Corporate Governance and Accounting Standards– How to Make Use of Accounting Information for Investor Protection and Awareness

Even though the law and ethics of corporate governance require setting up of audit committee, in certain large companies, to discuss the accounts and auditors report, there is no guaranteed protection for the investor that accounts do present a true and fair position. In this backdrop, a close look at the methods to be adopted for preparation and presentation of financial information to the shareholders and other stakeholders is a must so as to create awareness amongst the investing public. This article focuses on certain empirical relationships between the practice of not following the prescribed norms/standards and the effect thereof on shareholders.

"Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance," OECD April 1999.

The issue of Corporate Governance has assumed greater significance ever since frauds in multinational and global corporations have come to light. The very purpose of having an entity clothed in separate legal personality in the form of a company is intended to enable easy and quick mobilisation of money in the form of share capital to take up activities requiring huge financial resources and also distribute the profits or losses arising out of such ventures. The other reasons are like pooling professional talents for smooth management of the affairs of the entity, obtaining quicker loans from banks and financial institutions, etc.


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A major advantage is that owners' liability even in the case of insolvency or dissolution of the corporate entity is restricted to the amount of shares already subscribed or maximum to the uncalled part of such subscribed share capital. Unlike in the case of other forms of organisation like partnership or sole proprietorship, where the personal assets of individual partners are also liable to be confiscated for payment of dues to creditors (whether secured or unsecured), the owners of corporate entity enjoy the privilege of immunity from attachment of personal properties in the case of winding up or default in payment to the creditors (secured) excepting where the owners themselves offered their personal properties as collateral security. Further, the corporate entities in a way enjoy certain privileges in operation and management of the business of the company. The financial information, at times, can be camouflaged to avoid detection of fraud or siphoning off the company's monies by the promoters or others having control over the affairs of the company. The accounts have to be prepared periodically, certified by a Chartered Accountant (statutory auditor) as true and fair and as per the extant provisions of the Companies Act and presented to the shareholders. These accounts along with the statutory auditors report thereon to the shareholders of a company have to be adopted by the shareholders in the Annual General Meeting (AGM) by passing a resolution. While a member may question the basis of accounting

for a transaction or the points raised by the auditors by way of qualifications, generally no AGM has so far rejected the accounts for want of true and fair presentation even in the worst cases. Though the Act provides that the shareholders can reject the accounts by a resolution, such incidences are unheard of in corporate history. Even the major qualifications, if any, of the auditors are not discussed in detail. Further, the adequacy of measures taken on issues raised by the statutory auditors is also generally not discussed at the AGMs. Under these circumstances, a close look at the methods to be adopted for preparation and presentation of financial information to the shareholders and other stakeholders is a must.

Fraud

The term fraud has been defined only in the Indian Contract Act. "Fraud" means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agents, with intent to deceive another party thereto, his agent, or to induce him to enter into the contract:

(1) the suggestion as a fact, of that which is not true, by one who does not believe it to be true;

(2) the active concealment of a fact by one having knowledge or belief of the fact;

(3) a promise made without any intention of performing it;

(4) any other act fitted to deceive;

(5) any such act or omission as the law specially declares to be fraudulent

Corporate Frauds

The corporate frauds are one of the white-collar crimes and such frauds have been committed ever since the corporate type of organisation came into existence. The earliest reported corporate fraud was recorded in 1882, well before the corporate type of organisation became familiar. The separate entity concept of corporate has been used for committing fraud as persons hide themselves behind the scene. Corporate frauds include frauds on and against the company committed by employees, outsiders and the management. While the first two may or may not have severe impact, the management fraud which forms majority of the corporate frauds have very high risk and costs associated with it not only for the company but also for investors and stakeholders. Of late corporate frauds have assumed greater significance not only due to the innovative and ingenious ways adopted by the perpetrators, but also because the nature of companies which are involved have the potential of shaking the fundamentals of the economy of a country (as in the case of Daewoo Corporation, Korea), share markets (Enron and Worldtel) and more so the investors (like stock market scams in 1994 by Harshad Mehta and in 2001 by Ketan Parekh). The manner and nature in which such corporate frauds are committed vary from issuance and allotment of share capital to the promoters and/or the public to accounting manipulations with a view to artificially jack up the share prices in the market so as to facilitate offloading the shares by the promoters when the share prices are ruling high. Recently, frauds were perpetrated through demat accounts and that too in the Initial Public Offering by reputed companies. The Joint Parliamentary Committee, which went into the Ketan Parekh scam, has observed in its report that *"Effective audit is central to keeping any accounting manipulation and irregularity in check. In this respect auditors form the backbone of transparent and authentic financial system."*

For the auditors and practising professionals (either employed or as a consultant or in any other capacity), the Accounting Standards issued by the ICAI is a bible as far as preparation and presentation of financial statements are concerned.

Accounting Frauds and Perceptible Deceptions

While there are many ways to defraud the investors and other stakeholders, in the case of

corporate entities, the promoters and directors are bound to present periodic financial information. Even management frauds manifest in accounts and would be evident from the reading between the lines of the financial information. As such, while the corporate entity is used as a boon by fraudsters, the same entity is also a bane for them as all transactions are accounted for and such accounts would reveal whether fraud has been committed by design or circumstances. The major accounting frauds can be categorised into the following:

a. **Heavy preferential allotment or conversion of debentures or any other debts into equity shares at a phenomenally high rate or ratio mainly to promoters or group companies or on any other non-cash consideration:** SEBI and Government of India permitted swapping of shares or allotment of shares on private placement basis to the promoters or other group companies with a good intention of pooling the available talent and in recognition of the fact that those who sweat have to get paid also. However, this provision is being misused by most of the listed corporate entities to unduly enrich themselves. The law also requires that where the promoters and directors have made any secret profit out of any contract with the company, the same shall be disclosed to the members. While the positive aspects of law have been beneficially misinterpreted by the promoters, the directive principles are generally not complied with as regards the secret profits. Hence the investors will have to be careful before approving any proposal for empowering the Board of Directors especially in cases where a family controls the board, for increasing the authorised capital or allotment of shares or convertible debentures.

b. **Non-recognition of matching expenditure:** While revenue or sales is set up, corresponding expenses in the relevant period are not recognised. Management typically attempts to defer the recognition of expenses to later periods to boost current-period earnings using one of the three general methods: (1) failing to write down assets whose fair value has decreased below the fair market value, (2) manipulating reserves despite estimable, probable contingent events that will impair the value of assets if they occur, and (3) capitalising expenses that the company should recognise in the current period.

c. **Bogus Revenue:** Where a revenue or income of a company is reportedly beyond its normal capacity, then investors can suspect a foul play. Though there is no rule as to what could be the income asset relationship, normally it is believed that in high fixed capital oriented industries, income cannot be in excess of the overall assets. Further, as a thumb rule, pay back period ranges from two to four years in the case of information, communication and electronics sectors; the same ranges over a period of 7 to 12 years normally in other industries. Hence any income and hence the cash profit reported (excluding depreciation which has been provided as initial cash flow in the form of assets and notional expenditure like provisions, etc not involving cash outflow), as bountiful ought to be seen with suspicion. A company reported huge income, almost thrice its asset base, over two years and the profit was also stated to be 100% of its asset base. The EPS was reported at Rs 45 per share leading one to believe that it was a good buy at Rs 150 per share as price earning ratio (P/E ratio) was less than 5. The company also showed allotment of shares to its group companies, as preferential allotment, at a premium of Rs 300 per share. It allotted bonus in the ratio of 13 bonus shares for every share held. It declared dividend of 100%. Only the promoters and group companies received the dividend and bonus. The public did not get anything. Nor was the issue raised in the next shareholders meeting (AGM). All these buoyed the share prices in excess of Rs 200 per share and

the promoters coolly off loaded their holdings in the market to enrich themselves by around Rs 200 crore. In the third year, the company showed under prior period item "Income written back as the agreement was defective", almost 90% of previous two years aggregate income. It reported heavy losses. But by then the damage was done. The income was not existent as the agreement was with its holding company and the bonus shares were allotted on preferential basis by indulging in "kiting". Kiting refers to issue of cheques without having balance in any of the bank accounts but at the same time credit and debits for equal sums would take place. But these facts would not be known on having a look at the financial statements. However, such instances shall have to be viewed by the investors with care and due diligence shall be exercised before making any decisions.

d. **Revenue Recognition:** This is another area of interpretation of provisions of the Sale of Goods Act with a view to manipulating the working results and profits of the company. Sale is recognised in some cases even without completion of the work order and before goods have been inspected by the buyers. Only the auditors shall have to look into and report the fact of deviation in practices to the members.

e. **Liabilities Recognition:** With a view to inflating another group company's sales, the reported entity may have agreed to purchase heavily, mostly on paper, and this might be only evident on paper without actual movement of goods. However, the liability has to be shown. Instead of showing the liability, the reported entity by a single journal entry shows non-existent lending and endorses to that entity the liability payable to the group company. Of course, the auditors have to be watchful in those circumstances where the transactions are material and take care that endorsement of liabilities mainly with group or related entities are brought to the notice of the shareholders suitably.

f. **Others:** Though the law requires transparency in providing financial information and this is the crux of the corporate governance principle, many companies still avoid disclosing the facts unambiguously. Even the adverse incidents and impacts on the future of the entity are sought to be assuaged by giving false management perception of the risk factors.

g. **Different accounting period for tax and financial accounts or deviations in accounting policies:** Majority of the companies adopt different accounting policies mainly relating to income recognition and expenditure provisioning for the purposes of reporting to the shareholders (General financial statements - GFS) under the Companies Act, 1956 and filing of income tax returns (IT accounts) under the Income-tax Act, 1961. The income tax returns might show losses whereas the GFS would be showing bountiful profits. There are certain legally permissible reasons like difference in depreciation rates, classification of expenditure as revenue or capital, etc. But there are also certain other designs in changing the accounting principles and disclosures. For example, for tax purposes mainly where the significant transactions are with related entities or only exist on paper, the cash basis of accounting may be adopted for IT returns whereas accrual basis may be adopted for GFS. Similarly an expenditure genuinely of revenue nature may be treated as capital in GFS for purposes of inflating the reported profit, whereas the same may be accounted as revenue expenditure only in IT returns.

h. **Frequent changes in accounting policies:** Another area of concern is the disclosures regarding the frequent changes in the accounting policies and the impact thereof. Investors should be wary of such changes and resist the attempt by management to

indulge in such frequent changes.

j. **Auditor's report:** Some of the issues raised by auditors even by referring to notes on accounts may appear to be trivial on the surface but may be touchy in purport. These qualifications and quantification of the impact on the working results and financial position have to be seen in due context. Further, a sort of compliance to previous year's qualifications made by auditors, especially previous auditors shall also be disclosed in the corporate governance.

Above are only a few instances, which would be evident. However, read in the context of statutory requirements and interpretation and application of Accounting Standards, the shareholders will have to question the management on dubious transactions or disclosures.

Statutory Requirement as to Accounts and Audit

The discussion will not be complete without understanding the basic requirements as to the preparation and presentation of accounts by a listed company both under the Companies Act and the listing agreement entered into between the company and the respective stock exchange under the Securities Contract and Regulation Act. The Companies Act is administrative in nature and directive in approach. The directive provisions include the formation of company, management, accounts and audit. As far as the accounts of a company are concerned, the Companies Act makes it mandatory for maintenance of books of accounts by following double entry system of accounting and on accrual basis. Further, Board of Directors of a company shall be responsible for preparation and presentation of audited accounts of that company to the shareholders. The accounts shall be prepared and presented in as near a form as in Schedule VI of the Companies Act. Such accounts prepared and presented shall not only conform to the double system of book keeping and accrual basis of accounting requirements but also comply with the Accounting Standards prescribed by the Institute of Chartered Accountants of India (ICAI). The liabilities and assets on the balance sheet in Schedule VI are arranged in the order of longevity. Similarly the profit and loss accounts shall be presented to reflect the income and expenditure from operations, administrative and selling expenses, interest, depreciation, etc. Any surplus over expenditure is to be shown as profit for the year and deficit, loss for the year. To this are added or deducted as the case may be, the extra-ordinary items, prior period adjustments, and opening balance of profit or loss as in the opening (or previous closing) balance sheet and appropriations from such accretions, if provisions are made towards, general reserve, dividends, if any, and any other specified purpose. The shareholders have powers to either approve the dividend as proposed by the directors or reduce it. In any case, the shareholders do not have any right to increase the proposed dividend though they are the owners. This is intended to mainly safeguard the company's interest (which is treated as separate entity from the owners) in preserving the free reserves (surplus otherwise available for distribution to the shareholders) for future expansions or any other financial requirements. Thus even the legal restraint otherwise in a democratically oriented type of organisation is obliquely to protect the long-term interests of the company. Thus the interests of the shareholders are to be protected but the company's interests have overriding priority to others, as, at the cost of repetition, a company is different from the owners. With this in mind the Statutory Auditors are required to report whether any fraud has been committed by the company or against the company. While fraud by the company can be committed only when its affairs are conducted in a fraudulent manner by the managers, fraud against the company may be committed by any or all – the promoters/directors, the managers, the employees, the creditors, the suppliers, the consumers, etc. The onus is on the management and the auditors to report that no fraud of any kind has been

noticed during the year under review for which the accounts have been prepared. While this is the latest requirement, other requirements pertain to ensuring compliance with the mandatory Accounting Standards, disclosures as to whether the terms and conditions of lending or borrowings transactions or any other trade transactions is prejudicial to the company or not. Further, the related party transactions that have taken place during the accounting period have also to be disclosed.

Efficacy Of Accounting Standards

To borrow from the speech of President of ICAI CA. T.N. Manoharan, *"accounting is the language and Accounting Standards are the grammar regulating the usage of that language".* Analogically, accounting is only an art and the professionals have to exhibit their proficiency in deducing the format and conclusions. However, since the structure in such an event may lead to many presumptions and imputations, there needs to be a guiding tool. Accounting Standards serve this purpose and if followed in letter and spirit, the intended benefit of communication of proximate results in the form of accounting will be effective. There are 29 Accounting Standards issued by ICAI as on date. These Accounting Standards can be classified as first generation and second generation AS. The first generation AS (from AS 1 to AS 15) focused more on the entity's accounting policies, disclosure requirements and accounting of material transactions including revenue recognition, capitalisation of fixed assets, depreciation accounting, liability towards accrued benefits of employees, prior period transactions, contingents and events occurring after year end, etc. The second generation of AS (from AS 16 to AS 29) concentrated more on group and associate entities and consolidation. The reporting requirements included reporting of related party transactions, consolidation of accounts of parent and subsidiary companies, investments in associate companies, impairment of assets, earnings per share, discontinuing operations, etc. No doubt some of the AS in second generation also focused on accounting issues like deferred taxation, leases, borrowing costs and intangible assets.

Creative or Inventive Accounting Practices

While approaches to accounting may be normative (accounting as and when a transaction takes place without analysing the impact and without any intention to window dress the affairs) and forensic (ensuring that accounts and transactions are evidenced by legally permissible documents – i.e. will stand legal scrutiny from all angles), the inventive accountant indulges in manipulations. The inventive or creative accountant tries to interpret (or misinterpret) the positive aspects of a law or accounting standard to his benefit with a view to project non-existent working results and financial position. This practice is more prevalent in management frauds. By using legally permissible accounting policies, they portray incorrect financial figures as correct ones. The instances given in TABLE A on the next page, reported in 'Outlook Money' are interesting.

Listing Agreement

The listing agreement which seeks to ensure compliance to best corporate governance practices as recommended by various committees including Kumaramangalam Birla Committee, Narayana Murthy Committee, etc., requires the listed companies to disclose (as part of Clause 49 – IV) different accounting treatment for any transaction from that prescribed in an Accounting Standard. The Companies Act on the other hand mandates the auditors to qualify deviations from the prescribed Accounting Standards. Also, it insists that management shall explain why it believes that such treatment is more representative of the true and fair view of the underlying business transaction in the Corporate Governance Report. It also mandates that related party transactions shall be disclosed. Further, a minute reading of the listing agreement would reveal that all information pertaining to related parties, whether any transaction took place during the

Table - A				
(Rupees in Crores) (Periods: 2002-03 and 2003-04)				
Sl no	**Name of the company**	**Reported Profit After Tax (PAT)**	**Adjusted PAT as per CDSIL**	**Accounting treatment**
1	ICICI Bank	1206.10	15.10	Rs. 1191 crore profit on sale of shares held by erstwhile ICICI treated as revenue instead of capital receipt.
2	Nagarjuna Fertilizers	29.50	Loss 461.50	Remission of Rs 14.6 crore loan – principal treated as income, irrecoverable loans of Rs 463.3 crore adjusted against reserves instead of profit and loss account.
3	Pentasoft	2.50	Loss 946.10	Intangible assets, unrealised debts, and erosion in value of investments worth Rs 946.10 crore written off against share premium reserve.
4	Himachal Futuristic	27.10	Loss 1083.40	Goodwill and Misc exp adjusted against reserves instead of profit
5	Zee Tele	118.30	Loss 1802.10	Rs 1920.5 cr diminution in value of investments due to merger set off against reserves instead of profit.
6	Essar Steel	59.90	Loss 426.50	Debt settlement treated as income instead of as capital gain and deferred revenue exp written off against reserves.

year or not, shall also be disclosed. Some of the clauses in the listing agreements are protective. One such clause is:

Clause 4.6 – Securities Ineligible for Computation of Promoters' Contribution: This clause provides *inter alia* that where the promoters of any company have acquired equity during the period of three years preceding the filing of the draft Offer Document with the Board, such equity shall not be considered for computation of promoters' contribution if:

(i) it is acquired for consideration other than cash and revaluation of assets or capitalisation of intangible assets is involved in such transaction, or

(ii) it results from a bonus issue by capitalisation of revaluation reserves or reserves without accrual of cash resources.

The Raison d'etre: The shareholders and members cannot be informed on day-to-day basis the accounting information, and other business affairs. Hence the consolidated financial statement summarising the transactions under relevant heads reflecting the major objectives of the entity is thought to be a better way of communication. This enables the shareholders and other stakeholders to know, in broader terms, the extent of achievement of entity's objectives, financial solvency and management team. In preparation of such summarised financial information, the underlying assumptions, events or phenomena peculiar to the nature of entity's operations and the overall scenario mainly having significance on financial affairs and working of the entity are to be disclosed.

What These Disclosures Mean

Section 209 of the Companies Act requires that accounts shall be prepared to comply with

all mandatory Accounting Standards (AS) issued by ICAI. Further, it casts a duty on the auditors under section 227 to report to the members whether the accounts comply with Accounting Standards or not? The statutory auditors in a limited time frame available for them have to rely upon management representations on various significant issues. There are certain AS like AS on related party transactions, requiring complete and exhaustive details to be disclosed. But again most of the companies try to escape the definition of related party by nominating some henchman as either directors or auditors of those related entities. Similarly in the cash flow statements only cash items shall have to be reflected and non-cash items especially shares allotted for other than cash or without receipt of cash have to be disclosed accordingly. But as there are no compulsions on the part of promoters or directors for such disclosures, the same have not been done. There are various other factors having influence on the very existence of the company which ought to be disclosed as per various AS but unless the investors know the significant AS they may not be able to read the financial statements in tandem with AS.

In a listed company, there were offers of shares for the public (initial public offerings) and allotments of shares on preferential basis to only related parties but these parties were not at all disclosed as such in the Corporate Governance reports. These issues were made from time to time to keep the control and management with the promoters even after offloading sizeable quantum of shares in the market. Further, the listed entity also had many transactions including purchases and sales, borrowing and lending, assignment of rights, discounting of bills with a bank even though no physical movement of goods were made, etc. Due to these transactions, which existed only in paper, the earnings per share increased to Rs 80 per share and hence naturally the share price touched somewhere around Rs 700 per share. After 5 years of offloading the promoters holdings, on one fine morning the promoter fled the country. The small investors lodged complaints with authorities but nothing happened. Even assuming that promoters made all these disclosures, do all the investors have the intelligence to decipher and interpret the same? Whether the common shareholders (who are mostly in minority status) have any say in the Annual General Meetings to question rationale behind the transactions and if at all such transactions were for true value or only paper transactions? These are some moot questions which need detailed discussions by the SEBI and other investor protection organisations for safeguarding the interests of investors in listed companies. SEBI can at best order probe and levy penalty on the errant promoters but will that in anyway ameliorate the financial position of those investors who lost money in the market? What mechanisms shall be in place to deal with such issues in the corporate sector? Basically in liberalised era the *laissez-faire* (i.e. let the buyer be aware) axiom applies and more so in the case of listed companies, and stock market operations, where the investors are expected to be intelligent and analytical. But two questions arise: even for the buyer to be aware there should be sufficient and factual information available and secondly whether the law provides for disclosure of essential information for the investor to decide on merit?

In another case, the promoters allotted shares to their group companies and with a view to manipulate share prices, indulged in window dressing of the affairs by showing non-existent overseas transactions. The dues were to be realised. Instead of realising the dues and as permitted by the then extant Exchange Control Regulations, promoters sought to set off dues receivable against some other intangible assets. RBI permission was also not obtained. However, the earnings per share, net worth, book value, etc were shown at a phenomenally higher side. Flamed by fancy for information technology shares, the scrip touched an all time high of Rs 2000 per share during which the promoters offloaded almost 1.3 crore shares held by them. The real value was not even

10% of the quoted rate if statutory auditors qualifications were considered. The Statutory auditors mainly relying on Accounting Standard 9 (Revenue Recognition), Accounting Standard 4 and Auditing and Assurance Standard regarding evidence, qualified almost 90% of the transactions in profit and loss account and balance sheet as not substantiated by proper evidence or confirmation. Under these circumstances, it is desirable that auditors should have given a negative opinion and this would have sent strong signals to the market and alerted the investors.

Even going by the requirements of listing agreement that maximum and significant disclosures shall be made, who will ensure that the management has made all required significant disclosures for the purposes of investor making his own judgment? The issue is wide open but the same lacunae have been misused by most of the companies in deceiving the investors. While on historical cost basis, the past events of payments and receipts may have to be disclosed either as expenditure or assets or debts, the receipts have to be disclosed as income or liability or capital contribution. What is more intriguing and worrying is the accounting on accrual basis and by passing book entries only which have not been aptly brought out neither by way of disclosures nor by the auditors suitably. The problem gets more complicated where fair value and judgemental issues involving forming of opinion by directors are concerned.

The Accounting Standards (AS) are in a way guiding tools for the investors in interpretation of the disclosures made and in judging the transparency and impact of various significant accounting policies. An attempt is made in the following paragraphs to highlight the significance of some of the AS having direct impact on presentation of the financial statements and aimed at investor protection:

AS 1 – Disclosure of Accounting Policies: It is mandatory on the part of every company to disclose the underlying assumptions and presumptions in presentation of the financial statements by way of significant accounting policies. These assumptions mainly relate to basis of accounting for revenue (revenue recognition), receivables, major transactions, claims and counter claims, etc. Companies are also required to follow accrual basis of accounting. However, where cash basis of accounting has been followed, the impact thereof on the working results of the company shall have to be given. However most of the companies do not present the impact. Also, the companies are required to disclose the deviations, if any, from:-

(i) generally accepted accounting principles and practices which are in the form of Accounting Standards prescribed by ICAI.

(ii) Previously adopted accounting policy and its impact on the working results (profit and loss account) and financial position.

In one of the listed companies, it has been noticed that the accounting policies for revenue recognition and inventory valuation were changed frequently which is a sign of weakness and also implies fraudulent intentions.

The Institute of Chartered Accountant of India has identified the areas where different accounting policies can be followed like in the case of inventory valuation, depreciation provision, revenue recognition, recognition of prior period items, etc. Now the different accounting policies can also be adopted in the case of deferred taxation, borrowing costs, accounting for foreign exchange fluctuations, etc.

For a layman it is sufficient to note the following as far as the disclosure of significant accounting policies are concerned:

(a) Items for which the accrual or cash basis of accounting is adopted and whether these transactions are significant in nature?

(b) Whether the company has been frequently changing its accounting policies for any of the items and reasons for the same?

(c) Deviations made from the GAAP and whether its impact has been quantified by management or the statutory auditors?

AS 2 - Inventory Valuation: According to this AS, closing inventory held in the business as on the closing date of accounting period have to be valued at lower of cost or net realisable value. Though it appears to be simple, there are hidden interpretations for the unscrupulous elements. So the simple check for the investors would be whether the closing stock value (per unit) is synchronous with either purchase or sale price.

AS 3 - Cash Flow Statement: The avowed purpose of cash flow is that the information would be useful in assessing the ability of the enterprise to generate cash and cash equivalents and enable users to develop models to assess and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events. A comparison of cash flow statement with the balance sheet figures would reveal the aspects of non-cash items and may give rise to further probing where actual cash has not been realised. Cash flow statement can be prepared either under direct or indirect method. Direct method provides information about major classes of gross cash receipts and gross cash payments (i.e. it is almost abstract of cash book under relevant headings). However, the listing agreement specifically stipulates that cash flow statements shall be prepared using indirect method – i.e., the net profit shall be adjusted for non-cash items like depreciation etc. Further, the same shall be adjusted to reflect the changes in financial position from the closing date of the previous year to the closing date of the current year. The major lacuna in adopting indirect method is that the effects of overvaluation of inventory, investments etc also get adjusted as cash inflow whereas the provisions and other credit entries represented only by book adjustments also get adjusted. Further, where the promoters have swapped the shares of a company for shares of other companies are also reflected as part of cash flow statement under indirect method either knowingly or unknowingly. To this extent the author is not in agreement with SEBI listing agreement requiring companies to furnish cash flow statement under indirect method only. This is fraught with greater risk especially for investors as frauds can be somewhat camouflaged by the management by showing simply the difference in opening and closing balances only.

AS 5 - Extraordinary Items: Apart from normal working, sometimes companies may receive or pay as compensation etc amounts which are in the nature of windfall and not earned. Such items shall be treated as extraordinary items and disclosed separately in the profit and loss account. Existing and profit making companies are allowed to make premium issue, if the company reported profits for continuous three years. In order to ensure that earned profits (profits from regular operations of the company) only are reckoned, the separate disclosure is required. The Disclosure for Investor Protection Guidelines issued by SEBI and Malegam Committee report suggested the following:

Existing and profit making companies are allowed to make premium issue if the company reported profits for continuous three years.

"Definition of Profit in Eligibility Criteria: *As per the extant Guidelines, an unlisted company could come out with a fixed price issue only if it had a track record of profits in three of the immediately preceding five years. To make this criterion more effective, the Committee recommended that all extraordinary items should be excluded when calculating the profits for the said purpose. This recommendation of the Committee was accepted by the Board and accordingly the Guidelines were*

amended vide CFD/DIL/DIP/Circular No. 11 dated August 14, 2003."

AS 9 – Revenue Recognition: This is another interesting AS. Revenue has been defined in this AS to include cash, receivables and other consideration arising in the course of ordinary business transactions. This AS requires recognition of revenue only when significant risk and rewards have been transferred leaving no uncertainty as to realisability of the income.

Conclusion

To sum up, although the investors are expected to know the company in which they are investing, latest trends, technologies and new jargons have made it difficult even for a professional to decipher what has been reported in the financial statements. Under these circumstances, it becomes necessary to protect investors' interests. The Accounting Standards guide the management in preparation and presentation of financial statements within the permissible assumptions and make disclosures thereof. However, the investors cannot be expected to master the accounting standards and understand the significance of each and every accounting standard and the extent of compliance. For example, the oil refining and marketing companies disclose the method adopted for each of the category of inventory; the same cannot be equally said of the private sector refineries and oil marketing companies. There are many a hidden agenda of the management, which may be revealed if the financial statements are read in conjunction with and in the light of requirements of AS, the disclosures made under significant accounting policies. Similarly, the disclosures to be made in the Corporate Governance reports are nonetheless important but again the extent of transparency cannot be judged by general and vague statements made as is the case in many of the private sector companies.

In short, the Accounting Standards insist on transparency "Say What You Do And Do What You Say" and if correctly interpreted and applied it would go a long way in securing the interests of investors and other stakeholders. While the auditors may even call the financial statements as not giving true and fair view, it is the shareholders who have the final authority to accept or reject the accounts with the auditors report.

The Ministry of Company Affairs, SEBI, ICAI and various investor protection organisations shall have to work out the manner in which the shareholders get more information and even a lay person can understand the impact of the following, with a view to avoid recurrence of corporate frauds:

- Impact of not accounting of any expenditure whereas revenue has been recognised.
- Impact of related party transactions on the overall business of the entity.
- Impact of outstanding dues from related parties on the financial position, especially the working capital of the reported entity.
- Modifying the contents of the statutory auditors reports in such a manner that overall impact of notes on accounts and his qualifications shall have to be summarised in the form of shadow profit and loss account and balance sheet either on the face of the report (most preferred) or by way of annexure.
- Reporting to the shareholders, as part of good corporate governance, the income disclosed for the purposes of filing income tax returns, and where there is a wide deviation, a sort of reconciliation under major heads to make investors understand that their company is not indulging in any tax evasion or manipulations.
- Last but not the least, the audit fee payable to the statutory auditors shall be fixed as a percentage of turn-over or authorised capital instead of existing system of fixing a lump sum by the Board. This will be a deterrent for the unscrupulous elements and at the same time go a long way in elevated performance of the statutory auditors. Definitely the statutory auditors will try to lend credence to their report and ensure assurance levels for the stakeholders. ❐