Common Errors Found by FRRB in Implementation of AS 18, *Related Party Disclosures* and AS 2, *Valuation of Inventories*

Financial Statements are the paramount source in hands of the stakeholders to understand the financial well-being of an enterprise. The users are highly reliant on the information given in the financial statements and, therefore, the preparers ought to ensure that the information given in the financial statement is correct, complete, relevant and in adherence to the regulatory requirements. Financial Reporting Review Board (hereinafter referred as FRRB or Board) reviews the General Purpose Financial Statements (GPFS) of enterprises with the view to identify the non-compliances with Accounting and Auditing Standards, CARO, Companies Act, and other statutory requirements applicable in preparation and presentation of the financial statements. The non-compliances observed by the Board are compiled from time to time and published under the name of ''Study on Compliance with Financial Reporting Requirement''. Till date three volumes of the aforesaid publication has been released by the Board. In addition, the Board also publishes articles in the 'Journal' of the Institute on non-compliances with various reporting requirements to disseminate the awareness amongst the members as well as general masses. Further, the Board also organises the webcasts on commonly found non-compliances on various accounting standards, which are available on ICAI TV. This article deals with the non-compliances, observed by the Board, with disclosure requirements prescribed under Accounting Standard – 18 as well as Accounting Standard – 2.

AS 18, *Related Party Disclosures*

1. Non-Disclosure of description of relationship with Related Parties

It may be noted that paragraph 23(ii) of AS 18, provides that:

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"23. If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:

...

(ii) a description of the relationship between the parties;"

From the 'Related Party Disclosures' given in the Annual Reports of some companies, the following non-compliances have been observed:

- The names of the related parties as well as the transactions that have taken place with such related parties have been disclosed but the nature of relationship with them has not been disclosed.
- The phrase 'Other Related parties' has been used rather than giving, specific relationship details for parties with whom transactions have taken place.

From the 'Related Party Disclosures' given in the Annual Reports of some companies, non-compliances observed include that the names of the related parties as well as the transactions that have taken place with such related parties have been disclosed but the nature of relationship with them has not been disclosed.

Based on the above, it was viewed that non-disclosure of a description of the relationship between the parties is not in line with the requirement of paragraph 23(ii) of AS 18.

2. Non-disclosure of certain Related Parties

It may be noted that paragraph 21 of AS 18, states that:

"21. Name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties."

From the information given in the Annual Reports of some companies, the following discrepancies have been noted:

- It has been noted that certain companies are subsidiaries of other companies. However, the names of the holding companies have not been disclosed in the Related Party Disclosures.

From the information given in Annual Reports of some companies, it has been noted that the managing director or the whole time directors or the manager have not been identified as key management personnel and consequently the remuneration paid to them or any other transactions with them have not been disclosed under 'Related Party Disclosure'.

- From the Annual Report of another company, it has been noted that a wholly owned subsidiary has been formed during the year under review; however, the name of the subsidiary has not been disclosed as a related party under the Related Party Disclosures.

Accordingly, it was viewed that non-disclosure of the names of the holding companies or the subsidiary company in the 'Related Party Disclosures' is not in compliance with the requirements of paragraph 21 of AS 18.

3. Non-disclosure of Related Parties Transactions

It may be noted that Paragraph 23 of AS 18, *Related Party Disclosures*, notified under the Companies (Accounting Standards) Rules, 2006, provides that:

"23. If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date;"

(vii) amounts written off or written back in the period in respect of debts due from or to related parties."

The following information has been noted with regard to 'Related Party Disclosures' from Notes to Accounts, Cash Flow Statement, Director's Report, Corporate Governance Report given in the Annual Reports of a number of companies:

- Advances given to directors;
- Application money received from a key management personnel for preferential allotment;
- Equity shares allotted to key management personnel on conversion of warrants;
- Dividend paid to the holding company;
- Short-term loans given to related parties;
- Loans and advances given to as well as repaid by the subsidiary;
- Remuneration paid to directors (key management personnel);

It was noted from the above that if there have been transactions between the related parties during the existence of a related party relationship, the reporting entity should disclose the details of such transactions. It was viewed that all the transactions observed in the reported cases are in the nature of related party transactions and although these transactions have been reported in various parts of the Annual Reports, no disclosure has been made under 'Related Party Disclosures' as per the requirements of paragraph 23 of AS 18.

4. Non compliances relating to Key Management Personnel

It may be noted that paragraph 14 of AS 18, provides that:

"14. Key management personnel are those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise. For example, in the case of a company, the managing director(s), whole time director(s), manager and any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act, are usually considered key management personnel."

From the information given in Annual Reports of some companies, the following has been noted:

- The managing director or the whole time directors or the manager have not been identified as key management personnel and consequently the remuneration paid to them or any other transactions with them have not been disclosed under 'Related Party Disclosure'.
- From the Annual Report of another company, although the Chief Operating Officer (COO) has been reported as key management personnel, the Chief Executive Officer (CEO) who appears to have the authority and responsibility for planning, directing and controlling the activities of the company has not been identified as key management personnel. As per the above stated requirements, any person who has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise is Key Management Personnel. Accordingly, CEO should also be considered as KMP.
- In few cases, that the transactions (i.e. remuneration) with the key management personnel have not been disclosed under Related Party Disclosures; instead only a reference to the note on managerial remuneration has been given.

Accordingly, it was viewed that in the given cases, the disclosure requirements of AS 18 with regard to key management personnel have not been complied with.

AS 2, Valuation of Inventories

1. Incorrect disclosure of valuation of Inventories

It may be noted that paragraph 5 of AS 2, provides that:

"5. Inventories should be valued at the lower of cost and net realisable value."

Further, paragraph 3.2 of AS 2 defines the term 'Net Realisable Value' as follows:

"Net realisable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and the estimated costs necessary to make the sale."

It may be noted that paragraph 6 of AS 2, provides that:

"6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition."

The accounting policies regarding valuation of inventories as disclosed in the Annual Report of several companies are listed below:

- Stocks of Cards are valued at *Cost* and on FIFO basis and include all applicable overheads in bringing the inventories to their present location and condition. Work in progress is valued at *Cost.*
- Inventories are measured at cost. Cost is determined on weighted average basis.
- Work - in - Progress is valued at direct raw material cost and appropriate cost of completed process.
- Raw materials are valued at average cost. Raw materials at bonded warehouse stores, spares, consumables, packing material, coal & fuel are valued at cost.
- Work in Process is valued at raw material cost.
- Cost of finished goods and work in progress are determined on estimated cost basis.
- Inventories are valued at cost or net realisable value, whichever is less. Cost is determined by using the first in first out formula. Cost comprises all.
- Raw materials are valued at average cost.

It was noted from the given accounting policies that inventories have been valued at cost or average cost. In other words 'net realisable value' has not been considered for the purpose of valuation of these inventories. Further, in some of these cases given above, it is not clear from the stated accounting policies whether all the applicable costs as per paragraph 6 of AS 2 have been considered or not.

It was noted from the given accounting policies that inventories have been valued at cost or average cost. In other words 'net realisable value' has not been considered for the purpose of valuation of these inventories. Further, in some of cases, it is not clear from the stated accounting policies whether all the applicable costs as per paragraph 6 of AS 2 have been considered or not.

Accordingly, it was viewed that the valuation of inventories in all these cases is not in line with the requirement of paragraph 5 of AS 2.

2. Non-consideration of excise duty in valuation of Inventories

It may be noted that paragraph 7 of AS 2, provides that:

7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty draw backs and other similar items are deducted in determining the costs of purchase.'

It may be further noted that as per paragraph 18 of the Institute's 'Guidance Note on Accounting Treatment for Excise Duty,' the liability for excise duty arises when the manufacture of the goods is completed; hence, it is necessary to create a provision for liability of unpaid excise duty on stocks lying at the factory or bonded warehouse.

In the Annual Reports of few companies following notes have been given with regard to accounting treatment of excise duty in inventory valuation:

- The liability for excise duty on finished goods lying in stock at the close of the year has not been provided for in the accounts and hence not included in the valuation of inventory of such products. However, the said liability, if accounted, would have no impact on profit for the year.
- Raw material and finished goods are valued net of excise duty.
- Liability for excise duty on finished goods is accounted as and when they are cleared from the factory premises. No provision is made in the account for goods manufactured and lying in factory premises.

It was noted from the given notes that excise duty has neither been considered in the valuation of inventories nor provided for in the books of accounts, which is not in line with the above stated requirements.

Accordingly, it was viewed that the requirements of paragraph 7 of AS 2 as well as paragraph 18 of the Guidance Note on Accounting Treatment for Excise Duty have not been complied with.

3. Incorrect disclosure of cost formula of Inventories

It may be noted that paragraphs 16 and 26 of AS 2, provides that:

"16. The cost of inventories, other than those dealt with in paragraph 14, should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition."

"26. The financial statements should disclose:

(a) the accounting policies adopted in measuring the inventories, including the cost formula used;

…"

From the Annual Reports of some companies, it has been noted that different accounting policies have been adopted to determine the cost of inventories as given below:

- Inventories are stated at lower of cost and net realisable value. Cost is determined on weighted average/ first-in first-out (FIFO) basis, as considered appropriate by the Company.
- Cost of inventories is computed on weighted average / FIFO basis.

From the Annual Reports of some companies, it has been noted that different accounting policies have been adopted to determine the cost of inventories, like the Inventories are stated at lower of cost and net realisable value. Cost is determined on weighted average/ first-in first-out (FIFO) basis, as considered appropriate by the Company. Further, it was observed that cost of inventories is computed on weighted average / FIFO basis.

In these two cases though cost formula has been given, it was viewed that it would be more appropriate to disclose which cost formula has been used for which class of inventories.

Accordingly it was viewed that the stated methods of determining cost of inventories are not in accordance with paragraph 16 as well as paragraph 26 of AS 2. ■