International Journal of Commerce and Management Research
ISSN: 2455-1627; Impact Factor: RJIF 5.22
Received: 25-02-2019; Accepted: 27-03-2019
www.managejournal.com
Volume 5; Issue 3; May 2019; Page No. 171-174

Inclusion of qualitative factors in reading and measuring of financial statement: A Study

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Abstract

All the investors use different financial statements and ways to analyze the reports. But most of them fail to go beyond looking at bottom-line numbers. Doing so, they would not get the true picture of how a company is performing. Just because an expense doesn't produce revenue doesn't mean it's not a good investment. Likewise, just because spending boosts sales doesn't mean it provides the best return on investment. Analyzing both qualitative (non-financials) and quantitative impacts of activities done using relevant data financial data will help you make better management decisions. The companies should make necessary arrangements to disclose the qualitative data along with quantitative data periodically. So that the investment decision makers get to compare both qualitative and quantitative before taking a decision. The present study is the researcher's own compilation from various sources of the various Qualitative factors under the three categories of financial, social and corporate governance.

Keywords: qualitative, non-financials, financial statements

Introduction

Investor community analyses different financial statements viz., income statement, balance sheet and cash flow statement to invest and get good returns on their investments. Income statement or profit and loss account shows a company's revenues and expenses during a particular period. It indicates how the revenues are transformed into the net income or net profit. A balance sheet is a financial statement that reports a company's assets, liabilities and shareholders' equity at a specific point in time, and provides a basis for computing rates of return and evaluating its capital structure. Cash flow statement summarizes the amount of cash and cash equivalents of a company and measures how well a company manages its cash position. Comparison of these reports on year-on-year basis provides you the picture of the financial performance of the companies.

This is the normal practice, where you compare only numbers. Instead, to get a holistic view on the true performance of the company you need to look into the qualitative aspects as well. So as a practice, companies should integrate a brief note on the non- financial parameters (like the trainings conducted to upskill the existing staff, diversity, health and safety and also measures taken to reduce the impact on environment) in their financial statements.

Non-Financial Measures of Performance

Customers	Operations
1. Customer retention ratio 2. Customer satisfaction index 3. Percentage of delivery compliance on time 4. Number of customer complaints 5. Average time for complaint resolution 6. Time between a customer order and product delivery 7. Customer preference ranking	1. Number of new products introduced 2. Time to develop new products 3. Reduction in operation cycle time 4. Turnover per rupee of wage 5. Productivity 6. Scrap feed per production run 7. Overtime 8. Throughput time 9. Inventory turnover
Suppliers	**HR and Safety**
1. Suppliers performance index 2. Number of vendors chosen as strategic partners	1. Number of man-hours trained 2. Reduction in rate of accidents. 3. Employee satisfaction
Environment	
1. Air pollution level 2. Water effluent discharge level	

Exhibit 1 Non-finance Measures of Performance

Fig 1

- Departmental/divisional throughput
- Number of defects (by product, product line, supplier)
- Number of orders backlogged (by date, quantity, cost and selling price)
- Number of customer complaints (by type and product); method of complaint resolution

Barfield, Raiborn and Kinney have suggested the following important non-monetary information to given in responsibility reports.

Fig 2

- Percentage of orders delivered on time
- Manufacturing (or service) cycle efficiency
- Percentage of reduction of non-value-added time from previous reporting period (broken down by idle time, storage time, move time, and quality control time)
- Number and percentage of employee suggestions considered significant and practical
- Number and percentage of employee suggestions implemented
- Number of unplanned production interruptions
- Number of schedule changes
- Number of engineering change orders; percentage change from previous period
- Number of safety violations; percentage change from previous period
- Number of days of employee absences; percentage change from previous period

Traditional Financial Statement Analysis

Fig 3

Traditional FSA uses financial ratios to gain an insight on what have gone wrong and what are doing well. Unfortunately, they are based on historical figures.
Ratios express a relationship between 2 variables to form an assessment of their results. A financial ratio

a. Has a numerator and a denominator and both numerator and denominator must "jive".
b. Can be explained as $1 of denominator supporting (or covering) $x of numerator.

For a higher ratio, we need to either

1. Increase the numerator or decrease the denominator
2. Increase numerator more than the increase in the denominator or
3. Decrease numerator less than the decrease in the denominator.

Knowing these relationships will enable the accountant to orchestrate some desired results.
The key groups of financial ratios are:

- Liquidity
- Turnover
- Profitability
- Leverage and
- Coverage ratios

Drawbacks of traditional financial statement analysis (FSA)

It uses historical data which are after-the-fact. The analysis only points to what has gone wrong (not what will go wrong) and management will have to rectify the problems.
The company tends to drift along quarter by quarter rather than driving the business not only from operating performance but also from financial risk perspectives.
FSA does not answer the following questions

- Is the company expanding beyond its financial limits, which may lead to subsequent weak or poor operating performance?
- Are there growing signs of a slowdown in the economy or industry? How do we gauge that impending onset and be prepared for it?
- Is there a concentration risk in major product categories or geographic regions?
- Are too many resources applied to certain sectors of the businesses?
- Is there an optimal capital structure to grow the business?

Reasons to Integrate Qualitative (Non- Financials) in Financial Statements

Recently we have seen the investor community and some of the company's management professionals are frustrated with the short-term focus of the organizations. Main reason for this situation is due to lot of emphasis given to the numbers like earnings, assets created etc. As a result, investors have limited information with which to assess whether the longer term, value creating prospects of the business have been truly enhanced. We need to think of broader perspective and integrate Environment Social and Corporate governance data (ESG) to help investors take their assessments beyond current year earnings in a sustainable manner.
Some companies have provision of reporting ESG information through a separate corporate responsibility report (CSR) and some integrate it in annual report but under different section. As there is no law mandating to report on their non- financial disclosures, companies are not keen to report on this. Regulatory authority should impose necessary regulations to ensure companies report on their non- financial performances as
For most of the investors, the term "ESG" brings to mind the issues like climate change and resource scarcity and includes renewed efforts to combat global warming, cutting emissions, energy use and reducing the carbon footprint. It is not restricted to that it can also be used to evaluate any environmental risks a company might face and how the company is managing those risks. While Social criteria looks at the company's business relationships, human rights, training, labor standards in the supply chain, any exposure to illegal child labor, and workplace health and safety. Governance criteria provide insight about the policies the company has, accounting systems, responsibilities and

expectations between different stakeholders in the governance of corporations. A well-defined governance system is the key to align interests between stakeholders and can work as a tool to support a company's long-term strategy.

The investors need to use financial and non- financial data to help you make the best decisions for company. For both the corporate and investment world, a failure to discuss ESG risks can be dangerous. Extreme climate events could impact operations; a cyber-breach might threaten data; a lawsuit over gender discrimination or product quality could impact the brand and the bottom line. If such risks become reality, both corporates and their investors would suffer.

Review of literature

Deloitte attempts to study and assessing the quality of the company's financial position and concluded that we must move beyond the financial statement and perform further analysis to get a complete picture. The transparency of the financial statements and the quality of the financial position are critical in evaluating a company. With the media, analysts, investors, and government leaders all challenging companies' integrity, there is a need for greater transparency in financial reporting, especially given the proliferation of complex, global business structures.

Internal Standards on Auditing (ISAs) on audits draw on existing theoretical and empirical literature on the rationale behind the publication is a practical guide for auditors who are applying the materiality requirements in International Standards on Auditing (ISAs) on audits.

CFA institute articulated that how to evaluating quality of financial reports. The ability to assess the quality of reported financial information can be a valuable skill. An analyst or investor who can recognize high-quality financial reporting can have greater confidence in analysis based on those financial reports and the resulting investment decisions. Similarly, an analyst or investor who can recognize poor financial reporting quality early before deficiencies become widely known—is more likely to make profitable investment decisions or to reduce or even avoid losses.

Deloitte Public Company Accounting Oversight Board has identifying and assessing risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting.

Compudata: Top 20 financial KPI's every CFO dashboard should have; from this article highlighted that customer satisfaction and internal audit cycle time are the qualitative measures, which provide insight about non-financial performance of the company. There is much emphasis about whether this should be include in the financial statement of the companies.

The datapine Blog, enumerated about example of financial reports and listed out the top daily financial reporting examples and KPI is to be included in financial report. Analysis of organization performance is not mere financial data of the companies, employees' overtime, absenteeism, work quality and product will be make significant impact the long-term sustainability of the business.

Defining quality: Many qualitative and quantitative factors that influence a company's financial position may not be obvious from its financial statements. Because there is no single definition of what constitutes a high-quality financial statement, many factors must be reviewed to gain a comprehensive understanding of the strength of a company's financial position. If it is properly prepared and accompanied by appropriate disclosure, the balance sheet gives insight into the following factors, which often differ by company and industry.

Non-financial Indicators (NFI'S) - Brief summary

In today's world of globalization and interdependence, and in times of financial crisis, issues such as climate change, biodiversity, human rights, "license to operate," business ethics and corporate governance are at the forefront of public and political attention. The financial measures show the impact of the firm's policies and procedures on the firm's current financial position and its current return on shareholders. The non-financial factors show the firm's current and potential competitive position. ESG data makes it possible to understand the so-called hidden investment risks and value drivers, giving you the whole picture on company performance. Almost three-quarters of investment professionals worldwide (73%) consider ESG issues in the investment process, according to the CFA Institute ESG Survey.

Environmental: Measures a company's commitment and effectiveness towards reducing environmental emissions in the production and operational processes. Organizational Performance and capacity to reduce the use of materials, energy or water, and to find more eco-efficient solutions by improving supply chain management.

NFI-1: CO2 Equivalents Emission Total: Global warming/climate change is the biggest threat for the future generation in this earth therefore; investors will adopt the criteria to analysis the corban disclosure and potential for GHB emission savings.

NFI-2: Total water withdrawal and water recycling Volume of water withdrawn and various initiative in place to reduce the use of water and improve its water efficiency by adopting recycling techniques.

NFI-3: Total Renewable/energy consumption and Energy efficiently policy: How efficiently company minimizes its resource use through more eco-efficient solution.

NFI-4: Responsible investment: s an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns.

Social: Measures a company's capacity to generate trust and loyalty with its workforce, customers and society, through its use of best management practices. It is a reflection of The Company's reputation and the health of its license to operate, which are key factors in determining its ability to generate long-term shareholder value.

NFI-5: Gender pay gap: Percentage of remuneration of women to men, often for doing the same work. Under pay equity concept, how organization adopting equal pay concept without bias and gender discrimination.

NFI-6: Training cost total: Developing workforce and improving their skills through training can increase productivity improve the quality of work. Reduce faults, waste or customer complaints with streamlined processes and more staff that are competent.

NFI-7: Board Gender Diversity: How company providing equal opportunity for the women in the governance and in

terms of decision-making process. Variation in functional experience contributes to a board's diversity and produces better quality decisions, as well as more creative, innovative insights.

NFI-8: Health and safety of the employees: It is an employer's duty to protect the health, safety and welfare of their employees and other people who might be affected by their business.

Economic: The Economic pillar measures a company's capacity to generate sustainable growth and a high return on investment through the efficient use of all its resources. It is reflection of a company's overall financial health and its ability to generate long-term shareholder value through its use of best management practices

NFI-9: Customer Satisfaction percentage: Under client loyalty, the various stakeholder can measure the overall percentage of customer who are satisfied and this would reflect the efficiency of overall service quality and customer relationship management.

NFI-10: Employees Satisfaction percentage: Most of the top corporates treating that an employees are intellectual property of their companies. This key performance indicator shows how company build its trust, loyalty and investment on employees in the form of training and development, also this measure provided an indication of work and organizational culture of the organization.

NFI-11: Internal Audit Department Reporting: Under shareholder loyalty, assess the company's internal audit department report to the audit committee of the board. This function ensures that audit Committee's responsibility includes overseeing internal audit department because audit committee monitors and reviews the effectiveness of the internal audit function and internal audit program.

Obstacles of nonfinancial measure to integrate into financial statement

Reliability: Without clear regulation or effective auditing system governing nonfinancial reporting, the credibility of corporate disclosure may be called into question

Resource constraints: Related parties have limited time and resources to analyze corporate data. Information overloaded - especially if that information has no clear link to investment decision-making process or financial statement readers.

Comparability: Without adherence to consistent disclosure guidelines still absent despite the work of multi-stakeholder groups such as Global Reporting Initiative, nonfinancial information can lack of the comparability of traditional financial data.

Non-Compliance: Unlike, financial data statement mandatory disclosure as per the regulatory compliance, nonfinancial key measures are not mandatory to report by the corporate communities.

Lack of awareness: Most of the investment communities/stakeholders are not much aware about the nonfinancial measure, not showing substantial interest on how to read and measurement while applying their individual requirement.

Conclusion

The Corporate Governance pillar measures a company's systems and processes, which ensure that its board members and executives act that the best interests of its long term shareholders. It reflects a company's capacity, through its use of best management practices, to direct and control its rights and responsibilities through the creation of incentives, as well as checks and balances in order to generate long-term shareholder value. The Companies Act, 2013 which mandates the publication of the qualifying companies relating to CSR such as policy, committee, director's reports, and annual disclosure and spends of the companies. The CSR initiatives have been made mandatory for 2013 in the Indian Companies Act. But, however, it is up-to the companies to do it voluntarily possibly there is no point in playing hardball with the Act. The organizations should not take it as a compulsive enforcement but rather an initiative organization does it as something as reciprocate voluntarily.

For advocates, regulators, corporations and investors, it seems that there is a space for a multi-stakeholder process that helps to understand the complete contribution to the shareholder and various interested parties that helps additional standards from reporting information that is of use to internal and external stakeholder of the company.

Convergence between the Global Reporting Initiative and Financial Accounting Standard Board which brought together with hybrid reporting standard a wide range of interested parties to support new initiative that tends to be overwhelmingly positive guide.

National Advisory Committee on Accounting Standards (NACAS) should recommend to all public and private companies to Integrate the NFI's into financial statement, which reflect the complete and holistic picture of the organization. Accounting standard committee has to create new policy that latest common global language for business affairs so that company accounts are understandable through financial numbers along with non-financial measures.

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