

Coming up short on Disclosures *

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Introduction

Corporate Governance (CG) came into prominence largely due to the 'Cadbury Committee Report' published in 1991 in the UK. But there is one CG practice, which significantly predates the Cadbury Committee report. It is the disclosures given under the section Management Discussion and Analysis (MD&A) in company annual reports.

Financial statements contain data. But it is only if the data is properly interpreted by investors that one can say the disclosure has been effective. Even sophisticated readers of annual reports have difficulties in not only understanding their language but also the underlying mechanisms and conventions. Clearly, the ordinary investor needs simple narrative explanations to have a better understanding of a company's operations, the environment in which it operates and its future prospects. MD&A fulfills this objective by providing both a short and long-term analysis of the company's business prospects. The Securities and Exchange Commission (SEC) of the United States of America (USA) requires MD&A to *"provide such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations."*

Background Note

The history of MD&A goes back to 1968 when SEC included MD&A in the 'Guides for Preparation and Filing of Registration Statements'. In the mid-1970s, SEC made it compulsory for company annual reports to include a discussion and analysis of the summary of operations. In 1980, the SEC adopted the MD&A as a separate requirement and changed the focus from operating results to the financial statements as a whole. This resulted in a formal requirement for a discussion of issues and trends relating to liquidity, capital resources and the results of operations. The 1980s witnessed more such changes aimed at making MD&A disclosures more effective. Recently, in line with the Sarbanes-Oxley Act of 2002, (SOA) SEC has made a few more modifications with respect to the MD&A disclosure requirements.

In other countries also, particularly the developed ones, the market regulators have made it compulsory for companies to include an MD&A section in their annual reports. The disclosure requirements under MD&A do vary from country to country. But the basic objective of MD&A is the same across regulatory environments. The management of companies should provide relevant and important information to investors using language and formats, which are easy to understand.

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Given the increasing awareness about CG, MD&A disclosures have become important in India as well. The Kumaramangalam Committee report in 1999 talked about disclosure under MD&A. Accepting these recommendations, the Securities and Exchange Board of India (SEBI) made it mandatory for the companies to have an MD&A report as part of the annual report in 2000. The SEBI Listing Agreement Clause 49, states that the annual report should have a section titled "Management Discussion and Analysis report" (as part of or in addition to the directors' report) containing the following:

- a) *Industry structure and developments*
- b) *Opportunities and threats*
- c) *Segment and product-wise performance*
- d) *Outlook*
- e) *Risks and concerns*
- f) *Internal control systems and their adequacies*
- g) *Discussion on financial performance with regard to operational performance*
- h) *Material development in HR including number of people employed*

Disclosures should be made by the management to the board regarding all material, financial and commercial transactions including areas of personal interest or potential conflict with the interests of the company at large.

Meanwhile, the credit rating agencies, ICRA and CRISIL have come out with a rating for CG practices. Another rating agency FITCH has similar plans. One of the main criteria in the rating methodology adopted by these agencies is the quality of the disclosures in the MD& A report.

Our research

We attempted to find through our research, whether Indian companies are providing information in MD&A reports in a transparent manner and helping the investors to understand the factors that will affect the performance of the company.

In the first phase of our research, we studied in detail all the pertinent business issues including the macro industrial environment, related to all the selected companies. In the second phase, we studied the MD&A and the Directors' reports of selected companies and analyzed them. We examined whether there was any important piece of information that was not provided or vaguely discussed or misrepresented, which had the potential to affect the performance of the company in the future.

Our sample consisted of 52 companies, which figured in either BSE Sensex or NSE Nifty as on 31st October, 2003. The data for the research was collected from business newspapers & magazines, reports of equity research firms, the websites of the companies and annual reports of the companies. Where the latest annual report (FY 2002-03) was not available for the companies, reports for the financial year 2001-02 were used. We found that only 12 out of the 52 companies covered in detail all the major issues that might significantly affect their business.

To justify and examine the impact of the missing and incomplete information on the performance of the companies, we studied four companies from the sample in much greater detail – Dr Reddy’s, HDFC, ICICI Bank and Infosys. These are high profile companies, which are generally perceived to be well managed and having fairly good CG practices. They are led by highly respected CEOs, who are perceived to represent the best qualities of Indian entrepreneurship. We found that even these companies have major gaps in their MD&A disclosures.

For example, the MD&A Report of Dr.Reddy’s Laboratories for the year 2003 states, *“Currently, only process patents are recognized in India. However, by virtue of India being a member of the World Trade Organization (WTO), India has recently passed legislation to recognize product patents from 2005. This does not affect a discovery based company like Dr. Reddy’s. However, it will affect companies that survive only on reverse engineering”*. But with generics contributing Rs 1,896 million out of a total profit before tax of Rs.4313 million during 2003, the company’s claim that it is ‘discovery based’ is quite misleading.

‘Parallel imports’ is a way of lowering prices of patented drugs in developing countries. Many countries cannot afford the highly priced patented drugs. Parallel import involves a government or another importer shopping in the global market for the lowest priced version of a patented drug rather than accept the price at which it is sold in their country. When the South African Parliament passed legislation to this effect in 1997 (the Medicines and Related Substances Control Act), the Indian drug maker Cipla made a killing. Parallel import represents a major opportunity for companies like Dr. Reddy’s. The MD&A reports of the company for the past two years do not mention this issue at all.

As much as 82% of Dr. Reddy’s branded formulation sales in overseas markets come from the erstwhile USSR (65% from Russia and the rest 17% from other countries in the erstwhile Commonwealth of Independent States). Such a heavy dependence on one market is definitely a major risk. But this risk has not been adequately discussed in the MD&A report.

HDFC is India’s leading housing finance company. Risk management is a core function for any financial institution. In the directors’ report of HDFC, risk management is dealt with, at a very superficial level. There is some discussion on how the company protects itself from foreign exchange fluctuations. But operational, credit and other market risks have not been dealt with at all.

HDFC is in a business whose fortunes are closely linked to the performance of the economy. One parameter, which all housing finance companies track carefully, is interest rates. HDFC seems to be working on the assumption that interest rates in India will continue to fall. Indeed the company has tremendously benefited by a falling interest rate regime. Its disbursements have gone up by nearly three times in the last four years and more than made up for the decrease in spreads. But the report does not discuss what impact rising interest rates would have on the business of the company. This is clearly an important issue especially as data suggest that there is little scope for long-term yields in India to go down further.

There are some important omissions in ICICI Bank's MD&A disclosures. In June 2002, 'Securitisation & Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002' was passed by the Parliament. In the Business Overview part of the 2003 annual reports ICICI Bank does refer to the passage of the bill and says, "*The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 has significantly strengthened the ability of lenders to resolve non-performing assets by granting them greater rights as to enforcement of security and recovery of dues*". But the bank has not detailed its plans to take advantage of the Act. In contrast, the MD&A report of State Bank of India (SBI) deals with this issue in detail. To quote from SBI MD&A report "*Notices have been issued in respect of 6,330 cases involving dues of Rs.3, 642 crore and seizures of defaulting borrowers have been made in respect of 19 cases*".

The benchmark level of a bank's lending to the priority sector as a proportion of its net bank credit (NBC) should be 40%. In case a bank does not meet its priority sector lending targets, it has to invest in low interest National Bank for Agriculture and Rural Development (NABARD) bonds. ICICI Bank's MD&A report for the year 2003 skips this issue completely. Here again, the SBI annual report provides a much better disclosure and discusses the priority sector lending in detail.

The merger of the erstwhile ICICI and its two subsidiaries with ICICI Bank became effective on May 3, 2002. In its Business Overview, the bank discusses in detail the advantages of the merger but totally overlooks the disadvantages. The difficulties in implementing mergers, especially the integration of the pre merger entities have not been mentioned at all. Two out of three mergers have been known to fail in USA. Scores of research papers have drawn attention to the various risks associated with mergers. But these risks have not even been covered in passing in the ICICI Bank Annual report. Instead, the bank has presented a very rosy picture: "*The merger of ICICI and two of its subsidiaries with ICICI Bank has combined two organizations with complementary strengths and products and similar processes and operating architecture*".

Infosys, possibly India's most admired company, has been given the top rating by ICRA in Corporate Governance. But even in case of Infosys, there are various areas where the disclosures leave a lot to be desired.

Take the much publicized sexual harassment issue involving senior executive Phaneesh Murthy, against whom a former employee, Reka Maximowitch, filed a sexual harassment suit in December 2001 in USA. The consequences of such lawsuits can be very serious. But the 2001-02 annual report did not mention this issue. For all practical purposes, investors came to know about the incident only when Murthy resigned from the company in July 2002. The 2002-03 annual report mentioned this issue, but in very vague and general terms, "*An unfavorable resolution could adversely impact Infosys' results of operations, or financial condition*". The company could have easily quantified the possible damages. Besides, the report did not mention the company's plans to settle the issue, outside court. Finally Infosys paid US \$ 3 million to the plaintiff in an out-of-court settlement.

Infosys is considered to be one of the leaders in India in the area of risk management. But the risk management section in the company's annual report seems to be long on gloss and short on substance. Take for example foreign exchange risk. Given the fact that 89% of the revenue is in dollar terms, any change in 'Rupee-Dollar' value will have a significant impact on the top line and bottom lines of the company. But the report merely mentions that any change in the dollar-rupee value will affect the company's performance. This is a very general statement. Even a basic sensitivity analysis has not been provided. Some important issues like threat to Indian software professionals abroad, in the wake of growing concerns over outsourcing and Basel II regulatory compliances do not find any mention at all in the report.

Infosys' treatment of some issues is somewhat simplistic. The company mentions that it is facing competition from global consulting firms, divisions of large multinational technology firms, IT outsourcing firms, Indian IT services firms, software firms and in-house IT departments of large corporations. The report mentions that Infosys is well positioned against its competitors. But with a turnover of less than \$1 billion, while global competitors like EDS generate tens of billions of dollars, the claim that it is "well positioned" looks hollow and unsubstantiated.

Infosys claims that it follows the Sarbanes-Oxley Act (SOA). But a careful examination of its annual report reveals deviations. For example, SOA stipulates that a company has to identify any known trends or any known, commitments, events or uncertainties that are likely to affect the company's liquidity. But the liquidity section under Risk Management does not cover such issues.

We found several other instances of blue chip companies failing to include important information in their MD&A report. For example, the annual report of Grasim did not discuss anything about its plan to acquire L&T's cement business. But the business media had been speculating the move for nearly two years. Finally, within a month of releasing the annual report, Grasim went on to acquire a controlling stake in L&T's cement business.

Similarly, many companies vaguely discuss the important issues, thereby misguiding the investors about their importance. For example, most software companies report that the appreciating rupee and heavy dependence on the US market are major risks. But they do not quantify the possible impact.

Some companies tend to misrepresent information. For example, the annual reports of many Fast Moving Consumer Goods (FMCG) companies give two reasons for the poor performance of the FMCG sector. One is the weak economy. The second is that consumers are diverting their expenses towards consumer durables. These are contradictory statements. Consumers are hardly likely to purchase consumer durables, if the times are bad!

Many companies also tend to concentrate on positive pieces of information, while concealing the negative ones. For example, the petroleum ministry has done away with the nodal agency status of Indian Oil Corporation in crude import and allowed other oil refining companies to import crude oil on their own. The MD&A report of Bharat Petroleum Corporation Ltd.

(BPCL) discusses the advantages of the moves. But it fails to discuss the risks to which it will be exposed on account of fluctuations in the international oil market.

Conclusion

Our study shows that only 12 out of 52 BSE Sensex + NSE Nifty companies are making disclosures under MD&A in true spirit. There is a tendency on the part of companies to talk in general terms, not give specifics, misrepresent information and in some cases omit totally important issues. (See Table I).

One of the reasons for the inadequate disclosures can be the absence of specific directives from SEBI. Since SEBI guidelines do not explain what should come under each heading, the companies have a general tendency to omit certain issues of importance. Since types of transactions, and their frequencies, are likely to differ across an industry, it is tough for the regulator to define the disclosures under MD&A. Despite these problems, SEBI can do a lot more to improve the quality of MD&A reporting. The disclosures can be better classified, like in case of the SEC. The objectives of each disclosure item can also be more clearly defined. To cite an instance, under the heading 'Disclosures concerning Liquidity', SEC clearly defines, what is a liquidity concern and spells out the circumstances that may affect liquidity. SEC provides examples wherever possible, to illustrate how the information should be reported. For example, for most global pharmaceutical companies, operating cash flows constitute the main source of liquidity. In that case, the SEC requires the company to disclose the impact of a decrease in demand for the company's products on the availability of funds.

Another important issue is the timeliness of information. In India, companies disclose important information under MD&A once in a year. This means the investors have to wait till the arrival of the annual report. Companies take many important decisions during the course of the year. Such decisions may have an immediate impact on the company's performance and the stock price. There is no mandatory provision for the management to reveal the impact of important decisions as and when they are taken.

As a matter of fact, the issue of timeliness came up when we presented some of the findings of this paper at a seminar held by ICAI in December, 2003. In fact, some participants questioned the very utility of the MD&A report. They felt that such reports were too static in today's dynamic business environment, where real time reporting is the need of the hour. There can be no two views on the need to disseminate important information, without any delay, to investors. However, the essence of disclosures is not providing raw accounting data. Real time accounting can only present raw or at best semi processed data. It will not allow time for investigation of deviations, the obtaining of necessary explanations and processing of data. Even with its superb online accounting systems, Cisco could not avoid piling up billions of dollars worth of inventory during the tech slowdown in 2001. Moreover, real time disclosures may result in information overload. What the investors need are simple timely statements, which keep them informed about how the company is being managed and what its future prospects are. In this context, it is difficult to see how MD&A can be totally done away with. MD&A will also continue to serve an important role in providing a commentary on the strengths and weaknesses of the business. MD&A can explain to investors in simple terms, the company's business, the overall strategy, the principal drivers

of performance and the events & trends that may affect the business. The major risks faced by the company and how they are being managed can also be discussed. As a practical measure towards making information available on a timely basis, companies can be required to disclose MD&A every quarter along with the quarterly results.

Another important point raised in the seminar was whether the ordinary investor reads the MD&A report at all. Indeed the chances of an ordinary investor reading the MD&A report of a company are very less. But the fact that an ordinary investor does not refer to the MD&A report while deciding to buy/sell/hold a stock does not mean that MD&A is unimportant. The investor is certainly influenced by the views of the opinion makers (Analysts, Brokers, Business Journalists) whose views in turn are significantly influenced by the information that is disseminated by the company. MD&A is one of the ways through which companies disseminate information. As one writer has put it aptly, *“The fact that a professional swimmer may know nothing about the physics of fluid mechanics does not mean that the viscosity of water does not affect the way the swimmer moves”* (Angel, 97). In general, information dissemination is a complicated process involving layers of intermediaries. It is safe to assume that the layer closest to the source of information has the wherewithal to understand and digest the information. So time, effort and money invested in preparing good MD&A reports are worth invested.

In short, the disclosures in MD&A report need to be more transparent, readable and comprehensible to users. Indian companies also need to be more proactive. Their willingness to make adequate disclosures should not be driven only by SEBI requirements. CEOs and CFOs would do well to remember that MD&A disclosures should "express" rather than "impress."

Table I
Partial List of the findings

Company name	Major missing issue/Vaguely discussed issue/ Misrepresented issue
Asea Brown Boveri Ltd. (ABB)	ABB India is the main sourcing base for the parent company ABB. The parent company is performing poorly. This will affect the Indian subsidiary's exports. This issue has not been discussed.
Bajaj Auto	The scooter industry considers both geared scooters and automatic/gearless scooters (excluding scooterettes), together as a single segment. But Bajaj Auto considers only the geared scooter segment in which it happens to be the market leader, while ignoring the other segment.
Dabur India	The impact of the product patent regime on the firm's pharma division has not been covered. The less than satisfactory performance of the company in the FMCG sector has been attributed to environmental factors. Internal weaknesses have not been discussed.
Hindustan Lever	There is no disclosure on future plans for 'Dalda' even though the company admits that there has been a distinct shift in consumption pattern from vanaspati towards vegetable and soyabean oil. Stagnant sales for the last few years have been blamed on the increasing spend on consumer durables. This is hardly a logical explanation.
Ranbaxy Laboratories	Pharma companies in India are faced with the huge problem of spurious drugs eating into their markets. The impact of spurious drugs on the company has not been discussed.
Smithkline Beecham Consumer Healthcare	The Horlicks brand generates nearly three quarters of the sales of the company. The implications of the company's over reliance on the Horlicks brand have not been discussed.

State Bank Of India. (SBI)	Only facts are given and there is hardly any analysis. The ongoing Voluntary Retirement Scheme (VRS) process has not been discussed
Tata Engg. & Loco. Co. (TELCO)	The report does not discuss the impact of 16 percent excise duty on the chassis of commercial vehicle bodies built by the unorganized sector. The report is very vague on the company's future plans for product development.
Tata Iron & Steel Co. Ltd. (TISCO)	The report makes some misrepresenting statements. For example, it says one of the reasons for forecasting good steel demand is that GDP is expected to grow at 6%. The late nineties proved that there is no correlation between GDP growth and steel demand growth. The report also proudly showcases the award given by World Steel dynamics about its global competitiveness. But, Tisco is ranked 57 th globally in terms of steel capacity. Experts feel that only the big players can survive in the long run in the steel business. The report is silent on this issue.
Videsh Sanchar Nigam	The report does not discuss anything about the collapse of US telecom giant WORLDCOM, with which VSNL has significant business transactions. There is no discussion of the proposed unified license in the telecom sector.
Wipro	The section dealing with risk management is very vague. It does not indicate clearly how the risks identified will affect the company.

Source: Company Annual Reports