Accounting Standards in India and the Auditor

By
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It has been well established that the auditor is expected to perform his functions and carry out his duties with reasonable care and skill. Also, the auditor has to report to the shareholders whether the profit and loss account of the concerned company exhibits a true and fair view of the profit earned (or loss sufferred) during the year under report and the balance sheet exhibits a true and fair view of the financial position of the company as at the date on which it is drawn up. This paper seeks to examine the possible impact of accounting standards on the standard of reasonable care and skill and on the meaning of true and fair, the auditor being vitally concerned with both.

1. Reasonable Care and Skill

1.1 Over the years, the standards of reasonable care and skill have improved a great deal as a result of decisions by courts and of various pronouncements by the professional bodies. For example, it will probably no longer be possible for an auditor to remain unconcerned with physical inventories and to rely completely on certificates issued by officials of the company howsoever trustworthy they may be; and quote as defence the decision in The Kingston Cotton Mill Co's case where Justice Lindley said that it was no part of an auditor's duty to take stock and that he could rely on the certificates issued by the management in this regard. The Statement on Auditing practices in India clearly spells out the duty of the auditor in regard to stock-taking; he can ignore the guidance contained in this publication only at his own risk and peril.

1.2 One can say, however, that it is auditing practices and auditing standards that will have the most profound influence on what is reasonable care and skill. But it is

accounting standards, along with legal requirments, that govern the contents of the financial statements put before the shareholders. Therefore, if auditing standards fall short of the accounting standards, the auditor may still face the charge of not doing his duty adequately. It is not likely that the auditing standards will fall short of accounting standards in any material manner but it is possible that auditing standards may not provide for all the detailed work required for meeting an accounting standard. In such a case, the auditor must fall back on his own resources and knowledge. Thus accounting standards will have an impact on what is reasonable care and skill.

1.3 As an illustration, let us take the question of valuation of inventories. Under the Manufacturing and Other Companies (Auditor's Report) Order, 1975, the auditor is required to state whether he is satisfied that, *inter-alia,* the valuation of stocks is fair and proper in accordance with the normally accepted accounting principles. AS 2 lays down how inventories are to be valued. One must recognise the fact that till this Standard is made mandatory, the auditor would be free to accept "other methods of inventory valuation if they have been consistently followed and if he considers them as being fair and proper and in accordance with the normally accepted accounting principles". Thus, in any case, the auditor must apply the test of conformity with normally accepted accounting principles. It is, however, submitted that, since it is the authoritative view of the Institute of Chartered Accountants of India, the onus of proof will be on the auditor to show that valuation is proper in case AS 2 is ignored in a material manner. This is because the principles laid down in AS 2 will be treated as the generally accepted accounting principles. Some of the important points to be looked into are the following:-

(i) The cost formula used-whether a formula other than FIFO, LIFO and Average has been used; if so, whether there is adequate disclosure and ground for it.

(ii) Components of cost for valuing finished goods inventories. If absorption cost has been adopted, whether the amount per unit for fixed manufacturing overhead has been arrived at on the basis of the normal level of production.

(iii) Valuation of by-products and wastes.

(iv) Valuation of normal quantity of materials and other supplies held for use in production in case replacement cost is below the historical cost but the realisable price of the concerned finished product expected to be in excess of the historical cost.

1.4 It is noteworthy that according to the International Accounting Standard 2, exceptional amounts of waste-material, labour or other expenses-which do not relate to bringing the inventories to their present location and condition are to be excluded from conversion costs. The Indian Standard is silent on this point. It is a matter for interpretation-does the silence permit inclusion of exceptional waste-while computing conversion cost or, on the basis of sound accounting principles in general, such waste must be excluded?

1.5 The question taken up above is extremely important since correct and proper valuation of inventories is vital for true and fair financial statements. But the main point is that what is expected of the auditor, while he carries out his work, will be profoundly affected by the accounting standards that have already been promulgated and may be promulgated later. There is certainly a distinction between the standards that are mandatory and those that are recommendatory; the former have almost the full force of law since courts generally interpret the auditor's duties in the light of standards laid down by the professional body concerned. However, it would seem that, after a period of time, even recommendatory standards will acquire good strength and force. How long can a member of the Institute of Chartered Accountants of India ignore the authoritative recommended courses of action laid down by the Institute on the ground that these are mere recommendations? If he ignores them, he should be sure of the reasons why he could not follow them. The auditor must take full note of what the Institute says; not only of the various standards but also of the guidance notes that are issued from time to time.

1.6 In this respect, it would be interesting to note the requirements of the World Bank in regard to project accounting. To the extent possible, the World Bank prefers that the project accounts are maintained in accordance with generally accepted international standards. Recognising that these standards are constantly evolving and that they may be in conflict with local legal requirements, the Bank requires that the following fundamental principles be applied to all project accounting*:-

"(a) full accountability for all funds of the borrower, other lenders, and the Bank;

(b) adequate disclosure in the financial statements of all material information;

(c) a true and fair view of financial performance and status presented by the financial statements;

(d) a clear statement in the financial statements of accounting policies adopted; and

(e) an independent review of the accounts and systems."

"In many cases, the foregoing may be achieved by preparing financial statements in accordance with generally accepted accounting practices, based on the rules, procedures, and conventions of accounting commonly used in the borrower's country, provided that they are appropriate to support the objectives of the project and to illustrate the operations of the entity. *Such rules, procedures, and conventions should have substantial, authoritative support from the government, or from practising accountants in the country concerned.*"

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*Guidelines for Financial Reporting and Auditing of Projects financed by the World Bank, March, 1982, pp. 10-11.

"The standards and practices to be used normally should be determined by the accountants and auditors charged with the responsibility, respectively of maintaining and auditing the accounts... ...." (Emphasis added)

1.7 It would be useful to not what the Institute of Chartered Accountants of India says about the accounting standards promulgated by it. Paragraphs 6.1 and 6.2 of the "preface to the Statements of Accounting Standards" are relevant. They are reproduced below:--

> 6.1 While discharging their attest functions, it will be the duty of the members of the Institute to ensure that the Accounting Standards are implemented in the presentation of financial statements covered by their audit reports. In the event of any deviation from the Standards, it will be also their duty to make adequate disclosures in their reports so that the users of such statements may be aware of such deviations.
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> 6.2 In the initial years, the Standards will be recommendatory in character and the Institute will give wide publicity among the users and educate members about the utility of Accounting Standards and the need for compliance with the above disclosure requirements. Once an awareness about these requirements is ensured, steps will be taken, in course of time, to enforce compliance with the accounting standards in the manner outlined in para 6.1 above."

1.8 The question in this regard will be: if an accounting standard is promulgated and users become aware of its requirements, will they not be entitled to ask why it has not been complied with, even if it is not yet mandatory? Once some knowledge is made available, how can a professional person ignore it? This question would appear to cover not only accounting standards but also other authoritative publications of the Institute, such as the various guidance notes and publications concerning some industries, for example shipping, live-stock, agriculture, banking, etc. These contain valuable information about technical, economical and accounting matters concerning the industry in question. The exact impact of such publications on the standard of reasonable care and skill will naturally await a judicial consideration. But there is no doubt that these are of great help to the auditor in his work. A professional person's knowledge must always be uptodate; hence all the Institutue's pronouncements and publications are liable to be considered if a question of reasonable care and skill arises. The question is likely to be decided on the basis of the available knowledge. The present day auditor is condemned, it seems, to hard labour for life since accounting knowledge is increasing by leaps and bounds.

2. True and fair :

2.1 Though the law requires the final statements of account to be drawn so as to exhibit a true and fair position, the term "true and fair,, has not been defined. The various

legal decisions have covered negligence much more than the meaning of true and fair; that has not yet been the subject matter of legal interpretation by a court of law. Pending this, one must fall back on the common sense interpretation of the term in the context of accounting knowledge and practice.

2.2 Section 211 of the Companies Act is the governing section. It requires the final statements to be drawn up on a true and fair basis; it also requires compliance with Schedule VI of the Act as far as applicable and as far as circumstances admit. Sub-Section (4) of Section 211 states:

> "The balance-sheet and the profit and loss account of a company shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose—in the case of any company any matters which are not required to be disclosed by virtue of the provisions contained in Schedule VI or by virtue of a notification issued under sub-section (3) or an order issued under sub-section (4)."

2.3 This would lend force to the general belief that if the final statements of account are drawn up in accordance with Section 211 and, more specifically, Schedule VI to the Companies Act, that is, these are drawn up in the form prescribed for the Balance Sheet and give the information specified by the Schedule, the requirement of "true and fair" will be met. However, substance must not be lost sight of; therefore meeting technical requirements may not be enough "Substance over form" is well recognised; hence it is possible that the courts will require that the balance-sheet and the profit and loss account should comply with the spirit of Section 211 and not merely the latter. It may be required that the statements of account should be true and fair whether or not they comply with Schedule VI, non-compliance with Schedule VI being treated as a technical breach, serious if thereby the statements are rendered less than true and fair. For example, trade investments are treated as fixed assets and, if the concerned company's shares are not quoted on the stock exchange, it is generally enough if the investment is shown at cost. But what if the concerned company has been making losses continuously and the value of the shares is almost nil? Will it be then a good defence to say that all the information required to be disclosed by law has been disclosed and that nothing more was required? In an American case, *United States V. Simon*, the judge ruled that even compliance with generally accepted accounting practices is not enough if the financial statement are misleading and if the auditor, on the basis of questions that should have arisen in his mind, should have made further enquiries and elicited further information. The Court held that—

> "generally accepted accounting principles instruct an accountant what to do in the usual case where he had no reason to doubt that the affairs of the corporation are being honestly conducted. Once he has reasons to believe that this basic

assumption is false, an entirely different situation confronts him."

2.4 Broadly speaking, one may say that the profit and loss account will not be true and fair, if on a careful and intelligent perusal of the account, one is misled about the size of the profit (or loss) for the period concerned and about the factors that have contributed to the profit (or loss). This appears to be the burden of the disclosure requirements, specially the statistical disclosures. Similarly, the balance sheet will not be true and fair if, after being studied carefully and intelligently, one is misled about the financial position of the concerned company, both in the short-run and in the long run*. In other words, the information contained in the profit and loss account and the balance sheet should be comprehensive enough and accurate enough to satisfy the reasonable expectations of the "public" to whom they are addressed, basically shareholders. As yet, only general purpose statements are feasible and expected.

2.5 The degree of accuracy and comprehensiveness will obviously be limited by what is feasible, keeping in mind the cost and time involved. The accounting profession through various pronouncements, like Accounting Standards, seeks to provide guidance to practising accountants on this vital matter as to what is necessary, desirable, and feasible while preparing the financial statements. In this regard, courts themselves will attach weight to the professional pronouncements though they are not bound by them; as the following excerpt from the judgement in an English case shows-

> "In order to ascertain what are the correct principles (the court) has recourse to the evidence of accountants. That evidence is conclusive on the practice of accountants in the sence of the principles on which accountants act in practice. That is question of pure fact, but the court itself has to make a final decision as to whether the practice corresponds to the correct principles of commercial accountancy. No doubt in the vast proposition of cases the court will agree with the accountants but it will not necessarily do so............"**

2.6 Accounting Standards naturally determine the expectations of the readership since these mean that the accounting profession has, after weighing the relevant factors,

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*There is an obvious limitation-inflation-which does not permit a correct enough view of both the financial position and profitability on the basis of historical cost statements. The accounting profession is now grappling with this limitation. But in many countries, including India-no one can bring a legal case as yet charging that the historical cost statements are not true and fair. It is possible that the situation will change, if and when the Institute of Chartered Accountants of India makes Inflation Accounting mandatory.

**Pennycuick V-C in Odeon Associated Theatres Ltd. V Jones (Inspector of Taxes) 1971 W.L.R. 442 at 454, quoted in the Accountancy of November, 1983, p. 155

come to the conclusion that the various concerned accounting matters should be dealt with in the manner laid down by the standards and that it is possible and feasible to do so within the limits laid down by the standards. Informed readers will naturally be influenced by the accounting standards as to what the degree of accuracy and comprehensiveness in the final statements of account is. Thus, accounting standards will tend to influence both the courts and the consumers-shareholders and various other parties interested in the financial statements.

2.7 The Accounting Standards Committee of the English Institute recently obtained a written opinion from counsel on the meaning of 'true and fair'. The following significant statement occurs in the opinion:*

> "Thus, the value of a SSAP to a Court which has to decide whether accounts are true and fair is two-fold. First, it represents an important statement of professional opinion about the standards which readers may reasonably expect in accounts which are intended to be true and fair. Secondly, because, accountants are professionally obliged to comply with a SSAP, it creates in the readers an expectation that the accounts will be in conformity with the prescribed standards. This is in itself a reason why accounts which depart from the standard without adequate justification or explanation may be held not to be true and fair."

2.8 In the U S.A., the Securities and Exchange Commission (SEC) has the authority to lay down standards regarding disclosures by listed companies. It regards financial statements to be misleading if these are prepared according to accounting principles for which there is no authoritative support. The SEC, however, does not lay down any accounting principles or standards itself, but it is by no means a passive body in regard to disclosure requirements but its policy is that principles, standards and practices, promulgated by the FASB in its statements and interpretations will be considered as having substantial authoritative support and those contrary to such FASB promugations will be considered to have no such support."

2.9 It would appear that what is true and fair will be profoundly influenced by the accounting standards; certainly, the standards that are mandatory will have to be followed unless there is ample justification otherwise. There is reason to believe that even the standards that are as yet only recommendatory will also have an impact, if only after some time. It will normally be difficult for an auditor to justify non-compliance with a recommended course of action leading to material mis-conception about the profit earned by or the financial position of a company. One should remember that courts of law tend these days to

*Legal Opinion on 'True and Fair', Accountancy, Nov., 1983, p. 155.

be liberal in their interpretation of law in their anxiety to protect the public. One should also remember, as a responsible member of the society, that the auditor is the only person who has full and free access to the accounts of a company and who, thus, is the only person to whom the shareholders look for protection of their legitimate interest since they themselves are denied any access to the accounts, except the published accounts. And, all that they ask is that the published accounts be true and fair. The auditor, of all the persons, should be aware of the fact that the meaning of the term 'true and fair' goes on evolving and acquiring depth and width as accounting knowledge itself develops.

3. Some Important Requirements of Indian Accounting Standards :

3.1 The Institute of Chartered Accountants of India has issued seven Accounting Standards. These are the following:-

AS 1. Disclosure of Accounting Policies (Issued in November, 1979).

AS 2. Valuation of Inventories (Issued in June, 1981)

AS 3. Changes in Financial Position (Issued in June, 1981)

AS 4. Contingencies and Events Occuring After the Balance Sheet Date (Issued in November, 1982)

AS 5. Prior Period and Extraordinary Items and Changes in Accounting Policies (Issued in November, 1982)

AS 6. Depreciation Accounting (Issued in November, 1982)

AS 7. Accounting for Construction Contract (Issued in December, 1983)

The standard on Research and Development costs is under consideration.

The Council of the Institute has decided that two of the standards, out of Standards, No. 4, 5 and 6, will be made mandatory with effect from January 1, 19 5. It would be useful to note some of the important features, affecting true and fair status of the financial statements, even if the concerned standard remains recommendatory. Since As 7 has been issued only recently, it may not be pertinent for the time being. Paragraph 1.4 above broadly covers AS 2; hence there is no further need to comment upon this standard.

3.2 AS 1 is designed to make a radical and qualitative change in the disclosure requirements since it seeks disclosure of all accounting policies. This perhaps will have to await an amendment of Schedule VI. But AS 1 has two other significant points.

3.3 The first is the statement that disclosure of accounting policies or changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts. This is nothing but re-itreation of a basic accounting principle and perhaps for that reason, does not find a place in the main Accounting Standard. There is a number of companies, however, which do not follow this principle in all respects. What is worse, the disclosure is often tucked away so that one has to be quite diligent in reading everything contained in the financial statements to see the real situation. There are cases, for example, where capital profit, that is excess of sale price over the original cost of fixed assets, is shown as revenue income. The auditor should realise the sanctity of the profit and loss account; if it does not clearly show the true and fair figure of profit readily, it is only a mockery. It is not fair that one should start with suspicion while looking at the financial statements; one should be entitled to treat the disclosed profit or loss as true and fair and not be required to make adjustment after adjustment as he reads through the small print or notes. In a recent case, a company disclosed a huge profit after including a bigger adjustment for depreciation in "Other Income" The auditor is not a bloodhound but then is the reader of the accounts a hunter?

3.4 If a small diversion is premitted, the auditing profession should consider the nature of qualificatory notes. The notes should be clearly classified as explanatory and as qualificatory; one omnibus term "subject to" seems to be inadequate; the auditor should, it is submitted, clearly state what he does not approve. Also, it would bring more credibility to the accounting statements if the notes as a whole do not make more than a reasonable change to the profit or loss actually disclosed. In one company, the note regarding computation of profit for calculating managerial remuneration shows a big loss whereas the profit and loss account shows a huge profit. This, it is submitted, destroys the credibility of the profit and loss account. The auditor has a role in seeing to it that this does note occur.

3.5 The second point is about change in an accounting policy. AS 1 states that if the change has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later years, the fact of such change should be appropriately disclosed in the period in which the change is adopted. Schedule VI does not require the change to be disclosed if the effect of the change in the current period is not material even if it is material in later periods. Suppose a company, towards the end of its financial year, disposes of some of the important fixed assets and takes them back on lease. The sale or disposal will, of course, be disclosed but Schedule VI does not require disclosure of the fact of leasing-this year the amount is not material, next year there is no change. AS 1 will cover this and require disclosure of such a change. AS 5 reiterates this position.

3.6 AS 5 seeks to plug a big loophole for mischief. One knows how easy it is to change the figure of the reported profit by changing one or more accounting policies. The law merely requires disclosure of the change and the effect of the change, if material, but

does not put any other restriction The auditor may feel uneasy but as long as the required disclosure is made, there is not much that he can do. Now, AS 5 recommends and one hopes will soon require, that a "change in accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of an enterprise." This means that the management must furnish reasons, to the auditor at least, for the change. The auditor will be within his rights to ask for the reasons and qualify his report. If he is not satisfied that the reasons are valid and, thus, check the capriciousness of some of the managements. He may be failing in his duties if he does not ask for the reasons. It is considered that this requirement in AS 5 is a very important step towards making the financial statements more credible than at present, even if the degree of general credibility is quite high. It is a significant step towards making Accountancy a science for measuring the effects of various transactions and events affecting business enterprises.

3.7 Depreciation Accounting has often been used by people to show a profit of their choice and there was urgent need for clipping the wings of those who see in this branch of accounting a good opportunity for manipulating the published accounts. AS 6 has rendered excellent service in this regard. Application of this standard should mean that much greater rationality will be imparted to Depreciation Accounting than was required hitherto and, consequently, the profit and loss account will gain much in reliability. The salient features which have marked a significant departure from past practices and practices that were threatening to develop are given below:-

(i) A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of financial statements of the enterprise*. When a change in the method of deprepciation is made the unamortised depreciable amount of the asset should be charged to revenue over the remaining useful life by applying the new method. (Para 22). This requirement is two fold: the change has to be made on a rational basis and the change cannot be made with retrospective effect, something which even the Institute recommended previously. Many a company in India and abroad has made changes in the method of depreciation and with effect from a date quite remote in the past, only with a view to showing results much better than they actually were. It is hoped that AS 6 will put an end to this practice having such a potential for mischief.

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*The requirement is the same as AS 5 governing changes in Accounting Policies.

(ii) The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. On such a revision, the unamortised depreciable amount should be charged over the revised remaining useful life. In the alternative, the aggregate depreciation charged to date can be recomputed and the excess or short depreciation so determined can be adjusted, to be disclosed as an extraordinary item. (Para 24)

(iii) Where the historical cost of a depreciable asset has undergone a change due to increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties of similar factors, the depreciation on the revised unamortised depreciable amount should be provided *prospectively* over the residual useful life of the asset. (Para 26).

(iv) Where the depreciable assets are revalued, the provision for depreciations should be based on the revalued amount and on the estimate of the useful lives of such assets. (Para 27).

This should stop the practice that some companies were adopting: of revaluing the fixed assets but continuing to provide depreciation only on the basis of historical cost.

(v) Where the management's estimates of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provided is appropriately computed by applying a higher rate. But, if the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with the requirements of the Statute. (Para 13). This will mean that depreciation should be based on the effective rates or the statutory rates whichever is higher.

4. Conclusion

4.1 It is not necessary to touch upon all the Accounting Standards and all their details; many of the requirements codify the generally accepted principles, already an integral part of Accounting. The few points mentioned above and the discussion on the nature and impact of accounting standards should serve to show that these standards will have a profound effect on what is expected in true and fair financial statements and on the standard of reasonable care and skill expected to be displayed by the auditor while discharging his attest function.

4.2 Accounting Standards will provide both an opportunity and a challenge to the auditor. The opportunity will come in the form of lending a basis to him to require the

management to furnish him reasons for many a course of action which previously could not be challenged on the ground that the choice of the course was at the sole discretion of the management. This will help him to see that the profit and loss account and the balance sheet are based on logic and reason rather than on expediency or capriciousness. Thus, he has the chance of lifting Accountancy from an art to a science of measurement of the effect of operations on resources. The challenge lies in the fact that he must meet the expectations of the readers of the accounting statements, expectations that are greatly enhanced by the accounting standards themselves.

4.3 At the XII International Congress of Accountants held at Mexico in 1982, Allan Cook said, in his paper on "Accounting Standards":

> "Accounting Standards are a phenomenon of our times. They are something less than law but more than guidelines of professional notes. They serve not only the accounting profession but also the general public in a more direct way than by simply improving the quality of professional services offered to the public. They provide the essential means of communication for effective public discussions of business operations."

These remarks bring out clearly the impact of accounting standards on the readers' mind. The auditor can ill afford to ignore this vital aspect of accounting standards; he must meet the challenge. The challenge will be greater and greater as new accounting standards are issued and the old ones are revised.