Corporate disclosure and financial statements

Corporate disclosure and financial statements: a brief history While the history of private enterprise is thousands of years old, a relevant launchpad to understand the modern corporation, and its associated concepts of limited liability and disclosure etc. can be with the corporations of the 17th century.

Understanding the evolution of financial statements and disclosure in the private sector is critical to seeing the remarkable similarity between the evolution of “ Right to Information” issues in the private sector and the current debates on the same topic n our public institutions: While the history of private enterprise is thousands of years old, a relevant launchpad to understand the modern corporation, and its associated concepts of limited liability and disclosure etc. can be with the corporations of the 17th century.

Of special interest to India is that no institution offers a better case study here than the East India Company: Between 1600 and 1617 the company sponsored 113 voyages, each supplied with newly subscribed capital and treated as a separate venture. At the end of each voyage assets as well as arnings were subject to divisions among the shareholders. Profit was easily measured by the individual investor: he gained to the extent that he got back more than he had paid in. One of the first attempts to deny stockholders access to the records of their company occurred during 1633.

After a decline in the fortunes of the East India Company, some stockholders moved for the appointment of a committee of inspectors. The Governor (Chairman) refused to put the motion to the meeting and the governing committee decided that no-one should be permitted to read or copy, or o ‘ ravel and dive’ into the accounts without its consent. During 1841 a Select

Committee was requested to inquire into the State of the Laws respecting Joint Stock Companies with a view to the greater security of the public in Great Britain.

It published its First Report during 1844, including the following recommendations: “ The periodical holding of meetings, the periodical balancing, audit and publication of accounts, (would make) the Directors and officers more immediately responsible to the shareholders. ” “ Periodical accounts, if honestly made and fairly audited, cannot ail to excite attention to the real state of a concern; and by means of improved remedies, parties to mismanagement may be made more amenable for acts of fraud and illegality. “ It is expedient that the accounts of every such Company be open to the inspection of the shareholders: and that the annual balance-sheet, together with the reports of the auditors thereon, be registered. ” This report heralded the beginning of the never ending attempts to enforce proper disclosure of the affairs of corporations, the birth of the modern accountancy and audit professions and the ventual supervision by entities such as stock exchanges, central banks and securities commissions. ? Some of the “ Modes of Deception Adopted” by these companies recorded in the Report were: By the issue of prospectuses and advertisements containing false statements as to the authority under which it exists, By the concoctors and managers living at great expense, entertaining their neighbours, and thereby endeavouring to fortify themselves against suspicion; By the making up of fraudulent accounts, so as to deceive the directors and the shareholders, which has been facilitated sometimes by the accounts not being udited, or by the accountant being a near kinsman of the managing director, the only party

taking an active part in the concern; By declaring dividends out of capital, on false representations of profits realized; The 1844 Report was followed by the first general Companies Act, the Joint Stock Companies Act 1844 which provided for The institution of the Office of the Registrar of Joint Stock Companies Documentary information relating to companies to be kept for public inspection; The preparation and delivery of “ full and fair” audited balance sheets and the auditors reports hereon to all shareholders, The reading thereof and of the report of the directors at the annual meetings of companies, and the filing of the balance sheets and auditors reports at the Office of the Registrar; The right of shareholders to inspect the books of account of their companies. The Limited Liability Act was subsequently passed in 1855. This introduced the concept of general limited liability for shareholders i. e. their liability for the company’s debts, if it became bankrupt, was limited to the amount of share capital which they had invested.

It was felt important that the ompany’s creditors should be aware of the limited liability status of the company, and the requirement for companies to have “ limited” or “ ltd” in their name dates from this time. It was this 1855 Act which finally established companies as the major instrument in economic development. After this legislation, businesses mostly fell into two categories: incorporated companies and conventional partnerships. The numbers of incorporated companies increased steadily, in particular towards the end of the 19th century. By 1914 around 65, 000 were registered; by 1945 about 200, 000 ? As early as 1877, The Economist was among many institutions who were advocating the imposition of a form of account on

companies, to be adopted for regular disclosure. ? Numerous amendments and related statutory enactments followed during the ensuing years which culminated in the Companies (Consolidation) Act 1908. A provision was made for including a statement in the form of a balance sheet in the annual return to the Registrar of Companies. In the United States, progress on corporate disclosure followed the standards set in England, until the early 1900s. As ate as the 1920s many corporations still kept sales fgures secret, some did not depreciate assets, failed to treat non-operating income consistently, did not separate retained earnings from paid-in capital and did not disclose asset write-ups. It was after the Great Depression of 1929 that substantial changes were brought in.

The English Companies Act of 1929 served as the foundation for Felix Frankfurter and his team in drafting the Securities Act of 1933. Importantly, the 1929 Act was the source of two major components of the current American securities regulation regime, the oncept of full disclosure and the possibility of civil liabilities of the registrant, its officers, directors, and experts. Beyond the functional value of the 1929 Act is the reflection of the vision of the nation’s leadership at the time. President Roosevelt’s policy, which championed full disclosure as the preferable remedy to the malaise of American financial markets at the time can best be understood by Louis Brandeis’s diseases. Sunlight is said to be the best of disinfectants. Even as late as 1932, the New York Stock Exchange expressed concern about the wide variety of accounting nd reporting methods used by companies whose securities it listed. A committee of the American Institute of Accountants under the chairmanship of George May was appointed to formulate improved

accounting standards which could then be enforced through listing requirements. The committee's final report contained five recommendations: 1 . To promote consistency, corporations listing their stock on the exchanges were asked to adhere to certain broad accounting principles, within this framework, each firm could adopt the accounting methods it preferred. 2. Each listed ompany would prepare a summary of accounting methods used in its statements.

This summary would be formally approved by the firm's board of directors, would be filed with the exchange, and would be available on request to any stockholder. 3. The procedures listed in this summary would be consistently followed from year to year and would not be changed without prior notice to the Stock Exchange and to the company's investors. 4. Financial statements were to be the representations of management. The auditor's task was to inform stockholders whether the methods dopted by each company were actually being used, whether they were compatible with " generally accepted" principles of accounting, and whether they were being applied consistently. 5.

The committee suggested that a qualified group of accountants, lawyers, and corporate officials draw up an authoritative list of accounting principles to help corporations in preparing their own lists of proceduresls. The committee had two specific tasks: to educate the public as to why a variety of accounting methods was necessary, and to suggest ways to curtail this variety and gradually make the better methods universal. ? In 1938 the Haskins and Sells Foundation commissioned three educators, T H Sanders (Harvard), H R Hatfield (Berkeley), and Underhill Moore (Yale Law School) , to

formulate a code of accounting principles which would be useful in the clarification and improvement of corporate accounting and of financial reports issued to the public.

In preparing “ A Statement of Accounting Principles” they interviewed both makers and users of accounting data, reviewed the periodical literature, and studied laws, court decisions, and current corporate reports. A seminal document in the evolution of the universalisation of ccounting principles was Paton and Littleton’s “ An Introduction to Corporate Accounting Standards” (1940), the most coherent statement of principles to emerge from this period. This document set the tone for much of the subsequent evolution of corporate financial disclosure practices in the ensuing decades. The last fifty years have seen greater flesh being added to this skeleton of financial reporting that evolved in the mid 1930s and 40s, somewhat contemporaneously in the United States as well as in Great Britain.

This process of continuously raising the bar on disclosure tandards is never-ending, as evidenced by the recent example being the Sarbanes- Oxley Act following the collapse of Enron. The creation of standardised financial statements is not a guaranteed safety ticket to proper institutional conduct, rather that it provides a springboard from which stakeholders can hopefully procure sufficient early warning signals about the true state of an institution. The fundamental principles behind the creation of these standards have been the stakeholders by providing regular, detailed, and standardised information about the state of an institution. essay by charles