International Research Journal of Management and Commerce
Vol. 2, Issue 10, Oct 2015 IF- 3.007 ISSN: (2348-9766)

Website: www.aarf.asia Email : editor@aarf.asia , editoraarf@gmail.com

CORPORATE FINANCIAL STATEMENTS: CONFLICTING LEGAL PROVISIONS AND ACCOUNTING PRACTICES IN INDIA

Debansu Das
Associate Professor, Department of Commerce,
University of Kalyani, West Bengal, India.

ABSTRACT

The main purpose of this paper is to examine how far the general disclosure requirements under the newly introduced Companies Act, 2013 are harmonised with the existing Accounting Standards in India. The paper has identified and analysed three major areas of conflict between Accounting Standards and the Schedule III to the Companies Act, 2013 for preparation and presentation of corporate financial statements. These three areas relate to (i) disclosure and provisioning of proposed dividend, (ii) disclosure of cash and cash equivalents and (iii) presentation of current maturities of long term investment. The paper has discussed the recommendations made by the Institute of Chartered Accountants of India (ICAI) to resolve such conflicts. Accounting and disclosure practices relating to these conflicting issues of top 30 non-financial companies listed in Indian Stock Exchange have been examined. It has been observed that inconsistent legal provisions have lead to diverse accounting and reporting practices by Indian companies. On the basis of analysis of the extant regulatory provisions, recommendations of ICAI and corporate accounting practices, some specific suggestions are offered to remove anomalies in Indian Laws so as to harmonize the general disclosure requirements under Companies Act with those prescribed in the Accounting Standards.

KEYWORDS: Accounting Standards, Companies Act 2013, Conflicting Legal Provisions, Corporate Financial Statements, Harmonisation of Legal Requirement**,** ICAI.

1. Introduction

In the regime of the Companies Act, 1956, the provisions of section 211 read with Accounting Standards and Schedule VI primarily governed the requirements for preparation and presentation of financial statements of companies registered in India. Section 211 of the Act required that every Balance Sheet of a company should be in the form set out in Part I of Schedule VI and every Profit and Loss Account of a company should comply with the requirements of Part II of Schedule VI. On 28th February, 2011, the Ministry of Corporate Affairs, Government of India replaced the existing Schedule VI by a revised Schedule VI[1] which has become effective for the accounting year commencing on and after 1st April, 2011.

Afterwards, the Companies Act, 2013[2] has been enacted in August, 2013. Section 129 of the new Act requires that the financial statements shall comply with the notified Accounting Standards and shall be in the forms set out in Schedule III. The Companies (Accounts) Rules, 2014 provides that section 129 of the new Act becomes effective from the accounting year commencing on or after 01.04.2014. However, there is no difference between revised Schedule VI to the Companies Act, 1956 issued in February 2011 and Schedule III to the Companies Act, 2013.

As per the Explanatory Memorandum on Review of Schedule VI to the Companies Act, 1956 issued by the Ministry of Corporate Affairs, Government of India in 2008, following two major objectives underlie the revision of Schedule VI in February, 2011:

(i) to attain compatibility and convergence with the International Accounting Standards and practices and

(ii) to harmonize and synchronize the general disclosure requirements under Schedule VI with those prescribed in the Accounting Standards.

However, despite a thorough revision of Schedule VI, a number of conflicts still exist between the revised Schedule VI to the Companies Act, 1956 (presently Schedule III to the Companies Act, 2013) and existing Accounting Standards.

In this backdrop, the paper seeks to examine and analyses some major inconsistencies in the regulatory requirements governing corporate financial reporting in India.

[1] Vide Notification No S.O. 447(E) dated 28th February, 2011 issued by the Ministry of Corporate Affairs (MCA), Government of India.

[2] Passed by Lok Sabha on 18.12.2012 and by Rajya Sabha on 08.08.2013. It got assent of the President of India on 29.08.2013.

The rest of the paper proceeds as follows. Section 2 specifies the objectives of the present study. Section 3 speaks about research methodology. Section 4 examines some major conflicts between Accounting Standards and Schedule III to the Companies Act, 2013. This section also analyses the recommendations made by the Institute of Chartered Accountants of India (ICAI) to resolve such conflicts. Section 5 examines accounting and disclosure practices of top Indian companies in respect of conflicting legal issues. Section 6 offers some specific suggestions to remove the observed inconsistencies in the present regulation for preparation and presentation of financial statements in Indian context. Section 7 concludes the paper.

2. Objectives of the Present Study

The objectives of the present study are the following:

(i) To examine some conflicting legal requirements for preparation and presentation of financial statements in India;

(ii) To analyse the recommendations of the Institute of Chartered Accountants of India (ICAI) to resolve such conflicting legal issues;

(iii) To study accounting treatment and disclosure practices in respect of conflicting legal requirements by top companies listed in India Stock Exchange, and

(ii) To offer some specific suggestions to remove inconsistencies in legal requirements.

3. Research Methodology

The theoretical portion of the present study is based on relevant provision of the Companies Act, 1956, the Companies Act, 2013, Accounting Standards (ASs) issued by the ICAI and International Accounting Standards (IASs) issued by the IASB and other relevant literature. For examining accounting and disclosure practices in corporate annual reports, we decided to select 30 non-financial companies. Our sample comprises 30 top companies listed in Indian Stock Exchange, ranked on the basis of net sales for the year 2014-15 (Appendix 1). Annual reports of these 30 companies have been collected from their websites for the accounting year 2014-15.

4. Examination of Major Conflicts between Accounting Standards & Schedule III and Discussion of Recommendations made by the ICAI

Our examination of the Indian Laws reveals some conflicts in the regulatory requirements for preparation and presentation of financial statements. In this section, we have critically examined some of these conflicts and discussed the recommendations made by the Institute of Chartered Accountants of India (ICAI) to deal with such conflicts. The section proceeds as follows:

4.1 Treatment of Proposed Dividend: Contradiction between Schedule III and Accounting Standard (AS) 4

The pre-revised Schedule VI to the Companies Act, 1956 specifically required proposed dividend to be disclosed under the head 'Provisions'. The present Schedule III to the Companies Act, 2013 requires a company to disclose separately in the notes to financial statements the amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share. It does not require creation of any provision for proposed dividend.

But paragraph 14 of AS 4 on 'Contingencies and Events Occurring After the Balance Sheet Date' requires that dividends which are proposed or declared by the enterprise after the Balance Sheet date but before approval of the financial statements, should be adjusted. This implies that, as per AS 4, a provision is to be created for proposed dividend and disclosed in the Balance Sheet. Therefore, a contradiction lies between Schedule III and Accounting Standard 4 in regard to the treatment of proposed dividend in the financial statements.

On this issue, the ICAI (2011) has recommended, "Keeping the provision of AS 4 in view and the fact that the Accounting Standards override the Revised Schedule VI, companies will have to continue to create a provision for dividends in respect of the period covered by the financial statements and disclose the same as a provision in the Balance Sheet, unless *AS 4* is revised." The ICAI is also of the view that the disclosure to be made in the notes is over and above the disclosures pertaining to: (a) the appropriation items to be disclosed under Reserves and Surplus and (b) Provisions in the Balance Sheet.

4.2 Disclosure of Cash and Cash Equivalents: Contradiction between Schedule III and Accounting Standard (AS) 3

According to Schedule III to the **Companies Act, 2013**, “Cash and Cash Equivalents” is to be presented on the face of the Balance Sheet as a line item under Current Assets. Cash and cash equivalents are to be classified as:

(a) Balances with banks;

(b) Cheques, drafts on hand;

(c) Cash on hand;

(d) Others (specify nature).

Balances with banks may include items like earmarked balances with banks, balance held as margin money or security against borrowings, guarantees, etc., balance held due to repatriation restrictions and bank deposits with more than 12 months maturity.

However, AS 3 on Cash Flow Statements defines ‘Cash’ as cash on hand and demand deposits with banks. Cash Equivalents are defined as short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value. Paragraph 6 of the Standard further explains that an investment normally qualifies as a cash equivalent only when it has a short maturity of three months or less from the date of acquisition.

Going by the requirements of AS 3, only deposits with original maturity of three months or less should be classified as cash equivalents and hence, bank deposits with more than 12 months maturity cannot be presented as cash equivalents, as required by present Schedule III. Again, bank balances held as margin money or security against borrowings are neither in the nature of demand deposits, nor readily available for use by the company, and hence, do not meet the definition of ‘cash equivalents’ as per AS 3. Therefore, meanings of ‘Cash’ and ‘Cash Equivalents’ specified in AS 3 do not cover all the items required to be reported under “Cash and Cash Equivalents” as per Schedule III. Thus, there is a conflict between the requirement of the Schedule III and the Accounting Standard 3 with regard to the nature of items which should form part of cash and cash equivalents.

To resolve this conflict, the ICAI has considered two important provisions of the revised Schedule VI (presently Schedule III to the Companies Act, 2013). First, Accounting Standards prevail over revised Schedule VI and second, freedom of modification to add, substitute or delete on the face of financial statements head/sub-head or any other changes inter-se. Recognizing these two policy guidelines, the ICAI has recommended for changing the caption “Cash and

Cash equivalents” to “Cash and bank balances,” which may have two sub-headings, namely, “Cash and cash equivalents” and “Other bank balances.” The former should include only the items that constitute cash and cash equivalents defined in accordance with AS 3, while the remaining line-items of the heading “Cash and cash equivalents” of *r*evised Schedule VI (presently Schedule III) may be included under the latter heading.

4.3 Presentation of Current Maturities of Long Term Investment: Contradiction between Schedule III and Accounting Standard (AS) 13

The present Schedule III requires Investments, like other assets, to be classified as Current and Non-Current. According to AS 13 on ‘Accounting for Investments’, investments are required to be classified into two categories, namely, Current and Long-term. AS 13 defines current investment as an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. A long-term investment is defined by AS 13 as an investment other than a current investment.

As per AS 13, the period of holding, for determining whether an Investment is a current or long-term, is to be reckoned from the date of acquiring the same. On the other hand, by virtue of provisions contained in Schedule III, for determining current or non-current status of Investment, the expected period of holding has to be determined with respect to the reporting date. Thus, for example, an investment, which was acquired 4 years back, is a long-term investment on the current balance sheet date as per AS 13 but it may be qualified as a current investment as per Schedule III if its expected period of realisibility is one year or less on the balance sheet date. Therefore, the requirement of the Schedule III and that of the Accounting Standard 13 with respect to classification and presentation of investment is clearly inconsistent.

On the issue the ICAI (2011) has made the following observation and recommendation:

> “Though the Revised Schedule VI clarifies that the Accounting Standards would prevail over itself in case of any inconsistency between the two, it is pertinent to note that AS-13 does not lay down presentation norms, though it requires disclosures to be made for Current and Long-Term Investments. Accordingly, presentation of all investments in the Balance Sheet should be made based on Current/Non-current classification as defined in the Revised

Schedule VI. The portion of long-term investment as per *AS 13* which is expected to be realized within twelve months from the Balance Sheet date needs to be shown as Current Investment under the Revised Schedule VI."

In the next section, we shall examine corporate accounting and disclosure practices in respect of these conflicting legal issues.

5. Corporate Accounting and Disclosure Practices in India in respect of Conflicting Legal Issues

We have studied annual reports of top 30 companies listed in Indian Stock Exchange for the year 2014-15 to examine their accounting and disclosure practices regarding conflicting legal issues for preparation and presentation of financial statements. Our examination reveals the following:

5.1 Accounting and Disclosure Practices in respect of Proposed Dividend

(a) Out of 30 sample companies, 3 companies have not recommended any dividend for the accounting year 2014-15.

(b) Remaining 27 companies have made provision for proposed dividend, as per the requirements of AS 4. Proposed dividend has been shown as an appropriation item under reserves & surplus and as short term provision under current liabilities in the Balance Sheet.

As suggested by the ICAI, out of these 27 companies, 13 companies have made additional disclosure of the amount of proposed dividend and proposed dividend per share in the notes to financial statements while 7 companies have made such disclosure under reserves and surplus to comply with the requirements of schedule III of the Companies Act, 2013. However, other 7 companies did not make such additional disclosure in respect of proposed dividend though they have created provision for proposed dividend complying with the requirements of AS 4.

Thus, in effect, 20 companies out of 27 applicable companies, i.e., 74% companies have followed the recommendation of the ICAI in respect of proposed dividend.

5.2 Disclosure Practices in respect of "Cash and Cash Equivalents"

(a) The Schedule III to the Companies Act, 2013 requires that companies should use the caption "Cash and Cash equivalents" under current assets. But it has been observed that instead of using the caption "Cash and Cash equivalents", 25 companies have changed the caption to "Cash and bank balances" which has been further subdivided into (a) "Cash and cash equivalents" and (b) Other bank balances or others, as recommended by the ICAI.

(b) Remaining 5 companies used the caption "Cash and Cash equivalents" following the requirements of Schedule III to the Companies Act, 2013 and did not make any distinction between (a) "Cash and cash equivalents" and (b) Other bank balances or others, as suggested by the ICAI.

Thus, 25 companies out of 30 sample companies, i.e., 83% companies have followed the recommendation of the ICAI in respect of "Cash and Cash Equivalents".

5.3 Disclosure of Current Maturities of Long Term Investment

(a) As suggested by the ICAI, only 3 companies have presented current maturities of long term investment under current investments to comply with the requirement of schedule III to the Companies Act, 2013 for classification of assets into current and non-current elements.

(b) Remaining 27 companies did not make any specific disclosure regarding current maturities of long term investments.

Thus, 3 companies out of 30 sample companies, i.e., 10% companies have followed the recommendation of the ICAI in respect of presentation of current maturities of long term investment. In case of other 27 companies, it is not clear whether the concerned information was applicable to them or not.

6. Some Specific Suggestions to Remove Inconsistencies in Legal Requirements

In order to remove inconsistencies in Indian Laws for preparation and presentation of financial statements, the following suggestions are offered:

6.1 Suggestion regarding Treatment of Proposed Dividend

It should be noted that paragraph 13 of International Accounting Standards (IAS) 10 states that if dividends are declared after the reporting period but before the financial statements are authorised for issue, the dividends should not be recognised as a liability at the end of the reporting period because no obligation exists at that time. Thus, in the absence of a 'present obligation' in respect of proposed dividend on the reporting date, there is no theoretical basis for creating provision for the same on that date. Proposed dividend becomes an obligation when it is accepted by the shareholders at their AGM. So, according to normative accounting principle, the provision of IAS 10 seems to be more logical.

The accounting practice of creating a provision for proposed dividend by Indian companies, as suggested by the ICAI, also goes against the spirit of international harmonization. Hence, the Indian regulator should revise AS 4 in line with IAS 10, instead of asking companies to create provision for proposed dividend in accordance with AS 4 by applying the overriding provision of present schedule III to the Companies Act, 2013.

6.2 Suggestion regarding Disclosure of "Cash and Cash Equivalents

As an interim measure, the recommendation of ICAI, i.e., to change the caption "Cash and Cash equivalents" to "Cash and bank balances" and also to classify "Cash and bank balances" into (i) "Cash and cash equivalents" and (ii) "Other bank balances", is a good solution to resolve the conflict. However, necessary changes should be made in Schedule III to the Companies Act, 2013 for disclosure of "Cash and cash equivalents" in line of recommendation made by the ICAI for presentation of the item in the Balance Sheet.

6.3 Suggestion for Presentation of Current Maturities of Long Term Investment

Following the recommendation of ICAI, presentation of investments in the Balance Sheet on the basis of Current/Non-current classification as per revised Schedule VI seems to violate the provision of AS 13 as well as the overriding provision of revised Schedule VI with respect to supremacy of Accounting Standards. The reason is that paragraph 26 of AS 13 is very much clear and specific, which requires an enterprise to disclose current investments and long term investments distinctly in its financial statements and the meaning of current and long term investments should be taken from the standard itself.

To resolve this inconsistency, AS 13 should be amended immediately in line with the provisions of Schedule III with respect to criteria of current and non-current assets because for ascertaining the nature of investment, the provision for determining holding period calculated from the reporting date as per Schedule III is more logical in comparison to the provision of AS 13 for calculating holding period reckoned from the date of acquisition.

7. Conclusion

Our present study shows that the existing legal provisions for preparation and presentation of financial statements are inconsistent in a number of cases. These inconsistencies indicate that the objective of revising Schedule VI to harmonize and synchronize the general disclosure requirements under Schedule VI with those prescribed in the Accounting Standards has not been achieved fully. Moreover, attaining the objective of compatibility and convergence with the International Accounting Standards and practices has also been vitiated on account of such discrepancies in the legal requirements. These inconsistencies in Indian Laws have lead to diverse accounting and reporting practices by Indian companies which may adversely affect risk perception of foreign investors which in turn result in higher cost of capital for Indian companies. To make the Indian business competitive in global financial market the need is to frame regulatory provision in such manner which facilitates preparation and presentation of financial statements of Indian companies comparable with international standards.

In order to remove inconsistencies in Indian Laws, our recommendations are summarised as under:

i) AS 4 should be revised in line with IAS 10 deleting the requirement for creation of provision for proposed dividends;

ii) Amendment should be made in the Schedule III to the Companies Act, 2013 to change the caption "Cash and Cash equivalents" to "Cash and bank balances," which should contains two sub-headings, namely, (i) Cash and Cash equivalents and (ii) Other bank balances, as suggested by the ICAI;

iii) AS 13 should be revised in line with the provision of Schedule III to the Companies Act, 2013 with respect to criteria for classification of investments into current and non-current categories.

Reference

Companies (Accounting Standards) Rules

Companies (Accounts) Rules, 2014

Companies Act, 1956

Companies Act, 2013

ICAI (2011), *Guidance Note on the Revised Schedule VI to the Companies Act, 1956* (New Delhi: The Institute of Chartered Accountants of India).

Ministry of Corporate Affairs, Government of India (2008) *Explanatory Memorandum on Review of Schedule VI to the Companies Act, 1956.*

Appendix 1

Name of Sample Companies

(in alphabetical order)

Sl. No.	Name of Companies	Sl. No.	Name of Companies
1	Bharti Airtel	16	Larsen
2	BHEL	17	M&M
3	BPCL	18	Maruti Suzuki
4	Chennai Petro	19	MRPL
5	Essar Oil	20	NTPC
6	GAIL	21	ONGC
7	Hero Motocorp	22	Petronet LNG
8	Hindalco	23	Rajesh Exports
9	HPCL	24	Reliance
10	HUL	25	Ruchi Soya
11	Idea Cellular	26	SAIL
12	Infosys	27	Tata Motors
13	IOC	28	Tata Steel
14	ITC	29	TCS
15	JSW Steel	30.	Wipro