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Financial Reporting- An Overview

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ABSTRACT
We review the theory and evidence on IPO activity: why firms go public, why they reward first-day investors with considerable underpricing, and how IPOs perform in the long run. Our perspective on the literature is three-fold: First, we believe that many IPO phenomena are not stationary. Second, we believe research into share allocation issues is the most promising area of research in IPOs at the moment. Third, we argue that asymmetric information is not the primary driver of many IPO phenomena. Instead, we believe future progress in the literature will come from non-rational and agency conflict explanations. We describe some promising such alternatives.

KEYWORDS :

INTRODUCTION

The Indian retail industry has emerged as one of the most dynamic and fast-paced industries due to the entry of several new players. It accounts for over 10 per cent of the country's Gross Domestic Product (GDP) and around 8 per cent of the employment. India is the world's fifth-largest global destination in the retail space

India is one of the fastest growing retail markets in the world, with 1.2 billion people.

The organised retail market has a share of 9.5% as per 2014. While India presents a large market opportunity given the number and increasing purchasing power of consumers, there are significant challenges as well given that over 90% of trade is conducted through independent local stores.

The Boston Consulting Group and Retailers Association of India published a report titled, 'Retail 2020: Retrospect, Reinvent, Rewrite', highlighting that India's retail market is expected to nearly double to US$ 1 trillion by 2020 from US$ 600 billion in 2015, driven by income growth, urbanisation and attitudinal shifts. The report adds that while the overall retail market is expected to grow at 12 per cent per annum, modern trade would expand twice as fast at 20 per cent per annum and traditional trade at 10 per cent.

India is expected to become the world's fastest growing e-commerce market, driven by robust investment in the sector and rapid increase in the number of internet users. Various agencies have high expectations about growth of Indian e-commerce markets. Indian e-commerce sales are expected to reach US$ 55 billion by FY2018 from US$ 14 billion in FY2015. Further, India's e-commerce market is expected to reach US$ 220 billion in terms of gross merchandise value (GMV) and 530 million shoppers by 2025, led by faster speeds on reliable telecom networks, faster adoption of online services and better variety as well as convenience.

India's direct selling industry increased 6.5 per cent in FY2014-15 to Rs 7,958 crore (US$ 1.19 billion) and is expected to reach a size of Rs 23,654 crore (US$ 3.55 billion) by FY2019-20, as per a joint report by India Direct Selling Association (IDSA) and PHD.

Below is the competitive position in terms of revenue of the market leaders in the retail sector in India:-

Company	Rank	Revenue (INR) (USD)
Reliance Retail Ltd.	1	16169 cr, 2.45 billion
Future Retail Ltd.	2	10341 cr, 1.56 billion
Future Life	3	3134 cr, 483.6 million
Shoppers Stop	4	3041 cr, 483.5 million
Pantaloons Fashion	5	1850 cr, 284.6 million
Trent	6	1358 cr, 208.9 million

The purpose of this report is to prepare an analytical review comparing the financial reporting and financial position of the largest retailer in India with some of its international peers. The companies that I will be covering in this report are:-

- Reliance Retail Ltd., India (Reliance) - Reliance Retail Ltd. is a subsidiary company of Reliance Industries. Founded in 2006 and based in Mumbai, it is the largest retailer in India in terms of revenue.
- Future Retail Ltd., India- Future Group is an Indian private conglomerate, headquartered in Mumbai. The company is known for having a significant prominence in Indian retail and fashion sectors, with popular supermarket chains like Big Bazaar and Food Bazaar.
- Walmart Stores, United States (Walmart) - The largest retailer in the US and world's largest company by revenue. Walmart is an American multinational retail corporation that operates a chain of hypermarkets, discount department stores and grocery stores.
- Tesco Plc, UK (Tesco) - Tesco PLC is a British multinational grocery and general merchandise retailer headquartered in Welwyn Garden City, Hertfordshire, England, United Kingdom. It is the third largest retailer in the world measured by profits, second-largest retailer in the world measured by revenues and the largest retailer in UK with a market share of 28.4%.

In this report I will be benchmarking and providing information obtained through ratio analysis, regarding the profitability, liquidity, stability and solvency of the peer companies mentioned above.

From the view point of analysis it is prudent and practical to compare the financials with a 'peer' company. A peer company is a company of a similar size operating in the same industry.

This report will also comment on the standards of financial reporting adopted by the companies. To further add value, the report analyzes the financial strengths and weaknesses revealed by the financial statements of the companies. Lastly it gives a review of the market perception of the companies and their share price movements over the last three years.

Below I have given the views of some experts and their say on financial statement analysis of companies:-

Walter (1957) included cash flow statement items in ratio analysis. At the end of world war fund statement came into existence and with fund statement fund statement ratios was also produced.

W Braddock Hickman (1958) used times interest earned ratio and net profit ratio to predict the default rate on corporate bond.

Pinches, Mingo, and Caruthers (1973) and Pinches, Eubank, Mingo, and Caruthers (1975) carry on further worked on this subject and categorized the financial ratios in seven factors that include receivable

turnover, capital turnover, short-term liquidity, return on investment, inventory turnover, financial leverage and cash position.

Sorter and Becker (1964) examined the relationship between psychological model and corporate personality of financial ratios and found out that long-established corporations maintain greater liquidity and solvency ratios.

Fitzpatrick (1932), with the help of thirteen different types of ratio analysis of 120 failed firms, found that three out of thirteen ratios predict the failure of firms with precise accuracy while other ratios also shown some prediction power.

Rasmer and Foster (1931) used eleven ratios to examine that the successful firms have higher ratios than unsuccessful firms. Although this study was immature but immaturity was ignored by considering the vital contribution this study had in the evaluation of usefulness of ratios.

Gilman (1925) has following concerns on ratio analysis (1) ratios are bond with time and changed as time passed so cannot be interpreted (2) ratios are not natural measure for judging the performance companies manipulated them (3) ratios easily affect the mind of viewers and hide the actual position and (4) ratios swing widely that also affect the dependability. (4) Ratio analysis of companies in different countries is not always comparable due to the different reporting standards adopted by them.

Comparison of Financial Reporting Standards

- This section compares the financial reporting standards that have been adopted by the subject companies.
- Reliance and Future Retail Ltd. prepare their financial statements according to the Indian Accounting Standards (Ind AS)
- Tesco prepares its statements according to the International Financial Reporting Standards ; and
- Walmart Stores prepares its financial statement according to the US Generally Accepted Accounting Principles (US GAAP)
- The major differences between the financial reporting will be highlighted in the context of the following International Accounting

Standards (IAS):-

- IAS 1- Presentation of Financial Statements
- IAS 2- Inventory
- IAS 16- Property Plant and Equipment
- IAS 23- Borrowing Cost
- IAS 36- Impairment of Assets

Given that the companies I am covering in this report are retail companies, I have considered the above International Accounting Standards, which are relevant to such retail companies with fast moving stocks, investment in property and large working capital finances.

IAS 1: PRESENTATION OF FINANCIAL STATEMENTS

IFRS: - One year of comparatives is required for all numerical information in the financial statements, with limited exceptions in disclosures. In limited note disclosures more than one year of comparative disclosure is required. Accordingly, Tesco reveals information for the current two years to aid comparison in its financial statements.

US GAAP: - SEC requirements specify that all registrants should give two years of comparatives to the current year for all statements except the balance sheet which requires only one year of comparative. This rule applies whichever accounting principles are used in the primary financial statements. Accordingly Walmart publicises the two most recent years for the balance sheet and three years for other statements.

Indian GAAP: - One year of comparatives is required for all numerical information in the financial statements, with limited exceptions in the disclosure. The same is followed by Reliance and Future Retail.

IAS 2: INVENTORY

All the 3 companies use the retail method in order to measure large sums of inventories of items that change rapidly with similar margins. However differences in measurement of inventory as per requirements of applicable financial reporting standards are given below:-

IFRS: - Inventories are carried at cost or net realizable value whichever is lower, where net realizable value is equal to the sales proceeds recoverable minus the selling costs associated. Reversals of write downs are allowed only to the extent of write down done earlier i.e. the value of inventory cannot go above the cost.

US GAAP: - Inventories are carried at cost or market value whichever is lower. Market value is equal to the current replacement cost which is subject to an upper limit of net realizable value and a lower limit of net realizable value minus a normal profit margin. Moreover, reversals of inventory write downs are not permitted under US GAAP, as a write down creates a new cost basis.

Indian GAAP: - similar to IFRS

A summary of the methods of cost flow that can be used under the three reporting standards is given below:-

Method	IFRS	US GAAP	Indian GAAP
LIFO	Prohibited	Permitted	Prohibited
FIFO	Permitted	Permitted	Permitted
Weighted Average	Permitted	Permitted	Permitted

Walmart stores in the US use LIFO method of inventory while the international Walmart stores use the FIFO method. The US GAAP permits the use of LIFO inventory for accounting purposes, and so like many other US companies, Walmart also uses the LIFO method in lieu of the tax benefit that it brings. The Last in First Out (LIFO) method assumes that the units of inventory that are purchased most recently are the ones that are sold. Thus in an inflationary environment, the cost of the goods purchased more recently will be higher than the cost of the goods purchased earlier. Due to this reason LIFO results in a higher Cost of Goods sold figure than FIFO in an inflationary environment. This reduces the Gross Profit and hence the taxes due.

Tesco and Reliance use the FIFO method of cost flow as per IFRS and Indian GAAP.

Under all the three standards the same cost formula is used for all inventories that have a similar nature and use to the entity on the basic fundamental principle of consistency.

IAS 16: PROPERTY PLANT AND EQUIPMENT

IFRS: - PPE is accounted for under either the cost model or revaluation model. Under the cost model, PPE is carried at cost less accumulated depreciation and impairment. Under the revaluation model, PPE is carried at fair value at the date of revaluation less depreciation and impairment. The revaluation model is applied to an entire class of assets. Revaluations have to be kept sufficiently up to date to ensure that the carrying amount does not differ materially from fair value.

The increase in an asset's carrying amount as a result of revaluation is credited directly to Equity under the heading 'Revaluation Surplus', unless it reverses a revaluation decrease for the same asset previously recognized as an expense. In this case it is recognized in the income statement. A revaluation decrease is charged against any related revaluation surplus for the same asset; any excess is recognized as an expense.

Tesco did not use the revaluation model in the previous year. Tesco valued its assets at cost less depreciation and impairment.

US GAAP: - PPE is carried at cost less accumulated depreciation and impairment losses. Revaluations are not permitted under US GAAP. Consistent with IFRS impairment testing is performed whenever events or changes in circumstances suggest that the carrying value is not recoverable.

Indian GAAP: - Treatment is similar to IFRS. However, there would be a dip in charge to the income statement when compared to IFRS on an overall basis due to compensating transfer (attributable to depreciation suffered on the revalued part of the asset) made from revaluation reserve to income statement under Indian GAAP.

IAS 23:BORROWING COSTS

IFRS: - Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are required to be capitalised as part of the cost of that asset. A qualifying asset is one that necessarily takes a substantial period of time to get ready for its intended use or sale. The amount of interest eligible for capitalisation is either the actual costs incurred on a specific borrowing or an amount calculated using the weighted average method, considering all the general borrowings outstanding during the period for that entity. Interest can include foreign exchange differences but under tightly defined conditions. Any interest earned on temporary investment of funds borrowed to finance the asset's production is netted and the interest capitalised. Capitalisation of interest ceases once the asset is ready for its intended use or sale. To the extent borrowing costs are not specific, while applying the capitalisation rate (usually weighted average rate) the amount of borrowing costs capitalised during a period may not exceed the amount of borrowing costs incurred during that period.

US GAAP: - Treatment of borrowing costs is similar to IFRS. A qualifying asset is also defined similarly to IFRS, except that investments accounted for using the equity method meet the criteria for a qualifying asset while the investee has activities in progress necessary to commence its planned principal operations, provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. The method of measurement of capitalized interest is similar to IFRS, except that foreign exchange differences and interest earned on funds borrowed to finance the production of the asset cannot be netted against interest, except for certain governmental or private entities that finance qualifying assets through tax-exempt borrowings. In these cases, interest costs to be capitalised are required to be reduced by related interest income.

Indian GAAP: - Similar to IFRS, however, there is no choice but to capitalise borrowing costs. A period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified. The method of measurement is similar to IFRS.

IAS 36: IMPAIRMENT OF ASSET

IFRS: - An entity should assess at each reporting date whether there are any indications that an asset may be impaired. The asset is tested for impairment if there is any such indication. An impairment loss is recognized in the income statement when a non revalued asset's carrying amount exceeds its recoverable amount. Where the asset is carried at valuation, impairment loss is recognized directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount of revaluation surplus for that same asset and any excess is recognized in the income statement. The recoverable amount is the higher of the assets fair value less costs to sell and its value in use. The value in use represent the present value of the future cash flows to be derived from the particular asset using a pre tax market determined rate that reflects the current assessment of the time value of money and the risks specific to the asset for which the cash flow estimates have not been adjusted. Fair value less costs to sell represents the amount obtainable from the sale of an asset or a cash generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Tesco for the purposes of impairment testing, following a triggering event, treats each store as a cash-generating unit ('CGU').

US GAAP: - Like IFRS, long-lived assets are tested for recoverability whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. However, unlike IFRS, US GAAP requires a two-step impairment test. The carrying amount is first compared to the undiscounted cash flows that are expected to result from the use and eventual disposal of the asset. If the carrying amount is lower than the undiscounted cash flows, no impairment loss is recognised, although it may be necessary to review depreciation estimates and methods or amortisation periods for the related assets. If the carrying amount is higher, the impairment loss (if any) is measured as the difference between the carrying amount and fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Indian GAAP: - Similar to IFRS, except that (a) all intangible assets are amortised and not considered to have indefinite useful lives and (b) assets are not separately classified or disclosed as held for disposal (sale) on the face of the balance sheet.

Reversal of impairment loss

IFRS: - Impairment losses are reversed when there has been a change in economic conditions or in the expected use of the asset. Reversal of impairment loss for goodwill is not permitted. No impairment loss recovery was reported by either Tesco or Sainsbury.

US GAAP: - Impairment losses cannot be reversed for assets to be held and used.

Indian GAAP: - Similar to IFRS. However, reversal of impairment loss for goodwill is required when the impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur and subsequent external events have occurred that reverse the effect of that event.

CONCLUSIONS

We investigate why there is heterogeneity in countries' decisions to adopt IFRS; in other words, why some countries adopt IFRS while others do not. We focus our analysis on a sample of 102 non-EU countries, excluding the EU because of it closeness to the IASB. We examine IFRS adoption over the period 2002 (the first full year of the IASB's existence) through 2007.

We use the economic theory of networks to develop our hypotheses since a standard like IFRS is likely to be more appealing to a country if other countries adopt it as well. In other words, network theory allows us to explain the inter-temporal increase in the adoption of IFRS across countries. We find evidence consistent with the likelihood of IFRS adoption for a given country increasing with the number of IFRS adopters in its geographical region and with IFRS adoption among its trade partners. The result is significant for at least two reasons: (1) it suggests countries internalize the network effects of IFRS in their adoption decisions; and (2) it suggests that as the network benefits from IFRS get large, countries may adopt the international standards even if the direct economic benefits from such standards are inferior to those from locally developed standards.

The net economic value of IFRS is intended to capture direct pecuniary benefits as they are usually conceived in economic models of networks. Accordingly, we test whether economies that are more reliant on foreign investment and trade are more likely to adopt IFRS and whether the likelihood of IFRS adoption decreases with the quality of domestic governance institutions (a proxy for both opportunity and switching costs). We find no evidence that the level of and expected changes in foreign investment and trade affect the likelihood of adoption. Thus, we cannot confirm that IFRS lowers information costs in more globalized economies. We do find some evidence that the likelihood of IFRS adoption at first increases and then decreases in the quality of countries' domestic governance standards. This result can be interpreted as consistent with both the most poorly governed countries being less responsive to international standards, and all other countries conditioning their IFRS adoption decisions on the opportunity and switching costs of domestic governance standards.

Firm-level studies of IFRS adoption are conditional on countries' decisions to allow or mandate IFRS, suggesting that firm-level studies examine the second stage in what is at least a two-stage process. Further, since firm-level studies require significant amounts of cross-company data, they have been limited to firms in a few (mostly developed) countries where corporate financial reports are available in machine-readable format. By examining IFRS adoption across 102 different (non-EU) countries, we expand our understanding of the determinants and consequences of IFRS adoption to a more global sample. Our evidence of a higher IFRS adoption rate among countries with moderate governance standards is consistent with IFRS being adopted for reasons that can be beneficial to a country. At the same time, the evidence that the best governed and most powerful non-EU countries were, as of 2007, less likely to adopt IFRS, suggests that several countries still perceived IFRS as being costly.

The network-theoretic framework we use to explain the adoption

of IFRS across country- time can be applied in the study of other accounting and corporate governance phenomena. For example, the adoption of accounting methods, accounting standards, and corporate governance best practices by firms and jurisdictions are likely to depend on similar such actions by competitors and associates. In other words, inter-temporal variation in adoption decisions in panel data, commonly studied in the accounting literature, can be explained by the "network" value of the product being adopted. The method employed in this paper can be a first step towards a broader use of network theory in motivating such studies.

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