Financial Reporting Practices

Normally, all professionals exercise care and due diligence in discharging their responsibilities in the utmost sincere and efficient manner. But still there can be certain instances, which require little more closer look for better understanding and application. Through this column, we wish to share with members, both in practice or industry, some such instances, so that they observe the highest level of best practices. In nutshell, this column aims to empower the professionals in their day-to-day work and thus enhance overall image of the profession. Members are requested to send their response and contribute.

Schedule VI to the Companies Act, 1956

1. Some companies, presenting their balance sheet in the vertical form, do not disclose Secured and Unsecured loans separately on the face of balance sheet; rather, the same are clubbed and only one figure of 'Loan Funds', is shown on the face of the balance sheet. This is contrary to the Vertical Form of Balance Sheet as prescribed in Schedule VI to the Companies Act, 1956, which requires 'Secured Loans' and 'Unsecured Loans' to be disclosed separately on the face of the balance sheet.

2. In a few cases, companies presenting their balance sheet in the vertical form have disclosed only total amounts of (a) Current assets, loans and advances, and (b) Current liabilities and provisions, on the face of balance sheet. This is not as per the Vertical Form of Balance Sheet as prescribed in Schedule VI to the Companies Act, 1956, which requires the following details to be given on the face of the balance sheet:

   For Current Assets, Loans and Advances:
   - (a) Inventories
   - (b) Sundry debtors
   - (c) Cash and bank balances
   - (d) Other current assets
   - (e) Loans and advances

   For Current Liabilities and Provision:
   - (a) Liabilities
   - (b) Provisions

3. Part II of Schedule VI to the Companies Act, 1956, requires the value of raw material consumed to be disclosed in case of manufacturing companies. It is noted that some manufacturing companies are adding the value of opening stock of raw materials, work-in-progress and finished goods to the raw material and components purchased and deducting there from the closing stock of raw materials, work-in-progress and finished goods, to arrive at the value of raw materials and components consumed. These results in an incorrect computation of raw material consumed since the value of work-in-progress and finished goods also include other expenses such as labour and production overheads and in any case, they are not a part of raw material.

4. Schedule VI to the Companies Act, 1956, requires that the terms of redemption or conversion (if any) of any redeemable preference shares to be stated, together with earliest date of redemption or conversion. However, some companies fail to disclose the same.

II. Accounting Standards

AS 2, Valuation of Inventories

5. As per AS 2, Valuation of Inventories, 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. As per the *Guidance Note on Accounting Treatment for Excise Duty,* which is based on AS 2, excise duty is a cost incurred in bringing the inventories to their present location and condition. Accordingly, a provision needs to be created

for excise duty payable on goods manufactured during the year and lying in the stock at the end of the year. Certain enterprises are not creating provision for excise duty payable on finished goods lying in the stock. This treatment results in understatement of liabilities as well as value of inventories and it is contrary to AS 2 as well as the *Guidance Note on Accounting Treatment for Excise Duty.*

AS 3, Cash Flow Statements (revised 1997)

6. Certain companies which are disclosing dividend paid under the heading 'Cash Flow from Financing Activities', have disclosed 'tax on dividend paid (corporate dividend tax)' under the heading 'Cash Flow from Operating Activities'. It may be noted that the tax on dividend paid (corporate dividend tax) is related to distribution of profits. The *Guidance Note on Accounting for Corporate Dividend Tax* requires the corporate dividend tax to be disclosed alongwith the dividend paid in the profit and loss account, 'below the line'. Applying the same principle, tax on dividend paid (corporate dividend tax) should be shown alongwith the dividend paid in the Cash Flow Statement under the heading 'Cash Flow from Financing Activities'. It is not correct to show this amount as 'Cash Flow from Operating Activities' while dividend paid is disclosed as 'Cash Flow from Financing Activities'.

AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

7. Paragraph 15 of AS 5 requires that the **nature and** amount of prior period items **should be separately disclosed** in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived. However, certain enterprises disclose prior period items in their profit and loss account but fail to mention the nature, i.e., the exact reason for arising of these items either in the profit and loss account or in the schedules or in the notes.

AS 6, Depreciation Accounting

8. Certain enterprises do not provide depreciation on their plant and machinery for the shut down period. This is not as per AS 6 (revised 1994), *Depreciation Accounting*. As per the definition of the term 'Depreciation' given in the AS 6, depreciation is, *inter alia,* a measure of the loss of value arising from **effluxion of time.** Keeping this in view, depreciation for the shutdown period needs to be provided.

9. Paragraph 21 of Accounting Standard (AS) 6, *Depreciation Accounting,* requires that any deficiency or surplus **arising from retrospective re-computation** of depreciation should be **adjusted in the statement of profit and loss.** However, certain enterprises transfer an amount equivalent to differential depreciation pertaining to earlier years on account of change in the method of charging depreciation, from general reserve to the profit and loss account, **above the line.** This treatment has the effect of negating the requirement of paragraph 21 of AS 6 since the profit and loss account for the year is not affected by the amount of depreciation arising from retrospective re-computation of depreciation. Thus, this practice is contrary to the requirements of AS 6.

AS 11 (revised 1994), Accounting for the Effects of Changes in Foreign Exchange Rates

10. Certain enterprises recognise exchange differences arising on foreign currency transactions on realisation basis, i.e., upon the final settlement of the foreign currency assets and liabilities resulting into such differences. This is contrary to AS 11 (revised 1994) which requires gains as well as losses on account of foreign exchange rate fluctuations, except exchange differences arising on liabilities incurred for the purpose of acquiring fixed assets, to be recognised immediately in the statement of profit and loss.

AS 13, Accounting for Investments

11. In a few cases, provision for diminution in the value of investments has been charged directly to the Investment Fluctuation Reserve, without even routing it through the profit and loss account. This is not as

per paragraph 33 of AS 13, *Accounting for Investments,* which requires that any reduction in the carrying amount of any investment should be charged to the profit and loss statement.

12. Paragraph 26 of AS 13 requires that an enterprise should disclose current investments and long-term investments distinctly in its financial statements. However, certain enterprises do not disclose the same either in the Schedule 'Investments' or in the notes which is a violation of AS 13.

AS 17, Segment Reporting

13. Certain enterprises which do not have any separate business segments have stated that they consider business segment to be primary segment. They have disclosed the information about the geographical segments as secondary segments and made disclosures accordingly, which are less than disclosures required for primary segments. This is not strictly in accordance with AS 17. In case an enterprise does not have separate business segments but has separate geographical segments, geographical segments should constitute primary segments for the enterprise.

AS 20, Earnings Per Share

14. Accounting Standard (AS) 20, *Earnings Per Share,* requires that the enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India, should disclose the basic as well as diluted Earnings Per Share on the face of the statement of profit and loss also. However, certain enterprises whose equity shares are listed on recognised stock exchanges have not disclosed the same on the face of the profit and loss account.

AS 22, Accounting for Taxes on Income and AS I7, Disclosure of deferred tax assets and deferred tax liabilities in the balance sheet of a company (Re. AS 22, Accounting for Taxes on Income)

15. Certain enterprises have disclosed deferred tax credit under the heading 'Reserves and Surplus'. This is not as per Accounting Standard (AS) 22, *Accounting for Taxes on Income* as well as Accounting Standards Interpretation (ASI) 7 on 'Disclosure of deferred tax assets and deferred tax liabilities in the balance sheet of a company' (Re. AS 22, *Accounting for Taxes on Income*). As per AS 22, deferred tax credit (deferred tax liability) is a liability of the enterprise and, therefore, it cannot be disclosed as a part of 'Reserves and Surplus'. ASI 7 requires that deferred tax liabilities should be disclosed on the face of the balance sheet separately after the head Unsecured Loans.

16. Certain companies disclose deferred tax asset after the heading 'Net Current Assets', which is contrary to ASI 7. As per ASI 7, deferred tax asset should be disclosed on the face of the balance sheet separately after the head Investments.

17. As per AS 22, *Accounting for Taxes on Income*, in case any announcement of tax rates and tax laws by the government has the substantive effect of actual enactment, deferred tax assets and liabilities should be measured using such announced tax rates and tax laws. However, certain enterprises calculate deferred tax asset or liability using the tax rates enacted by the balance sheet date and fail to consider the substantively enacted tax rates and tax laws for calculation of deferred tax asset or liability.

18. A few enterprises have charged tax expense, comprising current tax and deferred tax, to the profit and loss account, below the line, i.e., after crediting profit brought forward from earlier years. This is contrary to AS 22, *Accounting for Taxes on Income,* which provides that tax expense for the period, comprising current tax and deferred tax, is an actual expense and should be included in the determination of the net profit or loss for the period, i.e., above the line.

19. Some enterprises having unabsorbed depreciation or carry forward of losses under

tax laws have mentioned in their accounting policies that the deferred tax asset is recognised and carried forward only to the extent that there is a **reasonable certainty** that the asset will be adjusted in future. This is not as per AS 22, Accounting for Taxes on Income. Paragraph 17 of AS 22 requires that where an enterprise has an unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised **only to the extent that there is virtual certainty supported by convincing evidence** that sufficient future taxable income will be available against which such deferred tax assets can be realised. As per the said paragraph, in case an enterprise has unabsorbed depreciation or carry forward of losses, it is required to consider *virtual certainty* supported by *convincing evidence* for recognition of all deferred tax assets and not only for the deferred tax assets arising from unabsorbed depreciation or carry forward of losses.

Paragraph 32 of AS 22 requires that the nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws. Enterprises have also not disclosed the nature of the evidence supporting the recognition of deferred tax assets as per the paragraph.

III. Announcement on Preparation of Financial Statements on Letter-Heads and Stationery of Auditors

20. The Research Committee of the Institute has issued an Announcement on 'Preparation of Financial Statements on Letter-Heads and Stationery of Auditors' (published in the August, 1982 issue of 'The Chartered Accountant' p. 175), which provides that practice of preparing financial statements on the letter-head/ stationery of the auditor is liable to be misinterpreted and, therefore, should be avoided. Despite this, some auditors have prepared the financial statements of their clients on their letter-heads.

IV. Auditing and Assurance Standard (AAS) 28, The Auditor's Report on Financial Statements

21. Some auditors sign their audit reports without mentioning their membership number assigned by the Institute of Chartered Accountants of India. This is contrary to the Auditing and Assurance Standard (AAS) 28, *The Auditor's Report on Financial Statements*. Paragraph 28 of AAS 28, inter alia, requires that the partner/proprietor signing the audit report should also mention the membership number assigned by the Institute of Chartered Accountants of India.❐