in consultation with IDBI, yet this consultation rarely takes place before the appointment is made.

As a result, appointment of MDs without considering their background, etc., and their frequent transfers played havoc with the management of these corporations. (29)
Kapoor Committee passed the recommendations as to the organizational setup of SFCs. In the report of the committee, importance was not given to financial reporting and disclosures. Specifically, the observations of the Kapoor Committee were on SSIs only.

**h) Khan Working Group Committee (24 April 1998):**

A high level committee under the chairmanship of the then CMD of IDBI Shri S.H. Khan was constituted in October 1993, to undertake a comprehensive review of the SFCs Act, 1951 and to suggest amendments to the Act. The committee submitted its report to the Ministry of Finance, Government of India, through IDBI in June 1994, for further follow-up. The report of Khan Working Group was submitted to RBI on 24th April 1998.\(^{(30)}\)

The Ministry of Finance, Government of India, had taken almost six years to process the recommendations of the above committee and carry out desired amendments of the SFCs Act.

According to the Khan Committee, the chief executives of State Level Institutions should be professionals / technocrats and be appointed by the Board and share holders for a fixed term to whom one should be accountable for the performance.\(^{(31)}\)

The Khan Working Group recommended for the merger of SFCs, SIDCs and SSIDCs (State Small Industries Development Corporations). While SFCs and SIDCs are largely covered by IDBI’s refinance scheme, SSIDCs are not financial institutions in any sense of the term.

The observations of the Khan Working Group were on harmonizing the role and operations of DFIs and Banks only and did not say anything with regard to financial reporting of SFCs.
i) G. P. Gupta Committee (30 Jan 2001):

The Ministry of Finance (Banking Division), constituted a committee under the chairmanship of Shri.G.P.Gupta, the then chairman and MD, IDBI in 2000, to look into the functioning of SFCs and make recommendations for their restructuring and revitalization.\(^{(32)}\)

The committee submitted its report to Ministry of Finance on 30\(^{th}\) January 2001. The committee recommended sharing of recapitalization costs of SFCs by all stakeholders.\(^{(33)}\)

It also recommended the Government of India and RBI, both, in lending a helping hand in restructuring the SFCs without giving any impression to other intermediaries in the financial sector of encouraging a financial profligacy.

The recommendations for restructuring of SFCs taking into consideration the dimensions of (1) Operational (2) Managerial (3) Organizational (4) Human Resource (5) Financial strategies.

It is noted that some of SFCs are not adopting uniform accounting standards. Although the report of the Gupta Committee was submitted to the Government of India in January 2001, no decision so far has been taken on the implementation of the recommendations particularly the one relating to recapitalization of SFCs. Even Gupta Committee failed to highlight the significance of financial reporting and disclosure practices to be followed by SFCs.

Committees Recommendations - A comparative study

Table 2.01 gives a comparative picture of recommendations of various committees and the extent of changes in SFCs Act:
**Table - 2.01**  
Item – wise Disclosure  
A Comparative Study

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<td>1</td>
<td>Re-Capitalization</td>
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<td>2</td>
<td>Restructuring of SFCs</td>
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<td>3</td>
<td>Resource raising strategy</td>
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<td>4</td>
<td>Operational issues:</td>
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<td></td>
<td>a) Loan assistance to SSIs</td>
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<td>b) Redesigning business processes</td>
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<td>c) Supplementary &amp; complementary role of SIDBI</td>
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<td>5</td>
<td>Management and good governance</td>
<td>Recommended</td>
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<td>* M/D Appointent</td>
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<td>* Nominees from SIDBI, Financial Institutions &amp; Banks</td>
<td>Recommended</td>
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<td>* Appointment of professional as Executive -Director</td>
<td>Recommended</td>
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<td>6</td>
<td>Organization &amp; Management Information System:</td>
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<td>* Merger</td>
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<td>* Rationalization</td>
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<td>* Computerization on ongoing basis</td>
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<td>7</td>
<td>NPAs and their containment Disclosures:</td>
<td>Recommended</td>
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<td>a) Expedite recovery of NPAs</td>
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<td>b) Quality of addition of new asset - monitoring</td>
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<td>Financial cost related issues:</td>
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<td>a) Cash mgmt - Huge closing balance is waste</td>
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<td>b) Asset Liability Management</td>
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<td>9</td>
<td>General disclosures -</td>
<td>Recommended</td>
<td>Recommended</td>
<td>Not Recommended</td>
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<td>SFCs should consider desisting from:</td>
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<td></td>
<td>a) Expanding branches &amp; appointing non-professional staff without considering their impact on operations</td>
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<td>b) Depending on cheap resources, the channels of which are drying-up, etc.,</td>
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<td>c) Creating unduly mismatches between their Assets &amp; Liabilities</td>
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<td>d) Introducing new products without considering impact on overall profitability</td>
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<td>e) Large scale concentration in a few industries</td>
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Source - Compilation of Items -  
* Report the of Mada Committee to review the Operations and Resource - Mix
International Accounting Standards (IAS 30):

The accounting policies and systems of SFCs would require a review to achieve a greater degree of transparency in accounts. During the discussions and deliberations, Dr. K.U. Mada Committee considered the provisions of the International Accounting Standards (IAS 30) concerning disclosures in financial statements by banks and similar financial institutions (FIs), which are supplementary to the fundamental accounting assumptions and other international accounting standards. It was felt that certain requirements of IAS 30 could be considered as being applicable to SFCs as follows: (34)

A] Accounting Policies:

IAS 30 requires accounting policies to understand the basis on which the financial statements are prepared. All the dealings of the business of the financial institutions should be laid down in clear-cut terms. The methods used by entities to apply accounting standards or account for transactions or other events where there is no applicable standard (that is, accounting policies) should be disclosed. In view of this, the Board of Directors of SFCs should adopt and disclose an accounting policy statement, drawn up in consultation with the apex institutions and the state governments.

The policy statements should cover the following areas:

- Principles governing recognition of the main items of income.
- Treatment of interest, including compound and penal, fallen due but not received.
- Valuation of investments.
o Basis for classification of assets (loan/investment portfolio) i.e. health code analysis.

o Basis for determination of write offs / provisions towards possible loan losses.

o Determination of the collectible demand (both principal and interest) for the year and of recoveries there on.

o Rationale for rescheduling of loans, interest funding and waiver of charges.

o Treatment of valuation of assets taken over under Section 29 of the SFCs Act, 1951.

o Treatment of expenses on assets taken over.

o Treatment of convertible loans/loans-in-lieu of capital.

o Treatment of balance sheet items.

o Treatment of dividend.

o Basis for asset valuation and depreciation, and

o Such other aspects as the auditors of the SFC might suggest.

B) Income Statement:

As regards income statement IAS 30 requires that:

a) FIs should present an income statement with groups of income and expenses by nature and disclose the amounts under principle type of income and expenses.

b) Income and expense items should not be offset unless legal right of set-off exists.

c) Provision for bad and doubtful debts should be made in line with the clearly formulated accounting policy specifying timing and basis on which uncollected loans and advances are recognized
as bad or doubtful debts as also the basis for provisioning for possible loan losses.

d) Management of financial institutions should provide separately commentary on average interest rates, average interest-earning assets and interest-bearing liabilities for the period under review so that better understanding of the composition and reasons for changes in net income are available.

e) Management of the state financial institutions should also disclose the extent of assistance by way of deposits, credit facilities and capital available from various agencies of rates substantially below market rates and its impact on the net income.

While aspects (a) and (b) above are broadly taken care of the present accounting format and system of SFCs. SFCs would have to pay special attention to items (c), (d) and (e) above.

As regards (c), SFCs should assess the amounts required to be provided annually towards write-offs and provisions for bad and doubtful debts. This assessment should be in line with the accounting policies approved by the Board of Directors and confirming to the prudential requirements. The amount of such provisions, write-offs which cannot be made during the year should be reported separately to the State Governments and apex institutions. Also, disclosure be made of the extent of exposure in loans and advances due in future periods which have been classified as doubtful. Movement in the provisions accounts, including the amount previously provided and recovered during the period under review and credited to the provision accounts, should be shown separately in the annual accounts.
As regards interest receipts and interest expenses, SFCs should provide separately.

I. Interest Income:
   a. Interest rate-wise break-down of outstanding assistance;
   b. Make specific mention of any concessional assistance schemes operated by it at the instance of the State Government;
   c. Age-wise analysis of overdue-affected portfolio, giving overdues of one year or more with details of principal and interest (including compound and penal interest) in arrears; and
   d. Collectible demand relating to the period under review and prior periods and amount collected there against;

II. Interest & Other Payments:
   a. Break-down of outstanding refinance, interest rate-wise;
   b. Interest rate-wise, break-down of bonds, other borrowings and deposits;
   c. Break-down of loan-in-lieu-of-capital, interest rate-wise; and
   d. Break-down of paid-up share capital including advance on share capital at varying dividend rates.

To start with, such information should be given to apex institutions and State Governments and after year or two they should be incorporated in the annual accounts.

C] Balance Sheet:

As regards balance sheet, the International Accounting Standard requires that:
i) Financial institutions should present balance sheet by grouping assets and liabilities by their nature and list them in an order that reflects their relative liquidity and their most likely maturities;

ii) The current and non-current assets and liabilities should be shown separately where applicable;

iii) The amount of any assets or liabilities as stated in the balance sheet should not be offset by deduction of another liability or asset unless legal right of set-off exists;

iv) Off balance sheet contingences and commitments if any should be clearly specified;

v) Concentration of assets and liabilities and off balance sheet items should be brought out;

vi) An analysis of assets and liabilities by relevant maturity periods should be provided for and commented upon;

It is seen that the present format of balance sheet used by SFCs broadly meets the requirements at (i), (iii) and (iv) above. As regards (ii) the assets and liabilities due within one year should be disclosed as current assets and liabilities. In respect of item (iv) above the nature and amount of commitments to extend credit that are irrevocable should be quantified. As regards (v), SFCs should give separately break-down of their outstanding assistance on an industry wise, size-wise, district-wise and scheme-wise basis.

Keeping in view the foregoing, the Mada Committee recommends that IDBI /SIDBI should assist SFCs in formulating accounting policies and in standardizing the presentations of financial statements and data by SFCs in conformity with the above provisions of
IAS 30. These should be made uniformly applicable to all the SFCs to enable meaningful comparison of performance of data. The management of SFCs should also cover these issues in their policy statement. Also the implementation and subsequent adherence to the policies formulated and the presentation standards by SFCs should be monitored stringently.

The feasibility of SFCs shifting to the mercantile system of accounting, introducing long term audit in regard to their loanees above a certain cut off limit, etc., should also be explored. The long term audit reports could be submitted for the confidential information of SFCs, State Governments and apex institutions.

**A comparative study of Western Countries requirements and SFCs in India:**

From the 1960s onwards, the focus moved to users’ needs and the provision of information to enable users to take economic decisions.\(^{(35)}\)

In the USA, in the wake of the stock market crash of 1929 and the great depression, efforts were made to examine the problems of the investors, the stock market and the accountants in relation to financial reporting.

In the UK, the Cohen Committee was established in 1941 to consider the reform of the Company’s Act. The ICAEW (Institute of Chartered Accountants in England in Wales) formed the view that the committee was likely to recommend a significant increase in legal control over financial reporting.

In 1942, the ICAEW issued the first of its recommendations on accounting principles. All together, 29 recommendations were issued until 1969, but they were not mandatory.
Since 1970s the standard setters all around the world have been attempting to ensure a conceptual basis to underpin the promulgation of standards.

This has resulted in a quest to develop a "Conceptual Framework". A "Conceptual Framework" could be seen as an attempt to operationalize the accounting theory.\(^{(36)}\)

In 1974, the FASB published its consideration of the "True Blood Report". In 1976, it published the Tentative Conclusions on Objectives of Financial Statements for Business Enterprises. In 1978, the FASB specified the objective of "financial reporting should be to provide the information that is useful to present and potential investors and creditors and other users in making rational investment credit and similar decisions".\(^{(37)}\)

The IASC was formed in 1973 and is based in London, but has membership of accounting bodies from all over the world, and in 2001, it was renamed as the International Accounting Standards Board (IASB).

The Dearing report (1988) has considered that the new ASB should:

a) Limit the abuses taking place in financial reporting.

b) Harmonize with International Accounting Standards.

c) Adopt a framework that was in line with those of other standard setters.

True Blood Report (AICPA, 1973) in the USA, The Corporate Report (ASSC, 1975) in the UK and other reports of FASB, IASC broadly agreed that:

- Financial reports are intended to serve users.
- The balance sheet and profit and loss account, supplemented by funds statements or a cash flow statement, are the fundamental financial statements.
• Users are concerned with economic evaluation and decision making.\(^{(38)}\)

The globalization of commerce has intensified the drive for the international harmonization of accounting standards. The standard setters are the parties most involved with the production of conceptual frameworks for financial reporting. The main basis appears to be IASB and FASB; however, these frameworks have not been without criticism.\(^{(39)}\) The focus of financial reporting has moved from statements to shareholders, to the provision of general purpose financial statements to enable users to take decisions and make predictions of future cash flows. Today's dynamic business environment is heralding a revolution in the need for, and the way in which, accounting data is utilized.

In a comparative study of financial reporting in India and Malaysia, it is indicated that there is a significant difference in the accounting disclosure practices of the two countries.

The comparative development of local authority accounting is very much influenced by the level of interest expressed by the central and state authority, professional bodies and user groups.\(^{(40)}\)

Conclusion:

Financial reporting is one source of information needed by those who make economic decisions. The information provided by financial reporting largely reflects the financial effects of transactions and events that have already happened. 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.
Annual report is the medium of presentation of annual accounts together with the review of performance for the year usually for twelve months to the Board of Directors and to the shareholders. An annual report contains a report on the business assets, liabilities, earnings and its progress.

The present practice of financial reporting is neither complete nor perfect. Majority of SFCs are presenting full disclosures of information. Knowingly or unknowingly the requirements of AICPA model are fulfilled by SFCs, since a long time. SFCs have been making their annual reports available on their websites and have been disclosing, through websites, only statutory information pertaining to the profit & loss account, the balance sheet, the directors’ report, the auditor’s report, schedules and notes.

At present, SFCs are required to present their accounts in conformity with the format prescribed by general regulations formulated by the SFCs Act. Previous sanction of the state governments and consultation with IDBI are essential to design the format. Though the diversity of SFCs operations has increased, their accounting formats have not been revised over a long period of time.

While SFCs were earlier following the mercantile system of accounting, they (including Assam and Madhya Pradesh SFCs from FY1991) have by now shifted over to the cash system of accounting. SFCs do not follow a uniform practice with regard to grouping of various items and details to be presented in schedules\(^{(41)}\)

The CBDT gave permission to SFCs in June 1987, to maintain their accounts on cash basis. SFCs should, over a period of time, fall in line with the practice followed by All India Financial Institutions and Banks.
In line with the approach now being adopted in regard to prudential regulations as also to achieve a greater degree of transparency in accounts, the accounting policies and systems of SFCs would require a review. It was felt that certain requirements of IAS 30 could be considered as being applicable to SFCs as they act as supplementary to the fundamental accounting assumptions and other International Accounting Standards.
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