

## REGULATION OF MD & A REPORTING IN INDIA: SOME QUALITATIVE ISSUES

### Abstract

During the last two decades or more, Management Discussion and Analysis (MD&A) report assumes growing importance in the decision-making process of the stakeholders. In India, MD&A report was made mandatory for listed companies in 2000 through the listing agreement by the Securities and Exchange Board of India (SEBI). In 2015, SEBI thoroughly revised its regulation by virtue of its revised regulation, every listed company is required to publish MD&A report. Despite its immense importance to the decision maker, legal requirement in India is limited to making discussion and analysis on eight specified areas in MD&A report. The present legal framework in India suffers from a number of deficiencies involving certain qualitative issues. Such qualitative issues include detailed contents of MD&A report, its timing of publication, disclosure of potential impact of environmental risks on entity's performance, assessment of possible financial liabilities arising due to activities of an entity affecting environment, etc. In this backdrop, the present paper analyses some qualitative issues in the present legal framework of MD&A report and suggests some changes in it for improving the quality of MD&A report.

**Keywords:** MD & A Reporting; SEBI; Qualitative Issues; Annual Report; India

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## I. INTRODUCTION

At present the academicians and researchers mainly focus on narrative disclosure as information presented in financial statements is primarily financial, quantitative and historic in nature. Though some non-financial and descriptive disclosures are made in notes on accounts, but these are inadequate for explaining entire operating and financial performance of a business and predicting its future prospect. Thus, there is a consensus that the business reporting model needs to be changed in such a way so as to serve the changing information needs of the external users (Beattie. V. et al., 2004). Here arises the necessity of a separate report that could meet such information deficiency by furnishing detailed and analytical information in narrative form.

Management Discussion and Analysis (MD&A) is one such report which contains narrative disclosures by the management. The MD&A Report supplements the financial statements and is intended to provide a narrative explanation, as perceived by the management, of how an entity has performed in the past, its present financial and operating condition, and its future prospects. The MD&A supplements the financial statements. The objective of preparing the MD&A is to improve reporting the company's overall financial disclosure by providing a balanced discussion of firm's operating and financial results. Such disclosure in MD&A report would reduce the information asymmetry between the managers and that of current and potential investors (Bhattacharyya et al., 2005).

The remainder of this paper is organised as follows. Section II provides a brief literature review. Section III specifies the objectives of present study. Research methodology has been stated in section IV. Section V presents international scenario on MD&A reporting, while section VI discusses the regulation of MD&A reporting in India. Section VII analyses the qualitative issues in MD&A reporting in India and offers suggestions for its improvement. Section VIII. concludes the paper.

**Need for mandatory disclosure:** A mandatory regulation ensures increased disclosure over the information provided by firms under the detail guideline of voluntary recommendations (Atmadja and Tarca, 2004). Watts and Zimmerman (1986) viewed accounting information as a public goods since existing stockholders implicitly pay for its production. By creating minimum disclosure requirements, regulators reduce the information gap between informed and uninformed. Thus, there must be some regulation to prescribe certain level of information to be disclosed by all the companies.

**A number of reasons for having a regulatory framework for the preparation of financial statements may be:**

1. To ensure that the users of financial statements are provided with a minimum level of information for their decision making.
2. To ensure comparability and consistency of the information provided to the users.
3. To increase users' confidence in the financial reporting process.
4. To regulate the behaviour of companies and directors towards their investors.

In India, MD&A report was made mandatory for listed companies in 2000 through insertion of Clause 49 of the listing agreement by the Securities and Exchange Board of India (SEBI). Since then, no development was made in the regulatory requirements governing

MD&A reporting. Despite its immense importance to the decision maker, legal requirement is limited to making discussion and analysis on eight specified areas. No detail disclosure provisions are prescribed in respect of information to be disclosed under each of these areas. Rather detailed content is left to the discretion of the management. In this backdrop, the paper discusses legal environment of MD&A reporting vis-à-vis analyses some qualitative issues involved in such reporting in India and offers suggestions for its improvement.

## **II. LITERATURE REVIEW**

All over the world a good number of studies have been carried out on MD&A reporting. Such studies include Atmadja and Tarca (2004) in the context of Australia, Ahn and Lee (2005) in the context of Korea, Celik, et al. (2006) in the context of Turkey, Tauringana and Mangena (2006) in the context of United Kingdom, Arshad, et al. (2011) in the context of Malaysia, Macchioni, et al. (2013) in the context of Italy, Hui-yun and Lin (2014) in the context of China, Carini, (2014) in the context of Italy.

However, the number of studies on MD&A reporting in Indian context is very limited. For example, Vedipuriswar et al. (2003) examined the missing and incomplete disclosure regarding the major issues in MD&A report. Srinivasan, R (2009) attempts to study the content and quality of strategy related information and the extent of its disclosure in the MD&A Report. Singh and Jhunjhunwala (2010) made a company specific study on Reliance Industries Limited for a period of 10 years from 1999 to 2008, to judge the impact of disclosure of information in MD&A report on the shareholders wealth, goodwill of the company, dividend and market capitalisation.

Our review of literature in Indian context reflects that either company specific study was made or the study examined only non-disclosure of information in MD&A section of annual reports and its impact. But none of the studies have focused on the legal aspect relating to MD&A reporting in India.

## **III. OBJECTIVE OF THE STUDY**

**The present study has following objectives:**

1. To examine regulatory requirement of MD&A reporting in the global context.
2. To discuss and analyse some qualitative issues involved in the present regulatory requirement of MD&A reporting in India.
3. To offer suggestions for improvement in the legal framework of MD&A reporting in India.

## **IV. RESEARCH METHODOLOGY**

The present research is theoretical and explorative in nature which is based on relevant provisions of the SEBI (Listing Obligation and Disclosure Requirements) Regulation, 2015.

## **V. MD AND A REPORTING IN THE GLOBAL CONTEXT**

Globally, disclosure in MD&A report is made in a more regulated environment in developed countries as compared to developing one, mainly because of the existence of

advanced capital market. Disclosure regulations of MD&A reporting in some advance countries are discussed below.

**U.S.A.:** In the U.S.A., the Management Discussion and Analysis (MD&A) is regulated by the Securities and Exchange Commission (SEC). Since 1968, inclusion of MD&A report in annual report of the listed companies was made mandatory. Over the years from 1980 to 2003, several modifications were proposed and implemented which require more detailed disclosure on the firm's performance, and forward- looking information.

The reporting requirements as issued by the SEC intends to focus analysis on the areas which include key indicators of financial condition and operating performance; materiality; material trends and uncertainties; liquidity, capital structure and critical accounting estimates; Off-balance sheet transactions etc.

**U.K.:** In 1993, the Accounting Standards Board (ASB) proposed the Operating and Financial Review (OFR) as a voluntary document to be included in the annual report to enhance disclosures in director's report. The same had been revised in 2006. Following the best practices, the OFR provides detailed guidelines in order to assist management in the process of their communicating information to the investors. In particular, the OFR aimed at providing disclosures which are useful in analysing the business strategies, risk and performance of the companies (**Ginesti. G, 2010**).

The main areas of disclosure in an OFR as prescribed by the ASB focuses mainly on the nature, objective and strategies of the business; current and future development and performance; resources; risks and uncertainties; relationships and financial position.

**Canada:** In Canada, the Management Discussion and Analysis (MD&A) is regulated by the Ontario Security Commission (OSC). Since 1989, it was mandatory for listed companies to provide compulsory MD&A report for which the Guidance, last revised in 2014, was issued by the Canadian Institute of Chartered Accountants (CICA).

In 2001, based on Jenkins report principles, CICA designed and issued guidance on MD&A report. The aim of the guidance is to assist management to provide relevant information through single document to meet the user's information needs.

As revised last in 2014, the key disclosure areas as identified by CICA in its guidelines include among others are Core businesses; Objectives and strategy; Capability to deliver results- Resources, Relationships and Risk; Results and outlook; Key Performance Measures and Indicators.

**In the member states of European Union:** In the Europe, the management discussion and analysis section was introduced into the community regulations as per Article 46 under Directive 1978/660/EC and Directive 1983/349/EC. The provisions of the above directives require a minimum level of information by the companies belonging to the EU member states.

Major change was brought in by pronouncing Directives 2001/65/EC to adopt fair value in evaluating financial instruments and related disclosure in the MD&A. Afterwards, issue of Directive 2003/51/EC by EU, in 2003, significantly widened the information content of the management discussion section. This was done by broadening Article 46 which

requires that financial risk management objectives and policies in relation to use of the financial instruments should be disclosed in MD&A.

Thus, in many advanced countries including member states of European Union, disclosure regulations of MD&A reporting provide guidelines with detailed contents for preparation of MD&A Report.

**The I.A.S.B. Guidelines:** In 2010, the International Accounting Standard Board (IASB), issued a non-binding standard called IFRS Practice Statement Management Commentary –A framework for presentation. The objectives of such an effort were (i) to improve the international comparability of financial and non-financial information contained in the Management Commentary (MC) provided by the firm, and (ii) to provide guidelines in order to ensure that there is uniformity in management’s report by the firms. In doing so, the IFRS practice statement invites the preparers to develop a useful Management Commentary considering the following principles:

1. To provide a management view of the entity’s performance, position, and progress.
2. To supplement and complement information presented in the financial statements.

**Keeping in mind these principles, Management Commentary should include:**

1. Forward-looking information;
2. Information that possesses the qualitative characteristics described in the conceptual framework for financial reporting.

The IFRS practice statement is not, in the opinion of IASB, an IFRS, hence non-compliance of the same will not prevent an entity’s financial statements from complying with IFRS, if they otherwise do so. However, although it is a non-binding standard it does not exclude the fact that the statement may be subject to mandate by local authorities (IASB, 2010).

Though the MD&A requirement may vary across the countries but the basic principles governing its preparation need that it should provide relevant, useful, forward-looking, understandable, comparable and timely information in narrative form.

## **VI. REGULATION OF MD & A REPORTING IN INDIA**

In aligning with the Companies Act, 2013, SEBI implemented revised regulation in 2015 after repealing Clause 49 and requires that as per Listing Agreement, either as a part of director’s report or in addition thereto, a Management Discussion and Analysis report shall be submitted to the stock exchange where the shares are listed and the report may be presented pursuant to the framework mentioned in Schedule V of Part B of the SEBI (Listing Obligation and Disclosure Requirements) Regulation, 2015.

The report should include discussion on the following eight **areas** within the limits set by the company’s competitive position:

1. Industry structure and developments.
2. Opportunities and threats.

3. Segment-wise or product-wise performance.
4. Outlook.
5. Risks and concerns.
6. Internal control systems and their adequacy.
7. Discussion on financial performance with respect to operational performance.
8. Material developments in Human Resources/ Industrial Relations front, including number of people employed.

Where a treatment different from that prescribed under ‘Accounting Standards’ has been followed in preparing financial statements, the SEBI Regulation requires that the management of the company should provide an explanation about the alternative treatment to ensure that such treatment will represent the true and fair view of the underlying business transaction.

## VII. QUALITATIVE ISSUES IN MD & A REPORTING IN INDIA AND SUGGESTIONS FOR IMPROVEMENT

This section analyses certain issues which impair quality of MD&A reporting in India and provides some suggestions for its improvement. These issues and suggestions are discussed under the following heads:

- Contents of MD and A report
  - Timeliness and frequency of MD&A report
  - Overlapping Areas in MD&A Report and Directors’ Report
  - Additional Disclosure in MD&A Report
- Environmental Consideration
  - Organisational Culture

1. **Contents of MD & a report:** Unlike the existing model of MD&A report issued by the regulators of advanced countries, for example, the SEC in USA, the CPRB in Canada and the ASB in UK, there is no directive regarding detail disclosures under different areas in MD&A report in India. Under the SEBI (LODR) Regulation, 2015, the disclosure of eight specified areas in MD&A report is mandatory, but detailed contents of each area have not been prescribed by the SEBI. It is left to the discretion of the management. Thus, within a mandatory regulatory framework of MD & A Report in India, the detail disclosures are voluntary.

This may result in non-disclosure of important information in the MD&A report. Though, it may be argued that directives for detail disclosure items are difficult to be specified due to varied nature of business across the industries, but still prescribing a general disclosure guide line may play a positive role to ensure an extensive and better disclosure in MD&A report which in turn helps the stakeholders to take their economic decision on an informed basis.

In this connection, the non-binding standard of the IASB on Management Commentary ‘*IFRS Practice Statement*’ (issued in 2010) may be useful. This standard is intended to facilitate preparation of globally comparable MD&A report.

2. **Timeliness and frequency of MD & a report:** In India, MD&A report is published as a component of annual report once in a year with a time gap of 2 to 4 months from the end of the accounting year. As a result, the investors and other stakeholders have to wait for their information requirements till the annual reports are published. By the time the MD&A report is published, many information in the report may lose its relevance.

Like quarterly financial statements, the regulator may make provision for quarterly publication of MD&A report by the companies so that stakeholders remain continuously updated about the operational and financial performance, risk, future plans and prospect of the company as perceived by the management.

3. **Overlapping areas in MD & a report and directors' report:** The Companies Act, 2013 requires reporting for in director's report regarding internal financial control which is also a reporting area in MD&A report under SEBI (LODR), 2015. As a result, many companies report their internal financial control in the directors' report only while in the MD&A report a mere reference is made regarding disclosure of such information in directors' report. However, point in consideration is that these two reports differ in their nature and spirit. The first one is traditional disclosure of information about internal financial control relating to its nature, organisation, effectiveness, etc. as stipulated in the regulation, while the later is supposed to be explanatory in nature. Director's report discloses mere information regarding the policies, strategies and adequacy of internal financial control which includes financial reporting control and business control only while the MD&A report is required to make detailed discussion and analysis of such information. MD&A report should also explain such matters along with any deviations from the existing norms and its potential impact on the company performance, which remain absent in the director's report.

Hence, it is suggested that reporting on common issues should be made independently in MD&A report and Director's report, maintaining their own spirit and purposes.

#### 4. Additional disclosure in MD and a report

- **Environmental consideration:** In the present-day context, the activities of household, business and other organizations have both direct and indirect impact on the environment. The impact of the business activities on the environment should be informed to the stakeholders (Girdharry et al, 2011). IASB also, based on materiality consideration, suggested in its IFRS Practice Statement for inclusion of environmental related information in MD&A report since environmental information is likely to influence decision of different stakeholders like Government, local people, investors and general public at large.

Worldwide, several recommendations and regulations have been well documented relating to reporting environmental issues either in the Annual Report or in MD&A report. For example, in the USA, SEC in its interpretive release Nos. 33-9106; 34-61469; FR-82, effective from February 8, 2010 provides guidance relating to climate change matters. In Canada, CICA issued guidance on climate

change disclosure in MD&A in 2005. In the U.K., Climate Change Act, 2008 requires companies to disclose environmental related issue in OFR. All these show that there is a pressing need for disclosing information relating to environment issues to meet the stakeholders' information needs. In India, reporting of some environmental issues is mandatory under the Companies Act, 2013 and SEBI (LODR) regulation, 2015 both. The Companies Act prescribes to include in the Directors' Report information relating to 'conservation of energy', while the SEBI regulation, 2015 requires the corporate entities to prepare a Business Responsibility Report to include information regarding environmental issues. However, both the Acts remain silent regarding disclosure of potential impact of environmental risks on entity's performance and assessment of possible financial liabilities arising due to activities of an entity affecting environment.

Investors, while determining their investment strategy, must have an insight about environmental issues. Such an insight will enable investors to make assessment about 'financial liabilities' arising from effects of environmental policies and environmental risk factors etc. Consequently, environmental matters may be included in the MD&A when classified as material under certain circumstances and accordingly, it may be in the best interest of companies to adopt environmental factors in their MD&A as best practice.

- **Organisational culture:** One of the interesting features of modern enterprise is its multiculturalism. Members of the entity come from different ethnic, religious and professional societies having different outlook, economic & political views, interests, etc. This creates cultural diversity resulting in communication problem. The management of cultural diversity becomes an increasingly important part of corporate strategy (**Kabalski, 2012**). In its recommendations concerning the MC, the IASB suggests that the management should describe structure and process of an entity so that the users of financial statements can properly understand it. However, IASB's Practice Statement remains silent about organisation culture. Without the knowledge of organisational culture, it is impossible to understand the organisation. Accordingly, organisational culture may be an important reporting area to be included in MD&A Report.

## VIII. CONCLUSION

On an overall analysis, it is observed that at present the legal requirement for preparation of MD&A Report in India is narrow and limited in scope. The disclosure requirement for MD&A report should be more detail, elaborate, comprehensive and transparent in nature so as to cater the information needs of different stakeholders. Considering India's active participation in the IFRS convergence process, it is suggested that IASB's IFRS Practice Statement–Management Commentary may be used in developing the detailed regulatory guidelines for MD&A reporting in India. This would facilitate comparability and transparency of Indian MD&A Report which would make Indian business competitive in the world capital market by reducing their cost of capital.



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