FINANCIAL LITERACY



FOR

DIRECTORS





CA. PRAMOD JAIN

B. COM (H), FCA, FCS, FCMA, LL.B, MIMA, DISA, IP

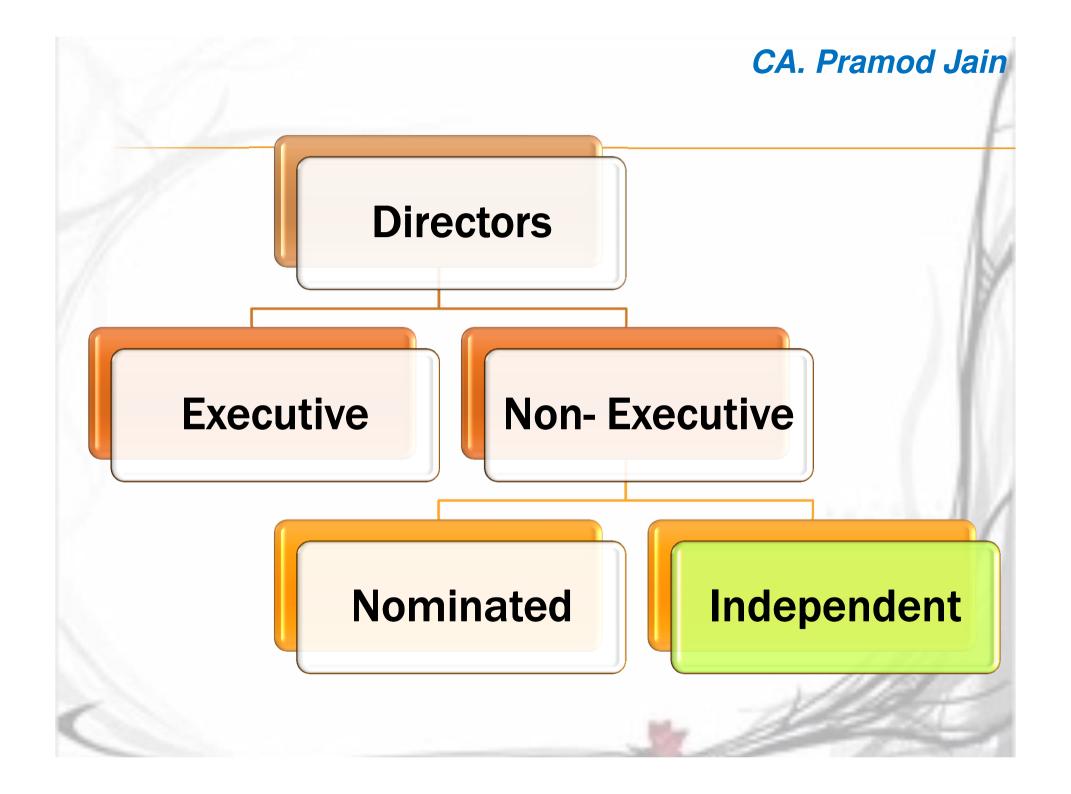
27th June 2019, IOD

CONTENTS

- Necessity for financial knowledge to perform as a director
- ×7 key Finance domain activities
- **× Financial Reporting**
- **× Investment Decisions**
- **× Financing Decisions**
- Compliance and Governance

INTRODUCTION

- **×** Financial failures & <u>scandals</u> in last two decades
- Enron and Worldcom in 2000-01 in US, Tesco and British Telecom in the UK, Satyam, ILFS in India
- How have these happened? What can be done to prevent them?
- Only a few directors of the concerned companies involved
- Other directors? Total ignorance and not conscious abetment
- What company directors should know about Finance, how they should apply the knowledge



DIRECTORS' ROLE IN FINANCIAL MANAGEMENT

- 7 Key Finance-related activities:
- Tracking financial performance and position
- 2. Annual financial report and dividend
- Annual business plan, operating budgets, budgetary control
- 4. Investment decisions
- 5. Financing decisions
- 6. Statutory and Secretarial compliances
- 7. Financial and Governance strategies

Annual Report

Director's Report

Auditor's Report

Financial Statements

Balance Sheet

Profit /Loss

Statement of changes in equity, if any

Cash Flow

Notes

FINANCIAL PERFORMANCE AND POSITION

- Annual Financial Report presented to the Board by the CEO / CFO: the most significant report to the owners of a company
- Board to clear the audited financials to be approved to the shareholders at the AGM
- Quarterly financials presented at other Board meetings
- At all these meetings a few non-executive directors ask some factual questions related to operations ...enough?

READING THE ANNUAL REPORT

- Annual Report
 - + Financial performance during the year with the help of the Profit & Loss a/c and the Cash flow; and
 - + Financial position at the end of the year with the help of the Balance sheet and Statement of stockholders' equity
- Identify obvious and not-so-obvious issues through the numbers



CA. Pramod Jain **ISSUES Impacting Technical Finance Disclosures** Non-Formats, impacting compliances wordings etc **Financial** resulting in **Decisions Huge fines**

FILING OF FS

- To be filed with ROC in Form AOC -4 within 30 days of AGM
- Upto 30.6.2018 additional fee till 300 days
- W.e.f. 1.7.2018 additional fee Rs. 100/- pd
- × Penalty on
 - +Company 1k p. d > 10 L;
 - + MD, etc in charge by Board- if no one all directors
 - Penalty 1L (Rs. 100/- per day if continuous default) to 5L

ANNUAL RETURN - PENALTY

- ★ If filed within 60 days in MGT 7 normal fee
- Upto 30.6.2018 additional fee till 300 days
- W.e.f. 1.7.2018 additional fee Rs. 100/- pd
- After that penalty (earlier fine w.e.f. 2nd November 2018):
 - +On Company and Officer in default
 - ×minimum 50K plus Rs. 100/- per day on continuous default.
 - ×maximum 500K

BASICS – CURRENT VS. NON-CURRENT

- Current Asset satisfies any of following criteria;
 - + In the company's normal operating cycle it is;
 - ×Intended for sale; or
 - ×Intended to be consumed; or
 - **×** Expected to be realized.
 - + Held primarily for the purpose of being traded; or
 - Expected to be realized within 12 months after reporting date; or
 - + Cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least 12 months after reporting date.

BASICS - CURRENT LIABILITY

- A liability would be a current liability if it satisfies any of the following criteria; if it is:
 - + Expected to be settled in the company's normal operating cycle; or
 - + Held primarily for the purpose of being traded; or
 - + Due to be settled within 12 months after reporting date; or
 - + The company does not have an unconditional right to defer settlement of liability for at least 12 months after reporting date. Terms of a liability that could, at option of counterparty, result in its settlement by issue of equity do not affect its classification.

FINANCIAL STATEMENTS

- Balance sheet: Financial position on the reporting date
- Statement of Profit & Loss [P&L a/c]: A flow report on financial performance during period
- Cash flow statement: Cash movements during the period, classified to give insights into the liquidity and cash flows of the company
- Statement of changes in stockholders' equity: The equity shareholder's position at the start of the year, changes during the year and position at the year-end

FINANCIAL STATEMENTS

- Impact of annual published financial report on the company's stock prices
- **×** Measurement of profit of a business:
 - + Surplus/deficit from cash inflows minus cash outflows? X
 - + Surplus/deficit from incomes and expenditures? √
- The double entry bookkeeping system
- 'Accrual' concept versus 'cash' concept
- Accrual rules: (a) income accounted when earned, not when received; and (b) expense accounted when incurred, not when paid

THE ACCRUAL CONCEPT

- Goods or services bought and used but not paid for: recognise expense but simultaneously record liability
- Cash received for service to be rendered in the future: not revenue but liability
- Something bought & used for a few years: recognise cost over its life, show the balance as an asset
- Money paid or material delivered that will give you value even after the period ends: not expense but asset
- Not only transactions but invisible happenings that have a financial impact e. g. asset value reduction, exchange rate fluctuation etc.

BALANCE SHEET AS AT ... Pramod Jain

Particulars	Note No.	Figures as at the end of the current reporting period	Figures as at the end of the previous reporting period
I. EQUITY AND LIABILITIES			189
(1) Shareholders' Funds			
(2) Share Application Money Pending Allotment			- / (1)
(3) Non-Current Liabilities			/ N
(4) Current Liabilities			
TOTAL			
II. ASSETS			
(1) Non-Current Assets			
(2) Current Assets			1/1/2/12
TOTAL		No.	

FORM OF BALANCE SHEET (PART 1)

PLANIN OF BALAIN			/// T/
Particulars	Note	Figures as at the	Figures as at the
	No.	end of the CRP	end of the PRP
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds			- /
(a) Share capital	1		//
(b) Reserve and Surplus	2		10
(c) Money received against share warrants			
(2) Share application money pending allotment	3		- / 1
(3) Non-current Liabilities			/ 11
(a) Long term borrowings	4		1 11
(b) Deferred tax liabilities (net)	5		1.0
(c) Other long term liabilities	6		11/
(d) Long term provisions	7		
(4) Current Liabilities			7///
(a) Short term borrowings	8		-X////
(b) Trade payables			/ 1///
(c) Other current liabilities	9		1888
(d) Short term provisions	10	- 2	
TOTA	L		The second second

BALANCE SHEET AS AT 31 MAR'18

	As at 31/3/18	
	Rs Lakh	Rs Lakh
EQUITY AND LIABILITIES		
Shareholders' Funds / Equity		
Share Capital	1184	1184
Reserves and Surplus	1273	1191
Total Equity	2457	2375
Non-current Liabilities		
Secured Loans	1037	1158
Other Long term Liabilities	525	491
Current Liabilities		
Trade Payables	1022	1129
Short term Debt	100	150
Current Portion of Long term Debt	52	51
Total Current Liabilities	1174	1330
Total Liabilities	2736	2979
Total Equity and Liabilities	5193	5354

IMPORTANT ITEMS - EQUITY & LIAB.

- Reserves Revaluation?
- Trade Payables ageing
- Share Application Money pending allotment
- Loans from friends not allowed
- **×** Loans Current / Non-Current

FORM OF BALANCE SHEET (PART 2)

Particulars	Note No.	Figures as at the end of the CRP	Figures as at the end of the PRP
II. ASSETS			- 1
(1) Non-current assets (a) Fixed assets (i) Tangible assets (ii) Intangible assets	11 12		
 (iii) Capital work-in-progress (iv) Intangible assets under development (b) Non- current investments (c) Deferred tax assets (Net) (d) Long term loans and advances (e) Other non-current assets 	13 14 15		
(2) Current assets (a) Current investments (b) Inventories (c) Trade receivables (d) Cash and cash equivalents (e) Short term loans and advances (f) Other current assets	16 17 18 19 20		
TOTAL		July 1	

BALANCE SHEET AS AT 31 MAR'18

	As at 31/3/18	As at 31/3/17
ASSETS	Rs Lakh	Rs Lakh
Fixed Assets	2230	2264
Other Non-current Assets	213	233
Total Non-current Assets	2443	2497
Current Assets		
Cash	83	72
Trade Receivables	1312	1204
Inventories	1270	1514
Other Current Assets	85	67
Total Current Assets	2750	2857
Total Assets	5193	5354

IMPORTANT ITEMS - ASSETS

- Tangible Assets Immovable property related to business?
- Tangible Assets Non earning assets vehicles?
- Depreciation as per Schedule II
- Intangible assets Real? self generated?
- Investments required? Subsidiary & Associates CFS
- Loans & Advances business? Subsidiary & Associates directors?
- Inventory valuation? slow / non-moving INSURANCE
- Trade Receivables > 6 Months ageing > 1 yr doubtful
 - Provision

CA. Pramod Jain FORM OF STATEMENT OF PROFIT AND LOSS

AIV		
Note No.	Figures for the CRP	Figure for the PRP
21		- 1
22		- 4
		- //N
23		119
		- 10
24		7.8
		/ III
25		
		1.0
26	10.2	11/
		11/11
27		////
28		VIII
	1	1/4
29	100	
-72	200	921-5
	No. 21 22 23 24 25 26 27 28	No. the CRP 21 22 23 24 25 26 27 28

STATEMENT OF PL FOR YEAR ENDED 31 MAR'17

	Year ended	
		31 Mar'16
	Rs Lakh	Rs Lakh
Sales	8689	8244
Cost of Goods Sold	6756	6390
Gross Profit	1933	1854
Selling. General and Admin (SG&A)	1061	1022
Depreciation	239	244
Other income	19	22
PBIT	652	610
Interest	191	201
PBT	461	409
Taxes	159	145
PAT / Net profit	302	264

CASH FLOW STATEMENT FOR YEAR ENDED 31.3.18

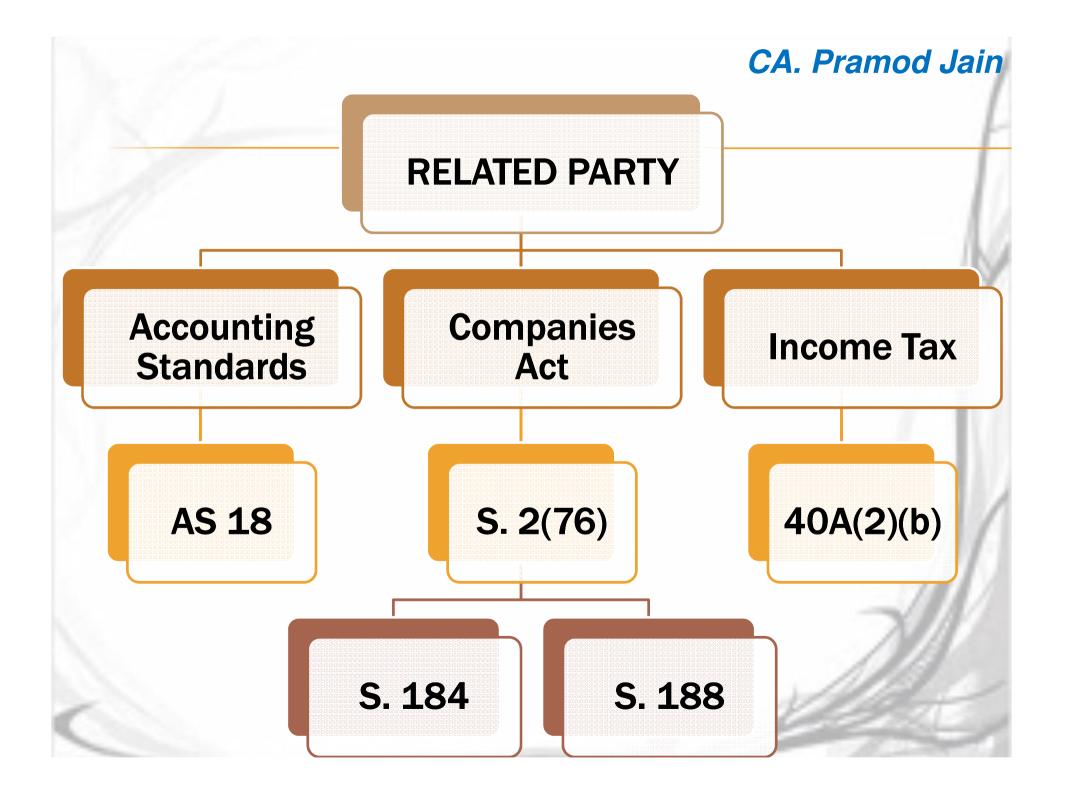
	As at	As at
	31/3/18	31/3/17
Cash from Operating Activities	Rs Lakh	Rs Lakh
Net profit	302	264
Depreciation	239	244
Change in Trade Receivables	-108	84
Change in Inventory	244	-164
Change in Other Current Assets	-18	-40
Change in Trade Payables	-107	99
Net Cash from Operations	552	487
Cash from Investing Activities		
Fixed Assets	-205	-356
Other Non-current Assets	20	-9
Net Cash from Investing	-185	-365

CASH FLOW STATEMENT FOR YEAR ENDED 31.3.18

	As at 31/3/18	As at 31/3/17
Cash from Financing Activities	Rs Lakh	Rs Lakh
Short term Debt	-50	10
Current Portion of Long-term Debt	1	0
Long term Debt	-121	100
Other Long-term Liabilities	34	24
Dividends and Distribution Tax	-220	-220
Net Cash from Financing	-356	-86
Net Cash Surplus / (Deficit)	11	36
Opening Cash Balance	72	36
Closing Cash Balance	83	72

IMPORTANT ITEMS - NOTES

- Significant Accounting Policies
- Contingent Liabilities pending litigation, tax disputes, claims against company
- **× Commitments future commitments**
- **×** Foreign Currency Transactions
- Loans given Interest charged
- **×** Related Party Transactions



STANDARDS

- ***Accounting Standards**
- **×IFRS**
- ***** Convergence to IFRS Ind AS
- **×** Auditing Standards
- Secretarial Standards
- Standards of Internal Audit
- Income Computation & Disclosure Standards (ICDS)

FINANCIAL STATEMENTS (CONTINUED)

- Notes to the accounts classified into
 - Accounting Policies and
 - + Explanatory information on P&L a/c and Balance Sheet
- Accounting principles: concepts, conventions, policies and standards
- **×** Accounting, reporting and disclosure norms
- Sensitive and control information not apparent from the financials: contingent liabilities and commitments, various segments, related party disclosures audit expenses
- Many shades of grey and hence room for manipulation: for example, off-balance sheet financing

OFF-BALANCE SHEET FINANCING

- Operating leases
- Pension obligations
- Guarantees
- Captive and project financing arrangements
- x Take-or-pay contracts
- Throughput and deficiency agreements
- Receivables that are transferred / factored / securitized
- Debts of joint ventures and unconsolidated subsidiaries

FINANCIAL REPORTING REQUIREMENTS

- Specifications of format, content, frequency and due dates for financial reporting
- Board of Directors' report a crucial segment of the annual report
 - + Financial highlights and replies to qualifications if any
 - + Directors' responsibility statement for listed companies
 - + For companies with paid-up capital over Rs 25 crore, annual evaluation of performance of the Board, committees and individual directors to be done and Board report to say how this was done
- Rules on consolidated financial reporting in case of a company with one or more subsidiaries

AUDIT COMPLIANCE REQUIREMENTS

- All companies to get their annual accounts audited by a practicing member of the ICAI
- Provisions on auditor's appointment, rotation of auditors, content of audit report, fraud reporting etc.
- Tax audit compulsory for businesses with gross revenues exceeding Rs 100 lakh and professionals Rs 50 lakh
- Auditor to comply with the auditing standards

AUDIT COMMITTEE

- Following Cos to constitute Audit committee:
 - + Listed companies
 - + Public companies having capital > Rs. 10 Crore;
 - + Public companies having turnover > Rs. 100 Crore;
 - + Public companies, having in aggregate, outstanding loans, borrowings, deposits, etc > Rs. 50 Crore
- Limits as per last audited FS

AUDIT COMMITTEE - SEBI

- SEBI (Listing Obligation & Disclosure Req.)
 - Listed Co to constitute qualified and Independent Audit Committee
 - + Minimum 3 directors as members
 - +2/3rd to be independent directors
 - +All members of audit committee shall be financially literate (read and understand basic FS) and at least 1 member shall have accounting or related financial management expertise

REPORT - COMPANIES

- ▶ Inquiry u/s 143(1) 6 points only to be reported when comments required
- > Report to include:
 - Matters specified u/s 143(3) 9 points
 - > Matters specified in Rules 3 points
 - ➤ Any order made u/s 143(3) for specified Companies in consultation with NFRA CARO 2016 16 points

CA. Pramod Jain

IMPORTANT IN AUDITOR REPORT

- Pending litigation
- **× CARO Points**
 - + Deposits
 - + Loans given 185 / 186
 - + Statutory dues payable
 - + Any adverse comment
- **×** Audit report
 - + Modified Report?
 - × Qualification
 - × Emphasis matter
 - + KAM w.e.f. FY 2018-19 SA 701

FINANCIAL ISSUES AT BOARD MEETING

- Dividend: dividend that can be declared out of the profit for the year and the accumulated profits till end of PY subject to Dividend Rules
- Important statutory and governance issues
- **×** Review of statutory matters
- Statutory checklist preferable for every meeting
- Voluntary reopening / revision of accounts & financial report for earlier periods: up to 3 years

INVESTMENT DECISIONS

- **×** Three types:
 - + Project capital expenditure: major initiatives of expansion and diversification
 - + Other capital expenditure: routine expenditure on replacement of capacity
 - + Investment of surplus funds: return v. risk of the selected channel
- Systems for Board approval based on the Memorandum and Articles of Association
- Significant area of director participation in growth companies

PROJECT CAPITAL EXPENDITURE

- **Expansion**, diversification or acquisition of a business
- Required of the director: a fairly good grasp of the business as well as knowledge in financial evaluation
- Three key dimensions in project capex evaluation
 - + Investment proposed: amount, timing and horizon
 - + Expected cash flows from the project and the risk that they may not happen
 - + Required rate of return
- Discounting of cash flows to build in time value of money, using required rate of return as discount rate
- The concept of weighted average cost of capital (WACC)

OTHER CAPITAL EXPENDITURE

- Replacement of equipment, overhead capex, enhancements in processes
- Routine capex that does not add directly to the bottom line
- Overall amount spent to yield a return > WACC
- Payback approach for small cost reduction initiatives
- Innovation to figure in annual capex budget
- Every item of capital expenditure to be evaluated in terms of return except CSR initiatives
- CSR not to be based on return to the investor but on return to the community

OTHER INVESTMENTS

- Surplus cash to yield a decent return without undue risk
- Short-term parking of funds using interest arbitrage to increase shareholder wealth
- Diversion of funds a danger to look for
- Acquisitions and diversifications that yield economic rents
- Buyback of shares, substantial dividends

INVESTMENT ACCOUNTING AND REPORTING

- Passive and Active Investments
- Reporting of passive investments on financial statements
- Elaborate accounting standards prescribed
- Two possible signs of something fishy:
 - + High non-cash returns reported from investments
 - + Valuation of loss-making subsidiaries

FINANCING DECISIONS

- **×** Three distinct financing decision areas:
 - + Financing of capital expenditure and investments (balance sheet)
 - + Financing of working capital (P&L Account)
 - + Financing strategy for revival of sick companies
- When project capital investment to be proposed together with the financing plan
- **×** Funding of other capex items
- Working capital financing by banks with diverse ad hoc ideas
- Sanctioning changes in bank limits

SOURCES OF FINANCE

- **x** Two broad sources of funds: equity and debt
- Avatars of equity:
 - + Initial investment by the owners
 - + Rights issues
 - + Other types of shares preference capital and hybrid securities
 - + Use of retained earnings
- **×** Balancing two contrary objectives:
 - + cost of money
 - + risk involved
- Importance of capital market conditions and shareholder preferences

OTHER STATUTORY COMPLIANCES

- **×** Three distinct domains:
 - + Company law and secretarial compliances
 - + Compliance with other applicable statutes
 - + Compliance for listed companies (Listing Obligations and Disclosure Requirements)
- Companies Act 2013, Rules and Notifications
- Other statutes: direct and indirect taxes, foreign exchange, PMLA, laws specific to the industry
- Know what questions to ask and where to look for answers

TAX LAWS

- ×Indirect − (GST)
- ★ Direct Income Tax
 - +Tax Audit
 - +TP Audit
 - +ICDS
 - + Various Returns & Compliances TDS / TCS
 - +GAAR Tax benefit 3 Crs
 - +POEM 50 Cr.
 - +Undisclosed Incomes S. 115BBE

OTHER FINANCIAL MATTERS

- **×** Managerial remuneration
- Insurance and risk mitigation
- Stock market performance
- Financial crises, external and internal
- Board composition, committees & Independent directors
- **×** Statutory pronouncements and company responses
 - × In company law matters (like the new Act, CSR regulation etc.)
 - In other statutes (like GST, the annual Finance Act etc.)
 - × Laws specific to the business of the company
- Matters requiring approval of company in GM: director to be well prepared with his homework

FRAUD



DEFINED (447)

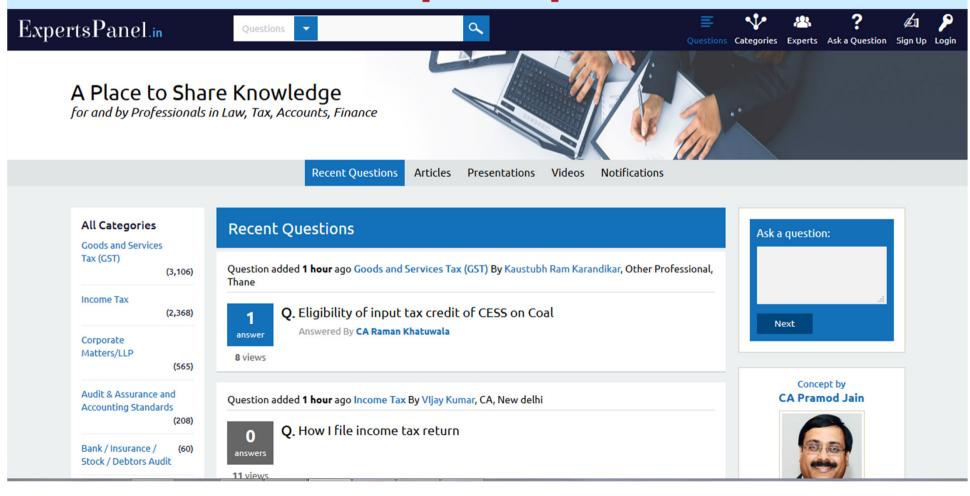
- × Any act or omission,
- Concealment of fact or
- Abuse of position of any person (by him or herself or by any other person in connivance in any manner).
- With the intent to deceive or to gain undue advantage to injure the interest of
 - + Company, or
 - + Shareholders, or
 - + Creditors, or
 - + Any other person (whether or not there is any wrongful gain or loss).

S. 447 FRAUD

- Imprisonment not less than 6 months to 10 years
- + Fine not be less than amount involved in the fraud which may extend to 3 times.
- If fraud in question involves public interest then the imprisonment shall not be less than 3 years.
- ★ If amount involved in fraud is less than Rs. 10L or 1% of turnover – imprisonment upto 5 years or fine upto Rs. 25 Lacs or with both. No minimum term or amount -(9.2.2018)
- ★ Ordinance 2019 Fine limit increased to Rs. 50
 Lacs

A one stop place where all your Queries can be answered by various Experts throughout the Country

www.expertspanel.in



This Presentation would be available on

www.lunawat.com

Also may download free mobile app "LUNAWAT"

for all updates since year 2007



CA. Pramod Jain

pramodjain@lunawat.com

+91 9811073867









