

Corporate Financial Reporting

BASIC CONCEPTS

Financial Reporting

Corporate financial disclosure through published annual reports plays an important role in the efficient allocation of limited resources of a country as most of the investors make their decision based on such fundamental analysis. Adequacy of disclosure cannot be tested accurately and precisely since no definite test to measure it exists in financial reporting. But when information is reported outside the business enterprise, adequacy of disclosure can be tested through questionnaire. The basis of the test is the extent to which the items of information are helpful to users in making economic decision. The quantum and quality of information will vary according to the needs of the users. The preparation and publication of a company's annual report on practices and internal structures of corporate governance used by that same company may prove very useful to the shareholders or qualified investors. It may, however, be emphasized that financial reporting does not imply unidirectional and unlimited flow of all kinds of information. How companies can improve their disclosures to investors is an important one as it is perceived by different persons in different ways. Financial reporting is the communication of financial information of an enterprise to the external world. Measurement and disclosure are two dimensions of reporting process and these two aspects are interrelated. Together, they give corporate reporting its substance.

Corporate accounting Disclosure or financial reporting can be defined as a process through which a business enterprise communicates accounting and financial information with external parties.

A complete set of financial statements normally consists of a Balance Sheet, a Profit & Loss A/c, a Statement of Changes in Equity and a Cash Flow Statement together with notes, statements and other explanatory materials that form integral parts of the financial statements. The component parts of financial statements are interrelated because they reflect different aspects of same transactions or other events.

ICAI Conceptual Framework earmarks four principal qualitative characteristics viz., understandability, relevance, reliability and comparability. **According to the ICAI Conceptual Framework, materiality is not a principal qualitative characteristic.** Materiality is considered as a threshold limit, which needs to be judged before referring to any other qualities of any information provided in financial statements. If any piece of information does not fulfill the threshold criteria, it need not be considered further.

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Question 1

What are the main limitations of financial statements?

Answer

Limitations of Financial Statements:

- (i) **Financial statements provide mostly historical data and ignore price level changes:** Elements of financial statements, i.e., assets, liabilities, income and expenses are measured mostly using historical cost. So in the balance sheet, most of the assets do not represent their current values. Users of accounts cannot understand the real value of the reporting entity from such balance sheet.

Under the historical cost accounting framework impliedly money capital is maintained - not the real value of capital. Thus the profit and loss statement does not represent real profit/loss. Thus, under inflationary environment, traditional historical cost based financial statement fail to reflect operating result and financial position of the reporting entity.
- (ii) **Financial Statements ignore substance and simply recognize form:** In India, financial statements are prepared recognizing legal form of the transactions and ignoring the substance. For example, when the reporting entity uses assets on finance lease basis, value of such assets are not shown in the balance sheet. So the balance sheet fails to show the assets used for revenue generation.
- (iii) **Financial statements are essentially based on going concern assumption:** AS 1 'Disclosure of Accounting Policies' suggests that going concern is a fundamental accounting assumption, a departure from which should be disclosed. In practice, the assumption has been applied universally. Even if the reporting entity has become a sick industrial undertaking and waits for BIFR judgement, still its financial statements are prepared following going concern assumption showing its assets and liabilities at historical cost which is highly illogical and totally misleading.
- (iv) **Financial statements are over-generalized:** Users of accounts are many; prominent among those are shareholders – existing and potential, employees, lenders and other suppliers, government/regulatory agencies, managers and the public at large. Every section has specific data requirement for making economic decisions. Sometimes the interests of different sections may be conflicting in nature. Financial statements cannot meet the specific data requirement of the users. These are general purpose statements.
- (v) **Not free from Bias:** The accountant has to make a choice out of various alternative accounting method e.g., methods of inventory valuation, depreciation, goodwill valuation. Since the subjectivity is inherent in personal judgement, the financial statements are, therefore not free from bias.

- (vi) **Variation in Accounting Practices:** As there are variations in accounting practices followed by different firms, a valid comparison of their financial statements is not possible.
- (vii) **Qualitative Aspects Ignored:** Financial statements portray the position in monetary terms. Financial statements do not consider nonmonetary aspects like efficiency of management, customer case etc.
- (viii) **Ignore the price level changes:** Different assets are shown at the historical cost. It therefore, ignores the price level changes or present value of the assets.

Question 2

Briefly explain the qualitative characteristics of Financial Statements.

Answer

Qualitative characteristics are the attributes that make the information provided in the financial statements useful to the users. The four principal qualitative characteristics are: (i) Understandability, (ii) Relevance, (iii) Reliability and (iv) Comparability.

- (i) **Understandability:** An essential, quality of the information provided in the financial statement is that it is readily understandable by the users. For this purpose, users are deemed to have reasonable knowledge of business and economic activities. However, information about complex matters should be included in the financial statements which is relevant to the users of accounts for their economic decision making although this may be too difficult for certain users to understand.
- (ii) **Relevance:** To be useful, information must be relevant to the decision making needs of all the users. Information has the quality of relevance when it influences the economic decisions of users by helping them to evaluate past, present or future events or confirming, or correcting their past evaluations.

Relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. In other cases, both the nature and materiality are important.

- (iii) **Reliability:** To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which, it either purports to represent or could reasonably be expected to represent.

Reliability of the financial statement information is dependent on faithful representation, substance over form, neutrality, prudence, and completeness. If information is to represent faithfully the transactions and other events, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely by their legal form. To be reliable, the information contained in financial statement must be neutral i.e. free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or

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judgement in order to achieve a pre-determined result or outcome. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty. To be reliable, information in financial statements must also be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

- (iv) **Comparability:** Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance. An important implication of this qualitative characteristic is that users should be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes.

Question 3

One of the important factors generally considered for awarding shields and plaques in India for 'Excellence in Financial Reporting' is that the information presented in the accounts make useful disclosures.

What are actually looked into in this regard?

Answer

A financial report of an enterprise is arguably the most important medium of dissemination of such information. With a view to promote better standards in the presentation of information in the financial report, the Institute of Chartered Accountants of India has been holding an annual competition for the ICAI Awards for Excellence in Financial Reporting.

In order to ascertain whether the nature and quality of information presented in the accounts make useful disclosures, the following features are generally looked into:

1. Statement of changes in financial position.
2. Sufficient details of revenues / expenses for financial analysis e.g. distinction between manufacturing cost, selling cost and administration cost.
3. Use of vertical form as against the conventional T form; judicious use of schedules, use of sub-totals, manner of showing comparative figures, ease of getting at figures.
4. To what extent additional financial information is provided to the readers through charts and graphs.
5. Financial highlights and ratios including earnings per share.
6. Inclusion of one or more bits of information like value added statement, break up of operations, organization chart, location of factories / branches, human resource accounting, inflation adjusted accounts, social accounts etc.

Question 4

What are the objectives of financial reporting?

Answer

The following are the objectives of financial reporting:

- (i) **Useful Information to Users**-To provide information that is useful to present and potential investors and trade payables and other users in making rational investment, credit, and similar decisions.
- (ii) **Assess Prospective Cash Inflows**-To provide information to help investors, trade payables, and others to assess the amount, timing and uncertainty of prospective net cash inflows to the related enterprise.
- (iii) **Information about the economic resources of an enterprise** -To provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events and circumstances that change resources and claims to those resources.
- (iv) **Financial Performance**- To provide information about an enterprise's financial performance during a period. To give information about an enterprise's performance provided by measures of earnings and its components.
- (vi) **Information about Utilization of Cash**- To provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise's resources to owners, and about other factors that may affect an enterprise's liquidity or solvency.
- (vii) **How Responsibility is Discharged**- To provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it.
- (viii) **Decision making**- To provide information that is useful to managers and directors in making decisions in the interest of owners.

Question 5

On 30th September, 2014, Beta Enterprises Ltd. was incorporated with an Authorised Capital of ₹ 50 lakhs. Its first accounts were closed on 31st March, 2015 by which time it had become a listed company with an issued, subscribed and paid up capital of ₹ 40 lakhs in 4,00,000 Equity Shares of ₹ 10 each.

The company started off with two lines of business namely 'Engineering Division' and 'Chemicals Division', with equal asset base with effect from 1st April, 2015. The 'Ceramics Division' was added by the company on 1st April, 2016. The following data is gathered from the books of account of Beta Enterprises Ltd.:

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Trial Balance as on 31st March, 2017

(₹ in 000's)

	Dr.	Cr.
Engineering Division sales	–	6,000
Cost of Engineering Division sales	2,600	–
Chemicals Division sales	–	8,000
Cost of sales of Chemicals Division	4,300	–
Ceramics Division Sales	–	1,500
Cost of sales of Ceramics Division	900	–
Administration costs	2,000	–
Distribution costs	1,500	–
Dividend-Interim	1,200	–
Dividend Distribution Tax	194.67	–
Fixed Assets at cost	9,000	–
Depreciation on Fixed Assets	–	1,500
Inventory on 31 st March, 2017	400	–
Trade receivables	246	–
Cash at Bank	159.33	–
Trade payables	–	500
Equity Share Capital in shares of ₹ 10 each	–	4,000
Retained Profits	–	<u>1,000</u>
	<u>22,500</u>	<u>22,500</u>

Additional Information:

- Administration costs should be split between the Divisions in the ratio of 5 : 3 : 2.
- Distribution costs should be spread over the Divisions in the ratio of 3 : 1 : 1.
- Directors have declared a Final Dividend of ₹ 800 thousands and desired to transfer 10% of current profits to reserves.
- Some of the users of Ceramics Division are unhappy with the product and have lodged claims against the company for damages of ₹ 750 thousands. The claim is hotly contested by the company on legal advice.
- Fixed Assets worth ₹ 3,000 thousands were added in the Ceramics Division on 1.4.2016.
- Fixed Assets are written off over a period of 10 years on straight line basis in the books. However for Income tax purposes depreciation at 20% on written down value of the assets is allowed by Tax Authorities.

- (g) Income tax rate may be assumed at 35%.
- (h) During the year Engineering Division has sold to Alpha Ltd. goods having a sales value of ₹ 2,500 thousands. Mr. Gamma, the Managing Director of Beta Enterprises Ltd. owns 100% of the issued Equity Shares of Alpha Ltd. The sales made to Alpha Ltd. were at normal selling price of Beta Enterprises Ltd.

You are required to prepare Profit and Loss Account for the year ended 31st March, 2017 and the Balance Sheet as at the date. Your answer should include notes and disclosures as per Accounting Standards.

Answer

**Beta Enterprises Ltd.
Profit and Loss Account for the year ending 31st March, 2017**

	Particulars	Note No.	(₹'000)
I.	Revenue from operations (6,000 + 8,000 + 1,500)		15,500
II.	Total revenue		15,500
III.	Expenses		
	Cost of Sales		(7,800)
	Distribution costs		(1,500)
	Administration costs		(2,000)
	Total expenses		11,300
IV.	Profit before tax		4,200
V.	Tax Expenses		
	Current tax	1,239	
	Deferred tax	<u>231</u>	(1,470)
VI.	Profit or Loss for the period		2,730

**Beta Enterprises Ltd.
Balance Sheet as at 31st March, 2017**

Particulars	Note No.	(₹'000)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	4,000.00
(b) Reserves and Surplus	2	1,162.33
(2) Non-Current Liabilities		
Deferred Tax Liability (210 + 231)		441.00

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(3) Current Liabilities		
Trade payables		500.00
Other current liabilities	3	963.00
Short term provisions	4	1,239.00
	Total	<u>8,305.33</u>
II. Assets		
(1) Non-current assets		
Fixed assets		
Tangible assets	5	7,500.00
(2) Current assets		
(a) Inventories		400.00
(b) Trade receivables		246.00
(c) Cash and cash equivalents		159.33
	Total	<u>8,305.33</u>

Notes to Accounts:

	(₹ '000)	(₹ '000)
1. Share Capital		
Authorised Share capital		
5,00,000 Equity shares of ₹ 10 each		<u>5,000.00</u>
Issued and subscribed		
4,00,000 shares of ₹ 10 each, fully paid up		<u>4,000.00</u>
2. Reserves and surplus		
Retained profit brought forward (1,000 – 210)		790.00
Profit after tax of the current year	2,730.00	
Amount transferred to General Reserve (10% of 2,730)	(273.00)	
Amount transferred to DDT** [(17.304% of 941) +194.67]	(357.67)	
Dividends (1,200 + 800)	<u>(2,000.00)</u>	
Profit for the year		<u>99.33</u>

** The dividend distributed by an Indian Company is exempt from income tax in the hands of shareholders. However, the Indian company is liable to pay Dividend Distribution Tax (DDT) @ 17.304% to the Central Government within 14 days from the date of declaration (i.e. inclusive of surcharge and education cess on such dividend). It is assumed that the dividend has already been declared by the company.

	Total Profit		889.33
	Reserves		<u>273.00</u>
			<u>1,162.33</u>
3.	Other Current liabilities		
	Dividend**	800.00	
	Dividend Distribution Tax**	<u>163.00</u>	<u>963.00</u>
4.	Short term provisions		
	Provision for tax		<u>1,239.00</u>
5.	Tangible assets		
	Fixed Assets		
	Gross block	9,000.00	
	Less: Depreciation	<u>(1,500.00)</u>	<u>7,500.00</u>

Disclosures

1. Segmental Disclosures (Business Segments)

(₹ in '000)

	Engineering Division	Chemical Division	Ceramics division	Total
Sales	<u>6,000</u>	<u>8,000</u>	<u>1,500</u>	<u>15,500</u>
Cost of Sales	2,600	4,300	900	7,800
Administration Cost (5:3:2)	1,000	600	400	2,000
Distribution Cost (3:1:1)	900	300	300	1,500
Profit/Loss	<u>1,500</u>	<u>2,800</u>	<u>(100)</u>	<u>4,200</u>
	<u>6,000</u>	<u>8,000</u>	<u>1,500</u>	<u>15,500</u>
Original cost of Assets (Equal Capital Base)	3,000	3,000	3,000	9,000
Depreciation @ 10% p.a.				
For the year ended 31.3.2016	300	300	NIL	600
For the year ended 31.3.2017	300	300	300	900

Note: Ceramics division is a reportable segment as per assets criteria.

2. Deferred Tax liability (as per AS 22 on Accounting for Taxes on Income)

	₹ in '000
Opening Timing Difference on 1.4.2016	
WDV of fixed assets as per books	5,400

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WDV of fixed assets as per Income Tax Act	<u>4,800</u>
Difference	<u>600</u>
Deferred Tax Liability @ 35% on ₹ 600	210
This has been adjusted against opening balance of retained profits.	
Current year (ended 31st March, 2017)	<i>(₹ in '000)</i>
Depreciation as per books	900
Depreciation as per Income Tax Act (₹ 480 + ₹ 480 + ₹ 600)	<u>1,560</u>
Difference	<u>660</u>
Deferred Tax Liability @ 35% on ₹ 660 (to be carried forward)	231

3. **Contingent Liabilities not provided:** Company is contesting claim for damages for ₹ 7,50,000 and as such the same is not acknowledged as debts.
4. **Related Party Disclosure:** Para 3 of AS 18 lists out related party relationships. It includes individuals owning, directly or indirectly, an interest in voting power of reporting enterprise which gives them control or significant influence over the enterprises, and relatives of any such individual. In the instant case, Mr. Gamma as a managing director controls operating and financial actions of Beta Enterprise Ltd. He is also owning 100% share capital of Alpha Ltd. thereby exercising control over it. Hence, Alpha Ltd. is a related party as per para 3 of AS 18.

Disclosure to be made:

Name of the related party	Alpha Ltd.
Nature of relationship	common director
Nature of the transaction	Sale of goods at normal commercial terms
Volume of the transaction	Sales to Alpha Ltd. worth ₹ 2500 thousands

Working Notes:

1. **Tax computation**

	<i>(₹ in '000)</i>
Profit before tax for the year ended 31.3.2017	4,200
Add: Depreciation provided in the books (₹ 300 + ₹ 300 + ₹ 300)	<u>900</u>
	5,100
Less: Depreciation as per Income Tax Act (₹ 480 + ₹ 480 + ₹ 600)	<u>(1,560)</u>
Taxable Income	<u>3,540</u>
Tax at 35% on ₹ 3,540	<u>1,239</u>

2. Calculation of grossing up of dividend

	Rs. in '000s
Dividend	800
Add: Increase for the purpose of grossing up of dividend [$\{15/(100-15)\} \times 800$]	<u>141.18</u>
	<u>941.18</u>
Dividend distribution tax @ 17.304% $941 \times 17.304\% = 162.86$ i.e.	163 (approx.)

Question 6

After the havoc caused by flood in Jammu and Kashmir, a group of companies undertakes during the period from October, 2016 to December, 2016 various commercial activities, with considerable concessions/discounts, along the related affected areas. The management intends to highlight the expenditure incurred on such activities as expenditure incurred on activities undertaken to discharge corporate social responsibility, while publishing its financial statements for the year 2016-2017. State whether the management's intention is correct or not and why?

Answer

Corporate Social Responsibility (CSR) Reporting is an information communiqué with respect to discharge of social responsibilities of corporate entity. Through 'CSR Report' the corporate enterprises disclose the manner in which they are discharging their social responsibilities. More specifically, it is addressed to the public or society at large, although it can be squarely used by other user groups also.

Section 135 of the Companies Act, 2013 mandated the companies fulfilling the criteria mentioned in the said section to spend certain amount of their profit on activities as specified in the Schedule VII to the Act. Companies not falling within that criteria can also spend on CSR activities voluntarily. However, besides the requirements of constitution of a CSR committee and a CSR policy, the corporate entities should also take care that expenditure incurred for CSR should not be the expenditure incurred for the activities in the ordinary course of business. If expenditure incurred is for the activities in the ordinary course of business, then it will not be qualified as expenditure incurred on CSR activities.

Here, it is assumed that the commercial activities performed at concessional rates are the activities done in the ordinary course of business of the companies. Therefore, the intention of the management to highlight the expenditure incurred on such commercial activities in its financial statements as the expenditure incurred on activities undertaken to discharge CSR, is not correct.

Question 7

Due to immense loss to Nepal in the recent earthquake, one FMCG Company undertakes various commercial activities with considerable discounts and concessions at the related

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affected areas of Nepal for a continuous period of 3 months after earthquake. In the Financial Statements for the year 2014-15, the Management has shown the expenditure incurred on such activity as expenditure incurred to discharge Corporate Social Responsibility. State whether the treatment done by the management of management is correct. Explain with reasons.

Answer

The Companies Act, 2013 mandated the corporate entities that the expenditure incurred for Corporate Social Responsibility (CSR) should not be the expenditure incurred for the activities in the ordinary course of business. If expenditure incurred is for the activities in the ordinary course of business, then it will not be qualified as expenditure incurred on CSR activities.

The statutory guidelines relating to CSR also require the deployment of funds for the benefit of the local area of the Company. Since Nepal is another country the expenditure done there i.e. in Nepal shall not qualify to be accounted as CSR expenditure.

Further, it is presumed that the commercial activities performed at concessional rates are the activities done in the ordinary course of business of the company. Therefore, the treatment done by the Management by showing the expenditure incurred on such commercial activities in its financial statements as the expenditure incurred on activities undertaken to discharge CSR, is not correct.

Exercise

Question 1

What disclosures are required by the listed companies as per SEBI Guidelines?

Question 2

Marks Limited manufactures a special type of Computer. The company has a software division for developing programs with respect to specialized areas such as Medical Imaging, Process Control and Information System.

Following is the draft Profit and Loss Account prepared by the Chief Accountant for the year ended 31st March, 2017:

	Figures in lakhs	
	₹	₹
Sales: Hardware division	1,200	
Software division	<u>800</u>	2,000
Less: Opening inventory of finished goods	90	
Raw materials consumed	400	
Direct labour — Hardware division	250	
— Software division	150	
Variable production overheads — Hardware division	150	

	— Software division	50	
	<i>Fixed Production Overheads [including interest and depreciation]</i>		
	— Hardware division	290	
	— Software division	<u>100</u>	<u>(1,480)</u>
			520
	<i>Add: Closing inventory of finished goods</i>		<u>180</u>
	<i>Gross Profit</i>		700
	<i>Less: Administration Expenses</i>	50	
	<i>Selling and distribution expenses</i>	<u>150</u>	<u>(200)</u>
	<i>Profit before tax</i>		500
	<i>Less: Tax at 40%</i>		<u>(200)</u>
	<i>Profit after tax</i>		300
	<i>Add: Balance of profit b/f</i>		<u>200</u>
	<i>Profit carried forward</i>		<u>500</u>

The following further information are given:

- (a) 10 employees, who were working in a software division were made redundant on account of abandoning a particular software program and each of them were paid a compensation of ₹ 5 lakhs on the average. This cost is included in direct labour.
- (b) The fixed production overheads of Hardware division included interest of ₹ 50 lakhs and depreciation of ₹ 50 lakhs. Further this sum of ₹ 50 lakhs included an additional depreciation of ₹ 10 lakhs on a special machinery used in the manufacturer of computer parts for better display purposes.
- (c) During the year, the Software division supplied a special program for a foreign firm on a consideration of ₹ 100 lakhs. It was found on June 1st 2017 that the foreign firm has become bankrupt. The company had received an advance of ₹ 50 lakhs in the year ended 31st March, 2017 from the foreign firm.
- (d) The Software division was involved in a special program on hospital information system. The company so far incurred a sum of ₹ 20 lakhs as salaries and ₹ 10 lakhs as overheads, which were included in direct labour and fixed production overheads respectively. Management feels that a further ₹ 50 lakhs will be required to complete the program, so that it can be effectively marketed.
- (e) Included in Fixed production overheads of Hardware division is a sum of ₹ 50 lakhs being the cost of prototype computers manufactured by the company. These are not to be sold, but to be kept back for demonstrating the medical imaging software program.
- (f) The company manufactured 550 computers during the year. It has a policy of valuing finished inventory of goods at a standard cost of ₹ 1.8 lakhs per computer.

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You are required to:

- (i) *Redraft the Profit and Loss Account for the year ended 31st March, 2017 with reference to relevant Accounting Standards issued by the institute.*
- (ii) *Compute the value of Closing Inventory of finished goods.*

[Answer: Profit after tax ₹ 312 lakhs; Surplus carried to balance sheet ₹ 512 lakhs; for the purpose of tax computation, ₹ 520 lakhs have been taken as taxable profits.

As per AS 2 (Revised) on Valuation of Inventories, finished inventory of goods should be valued on the basis of absorption costing. In this case finished inventory has been valued at a standard cost of ₹ 1.8 lakhs per computer which incidentally synchronizes with the value computed on the basis of absorption costing (Cost per computer $990/550 = ₹ 1.8$ lakhs.)]