Financial Reporting Practices

As members are aware, with the phenomenal growth of enterprises and increasing competition, the regulators as well as and professional bodies have been in the forefront to recommend fresh accountability measures and suggest the best practices as a recipe to survive, grow and prosper. With all these complexities abound, there has been sudden spurt in ever increasing legal and professional requirements. All such initiatives ultimately put a lot of pressure on every individual while discharging their day-to-day responsibilities. Though, all professionals normally exercise 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.

I. Schedule VI to the Companies Act, 1956

1. Some companies, presenting their balance sheet in the vertical form, fail to disclose capital work-in-progress separately on the face of the balance sheet; rather the same is clubbed in the fixed assets schedule. This is contrary to the Vertical Form of Balance Sheet as prescribed in Schedule VI to the Companies Act, 1956, which requires the following disclosures to be made on the face of the balance sheet regarding fixed assets:

(1) Fixed assets:	
(a) Gross block	
(b) Less: Depreciation	
(c) Net block	
(d) Capital work-in-progress	

2. Previous year figures are not indicated in certain schedules and notes, e.g., fixed assets schedule and notes giving related party disclosures and segment information, etc., to the balance sheets and profit and loss accounts of certain companies. As per the requirements of Schedule VI to the Companies Act, 1956, previous year figures are required to be given for all items of the balance sheet and profit and loss account. Since these schedules and notes are also a part of the balance sheet/ profit and loss account, previous year figures are required to be given in these notes and schedules also.

II. Accounting Standards

AS 1, Disclosure of Accounting Policies

3. The policy regarding timing of recognition of revenue arising from the main source of revenue is considered to be one of the most significant accounting policies for any organisation. Certain enterprises do not disclose the policy regarding the timing of recognition of revenue from their main source of revenue, viz., sales, in the Statement of Significant Accounting Policies.

AS 2, Valuation of Inventories

4. AS 2 requires all inventories, including raw materials, and work-in-progress to be valued at the lower of cost and net realisable value. As per paragraph 24 of AS 2, net realisable value of raw materials and other supplies

held for use in the production is taken into consideration in the following manner:

"Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value."

Certain enterprises follow the policy of valuation of inventories of raw materials components, stores and spares parts, goods-in-progress and by-products at cost. Such a policy indicates that apparently the enterprise did not consider net realisable value in the valuation of such inventories.

5. Paragraph 26(a) of AS 2, Valuation of Inventories, *inter alia*, requires disclosure of cost formula used for valuation of inventories but many enterprises fail to disclose the cost formula.

AS 4, Contingencies and Events Occurring After the Balance Sheet Date

6. The liability in respect of warranty cost has been recognised in the year in which the claim actually arises, i.e., no provision is being created for warranties given on the products sold during the year, the claim in respect of which may arise in future. But, it needs no emphasis that liability in respect of a warranty arises as soon as the company sells the product. Thus, not creating any provision for warranties given on the products sold, the claim in respect of which may arise in future is contrary to the accrual basis of accounting which is a requirement under the Companies Act, 1956 and AS 4, Contingencies and Events Occurring After the Balance Sheet Date.

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 of these items either in the profit and loss account or in the schedules or in the notes.

8. It has been observed that certain enterprises adjust the excess depreciation arising due to revaluation of fixed assets directly against the revaluation reserves, without routing it through the profit and loss account. It may be noted that depreciation on fixed assets (including the portion arising due to revaluation) is an item of expense and, accordingly, is required to be charged to the profit and loss account as per paragraph 5 of AS 5. Charging only net depreciation to the profit and loss account is a violation of AS 5.

Certain enterprises follow the policy of valuation of inventories of raw materials components, stores and spares parts, goods-in-progress and by-products at cost.

The Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets, issued by the Institute of Chartered Accountants of India, provides specific guidance on treatment to be followed in case of revaluation of fixed assets which is in consonance with the requirements of AS 5. Paragraph 9 of the Guidance Note, *inter alia*, provides as below:

"… depreciation is required to be provided with reference to the total value of the fixed assets as appearing in the account after revaluation.

However, for certain statutory purposes e.g., dividends, managerial remuneration etc., only depreciation relatable to the historical cost of the fixed assets is to be provided out of the current profits of the company. In the circumstance, the additional depreciation relatable to revaluation may be adjusted against "Revaluation Reserve" by transfer to Profit and Loss Account. In other words, as per the requirements of Part II of Schedule VI to the Companies Act, the company will have to provide the depreciation on the total book value of the fixed assets (including the increased amount as a result of revaluation) in the Profit and Loss Account of the relevant period, and thereafter the company can transfer an amount equivalent to the additional depreciation from the Revaluation Reserve. Such transfer from Revaluation Reserve should be shown in the Profit and Loss Account separately and an appropriate note by way of disclosure would be desirable. …" (emphasis added)

AS 9, Revenue Recognition

9. AS 9 requires revenue arising from interest to be recognised on a time proportion basis taking into account the amount outstanding and the rate applicable. It also requires that dividends from investments in shares should be recognised when the owner's right to receive payment is established. But certain entities prefer to recognise revenue arising from interest on loans to subsidiaries and dividend on investments in shares, etc., on receipt basis and, thus, violating AS 9 as well as accrual basis of accounting.

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

10. Certain enterprises recognise exchange gains arising on foreign currency transactions on realisation basis, i.e., upon final settlement of the foreign currency assets and liabilities resulting into such gains. 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.

    Further, requirements to paragraph 26(i) of AS 11 regarding a disclosure of the amount of exchange differences included in the net profit or loss for the period are also not observed in actual practice.

AS 13, Accounting for Investments

12. Paragraph 32 of AS 13, "Accounting for Investments" requires that long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments. It may be noted that there is a difference between 'permanent diminution in the value of investments' and 'other than temporary diminution in value of investments' and normally, no diminution in value of investments may be termed as permanent. But even then certain enterprises, in their accounting policies, mention that provision is being made for any permanent diminution in the value of long-tem investments. (emphasis added).

AS 15 (issued 1995), Accounting for Retirements Benefits in Financial Statements of Employers

13. Paragraph 31 of AS 15 (issued 1995), inter alia, requires the following disclosure to be made in the financial statements:

    "31. … In case the costs related to gratuity and other defined benefit schemes are based on an actuarial valuation, the financial statements should also disclose whether the actuarial valuation was made at the end of the period or at an earlier date. In the latter case, the date of the actuarial valuation should be specified and the method by which the accrual for the period has been determined should also be briefly described, if the same is not based on the report of the actuary."

As per the requirement of the above paragraph, entities fail to disclose as to whether the actuarial valuation to determine liability for retirement benefits, e.g., gratuity, leave encashment, etc., is made at the end of the period or at an earlier date.

AS 22, Accounting for Taxes on Income

14. Certain enterprises disclose advance income tax paid (current tax asset) and provision for income tax (current tax liability) separately in their balance sheets, i.e., they do not offset the amounts. This is contrary to AS 22, Accounting for Taxes on Income. Paragraph 27 of AS 22 requires that an enterprise should offset assets and liabilities representing current tax if the enterprise:

(a) has a legally enforceable right to set off the recognised amounts; and

(b) intends to settle the asset and the liability on a net basis.

It may be noted that under the Income-tax Act, 1961, advance tax representing current tax is paid against provision for income tax representing current tax liability. Under the Act, an enterprise has a legal right to set off the two amounts and normally, the enterprises settles these amounts on net basis only. Keeping this in view, the enterprise should offset advance income tax paid against provision for income tax and show only the net amount in the balance sheet. Disclosing two amounts separately is contrary to AS 22.

15. Further, the break-up of deferred tax is not disclosed in the notes to accounts. This is contrary to AS 22. Paragraph 31 of AS 22 requires that the break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts. ❐

ANNOUNCEMENT

Whether members in practice can print their photograph on their visiting cards?

Themembers of the profession have sought the Institute's view as to whether the Chartered Accountants in Practice can print their photograph on their visiting cards.

The Committee onEthical Standards (CES), a non-standing Committee of the Institute, has examined the matter in detail. The Committee noted that the Institute has permitted display of Passport Size Photograph on the Website of Chartered Accountants in practice/firm of Chartered Accountants in practice, which run on a "pull" model. The Committee further noted the following directions/guidelines as appearing at page 197 of Code of Ethics, 2005 edition: -

"Public conscience is expected to be ahead of the law. Members, therefore, are expected to interpret the requirement as regards independence much more strictly than what the law requires and should not place themselves in positions which would either compromise or jeopardize their independence."

In view of the above, the Committee is of the opinion that mostly the business class prints the photograph on their visiting cards for promoting their business and soliciting clients. As such, it is not permissible for the Chartered Accountants in practice to print their photograph on their visiting cards.