Lesson 8 Corporate Financial Reporting

Key Concepts One Should Know

- Auditor's Report
- Director's Report
- EVA
- MVA
- SVA

Learning Objectives

To understand the:

- Purpose of auditors report, its coverage as per the requirements of the Companies Act and other before issues.
- Qualification in the auditor's report and corporate financial practices related thereof
- Purpose of director's report, its coverage as per the requirements of the Companies Act and other related issues.
- Corporate financial practices in respect of director's response in their report, to auditors qualification
- Objective and importance of corporate governance and contents of corporate governance report.
- Management discussion and analysis report, its contents and significance.

Lesson Outline

- Concept of Corporate Financial Reporting
- Various Requirements of Corporate Reporting
- Auditor's Report & Director's Report
- Disclosure on Notes to Accounts
- Value Added Statements and its Advantages
- Extracts of Value-Added Statements
- Economic Value-Added (EVA) and its Advantages
- Market Value-Added and its advantages
- Shareholders' Value-Added and its Advantages
- LESSON ROUND UP
- GLOSSARY
- TEST YOURSELF

INTRODUCTION

A company's annual report contains not only the financial statements, notes thereto and significant accounting policies followed in preparing them, but certain other financial reports as well. The most common and statutorily required reports are as under:

1. Auditor's report
2. Directors' report
3. Corporate governance report and within that or separately, management discussion, and analysis report.
4. Report on corporate social responsibility (CSR) activities.

The definition of Accounting suggests that "Accounting is Recording, classifying, summarizing, interpreting/ reporting and analyzing the financial transactions in a systematic manner". This information is studied by internal as well as external users. Its function is to provide quantitative information, primarily financial in name, about economic entities, that is intended to be useful in making economic decisions and related choice among alternative course of action. Financial reporting may be defined as communication of published financial statement and related information from a business enterprise to all users. It is the reporting of accounting information of an entity to a user or group of users. It contains booth qualitative and quantitative information.

The Financial report made to the management is generally known as internal reporting, while financial reporting made to the shareholder investors/management is known as external reporting. The internal reporting is a part of management information system, and is uses for MIS reporting for the purpose of analysis, and as an aid in decision-making process.

The management of a corporate is ultimately responsible for the generation of accounting information. The accountability of a company has two distinct aspects – legal and social. Under legal requirements a company has to supply certain information to the various users through annual reports and under the social obligation, a company has to provide additional information to various user groups

Need for Corporate Reporting

In accounting, Corporate Reporting is a very important issue nowadays. Various statues have prescribed certain statements to be disclosed periodically by a corporate entity. The purpose of such mandate is to convey a true and fair view of the operating results and the financial position to the users of financial reports. Within a corporate context, financial reporting covers three types of accounting data sets. These include a balance sheet, a statement of profit and loss and a statement of cash flows.

Disclosure of Significant Accounting Policies

As per AS-1 to ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. Such disclosure should form part of the financial statements. It would be helpful to the reader of financial statements if they are all disclosed as such in one place instead of being scattered over several statements, schedules and notes.

In respect of reporting of accounting policies a company needs to follow following principles.

All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.

Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

If the fundamental accounting assumptions, viz., Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

Features of Corporate Financial Reporting

Relevance: Information is relevant when it influence the economic decisions of users by helping them to evaluate past, present, and future events to confirm/correct their past evaluations. The relevance of information is affected by its nature and materiality (which is always the threshold for relevance). Information overload, on the other hand, can obfuscate information, making it hard to sift the relevant nuggets and interpretation difficult.

Reliability: Information should be free from material errors and bias. The key aspects of reliability are faithful representation, priority of substance over form, neutrality, prudence, and completeness.

Comparability: Information should be presented in a consistent manner over time, and consistent between entities to enable users to make significant comparisons.

Understandability: Information should be readily understandable by users who are expected to have a reasonable knowledge of business, economies and accounting, and a willingness to study the information with reasonable diligence.

The process of producing useful information includes a number of decision points, which may constrain the amount of information provided. These include:

- **Timelines:** A delay in reporting may improve reliability at the cost of relevance.
- **Benefit vs. Cost:** Benefits derived from information should normally exceed the cost of providing it.
- **Balancing of Qualitative Characteristics:** To meet the objectives of financial statements and make them adequate for a particular environment, providers of information must achieve an appropriate balance among the qualitative characteristics. The aim is to achieve a balance among characteristics in order to meet the objective of financial statements.

Recent trends in Corporate Financial Reporting

Investors, world over, are currently demanding more shareholder value than just high returns. Maximising shareholders value has always been the ultimate aim of every company. Investors are very keen in assessing the corporate financial performance that correlate with shareholders wealth, particularly the market price of a share. Traditional performance measures like return on investment, earnings per share have been used as the most important measure of shareholder value creation. But in the recent years, value based measures which measure performance in terms of change in value has received a lot of attention. There are several value based measures such as Cash Flow Return on Investment (CFROI), Shareholder Value-Added (SVA), Economic Value-Added (EVA), Market Value-Added (MVA) and Cash Value-Added (CVA) which are extensively used. Here we would be discussing about 'Value added statement' 'economic value-added' 'market value-added' and 'shareholder value-added' measures.

WHY CORPORATE FINANCIAL REPORTING?

The objectives of financial reporting given by Financial Accounting Standard Board (FASB) are summarized as follows:

Financial reporting should provide information that is useful to investors and creditors and other users in making rational investment, credit and similar decisions.

The information should be useful to both, the present and potential investors.

1. Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners equity) and the effects of transactions event, and circumstances that change resources and claims to those resources.

2. Financial reporting should provide information about the enterprise's financial performance during a period. Investors and creditors often use information about the past to help in assessing the prospects of an enterprise.
3. Financial reporting should provide information about how management of an enterprise obtains and spends cash, its borrowing and repayment of borrowing, capital transactions including cash dividends and other distributions of enterprise resources to owners, and other factors that may affect an enterprise's liquidity or solvency.
4. Financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibilities to owners (shareholders) for the use of enterprise resource entrusted to it.
5. Financial reporting should provide information that is useful to management and directors in making decisions in the interest of owners.

AUDITOR'S REPORT

An Audit Report is a key deliverable for any organisation which shows the end results of the entire audit process. The users of financial statements like Investors, Lenders, Customers, and others base their decisions and plans on audit reports of any enterprise. An audit report is always critical to influencing the perceived value of any financial statement's audit.

> The auditor should be careful in issuing the Audit Report as there is are a large number of people placing reliance on such report and taking decisions accordingly. The report should be issued by being unbiased and objective in discharging the functions.

Requirements of the Companies Act, 2013

Section 143 of the Companies Act, 2013 deals with the Auditor's Report which should fulfil following requirements :

1. The auditor shall make a report to the members of the company on the accounts examined by him, and on every financial statement and on every other document, which is to be a part of or Annexed to the Balance Sheet or Profit and Loss Account.
2. The report shall state whether, in his opinion and to the best of his information and according to the explanations given to him the said accounts.
   (a) Give the information required by the Companies Act in the manner so required and ;
   (b) Give a true and fair view ;
      - In the case of the Balance Sheet, of the state of the company's affairs as at the end of its financial year;
      - In the case of the Profit and Loss Account of the profit or loss in that financial year; and
      - In the case of the cash flow statement, of the cash flows for that financial year.
3. The Auditor's Report shall also state :
   (a) Whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit and if not, the details thereof and the effect of such information on the financial statements.
   (b) Whether, in his opinion, proper books of account as required by law have been kept by the company, and proper returns adequate for the purpose for his audit have been received from branches not visited by him.
   (c) Whether the report on the accounts of any branch office audited by a person other than the company's auditor has been forwarded to him, and how he has dealt with the same in preparing the auditor's report.
   (d) Whether the company's Balance Sheet and Profit and Loss Account dealt with by the report are in agreement with the books of account and return.

(e) Whether, in his opinion, the financial statements comply with the accounting standards.

(f) The observations or comments of the auditor's on financial transaction or matter which have any adverse effect on the functioning of the company.

(g) Whether any director is disqualified from being appointed as director under Sub-Section (2) of Section 164.

(h) Any qualification, reservation or adverse remark relating to the maintenance of accounts and other matter connected therewith.

(i) Whether the company has adequate financial control with reference to financial statements in place and the operating effectiveness of such controls.

The clause mentioned above disqualifies a person from being appointed as a company director if such person is already a director of a public company which.

- Has not field the annual accounts and annual returns for any continuous three financial years; or
- Has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend on due date and such failure continues for one year or more.

4. Where any of the matters referred to in above is answered in the negative, or with a disqualification, the auditor's report shall state the reasons thereof.

5. In the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Government, or partly by the Central Government and partly by one or more State Government, the Comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 and direct such auditor the manner in which the accounts of the company are required to be audited and" thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor- General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

6. The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report have a right to,—

(a) conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorise in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and

(b) comment upon or supplement such audit report :

Provided that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub section (1) of section 136 and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

7. The Comptroller and Auditor General of India may, in case of any government company if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

8. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed. Provided that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

9. Every auditor shall comply with the auditing standards.
10. The Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority :

    Provided that until any auditing standards are notified, any standard or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.
11. The Central Government may, in consultation with the National Financial Reporting Authority, by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.

    Provided that until the National Financial Reporting Authority is constituted under section 132, the Central Government may hold consultation required under this sub- section with the Committee chaired by an officer of the rank of Joint Secretary or equivalent in the Ministry of corporate Affairs and the committee shall have the representatives from the Institute of Chartered Accountants of India and Industry Chambers and also special invitees from the National Advisory Committee on Accounting Standards and the office of the Comptroller and Auditor-General.
12. Notwithstanding anything contained in this section, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed:

    Provided that in case of a fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed:

    Provided further that the companies, whose auditors have reported frauds under this sub-section to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.
13. No duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter referred to in sub-section (12) if it is done in good faith.
14. The provisions of this section shall mutatis mutandis apply to –
    (a) the cost accountant conducting cost audit under section 148; or
    (b) the company secretary in practice conducting secretarial audit under section 204.
15. If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12), he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.
16. The auditor shall make a statement as to whether the remuneration paid by the company to its directors is in accordance with the provisions of section 197, whether remuneration paid to any director is in excess of the limit laid down under this section and give such other details as may be prescribed.
17. On and from the commencement of the Companies (Amendment) Act,2017, any application made to the Central Government under the provisions of this section 197 [as it stood before such commencement], which is pending with that Government shall abate, and the company shall, within one year of such commencement, obtain the approval in accordance with the provisions of this section, as so amended.

Boards' Report

Section 134 of Companies Act, 2013 mandates certain disclosures to be made in the Board's Report, additionally, a listed company is required to comply with disclosures requirement stated under the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015

(1) The financial statement, including consolidated financial statement, if any, shall be approved by the Board of Directors before they are signed on behalf of the Board by the chairperson of the company where he is authorised by the Board or by two directors out of which one shall be managing director, if any, and the Chief Executive Officer, the Chief Financial Officer and the company secretary of the company, wherever they are appointed, or in the case of One Person Company, only by one director, for submission to the auditor for his report thereon.

(2) The auditors' report shall be attached to every financial statement.

(3) There shall be attached to statements laid before a company in general meeting, a report by its Board of Directors, which shall include—

(a) the web address, if any, where annual return referred to in sub-section (3) of section 92 has been placed

(b) number of meetings of the Board;

(c) Directors' Responsibility Statement;

(ca) details in respect of frauds reported by auditors under sub-section (12) of section 143 other than those which are reportable to the Central Government;

(d) a statement on declaration given by independent directors under sub-section (6) of section 149;

(e) in case of a company covered under sub-section (1) of section 178, company's policy on directors' appointment and remuneration including criteria for determining qualifications, positive attributes, independence of a director and other matters provided under sub-section (3) of section 178;

(f) explanations or comments by the Board on every qualification, reservation or adverse remark or disclaimer made –

(i) by the auditor in his report; and

(ii) by the company secretary in practice in his secretarial audit report;

(g) particulars of loans, guarantees or investments under section 186;

(h) particulars of contracts or arrangements with related parties referred to in sub-section (1) of section 188 in the prescribed form;

(i) the state of the company's affairs;

(j) the amounts, if any, which it proposes to carry to any reserves;

(k) the amount, if any, which it recommends should be paid by way of dividend;

(l) material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the financial statements relate and the date of the report;

(m) the conservation of energy, technology absorption, foreign exchange earnings and outgo, in such manner as may be prescribed;

(n) a statement indicating development and implementation of a risk management policy for the company including identification therein of elements of risk, if any, which in the opinion of the Board may threaten the existence of the company;

(o) the details about the policy developed and implemented by the company on corporate social responsibility initiatives taken during the year;

in case of a listed company and every other public company having such paid-up share capital as may be prescribed, a statement indicating the manner in which formal annual evaluation of the performance of the Board, its Committees and of individual directors has been made;

(p) such other matters as may be prescribed.

Provided that where disclosures referred to in this sub-section have been included in the financial statements, such disclosures shall be referred to instead of being repeated in the Board's report:

Provided further that where the policy referred to in clause (e) or clause (o) is made available on company's website, if any, it shall be sufficient compliance of the requirements under such clauses if the salient features of the policy and any change therein are specified in brief in the Board's report and the web-address is indicated therein at which the complete policy is available

(3A) The Central Government may prescribe an abridged Board's report, for the purpose of compliance with this section by One Person Company or small company

(4) The report of the Board of Directors to be attached to the financial statement under this section shall, in case of a One Person Company, mean a report containing explanations or comments by the Board on every qualification, reservation or adverse remark or disclaimer made by the auditor in his report.

(5) The Directors' Responsibility Statement shall state that –

(a) in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;

(b) the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;

(c) the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

(d) the directors had prepared the annual accounts on a going concern basis; and

(e) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

It may be noted that the term "internal financial controls" means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information;

(f) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

(6) The Board's report and any annexures thereto shall be signed by its chairperson of the company if he is authorised by the Board and where he is not so authorised, shall be signed by at least two directors, one of whom shall be a managing director, or by the director where there is one director.

(7) A signed copy of every financial statement, including consolidated financial statement, if any, shall be issued, circulated or published along with a copy each of—

(a) any notes annexed to or forming part of such financial statement;

(b) the auditor's report; and

(c) the Board's report.

(8) If a company contravenes the provisions of section 134 of the Companies Act, the company shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to twenty-five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.

COMPANIES (AUDITOR'S REPORT) ORDER, 2020

Ministry of Corporate Affairs 'MCA' notifies Companies (Auditor's Report) Order, 2020 (CARO 2020) which is applicable for audit of financial statements of eligible companies for the financial years commencing on or after the 1st April, 2020. **[CARO 2020 applicability extended to FY 2020-21 onward vide MCA order dated March 24th, 2020]**

The criteria of eligibility of companies on which the CARO, 2020 shall be applicable has not been changed and hence it shall be applicable to all those companies on which CARO, 2016 was applicable. Accordingly CARO 2020 will be applicable to all the companies including foreign companies except banking company, insurance company, section 8 company, OPC [section 2(62)], small company [section 2(85)], certain private limited co. This order stated that every report of the auditor under Section 143 of Companies Act, 2013 must contain the matters stated in 21 clauses as specified under paragraphs 3 and accord reasons for unfavorable or qualified answer as stated in paragraph 4 of CARO 2020.

CARO 2020 will not be applied with respect to auditor's report on Consolidated Financial Statements except clause (xxi) of paragraph 3. The order 2020 elaborated on all the matters which are to be included in the auditor's report. Wherein, the following details of the subject-matter are described:

- Whether the company is maintaining proper records showing full particulars such as:
  - i. The quantitative detail and situation of property, plant, and equipment,
  - ii. Physical verification of the property, plant, and equipment by the management at reasonable intervals,
  - iii. The details of the title deeds of the immovable properties held in the name of company,
  - iv. Revaluation of the property, plant, and equipment or intangible assets or both and if there is more than 10% of the change in the property, plant, and equipment or intangible assets,
- Details of proceedings against the company on the holding of any Benami property.
- Physical verifications of inventory by the management at reasonable intervals and proper treatment of any discrepancies of 10% or more found.
- Quarterly returns or statement filed by company having working capital limit more than 5 crore rupees with such banks or financial institution.
- Details of the investments made by the company(except companies dealing in loans), security or guarantee given by the company,
- Details of the payment pertaining to the undisputed statutory dues such as GST, provident Funds, Custom Duty, etc.
- Details of any default done by the company in making the repayment of the loan,
- Details of the funds raised by a company by the way of the Initial public offer,
- Details of fraud done by the company, and many more.
- The Auditor's Report Order 2020 of any company is supposed to state the reasons for unfavourable or qualified answers.

Clause by Clause Comparison of the Reporting Companies (Auditor's Report) Order 2020 *vis a vis* Previous CARO 2016

Clauses	**Companies (Auditor's Report) Order, 2016**	**Companies (Auditor's Report) Order, 2020**
	CARO 2016 contains Total 16 reporting clauses	CARO 20020 contains Total 21 reporting clauses
(i)	CARO 2016 required to report on all fixed assets	Reporting requirements on • Property, Plant, Equipment and intangible assets only. • Revaluation of Property, Plant, Equipment including rights of use assets or intangible assets • Proceedings under the Benami Transactions (Prohibition) Act, 1988 and disclosure in financial statements.

(ii)	Reporting requirement on physical verification of inventory at reasonable interval by management and material discrepancies noticed if any	Reporting requirements on • Physical verification of inventory at reasonable interval by management and the Opinion of the auditor on the coverage and procedure of such verification • The material discrepancies of 10% or more noticed if any • Compliances if company was sanctioned working capital limits in excess of five crore rupees or more from banks or financial institutions.
(iii)	Reporting requirement of granting any loans or advances to companies, firms, Limited Liability Partnerships or any other parties.	Reporting requirements of investments in or providing of any guarantee or security or granting any loans or advances to companies, firms, Limited Liability Partnerships or any other parties.
(iv)	Reporting requirement on the compliances of provisions of section 185 and 186 of the companies Act, 2013 in respect of loans, investments, guarantees and security.	Reporting requirement on the compliances of provisions of section 185 and 186 of the companies Act, 2013 in respect of loans, investments, guarantees and security. **(No change)**
(v)	Reporting requirements of compliances with RBI directives and the provisions the Companies Act with respect to deposits.	Reporting of compliances with RBI directives and the provisions the Companies Act with respect to deposits or **deemed deposits.**
(vi)	Reporting requirements of Maintenance of Cost Record	Reporting requirements of Maintenance of Cost Record **(No Change)**
(vii)	Reporting requirement on statutory dues	Reporting requirement on statutory dues **(No Change)**
(viii)	Reporting requirements on default in repayment of loans or other borrowing	**Reporting requirements with respect to transactions not recorded in the books of account surrendered or disclosed as income in the income tax proceedings.**
(ix)	Reporting requirement on utilization of money raised by way of IPO or further public offer for the purposes for which money has been raised	Reporting requirements on: • Default in repayment of loans or other borrowing or interest thereon • Declared as will defaulter by bank / financial institution / other lender • Utilization of term loan for the purposes for which term loan has been raised • Fund raised on short term basis have been used for loan term purposes • Funds taken by the company to meet obligation if its subsidiaries, associates or joint ventures • Loans raised on the pledge of securities held in its subsidiaries, associates, joint ventures
(x)	Reporting requirement on Notice of fraud by / on the company by its officers or employees	Reporting requirement on: • Utilization of money raised by way of IPO or further public offer for the purposes for which money has been raised • Preferential allotment or private equity placement of shares or fully or partly convertible debentures and compliance of section 42 of Companies Act, 2013

(xi)	Reporting requirement on Managerial Remuneration	Reporting requirement on • Notice of fraud by / on the company • Report u/s 143(12) filed by the auditors in Form ADT-4 • Treatment by auditor of whistle-blower complaints received during the year **by the company**
(xii)	Reporting requirements on Net Owned Funds to Deposits in the ratio of 1:20 and maintaining of 10% unencumbered terms deposits as per Nidhi Rules 2014	Reporting requirements on • Net Owned Funds to Deposits of Nidhi Company in the ratio of 1:20 and maintaining of 10% unencumbered terms deposits as per Nidhi Rules 2014 and • **for default in the payment of interest on deposits or repayments thereof for any period**
(xiii)	Reporting requirement on transaction with related parties	Reporting requirements on transaction with related parties **(No Change)**
(xiv)	Reporting requirement on preferential allotment or private equity placement of shares or fully or partly convertible debentures and compliance of section 42 of Companies Act, 2013	Reporting requirements **on internal audit system**
(xv)	Reporting requirement on non- cash transaction with director or person connected with him	Reporting requirements on non-cash transaction with director or person connected with him **(No Change)**
(xvi)	Reporting requirement of registration u/s 45IA of the Reserve Bank of India Act, 1934	Reporting requirement of: • Registration u/s 45IA of the Reserve Bank of India Act, 1934 • NBFC activities without valid certificate of registration • Fulfilling the criteria of Core Investment Company (CIC) • Number of CICs which are part of group
(xvii)	–	Reporting on cash losses (clause added)
(xviii)	–	Reporting on resignation of the statutory auditors **(clause added)**
(xix)	–	Reporting on uncertainty of company capable of meeting its liabilities **(clause added)**
(xx)	–	Reporting requirements on transfer of unspent CSR amount to Fund specified in Schedule VII **(clause added)**
(xxi)	–	Reporting requirements on qualifications or adverse remarks by the auditors in the CARO reports of companies included in the consolidated financial statements **(clause added)**

CORPORATE GOVERNANCE

Corporate Governance is how a corporation is administered or controlled. It is a set of processes, customs, policies, laws and instructions affecting the way a corporation is directed, administered or controlled. The participants in the process include employees, suppliers, partners, customers, government, and professional organization regulators, and the communities in which the organization has presence. The main theme of corporate governance is to integrate sound management policies in the corporate framework in such a manner to bring economic efficiency in the organization in order to achieve twin goals of profit maximization and shareholder welfare.

Definitions of Corporate Governance

"Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined." – *G20/OECD Principles of Corporate Governance*

"Corporate governance deals with laws, procedures, practices and implicit rules that determine a company's ability to take informed managerial decisions vis-à-vis its claimants - in particular, its shareholders, creditors, customers, the State and employees. There is a global consensus about the objective of 'good' corporate governance: maximising long-term shareholder value." – *Confederation of Indian Industry (CII) – Desirable Corporate Governance Code (1998)*

"Corporate Governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company." – Report of *N.R. Narayana Murthy Committee on Corporate Governance constituted by SEBI (2003)*

"Corporate Governance is the application of best Management Practices, Compliance of Laws in true letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders." – *The Institute of Company Secretaries of India.*

Objectives of Corporate Governance

The objectives of corporate governance include:

- To create social responsibility
- To create a transparent working system
- To create a management accountable for corporate functioning
- To protect and promote the interest of shareholders
- To develop an efficient organization culture
- To aid in achieving social and economic goals
- To improve social cohesion
- To minimise wastages, corruption etc.

Need for Corporate governance

The significance of good corporate governance system has widened because of the increasing conflict between ownership and management disciplines, the non-compliance of financial reporting by auditors which inflicts heavy losses on investors and lack of fair and transparent culture in the company which has lowered the investor trust in the financial viability of the company and its ethical standards. Thus there arises a need to imbibe a good corporate governance system for the betterment of all the stakeholders. It is important for the following reasons:

1. Corporate governance lays down the foundation of a properly structured Board and strives to a healthy balance between management and ownership which is capable of taking independent decisions for creating long-term trust between the company and external stakeholders of the company.
2. It strengthens strategic thinking at the top management by taking independent directors on the board who bring intellectual experience to the company and unbiased approach to deal with matters related to companies welfare.
3. It instills transparent and fair practices in the board management which results in financial transparency and integrity of the audit reports.
4. It sets the benchmark for the company's management to comply with laws in true letter and spirit while adhering to ethical standards of the company for bringing out effective management solutions in order to discharge its responsibility for smooth functioning of the company.
5. It inculcates loyalty among investors as their interest is looked after in the best manner by a company who adopts good management practices.

Corporate Governance under Companies Act, 2013

The Companies Act, 2013 has introduced various key provisions and mandatory disclosure requirements which have changed the corporate regime in such a way so as to run the corporate machinery in alignment with the globalised corporate world. The scope of corporate governance is no longer restricted to only listed public companies but it has also included unlisted public companies.

Some of the important areas of corporate governance introduced in Companies Act, 2013 has been introduction of:

1. Independent Director

Under the Companies Act, 2013 the strength of number of Independent directors for the prescribed companies under Section 149(4) read with Rule 4 of Companies (Appointment and Qualifications of Directors) Rules, 2014 is as follows:

Listed Public Company	At least one third of total number of directors
Unlisted Public Companies having turnover of 100 crores rupees or more	At least 2 directors
Unlisted Public companies having paid up capital of 10 crores rupees or more	At least 2 directors
Unlisted Public Companies with aggregate outstanding loans, debentures, and deposits, exceeding Rs. 50 crore	At least 2 directors

The terms and conditions of appointment of independent directors shall also be posted on the company's website.

2. Woman Director

Section 149(1) of the Companies Act, 2013 read with Rule 3 of Companies(Appointment and Qualifications of Directors) Rules,2014 prescribes the following classes of companies to have at least one woman director.

i. All listed companies

ii. Non-listed public companies having paid up share capital of Rs.100 crores or more or having turnover of Rs.300 crores or more

3. Audit Committees

Section 177 of the Companies Act, 2013 and Rules 6 and 7 of Companies (Meetings of Board and its Powers) Rules 2014 deals with Companies Act, 2013 has increased the ambit of companies to constitute audit committees. The Audit Committee shall consist of a minimum of 3 directors with independent directors forming a majority. The majority of members of Audit Committee including its Chairperson shall be persons with ability to read and understand, the financial statement. It shall be applicable to all the listed public companies or non- listed public companies having paid up share capital of Rs.10 crores or more, Turnover of Rs.100 crores or more, aggregate outstanding loan of Rs. 50 crores or more.

4. Composition of Nomination & Remuneration Committee & Stakeholder relationship Committee

Section 178(1) of the Companies Act and Rule 6 of Companies (Meetings of Board and its Powers) Rules 2014 deals with appointment of Nomination and Remuneration committee. The duty of the Committee shall be to identify the persons who are qualified to become directors and who can be appointed in the senior management and carry out the evaluation of directors. It shall specify the policy and manner for effective evaluation of performance of Board, its committees and individual director. Provided that such policy shall be placed on the website of the company, if any, and the salient features of the policy and changes therein, if any, along with the web address of the policy, if any, shall be disclosed in the Board's report

Section 178(5) prescribed appointment of stakeholder relationship Committee to resolve grievances of security holders of company. It shall be applicable to all the listed public companies or non-listed public companies having paid up share capital of Rs.10 crores or more, Turnover of Rs.100 crores or more, aggregate outstanding loan of Rs. 50 crores or more

5. Internal Audit

Companies Act, 2013 read with Rule 13 Of Companies (Accounts) Rules, 2014, has mandated the internal audit for certain classes of companies under Section 138.

Companies Act, 2013 has mandated the internal audit for certain classes of companies under Section 138. These companies includes all the listed companies, all the non-listed companies having paid up share capital of Rs.50 crores or more, turnover of Rs.200 crores or more in the preceding financial year, outstanding loans or borrowings from the banks or public financial institutions of Rs.100 crores or more outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year, every private company having turnover of two hundred crore rupees or more during the preceding financial year; or outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year:

6. Serious Fraud Investigation Office (SFIO)

Section 211 (1) of the Companies Act, 2013 states that the Central Government shall establish an office called the Serious Fraud Investigation office to investigate fraud relating to Company. SFIO can investigate into the affairs of the company on receipt of report of Registrar or inspector or on intimation of a special resolution passed by a company that its affairs are required to be investigated or in the public interest or on request from any Department of Central Government or State Government.

7. Corporate Social Responsibility

Section 135(1) of Companies Act, 2013 prescribes that every company having networth of Rs.500 crores or more, turnover of Rs.1000 crore or more, or net profit of Rs.5 crores or more during any the immediately preceding financial year shall constitute Corporate Social Responsibility Committee constituting of three or more directors with at least one independent director. Provided that where a company is not required to appoint an independent director under section 149(4) (i.e. Number of Independent Directors), it shall have in its Corporate Social Responsibility Committee two or more directors

The Board's report under sub-section (3) of section 134 shall disclose the composition of the Corporate Social Responsibility Committee.

Corporate Governance Report

As per SEBI circular dated 16th July 2019, the formats for Compliance Report on Corporate Governance as per Annexure I, II and III to this circular are being prescribed:-

Annex - I - on quarterly basis;

Annex - II - at the end of a financial year

Annex - III – at the end of six months from the close of financial year

Annex IV- on a half yearly basis (w.e.f. first half year of F.Y. 21-22)

The SEBI (Listing Obligation and Disclosure Requirement) Regulation, 2015 under Regulation 34(3) and 53(f) provides for disclosure to be made in the Annual Report (Schedule V of SEBI (LODR) Regulations 2015)

According to Schedule V of SEBI (LODR) Regulations 2015 the following disclosures shall be made in the section on the corporate governance of the annual report:

(1) A brief statement on listed entity's philosophy on code of governance.

(2) Board of directors:

(a) composition and category of directors (e.g. promoter, executive, non-executive, independent non-executive, nominee director - institution represented and whether as lender or as equity investor);

(b) attendance of each director at the meeting of the board of directors and the last annual general meeting;

(c) number of other board of directors or committees in which a directors is a member or chairperson126[, and with eff from the Annual Report for the year ended 31st March 2019, including separately the names of the listed entities where the person is a director and the category of directorship];

(d) number of meetings of the board of directors held and dates on which held;

(e) disclosure of relationships between directors inter-se;

(f) number of shares and convertible instruments held by non- executive directors;

(g) web link where details of familiarisation programmes imparted to independent directors is disclosed.

(h) A chart or a matrix setting out the skills/expertise/competence of the board of directors specifying the following:

(i) With effect from the financial year ending March 31, 2019, the list of core skills/expertise/competencies identified by the board of directors as required in the context of its business(es) and sector(s) for it to function effectively and those actually available with the board; and

(ii) With effect from the financial year ended March 31, 2020, the names of directors who have such skills / expertise / competence

(i) confirmation that in the opinion of the board, the independent directors fulfill the conditions specified in these regulations and are independent of the management.

(j) detailed reasons for the resignation of an independent director who resigns before the expiry of his tenure along with a confirmation by such director that there are no other material reasons other than those provided.]

(3) Audit committee:

(a) brief description of terms of reference;

(b) composition, name of members and chairperson;

(c) meetings and attendance during the year.

(4) Nomination and Remuneration Committee:

(a) brief description of terms of reference;

(b) composition, name of members and chairperson;

(c) meeting and attendance during the year;

(d) performance evaluation criteria for independent directors.

(5) Remuneration of Directors:

(a) all pecuniary relationship or transactions of the non-executive directors vis-à-vis the listed entity shall be disclosed in the annual report;

(b) criteria of making payments to non-executive directors. alternatively, this may be disseminated on the listed entity's website and reference drawn thereto in the annual report;

(c) disclosures with respect to remuneration: in addition to disclosures required under the Companies Act, 2013, the following disclosures shall be made:

(i) all elements of remuneration package of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options, pension etc;

(ii) details of fixed component and performance linked incentives, along with the performance criteria;

(iii) service contracts, notice period, severance fees;

(iv) stock option details, if any and whether issued at a discount as well as the period over which accrued and over which exercisable.

(6) Stakeholders' grievance committee:

(a) name of non-executive director heading the committee;

(b) name and designation of compliance officer;

(c) number of shareholders' complaints received so far;

(d) number not solved to the satisfaction of shareholders;

(e) number of pending complaints.

(7) General body meetings:

(a) location and time, where last three annual general meetings held;

(b) whether any special resolutions passed in the previous three annual general meetings;

(c) whether any special resolution passed last year through postal ballot – details of voting pattern;

(d) person who conducted the postal ballot exercise;

(e) whether any special resolution is proposed to be conducted through postal ballot;

(f) procedure for postal ballot.

(8) Means of communication:

(a) quarterly results;

(b) newspapers wherein results normally published;

(c) any website, where displayed;

(d) whether it also displays official news releases; and

(e) presentations made to institutional investors or to the analysts.

(9) General shareholder information:

(a) annual general meeting - date, time and venue;

(b) financial year;

(c) dividend payment date;

(d) the name and address of each stock exchange(s) at which the listed entity's securities are listed and a confirmation about payment of annual listing fee to each of such stock exchange(s);

(e) stock code;

(f) market price data- high, low during each month in last financial year;

(g) performance in comparison to broad-based indices such as BSE sensex, CRISIL Index etc;

(h) in case the securities are suspended from trading, the directors report shall explain the reason thereof;

(i) registrar to an issue and share transfer agents;

(j) share transfer system;

(k) distribution of shareholding;

(l) dematerialization of shares and liquidity;

(m) outstanding global depository receipts or american depository receipts or warrants or any convertible instruments, conversion date and likely impact on equity;

(n) commodity price risk or foreign exchange risk and hedging activities;

(o) plant locations;

(p) address for correspondence.

(q) list of all credit ratings obtained by the entity along with any revisions thereto during the relevant financial year, for all debt instruments of such entity or any fixed deposit programme or any scheme or proposal of the listed entity involving mobilization of funds, whether in India or abroad.

(10) Other Disclosures:

(a) disclosures on materially significant related party transactions that may have potential conflict with the interests of listed entity at large;

(b) details of non-compliance by the listed entity, penalties, strictures imposed on the listed entity by stock exchange(s) or the board or any statutory authority, on any matter related to capital markets, during the last three years;

(c) details of establishment of vigil mechanism, whistle blower policy, and affirmation that no personnel has been denied access to the audit committee;

(d) details of compliance with mandatory requirements and adoption of the non-mandatory requirements;

(e) web link where policy for determining 'material' subsidiaries is disclosed;

(f) web link where policy on dealing with related party transactions;

(g) disclosure of commodity price risks and commodity hedging activities.

(h) Details of utilization of funds raised through preferential allotment or qualified institutions placement as specified under Regulation 32 (7A).

(i) a certificate from a company secretary in practice that none of the directors on the board of the company have been debarred or disqualified from being appointed or continuing as directors of companies by the Board/Ministry of Corporate Affairs or any such statutory authority.

(j) where the board had not accepted any recommendation of any committee of the board which is mandatorily required, in the relevant financial year, the same to be disclosed along with reasons thereof:

Provided that the clause shall only apply where recommendation of / submission by the committee is required for the approval of the Board of Directors and shall not apply where prior approval of the relevant committee is required for undertaking any transaction under these Regulations.

(k) total fees for all services paid by the listed entity and its subsidiaries, on a consolidated basis, to the statutory auditor and all entities in the network firm/network entity of which the statutory auditor is a part.]

(l) disclosures in relation to the Sexual Harassment of Women at Workplace (Prevention, Prohibition and Redressal) Act, 2013:

a. number of complaints filed during the financial year

b. number of complaints disposed of during the financial year

c. number of complaints pending as on end of the financial year.]

(11) Non-compliance of any requirement of corporate governance report of sub-paras (2) to (10) above, with reasons thereof shall be disclosed.

(12) The corporate governance report shall also disclose the extent to which the discretionary requirements as specified in Part E of Schedule II have been adopted.

(13) The disclosures of the compliance with corporate governance requirements specified in regulation 17 to 27 and clauses (b) to (i) of sub-regulation (2) of regulation 46 shall be made in the section on corporate governance of the annual report.

VALUE ADDED STATEMENT

Introduction

Financial reporting has traditionally been concerned with the income statement, balance sheet and cash flow statement. Over the years, there have been initiatives to expand the financial reporting package. Accounting Standard Steering Committee (ASSC) of Britain suggested the inclusion of a value-added statement (VAS) along with conventional annual corporate reports in 1975.

> Value added can be defined as the value created by the activities of a firm and its employees, that is, sales minus the cost of bought in goods and services. The value-added statement (VAS) reports on the calculation of value-added and its allocation among the stakeholders in the company.

The Value Added Statement is divided into two parts: The first part shows how Value Added is arrived at the end and the second part shows the application of such Value Added.

The value-added statement (VAS) is a voluntary disclosure and adds little information to that contained in the income statement. During the last two decades various theories have been used to explain voluntary and social disclosures. The fact that the VAS has attained such widespread publication despite being a relatively marginal disclosure, gives an early indication that the VAS is not a neutral corporate social disclosure, but that it could be used to benefit those publishing it. VAS is used to alter perceptions about the company and in this way to manage stakeholder expectations.

Definition and Background of Value-Added and the Value-Added Statement (VAS)

The concept of value-added was initially used in 1790 in the first North American Census of Production (Gillchrist 1970). Trenche Cox, a treasury official, whose techniques have since been adopted by most industrial nations in the calculation of Gross National Product (GNP), was responsible for realizing that value-added would avoid double counting.

Value added has also been defined in the economic literature by Ruggles and Ruggles:

> The value-added by a firm, i.e., the value created by the activities of the firm and its employees, can be measured by the difference between the market value of the goods that have been turned out by the firm and the cost of those goods and materials purchased from other producers. This measure will exclude the contribution made by other producers to the total value of the firm's production, so that it is essentially equal to the market value created by this firm. (Ruggles and Ruggles, 1956)

The VAS is therefore based on an economic definition of value-added and calculates value-added in accordance with the calculation of GNP.

Suojanen (1954) suggests that the value-added concept for income assessment help the management satisfy the various interest groups by providing more information that was not possible from the income statement and balance sheet. This makes him one of the first writers to use the value-added concept in terms of accounting for the results of an enterprise.

In general words, "Value-added can be defined as wealth generated by the entity through the collective efforts of capital providers, management and employees".

Distribution of Gross Value Addition

As per the concept of value added statement, gross value-added is distributed to employees in the form of salaries and wages, to government in the form of taxes and duties, to financer in the form of interest, to shareholders in the form of dividend the and remaining balance in business in the form of retained earning including depreciation.

Value-Added Statement

A simplified financial statement that shows how much wealth has been created by a company. A value-added statement calculates total output by adding sales, changes in stock, and other incomes, then subtracting depreciation, interest, taxation, dividends, and the amounts paid to suppliers and employees.

Such value-added can be taken to represent in monetary terms the net output of an enterprise. This is the difference between the total value of its output and the value of the inputs of materials and services obtained from other enterprises. The value-added is seen to be due to the combined effect of capital, management and employees, and the statement shows how the value-added has been distributed among each of these factors.

Advantages of Value-Added Statement –

It is an alternative performance measure to profit and therefore helps in the comparison of the performance of the company. Value added is superior performance measure because it pays attention on inputs which are under the control of the management.

By employing various productivity measures like value-added per rupee of capital employed, value-added per rupee sales, value-added per employee, etc., it helps in judging the productivity of the company.

Resource allocation decisions are normally based on the concept of maximizing profit, but value-added statement provides a better alternative by focusing on other factors rather than just profit.

It also helps in devising the incentives schemes for the employees of the company in a better way.

It reflects a broader view of the company's objectives and responsibilities rather than merely focusing on the small aspects of the company

Limitation of Value-Added Statement

There is a duality associated with the VAS in that it reports on the calculation of value-added and its application among the stakeholders in the company. Many inconsistencies are found in practice in both the calculation and presentation of value-added in the VAS. These inconsistencies make the statement confusing, non-comparable and unverifiable. The main areas of inconsistencies include, though not limited to, the following:

- The treatment of depreciation resulting in gross and net value-added;
- The treatment of taxes like pay-as-you-earn, fringe benefits and other benefits in the employees' share of value-added;
- The timing of recognition of value-added production or sales;
- The treatment of taxes such as VAT /GST and deferred tax; and
- The treatment of non-operating items.
- This has resulted in a company having more than one possible value-added figure and that the allocation of value-added between the various stakeholders can be presented in different ways.

Difference between Value Added and Profit

Profit subtracts all the cost incurred in the process of generating revenues. The value added, on the other hand only subtracts the cost of bought-in goods and services. Profits are meant for shareholders whereas value added is meant for stakeholders who include shareholders also. Therefore, value added is a wider term.

FORMAT OF VALUE ADDED STATEMENT

ABC Company Ltd.

Value-Added Statement (Report or Vertical Form)

for the year ended 31st March ....

Particulars	Amount (Rs.)
A. Generation of Value-Added:	
Sales/Turnover (Including excise duties and sales tax excluding Returns, rebates & discounts, etc.)	xxx
± Stock of semi-finished and finished goods	xxx
Production value	xxx
Add: Income from services	xxx
Less : Bought-in-goods and services purchased from outsiders	xxx
Gross Value-Added (GVA)	xxx
Less : Depreciation and deferred Revenue expenses	xxx
Net Value-Added (NVA)	xxx
B. Application of Value-Added:	
Receipt by Workers/Employees	xxx
Receipt by Providers of Loan Capital	xxx
Receipt by Government	xxx
Receipt by Owners	xxx
Net Value-Added (NVA)	xxx

Extracts of Value-Added Statement Infosys Annual Report 2011-12

VALUE ADDED STATEMENT

	2012	% of VA	2011	% of VA	Growth (%)
Income	33,734		27,501		22.7
Less: Operating expenses excluding personnel costs					
Software development and business process management expenses	2,634		2,083		
Selling and marketing expenses	397		294		
General and administration expenses	1,647		1,304		
Value-Added from operations	29,056		23,820		22.0
Other income (including exceptional items)	1,904		1,211		
Total Value-Added	**30,960**		**25,031**		**23.7**
Distribution of Value-Added					
– Human resources					
Salaries and bonus	18,340	59.2	14,856	59.4	23.5

– Providers of capital					
Dividend(1)	2,699	8.7	3,445	13.8	(21.7)
Minority interest	–	–	–	–	–
Interest on debt	–	–	–	–	–
Taxes					
Corporate income taxes	3,367	10.9	2,490	9.9	35.2
Dividend tax(1)	438	1.4	568	2.3	(22.9)
Income retained in business					
Depreciation and amortization	937	3.0	862	3.4	8.7
Retained in business	5,179	16.8	2,810	11.2	84.3
Total	**30,960**	**100.0**	**25,031**	**100.0**	**23.7**

Note : The figures above are based on IFRS financial statements and they were considered on accrual basis

EXTRACTS OF VALUE ADDED STATEMENT OF BHARAT PETROLEUM CORPORATION LIMITED 2010-2011

Rs. in Crores

	2010-11	**2009-10**
HOW VALUE IS GENERATED		
Value of Production (Refinery)	71,660	55,153
Less : Direct Materials Consumed	(63,304)	(50,825)
Added Value	8,356	4,328
Marketing Operations	3,180	5,453
Value added by Manufacturing & Trading Operations	11,536	9,781
Add : Other Income and prior period items	1,745	2,185
Total Value Generated	13,281	11,966

Rs. in Crores

	2010-11	**2009-10**
HOW VALUE IS DISTRIBUTED		
Operations & Service Costs	5,162	5,509
Employees' Benefits		
Salaries, Wages & Bonus	1,507	1,606
Other Benefits	1,296	535
Providers of Capital		
Interest on Borrowings	1,101	1,011
Dividend	577	579

Income Tax	866	828
Re-Investment in Business		
Depreciation	1,655	1,242
Deferred Tax	148	(303)
Retained Profit	969	959
Total Value distributed	**3,281**	**11,966**

ECONOMIC VALUE ADDED

A critical concept in evaluating the performance of any business is termed us economic value-added. In generic terms, value-added refers to the additional or incremental value created by an activity or a business venture.

Economic value-added is a refinement of this concept – it measures the economic rather than accounting profit created by a business after the cost of all resources including both debt and equity capital have been taken into account.

Economic Value-Added (EVA) is a financial measure what economists sometimes refer to as economic profit or economic rent. The difference between economic profit and accounting profit is essentially the cost of equity capital – an accountant does not subtract a cost of equity capital in the computation of profit, so in fact an accountant's measure of income or profit is in essence the residual return to that equity capital since all other costs have been deducted from the revenue stream. In contrast, an economist charges for all resources in his computation of profit – including an opportunity cost for the equity capital invested in the business – so an economist's definition and computation of the profit is net above the cost of all resources.

How to Calculate Economic Value-Added (EVA)

Note that, as in the traditional computation of earnings, interest on debt capital is subtracted from operating earnings (earnings before interest and taxes (EBIT)) to obtain net income. Then, an opportunity cost on equity capital is subtracted to obtain EVA. The opportunity cost on equity capital is computed as the equity or net worth of the business times a rate of return that reflects the rate required by investors in the business. This required rate is in reality an opportunity cost measured by the rate of return that could be obtained on equity funds, if they were invested elsewhere. A positive EVA means the firm is generating a return to invest capital that exceeds the direct, i.e., interest and opportunity cost of that invested capital; a negative EVA means that the firm did not generate a sufficient return to cover the cost of its debt and equity capital.

The following tables gives a view how to calculate Economic Value-Added (EVA).

Earnings before Interest and Taxes (EBIT)	xxx
Less : Interest	xxx
Net Income	xxx
Less : Cost of Equity Capital	xxx
Economic Value-Added (EVA)	xxx

Expressed as a formula:

EVA = NOPAT-(WACC* Capital Employed)

Where NOPAT =“Net Operating Profit after Taxes”

WACC = Weighted Average Cost of Capital

Capital Employed /Invested Capital = Total Assets – Non interest-Bearing Current Liabilities

Balance Sheet of ABC Limited
as on 31st March, 2012

I. EQUITY AND LIABILITIES	Rs.
1. Shareholders' Funds	
Equity	400000
2. Non-Current Liabilities	
Long-Term Debt	600000
3. Current Liabilities	
(a) Account Payables	20800
(b) Bank Overdrafts	48400
TOTAL	**1069200**
II. ASSETS	
1. Non-Current Assets	
(a) Fixed Assets	1000,000
2. Current Assets	
(a) Inventories	
(i) Raw Material	8640
(ii) Finished Goods	17136
(b) Account Receivable	42930
(c) Cash	494
TOTAL	**1069200**

Statement of Profit of ABC Limited

Sales	286200
Less: Operating Expenses	114840
EBIT	171360
Less: Tax Expenses	68544
NOPAT	102816

The average rate of return on similar types of companies is 20%, while risk-free return is 12.5%. Rate of return as charged by bank is 18%, and the tax rate is 40%.

Calculate Economic Value-Added.

Solution

Step 1: Calculation of Capital Employed

Equity	4,00,000
Long-Term Debt	6,00,000
Bank Overdrafts	48,400
Total Capital Employed	10,48,400

Step 2: Calculation of Weighted Average Cost of Capital (WACC)

	Amount	Expected Return
Equity	400000	80000 (400000 x 20%)
Long-Term Debt	600000	45000 (600000 x 12.5% x 0.60)
Bank Overdrafts	48400	5227.2 (48400 x 18% x 0.60)
Total Capital Employed	**1048400**	**130227.2**

WACC = 130227.2/1048400

= 12.42%

Step 3:

Economic Value-Added = NOPAT - Weighted average cost of capital* Capital Employed

Rs.102816 – Rs.130227.2

Rs.27411.2

What insight does EVA provide about financial performance of a business?

First, like any financial measure, the trend may be more valuable than the absolute value of EVA. Even if EVA is positive, a declining EVA suggests that financial performance is deteriorating over time, and if this trend continues EVA will become negative and financial performance unacceptable. A negative EVA indicates that the firm is not compensating its capital resources adequately, and corrective action should be considered if this negative EVA persists over time.

Corrective Action to Improve EVA

First, operating performance with respect to operating profit margins or asset turnover ratios could be improved to generate more revenue without using more capital.

Second, the capital invested in the business might be reduced by selling under-utilized assets. This strategy will simultaneously improve operating performance through a higher asset turnover ratio, as well as a reduced capital charge against those earnings because of a reduced debt or equity capital investment.

Third, redeploy the capital invested to projects and activities that have higher operating performance than the current projects or investments are exhibiting.

And fourth, if the business is not highly leveraged, change the capital structure by substituting lower cost debt for higher cost equity. Although this last strategy will decrease net income because of the higher interest cost, it will improve the EVA of the business because the total cost of debt and equity is reduced, and EVA measures the value created after all costs of capital (debt and equity) have been taken into account.

Advantages of EVA Analysis

In various cases, company pays bonuses to the employees on the basis of EVA generated. Since a higher EVA implies higher bonuses to the employees, it motivates the employees to work hard and generate higher revenue.

Using EVA, company can evaluate the projects independently, and hence can decide whether to execute the project or not.

It helps the company in monitoring the problem areas and taking corrective actions to resolve those problems.

Unlike accounting profit, such as EBIT, Net Income and EPS, EVA is based on the idea that a business must cover both the operating costs as well as the capital costs and hence it presents a better and true picture of the company to the owners, creditors, employees, shareholders and all other interested parties.

It also helps the owners of the company to identify the best person to run the company effectively and efficiently.

However, there are some disadvantages of EVA like it is difficult to compute, and also it does not take into account inflation into its calculation. Therefore, company should take into account above advantages and disadvantages before deciding whether to implement EVA or not.

MARKET VALUE ADDED

Value based management and shareholder-value analysis is a well known concept. With the change of time newer related concepts such as MVA have gained importance.

Market value-added is the difference between the company's market and book value of shares. According to Stern Stewart, if the total market value of a company is more than the amount of capital invested in it, the company has managed to create shareholder value. If the market value is less than capital invested, the company has destroyed shareholder value.

Market Value-Added = Company's total Market Value – Capital Invested

With the simplifying assumption that market and book value of debt are equal, this is the same as Market Value-Added = Market Value of equity – Book value of equity.

Book value of equity refers to all equity equivalent items like reserves, retained earnings and provisions. In other words, in this context, all the items that are not debt (interest bearing or non-interest bearing) are classified as equity.

Market value-added (MVATM) is identical in meaning with the market-to-book ratio. The difference is only that MVA is an absolute measure and market-to-book ratio is a relative measure. If MVA is positive, it means that market–to– book ratio is less than one. According to Stewart's Market value-added tells us how much value the company has added to, or subtracted from, its shareholders investment. Successful companies add their MVA and thus increase the value of capital invested in the company. In unsuccessful companies decrease the value of the capital originally invested decreases.

Whether a company succeeds in creating MVA or not depends on its rate of return. If a company's rate of return exceeds its cost of capital, the company will sell on the stock market with premium compared to the original capital. On the other hand, companies that have rate of return smaller than their cost of capital sell with discount compared to the original capital invested in company. Whether a company has positive or negative MVA depends on the rate of return compared to the cost of capital.

Market value-added can also be defined in relation to Economic Value-Added Measures (EVATM). EVA measures whether the operating profit is enough compared to the total cost of capital employed. Stewart defines EVA as the surplus of Net Operating Profit after Taxes (NOPAT) and after adjusting capital cost, where NOPAT = Profit after depreciation and taxes but before interest costs and Capital Cost = Weighted average cost of capital X capital employed or EVA = (ROI – WACC) x Capital employed.

He further defines the connection between EVA and MVA as: Market Value-Added = Present Value of All future EVA by increasing EVA, i.e., a company increases its market value-added or in other words increases the difference between company's value and the amount of capital invested in it.

The relationship of MVA with EVA has its implication on valuation. By rearranging the formula, market value of equity can be defined as:

Market value of equity = Book value of equity + Present value of all future EVA.

Illustration

Company XYZ whose shareholders' equity amounts to Rs. 750,000. The company owns 5,000 preferred shares and 100,000 common shares outstanding.

The present market value for the common shares is 12.50 per share and 100 per share for the preferred shares.

Solution:

Market Value of Common Shares = 100,000 * 12.50 = Rs. 12,50,000

Market Value of Preferred Shares = 5,000 * 100 = Rs. 5,00,000

Total Market Value of Shares = 12,50,000 + 500,000 = Rs. 17,50,000

Using the figures obtained above:

Market Value Added = Rs. 17,50,000 – Rs. 750,000 = Rs. 10,00,000

SHAREHOLDER VALUE ADDED (SVA)

Shareholder Value-Added (SVA) represents the economic profits generated by a business above and beyond the minimum return required by all providers of capital. "Value" is added when the overall net economic cash flow of the business exceeds the economic cost of all the capital employed to produce the operating profit. Therefore, SVA integrates financial statements of the business (profit and loss, balance sheet and cash flow) into one meaningful measure.

Shareholder value added = Net operating profit after tax - Cost of capital

The cost of capital is comprised of the company's weighted average cost of debt and equity, which include preferred stock.

The SVA approach is a methodology which recognizes that equity holders as well as debt financiers need to be compensated for bearing investment risk. The SVA methodology is a highly flexible approach to assist management in the decision-making process. Its applications include performance monitoring, capital budgeting, output pricing and market valuation of the entity.

ADVANTAGES OF ADOPTING SVA

To create value, management must have an understanding of the variables that drive the value of the business. An organization cannot act directly on value. It has to act on factors it can influence, such as client satisfaction, cost, capital expenditures, the debt / equity mix and so forth. Through an understanding of these drivers of value, management is able to establish a consistent dialogue, both internally and with the shareholders, regarding what needs to be accomplished to create value. The benefits of moving towards SVA include:

Overall, the value-based performance measures will result in greater accountability for the investment of new capital, as well as for the use of existing investments.

Organization will have the opportunity to apply a meaningful private sector benchmark to evaluate performance.

Managers will be provided with an improved focus on maximizing shareholder value.

Limitations of Adopting SVA

A limitation in the use of SVA as a performance measure is that, by nature, it is an aggregate measure. In order to analyze the underlying causes of any changes in calculated value between years, it is necessary to fully comprehend the value drivers and activities specific to a given firm.

There may be certain enterprises which are subject to any degree of price regulation. Hence, then it may not be possible for management to adjust output prices to achieve a commercial return in response to upward movements in input prices. Such a situation may result in SVA getting reduced even though there may have been no decrease in overall efficiency.

Similarly, a reduction in direct Government funding would result in a decrease in SVA.

Combined with the use of traditional accounting measures, a thorough knowledge of the value drivers of the business will assist in determining the underlying causes of fluctuations in the value-added measure.

Again, the use of SVA is not a substitute for detailed analysis of business drivers, rather it is an additional measurement tool with an economic foundation.

The cost of capital may be difficult to ascertain if a company is privately held, so restricting the use of this measurement to publicly held companies is advised.

LESSON ROUND-UP

- Financial reporting includes not only financial statements but also other means of communicating information that relate to the information provided by the accounting system.
- The end product of accounting process should be such that it generates:
- information useful in investment and credit decisions,
- information useful in assessing cash flow prospects (amount, timing, and uncertainly), and
- information about enterprise resources, claims to those resources and changes therein.
- The Value-Added Statement (VAS) is a voluntary disclosure and adds little information to that contained in the income statement. It calculates total output by adding sales, changes in stock, and other incomes, then subtracting depreciation, interest, taxation, dividends, and the amounts paid to suppliers and employees.
- The Value Added Statement is divided into two parts : The first part shows how Value Added is arrived at the end and the second part shows the application of such Value Added.
- Economic value-added (EVA) measures the economic rather than accounting profit created by a business after the cost of all resources including both debt and equity capital have been taken into account.
- EVA = NOPAT-(WACC* Capital Employed)
- Where NOPAT = “Net Operating Profit after Taxes”
- WACC = Weighted Average Cost of Capital
- Capital Employed /Invested Capital = Total Assets – Non interest-Bearing Current Liabilities
- Market value-added (MVA) is the difference between the Company’s market and book value of shares.
- Market Value-Added = Company’s total Market Value – Capital Invested
- Shareholder Value-Added (SVA) represents the economic profits generated by a business above and beyond the minimum return required by all providers of capital.

GLOSSARY

Accounting: Accounting is Recording, classifying, summarizing, interpreting/ reporting and analyzing the financial transactions in a systematic manner.

Audit report: An audit report is a written opinion of an auditor regarding an entity’s financial statements.

Corporate Governance: Corporate Governance is how a corporation is administered or controlled. It is a set of processes, customs, policies, laws and instructions affecting the way a corporation is directed, administered or controlled.

Value added: Value added can be defined as the value created by the activities of a firm and its employees, that is, sales minus the cost of bought in goods and services.

Value added statement: The value-added statement (VAS) reports on the calculation of value-added and its allocation among the stakeholders in the company.

Economic value added: Economic Value-Added (EVA) is a financial measure what economists sometimes refer to as economic profit or economic rent.

Market value added: Market value-added is the difference between the company’s market and book value of shares.

Shareholder value added: Shareholder value added integrates financial statements of the business (profit and loss, balance sheet and cash flow) into one meaningful measure.

TEST YOURSELF

1. Discuss the concept of Corporate Financial Reporting and its requirements in India.
2. What are the objectives of corporate financial reporting?
3. What is Value-Added Statement (VAS)? State the merit and demerit of VAS.
4. What do you mean by Economic Value-Added? How is EVA related to valuation?
5. Discuss the Shareholder Value-Added (SVA), its benefits and drawbacks.
6. Write Short Notes on:
   (a) Market Value of Equity
   (b) Limitations of Value-Added Statement
7. What are the contents Corporate Governance report?
8. What is CARO? Explain in Detail.
9. State Salient Features of Corporate Financial Reporting.