

CORPORATE FINANCIAL REPORTING

BASIC CONCEPTS

Meaning of 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.

Meaning of Financial Statements

After the financial year is over, it is essential to stop and look at the performance during the year. It is necessary to know whether it has been **a good or a bad year**. It can be known with the help of accounting records. With the help of these records some statements are prepared. *One of these statements shows whether the business has earned profit during the year or has suffered a loss. The other statement shows the financial position at the end of the year.* These statements are known as:

- (i) **Income Statement or Trading and Profit & Loss Account** which shows the profit or loss arising from the operation of business during the year.
- (ii) **Balance Sheet or Statement of Financial Position or Position Statement.** This statement shows the financial position of a business as at the end of the accounting

Financial Reporting

period. This statement consists of details of assets and liabilities of the business at particular **point of time**.

“The financial statements provide a summary of the accounts of business enterprise the balance sheet reflecting the assets, liabilities and capital as on a certain date the income statement showing the results of operations during a certain period.”

– **John N. Myer**

There is one more statement that shows the cash movement and that is cash flow statement.

A complete set of financial statements normally consists of a Balance Sheet, a Profit & Loss A/c 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.

Thus, Financial statements are a central feature of financial reporting. Principal financial statements are:

1. Balance Sheet (or statement of financial position).
2. Profit & Loss Account (or statement of earnings or income statement).
3. Cash Flow Statement (or statement of cash flows).

Such financial statements are called *general purpose financial statements*.

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.

Content of Annual Report

A typical corporate annual report usually contains

- a balance sheet, profit and loss account, cash flow and / funds flow statement, and directors' report.
- Besides, the details of information and additional information are provided in the schedules and notes on accounts, which form parts of financial statements.
- Annual reports often contain useful supplementary financial and statistical data as well as management comments.
- Many companies in India now include Management Discussion and Analysis report, corporate governance report, chairman's statement, historical summary, operating positions, highlights of important data etc.

Question 1

What are the main limitations of financial statements?

Answer

Limitations of Financial Statements:

- (i) **Financial statements provide mostly historical data:** 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 recognise form:** In India, financial statements are prepared recognising 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. They may mislead the users of accounts about the degree of asset-turnover of the entity.
- (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 do not reflect cash flow:** In India, financial statements do not include a cash flow report to explain movement of cash during the accounting period. As such, there exists a big gulf between accrual profit and operational cash flow. However, now the listed companies/entities whose annual accounts are approved by the shareholders after 31.3.1995, are required to give a cash flow statement (as prescribed by SEBI) in their Annual Report.
- (v) **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

Financial Reporting

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.

- (vi) **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.
- (vii) **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.
- (viii) **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.
- (ix) **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 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 'best presented accounts' 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** (earlier known as 'Competition for the Best Presented Accounts').

ICAI List of documents forming part of Annual Report

- Balance Sheet
- Profit and Loss Account
- Director's Report
- Chairman's Statement or speech at the Annual General Meeting
- Declaration that the Annual Report submitted have been circulated to the shareholders.

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 creditors and other users in making rational investment, credit, and similar decisions.
- (ii) **Assess Prospective Cash Inflows**-To provide information to help investors, creditors, 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

The following balances are extracted from the books of Raj Ltd., a real estate company, on 31st March, 2010:

	Dr.	Cr. (Rs. '000)
Sales		2,760
Purchases of materials	1,218	
Share capital fully paid		100
Land purchased in the year as stock	73	
Leasehold premises	42	
Creditors		463
Debtors	735	
Directors' salaries	39	
Wages	111	
Work in progress on 01.04.2009	210	
Sub-contractors' cost	894	
Equipment, Fixtures and Fittings at cost on 01.04.2009	264	
Stock on 01.04.2009	59	
Profit and Loss Account, Credit Balance on 01.04.2009		128
Secured Loan		112
Bank Overdraft		105
Interest on Loan and Overdraft	22	
Depreciation on Equipment on 01.04.2009		164
Administration Expenses	147	
Office Salaries	<u>18</u>	
	<u>3,832</u>	<u>3,832</u>

You also obtain the following information:

- (a) On 31st March, 2010, stock on hand including the land acquired during the year, is valued at Rs. 1,42,000. Work in progress at that date is valued at Rs. 1,40,000.
- (b) On 1st October, 2009 the company moved to new premises. The premises are on a 12 years lease and the lease premium paid amounted to Rs. 42,000. The company used

Financial Reporting

sub-contract labour of Rs. 40,000 and materials at cost of Rs. 38,000 in the refurbishment of the premises. These are to be considered as part of the cost of leasehold premises.

- (c) A review of the debtors reveals specific doubtful debts of Rs. 35,000 and the directors wish to provide for these together with a general provision based on 2% of the balance.*
- (d) Depreciation on equipment, fixtures and fittings is provided at 15% on the written down value.*
- (e) Raj Ltd. sued Bright Ltd. for supplying defective materials which has been written off as valueless. The Directors are confident that Bright Ltd. will agree for a settlement of Rs. 50,000.*
- (f) The directors propose a dividend of 25%. Ignore dividend distribution tax.*
- (g) Rs. 20,000 is to be provided as audit fee.*
- (h) The company will provide 10% of the pre tax profit as bonus to employees in the accounts before charging the bonus.*
- (i) Income tax to be provided at 50% of the profits.*

You are required:

- (i) to prepare the company's financial statements for the year ended 31st March, 2010 as near as possible to proper form of company final accounts; and*
- (ii) to prepare a set of Notes to accounts including significant accounting policies.*

Notes: *Workings should form part of your answer.*

Previous year figures can be ignored.

Figures are to be rounded off to nearest thousands.

Answer

Raj Ltd.

Balance Sheet as at 31st March, 2010

(Rs. in thousands)

I	SOURCES OF FUNDS	
(1)	Shareholders' funds:	
(a)	Capital	100
(b)	Reserves and surplus(175.85+9)	<u>184.85</u>

Corporate Financial Reporting

		284.85
(2)	Loan funds:	
	(a) Secured loans	112
	(b) Unsecured loans	—
		<u>112</u>
	TOTAL	<u>396.85</u>
II	APPLICATION OF FUNDS	
(1)	Fixed assets:	
	(a) Gross block	384
	(b) Less: Depreciation	<u>184</u>
	(c) Net block	200
	(d) Capital work in progress	—
		200
(2)	Investments	—
(3)	Current assets, loans and advances:	
	(a) Inventories	282
	(b) Sundry debtors	686
	(c) Cash and bank balances	—
	(d) Other current assets	—
	(e) Loans and advances	—
		<u>968</u>
	Less: Current Liabilities and Provisions:	
	(a) Liabilities	588
	(b) Provisions	<u>183.15</u>
		<u>771.15</u>
	Net current assets	196.85
(4)	Miscellaneous expenditure (to the extent not written off or adjusted)	—
	TOTAL	<u>396.85</u>
	Contingent Liabilities	Nil

Financial Reporting

Profit and Loss Account for the year ended 31st March, 2010

(Rs. in thousands)

INCOME

Sales	2,760
-------	-------

EXPENDITURE

Manufacturing Expenses	2,205
------------------------	-------

Other Expenses	297
----------------	-----

Interest	22
----------	----

Depreciation on Fixed Assets	<u>20</u>
------------------------------	-----------

2,544

Profit before Taxation	216
------------------------	-----

Provision for Tax	<u>130</u>
-------------------	------------

Net Profit	86
------------	----

Balance brought forward from previous year	<u>128</u>
--	------------

Profit Available for Appropriation	214
------------------------------------	-----

Appropriations

Amount transferred to General Reserve* (10% of 86)	9
--	---

Proposed Equity Dividend	25
--------------------------	----

Amount transferred to CDT** (16.609% of 25)	<u>4.15</u>	<u>38.15</u>
---	-------------	--------------

Balance Carried Forward		<u>175.85</u>
-------------------------	--	---------------

* As per Companies (Transfer of Profits to Reserves) Rules, the amount to be transferred to the reserves shall not be less than 10% of the current profits since proposed dividend exceeds 20% of the paid up capital. In this answer, it has been assumed that Rs. 9,000 have been transferred to General Reserve. The students may transfer any amount based on a suitable percentage not less than 10%.

** Dividend distributed by an Indian Company is exempt from income-tax in the hands of many shareholders. The Indian Company is liable to pay Dividend Distribution Tax (DDT) @ 16.609 percent (i.e. inclusive of surcharge and education cess) on such dividends)

NOTES ON ACCOUNTS FOR THE YEAR ENDED 31ST MARCH, 2010

1. Accounting Policies: The Accounts have been prepared primarily on the historical cost convention. The significant accounting policies followed by the Company are stated below:

- (a) *Fixed Assets:* Fixed assets are shown at cost less depreciation. Cost comprises the purchase price and other attributable expenses.
- (b) *Depreciation on Fixed Assets:* Depreciation on equipment, fixtures and fittings has been provided on written down value method at 15% per annum. Lease-hold premises/improvements are being amortised over the lease period.
- (c) *Inventories:* Inventories are valued at the lower of historical cost or the net realizable value.

2. Other Matters:

- (a) The cost of leasehold premises includes the cost of refurbishment to the extent of Rs. 78,000 (Materials Rs. 38,000 + Labour Rs. 40,000).
- (b) Bright Ltd. has been sued for supplying defective materials. Settlement of Rs. 50,000 is hopeful however it has not been recognized in the accounts as it represents contingent gain.

Working Notes:

		(Rs. in thousands)
(1) Manufacturing Expenses		
Stocks at Commencement:		
Opening Stock	59	
Opening Work-in-progress	<u>210</u>	269
Purchases of Materials (1,218 – 38)		1,180
Purchase of Land		73
Wages		111
Sub-contractors' cost (894 – 40)		<u>854</u>
		2,487
Less: Stocks at close:		
Closing Stock	142	
Closing Work-in-progress	<u>140</u>	<u>282</u>
		<u>2,205</u>

Financial Reporting

(2)	Other Expenses	
	Administration Expenses	147
	Office Salaries	18
	Directors' Salaries	39
	Provision for Doubtful Debts [35 + 2% of (735 – 35)]	49
	Audit Fees	20
	Bonus (See Working Note 3)	<u>24</u>
		<u>297</u>
(3)	Bonus	
	Sales	2,760
	Less: Manufacturing Expenses	2,205
	Other Expenses (excluding bonus)	273
	Depreciation	20
	Interest	<u>22</u>
		<u>2,520</u>
	Pre-tax Profit	<u>240</u>
	Bonus (10%)	<u>24</u>
(4)	Fixed Assets	
(a)	Gross block	
	Equipment, Fixtures and Fittings	264
	Leasehold Premises (42 + 40 + 38) **	<u>120</u>
		<u>384</u>

** According to AS 19 'Leases' (issued in 2001), the leases are classified as finance lease and operating lease. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. An operating lease is a lease other than finance lease. At the inception of lease, assets under finance lease are capitalized in the books of the lessee with the corresponding liability of lease obligations as against the operating lease wherein lease payments are recognized as an expense in the profit and loss account on a systematic basis (i.e. straight line) over the lease term without capitalizing the asset. The person (lessor/lessee) presenting the leased asset in his balance sheet should also consider the additional requirements of AS 6 and AS 10.

(b) Depreciation		
Equipment, Fixtures and Fittings as on 1.4.2009	164	
For the year [15% on (264 – 164)]	<u>15</u>	179
Cost of Leasehold Premises written off**		5
$[(42 + 40 + 38) \times 1/12 \times 1/2]$		<u>184</u>
(5) Provision for Taxation		
Profit as per Profit and Loss Account		216
Add back: Provision for doubtful debts	49	
Cost of Leasehold premises written off	5	
Dep. on equipment, fixtures and fittings	<u>15</u>	<u>69</u>
		285
Less: Depreciation under Income-tax Act		<u>25</u>
		<u>260</u>
Provision for Tax (@ 50%)		130
(It has been assumed that depreciation calculated under Income-tax Act amounts to Rs. 25,000)		
(6) Current Liabilities		
(a) Sundry creditors		463
(b) Bank overdraft		105
(c) Audit fees		<u>20</u>
		<u>588</u>
(7) Provisions		
(a) Provision for taxation		130
(b) Proposed dividend		25
(c) Provision for bonus		<u>24</u>
		<u>179</u>

Financial Reporting

Question 6

On 30th September, 2007 Beta Enterprises Ltd. was incorporated with an Authorised Capital of Rs. 50 lakhs. Its first accounts were closed on 31st March, 2008 by which time it had become a listed company with an issued subscribed and paid up Capital of Rs. 40 lakhs in 4,00,000 Equity Shares of Rs. 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, 2008. The 'Ceramics Division' was added by the company on 1st April, 2009. The following data is gathered from the books of account of Beta Enterprises Ltd. :

Trial Balance as on 31st March, 2010

	(Rupees 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	–
Fixed Assets at cost	9,000	–
Depreciation on Fixed Assets	–	1,500
Stock on 31st March, 2010	400	–
Trade Debtors	440	–
Cash at Bank	160	–
Trade Creditors	–	500
Equity Share Capital in shares of Rs. 10 each	–	4,000
Retained Profits	<u>–</u>	<u>1,000</u>
	<u>22,500</u>	<u>22,500</u>

Additional Information:

- (a) Administration costs should be split between the Divisions in the ratio of 5 : 3 : 2.
- (b) Distribution costs should be spread over the Divisions in the ratio of 3 : 1 : 1.
- (c) Directors have proposed a Final Dividend of Rs. 8 lakhs.
- (d) Some of the users of Ceramics Division are unhappy with the product and have lodged claims against the company for damages of Rs. 7.5 lakhs. The claim is hotly contested by the company on legal advice.
- (e) Fixed Assets worth Rs. 30 lakhs were added in the Ceramics Division on 1.4.2009.
- (f) 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 Rs. 25 lakhs. 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, 2010 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, 2010

		Rs. '000
Sales		15,500
Cost of Sales		<u>(7,800)</u>
		7,700
Distribution costs		(1,500)
Administration costs		<u>(2,000)</u>
Profit before tax		4,200
Provision for tax	1,239	
Deferred tax (35% of Rs. 660)	<u>231</u>	<u>(1,470)</u>
Profit after tax		2,730
Amount transferred to General Reserve*		
(10% of 2730)		(273)
Amount transferred to CDT*(16.609% of 2000)		(332.20)

Financial Reporting

Dividends (Rs.1,200 + Rs. 800)	(2000)
Profit for the year	124.8
Retained profit brought forward (Rs. 1,000 – Rs. 210)	<u>790</u>
Retained Profit carried forward	<u>914.80</u>

Beta Enterprises Ltd. Balance Sheet as at 31st March, 2010

Liabilities	Amount Rs.'000	Assets	Amount Rs.'000	Amount Rs.'000
<i>Share Capital</i>		<i>Fixed Assets</i>		
Issued and subscribed		Gross block	9,000	
4,00,000 shares of Rs.10 each, fully paid up	4,000	Less: Depreciation	<u>1,500</u>	7,500
<i>Reserves and Surplus</i>		<i>Current Assets, Loans and Advances</i>		
Retained profits	914.8	(a) Current assets		
Reserve	273	Stock	400	
Deferred Tax Liability	441			
<i>Current liabilities and Provisions</i>		Debtors	440	
(a) Current liabilities		Cash at bank	<u>160</u>	1,000
Creditors	500	(b) Loans and Advances		NIL
(b) Provisions				
Provision for tax	1,239			
Proposed dividend	800			
CDT	<u>332.2</u>			
	<u>8,500</u>			<u>8,500</u>

Notes to Accounts:

1. Segmental Disclosures (Business Segments)

(Figures in Rs. 000's)

	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

Corporate Financial Reporting

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 31.3.2009	300	300	NIL	600
For the year ended 31.3.2010	300	300	300	900

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

2. Tax computation

(Rs. in 000's)

Profit before tax for the year ended 31.3.2010	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%	<u>1,239</u>

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

Rs.'000

Opening Timing Difference on 1.4.2009	
WDV of fixed assets as per books	5,400
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, 2010)	Rs.'000
Depreciation as per	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

Financial Reporting

4. **Contingent Liabilities not provided:** Company is contesting claim for damages for Rs. 7,50,000 and as such the same is not acknowledged as debts.
5. **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	
and nature of relationship	Alpha Ltd. common director
Nature of the transaction	Sale of goods at normal commercial terms
Volume of the transaction	Sales to Alpha Ltd. worth Rs. 25 lakhs.

Question 1

Question 2

Following is the draft of Profit and Loss Account prepared by the Chief Accountant for the year ended 31st March, 2010

Financial Reporting

The following further informations 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 Rs. 5 lakhs on the average. This cost is included in direct labour.
- (b) The fixed production overheads of Hardware division included interest of Rs. 50 lakhs and depreciation of Rs. 50 lakhs. Further this sum of Rs. 50 lakhs included an additional depreciation of Rs. 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 Rs. 100 lakhs. It was found on June 1st, 2010 that the foreign firm has become bankrupt. The company had received an advance of Rs. 50 lakhs in the year ended 31st March, 2010 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 Rs. 20 lakhs as salaries and Rs. 10 lakhs as overheads, which were included in direct labour and fixed production overheads respectively. Management feels that a further Rs. 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 Rs. 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 stock of goods at a standard cost of Rs. 1.8 lakhs per computer.

You are required to :

- (i) Redraft the Profit and Loss Account for the year ended 31st March, 2010 with reference to relevant Accounting Standards issued by the institute.
- (ii) Compute the value of Closing Stock of finished goods.

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

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