

SECURITIES AND EXCHANGE BOARD OF INDIA

ORDER

IN THE MATTER OF ALLEGED PRESENTATION OF MISLEADING FINANCIAL STATEMENTS BY ROLTA INDIA LTD.

WTMN/70/IVD/ 7 /04

1. Background

1.1 Rolta India Ltd. (hereinafter referred to as Rolta) is a company engaged in providing CAD/ CAM/ GIS solutions and services, having, as on December 31, 2001, a paid up capital of Rs. 63.69 crores comprising 6,39,92,695 equity shares of Rs.10/- each listed on BSE, NSE, Calcutta and Ahmedabad Stock Exchanges. In July 2002, an article which appeared in one of the financial websites, referred to improper accounting of certain transactions in the annual accounts of Rolta for the year ended December 31, 2001. According to the analysis presented in the article, sales turnover of Rolta for the year 2001 included an amount of Rs. 76.03 crores being the cost of self assembled and/ or integrated capital equipment transferred to company's internet service provider/ export division. The same had been capitalised as computer plant under fixed assets. It was also stated that the company had included the transaction in cash flow statement to disguise it as cash sales.

1.2 The company, in turn, had issued a press release on July 11, 2002 stating, inter alia, to the effect that the intra division sales represented direct cost of materials, labour and overheads and no profit element was involved and hence the bottom line was not affected; the same had been capitalised as computer plant under fixed asset and depreciation, provided accordingly; the company had been following this practice uniformly in the past and proper disclosure, made in the annual accounts every year.

1.3 The accounting policy and disclosure related issues arising out of aforesaid practice of Rolta came under scrutiny of SEBI and the stock exchanges were advised to further examine the matter with particular reference to compliance with Clause 41 of the Listing Agreement. On examination of the issue, the listing committee of the stock exchange had observed that intra division sale included in the turnover ought to have been disclosed by way of a note to the financial results published for the year ended 31 December 2001 and the quarter ended 31 March 2002. The stock exchange had observed that the transaction being material to the understanding of the financial results, warranted disclosure and therefore advised the company to publish the financial results with appropriate notes in respect of year ended 31 December 2001 and the quarter ended 31 March 2002 along with the results of quarter ended September 2002 on the lines of the format suggested by the Exchange. The company was also advised to make similar disclosure while publishing audited/ unaudited financial results in future.

2. Show cause Notice and reply

2.1 As the matter also raised the question of possible violation of provisions of SEBI (Prohibition of Fraudulent and Unfair Trade practices relating to securities market) Regulations, 1995 (hereinafter called as the said Regulations), an investigation was made by SEBI. The investigation confirmed that the company had been following the practice of including the cost of self assembled capital equipment in the sales turnover, before its capitalisation, in the previous years as well. As this practice was considered to have the potential of misleading the investing public, a notice was issued on February 24, 2004 by SEBI to the company, to show cause as to why action under the said regulations should not be taken against the company for publishing such misleading information. Rolta sought time till April 16, 2004 to submit a reply and in its reply submitted on April 15, 2004, Rolta desired to avail itself of an opportunity of being heard. Such an opportunity was granted and the company represented by the Kanga & Co appeared before me on June 23, 2004 and the company made the following submissions:-

- o Rolta had been following this practice for the past 7 years.
- o Significant accounting policy and notes on accounts disclosed the practice followed and also stating the quantum of such assembled integrated equipment included in the sales turnover.
- o The profit and loss of the company had not been affected by this practice.
- o Rolta had not sought to present a rosy picture; the market price of shares does not depend only upon the turnover of the company but mainly on the working results, that too on the profit.
- o There was no requirement under clause 41 of the listing agreement to disclose intra division sales separately in the quarterly financial results.
- o Based on the hearing before the listing committee of the stock exchange chaired by Justice B.R. Dhanuka (retd.), the listing committee closed the matter by directing the company to publish financial results with appropriate notes and the directions have been followed by the company.
- o A similar practice is being followed by certain other companies.

3. Consideration of Issues

3.1 The issue that arises for consideration is whether Rolta has violated the provisions of the said regulations and if so, what regulatory directions are called for.

3.2 In terms of Regulation 5 of SEBI (Prohibition of Fraudulent and Unfair Trade practices relating to securities market) Regulations, 1995, inter alia, no person shall make or disseminate any information which – (a) is misleading in any material

particular; and (b) is likely to induce the sale or purchase of securities by any person or is likely to have the effect of increasing or depressing the market price of securities, if when he makes the statement or disseminates the information, – (i) he does not care whether the statement or information is true or false; or (ii) he knows, or ought reasonably to have known that the statement or information is misleading in any material particular

3.3 Although the above Regulations stand replaced by SEBI (Prohibition of Fraudulent and Unfair Trade practices relating to securities market) Regulations, 2003, effective July 17, 2003, Regulation 13 of the new Regulations contain a savings provisions, whereby any violation of the Regulation 3, 4, 5 and 6 of the 1995 Regulations can be investigated and proceeded against in accordance with the new Regulations and any investigation pending at the commencement of the new Regulations can be continued and disposed of in accordance with the procedure laid down in the new Regulations.

3.4 It is observed that as per Annual Accounts of Rolta India Ltd., for the year ended 31 December 2001, it's "sales and other income" were shown at Rs.302.65 crores (Rs.256.20 crores in the previous year). The accounts had been certified as "true and fair" by the Auditors (Khandelwal Jain & Co). The relevant part of the Auditors' Report is as under

" (e) In our opinion and to the best of information and according to the explanations given to us, the Balance Sheet and the Profit and Loss Account, subject to accounting of income from maintenance contract when it becomes due instead of on accrual basis (Refer Note No. 1(a)(ii) of schedule Q) and revenue from Internet Services which is recognised on the basis of actual billing instead of on time basis (Refer Note No. 1(a)(iii) of Schedule Q) and read together with the Significant Accounting Policies and other notes appearing in Schedule 'Q' give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view :-

(I) in the case of Balance Sheet, of the state of affairs of the Company as at 31st December, 2001

(ii) in the case of the Profit and Loss Account, of the Profit of the Company for year ended on that date

While the true & fair view certification has been subject to two qualifications viz. (i) (I)accounting of income from maintenance contract on due basis and (ii) recognition of revenue from internet services on the basis of actual billing, there has been no other qualification except inviting a general reference to the 'Significant Accounting Policies and other notes on Accounts appearing in Schedule Q. Note No. 16 of Schedule Q forming part of the Balance Sheet and Profit and Loss Account states that Sales turnover included Rs.76.03 crores (previous year Rs.46.09 crores) being the cost of self assembled and/ or integrated capital equipment transferred to company's internet service provider division/ export division; the same had been capitalised as computer plant under the head fixed assets and depreciation had been provided accordingly. The transfer cost included actual material cost and estimated labour and overhead charges as certified by the management. The computer plant and machinery had been shown as a separate item in the schedule of fixed assets. The relevant Directors' Report (Page 57) accompanying the said Annual Accounts stated, inter alia, that during 2001, the company registered a significant growth of 18.13% in total revenue at Rs.3026.55 million (i.e. Rs.302.65 crore) as compared to Rs.2562.09 million (Rs.256.20 crore) in the previous year. If the cost of self assembled and integrated capital equipment capitalised as computer plant had not been reckoned as part of "sales and other income", the resultant 'sales and other income' would have been only Rs. 226.62 crore for 2001 as against similarly adjusted previous year's figure of Rs. 210.77 crore. Thus, the growth of sale turnover for 2001 over the previous year would have been only 7.3% as against 18.1% claimed in the Directors Report.

3.5 Examination of the Company's annual accounts for the previous years indicates that the company resorted to this practice of including the cost of capitalisable and, in fact, capitalised items in the sale turnover probably for the first time in the year 1996. Since then, the company had been adopting the practice every year through 2001. Khandelwal Jain & Co. had been its statutory auditors all these years and the auditors have made similar report while giving true and fair certification of the accounts every year. As may be seen from the following table, the figures of sales and other income and sales-growth rates have been distorted all the seven years.

Year ended Dec. 31	Sales (and other income) Rs. cr	Item (2) included capitalised assets Rs. cr	Adjusted sales of other income) (3-2) Rs. cr	% of sales/ revenue growth highlighted in Annual Report	Adjusted % of Growth of sales and other income
(1)	(2)	(3)	(4)	(5)	(6)
1996	76.31	8.23	68.06	50	33.7
1997	100.63	23.43	77.20	31.8	13.4
1998	120.69	13.80	106.89	20	38.5
1999	184.85	27.29	157.56	53	47.4
2000	255.86	45.09	210.77	38.4	33.8
2001	302.65	76.03	226.62	18.1	7.3

3.6 I am inclined to agree with the argument that this practice had not affected the bottom line i.e. profit or loss. However, in cases of corporates like Rolta engaged in IT related business, bottom-line apart, growth in the topline i.e. Sales / Revenue also has significant potential in influencing the price of the shares. The fact of inclusion of the cost of certain self-assembled items in the sales & other income as well as cost of such items had been disclosed in the Schedule of Significant Accounting Policies and Notes on Account. Mere disclosure, however, may not go to validate a basically inappropriate accounting. Similarly, consistency in practice – repeated for seven consecutive years – cannot negate the inconsistency, if any, with basic accounting principles/ standards. On the one hand, recognition of inter-division transfer as sales is by itself inappropriate; it

is contrary to the definition of "revenue" and inconsistent with the principles of "revenue recognition" as laid down in the Accounting Standard (AS) 9, Revenue Recognition issued by ICAI, for, an enterprise cannot sell goods to itself and in the case of inter-division transfer, risks and rewards are not transferred to any outsider, but remain within the enterprise. On the other, inclusion of the cost of a capitalised item in the sales & other income i.e. Revenue is basically improper accounting.

3.7 Debit of a cost of an item partaking the nature of a fixed asset in the profit and loss accounts, its inclusion in the "sales" and then capitalisation thereof under "fixed assets", though apparently not impacting the profit or loss, is obviously against the accepted canons of accountancy. The practice cannot claim any substantial authoritative support. In fact, according to the opinion of ICAI, obtained on a specific reference of the facts of the case, the aforesaid accounting treatment was "incorrect".

3.8 The disclosure of the cost of capitalised item included in the sales in the schedule of Significant Accounting Policies and Notes on Account will no doubt enable a diligent reader to make necessary adjustment to arrive at actual sales figure. However, the cost includes (i) actual material cost and (ii) estimated labour and overhead charges as certified by the Management and the break-up of the cost has not been disclosed. The statutory auditors, have only relied upon the certificate of the management in regard to the labour and overhead charges capitalised and included in the sales. Thus, though the practice had been consistently followed, (against the recognised accounting principles), the amount of such capitalised item included in the sales have varied from year to year, from 10.8% in 1996 to 25.1% in 2001. A part of the element of cost of such items, being based on management's certificate, had not been subjected to independent authentication of the Auditors, leaving scope for adjustment so as to maintain a sales growth rate above a particular level.

3.9 Whether mere general reference to the Schedule of Significant Accounting Policies and Notes on Accounts without any qualifications as to the manner of accounting the self assembled capital equipment with particular reference to the relevant Note no. in the said schedule, while giving "true and fair" view certification of Accounts, year after year for seven consecutive years would absolve the Auditors of their professional responsibilities is a moot point, fit to be referred to the Institute of Chartered Accountants of India for such action as it may deem fit.

3.10 So far as Rolta is concerned, by inclusion of the cost of self assembled capital equipment in the sales, the company has adopted inappropriate accounting and though the practice did not apparently impact the profit or loss, it had distorted the sales turnover figures. The sales-growth rates had been highlighted at a level better than what they would have been but for the accounting practice followed. Thus, the practice followed by Rolta had the potential of misleading the investors and / or influencing the price of the scrip, as borne out by the behaviour of the share price subsequent to its improper accounting policy catching the public attention. It is seen that the market price of Rolta's share was hovering over Rs. 140/- towards the end of May 2002. (The company had sent the Audited Annual Accounts for the year 2001 and notice for AGM on May 24, 2002). The price fell sharply to Rs. 119.50 on July 11, 2002, when the company issued press release clarifying its accounting policy in question. It steadily fell thereafter to as low as Rs. 83.0 by July 31, 2002.

3.11 There are, however, a few mitigating factors which deserve due consideration : The company had been adopting the said accounting practice since 1996 onwards; the accounting policy adopted and the cost of capitalised item included in the sales had been disclosed in the relevant schedule to the accounts; it had not impacted the profit and loss of the company; following the advice of the stock exchange, the company had appended appropriate notes in the published quarterly financial statements; there have been no allegations or evidence pointing to any manipulation of the price. It is, nevertheless, observed that despite the accounting practice adopted by it having been subjected to critical observations, the company continued the practice while presenting Annual Accounts for the period ended June 30, 2003 as well, though with usual disclosures.

3.12 In the interest of investing public and so as to ensure confidence of the shareholding public in the reliability of standards of financial statements, it is necessary for the corporates to scrupulously adopt proper accounting practices. The corporates should not be let free to resort to any basically improper accounting, whatever be the related disclosure in the schedule or notes on accounts, particularly when it has the potential of influencing the price of the scrip.

4. Order

4.1 In view of the foregoing, in exercise of the powers conferred upon me by virtue of Section 19 read with Section 11 and Section 11B of the Securities and Exchange Board of India Act, 1992 read with regulation 5 of SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 1995 and also read with Regulation 11 and 13 of the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003, I, hereby direct that Rolta India Ltd be advised to discontinue its practice of including the cost of self assembled capital equipment or any capitalisable item in the sales/revenue, henceforth and not to adopt, in future, any accounting practice inconsistent with relevant Indian / International Accounting standards.

T. M. NAGARAJAN

Date : 20.7.2004

WHOLE TIME MEMBER

Place : MUMBAI

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