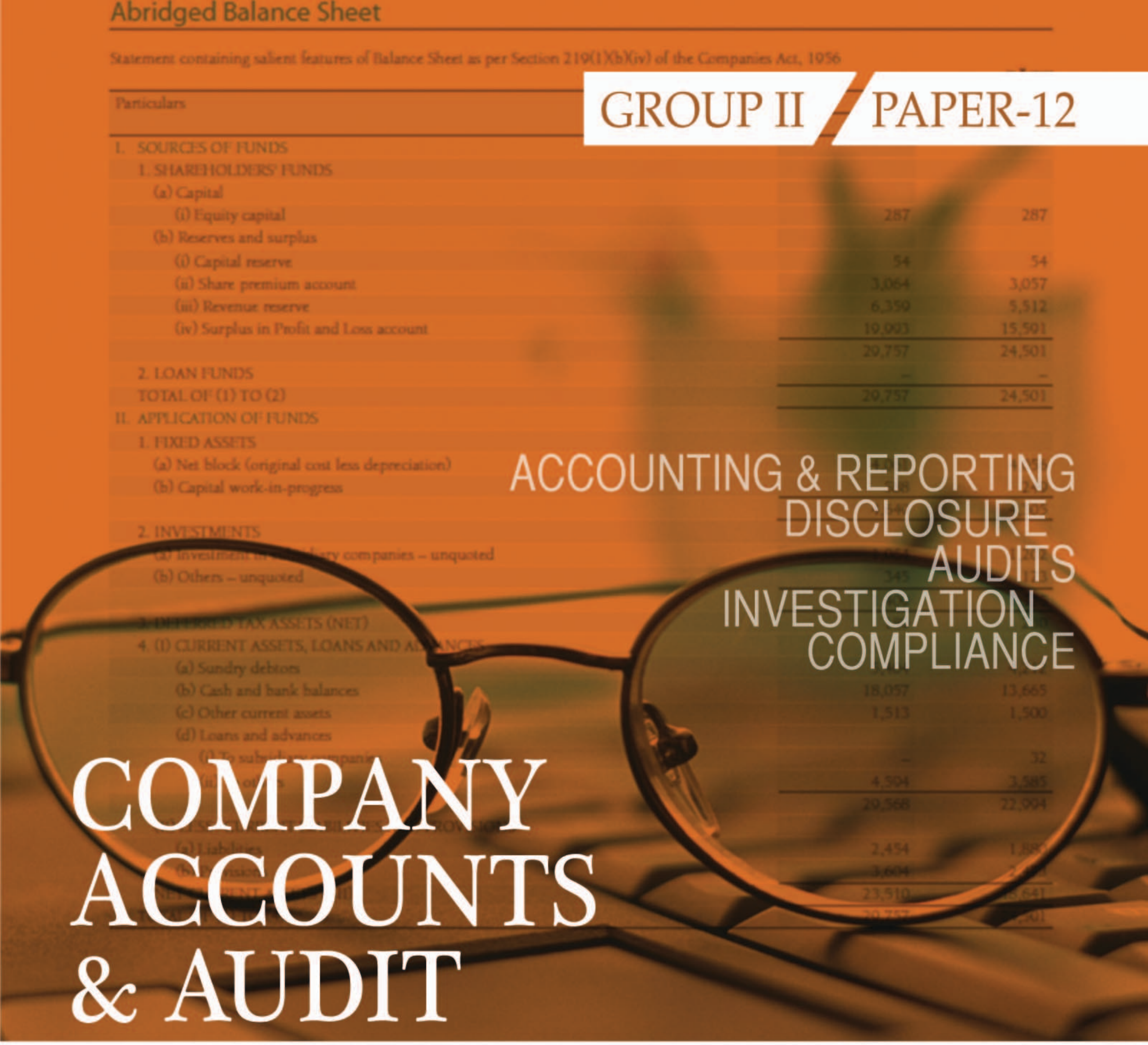

GROUP II / PAPER-12

ACCOUNTING & REPORTING
DISCLOSURE
AUDITS
INVESTIGATION
COMPLIANCE

COMPANY ACCOUNTS & AUDIT

INTERMEDIATE

The Institute of Cost Accountants of India
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INTERMEDIATE : PAPER - 12

COMPANY ACCOUNTS & AUDIT

INTERMEDIATE

STUDY NOTES

The Institute of Cost Accountants of India
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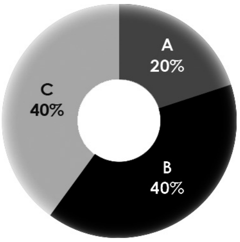
Syllabus

Syllabus Structure

A	Generally Accepted Accounting Principles (GAAP)	20%
B	Accounts of Joint Stock Companies	40%
C	Auditing	40%



ASSESSMENT STRATEGY

There will be written examination paper of three hours.

OBJECTIVES

To gain in depth knowledge of the professional standards, principles and procedures regarding preparation of financial accounting statements. To provide basic knowledge of auditing

Learning Aims

The syllabus aims to test the student's ability to:

- Understand the framework of financial statements various pronouncements of professional standards and their applicability
- Prepare financial statements as may be required under applicable statutes for fair representation, understanding and reliability of stakeholders
- Explain basic knowledge of auditing

Skill sets required

Level B: Requiring the skill levels of knowledge, comprehension, application and analysis.

Note: Subjects related to applicable statutes shall be read with amendments made from time to time.

Section A : Generally Accepted Accounting Principles (GAAP)	**20%**
1. Conceptual Framework for preparation and Presentation of Financial Statements	
2. Accounting Standards	
Section B : Accounts of Joint Stock Companies	**40%**
3. Accounting for Shares and Debentures	
4. Presentation of Financial Statements (Schedule III)	
5. Cash Flow Statement (AS 3)	
6. Segmental Reporting (AS 17)	
7. Business Combinations and Corporate Restructuring	
8. Accounting involved in liquidation of companies, Statement of affairs (including deficiency/surplus accounts) and Liquidator's statement of account of winding up	
Section C : Auditing	**40%**
9. Auditing Concepts	
10. Provision relating to Audit under Companies Act	

SECTION A: GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) (20 MARKS)

1. **Conceptual Framework for preparation and Presentation of Financial Statements**

   Financial Statements in line with the Companies Act, 2013

2. **Accounting Standards:**

   AS 11: The Effects of Changes in Foreign Exchange Rates (Revised 2003)

   AS 12: Accounting for Government Grants

   AS 15: Employee Benefits

   AS 19: Leases

   AS 20: Earning Per Share

   AS 26: Intangible Assets

   AS 29: Provisions, Contingent Liabilities and Contingent Assets

SECTION B: ACCOUNTS OF JOINT STOCK COMPANIES (40 MARKS)

3. **Accounting for Shares and Debentures**
   - (a) Issue of Equity shares – IPO (Initial Public Offer), FPO (Follow on Public Offer), Right Shares, Bonus Shares, Sweat Equity Shares, Shares issued otherwise than for cash
   - (b) Forfeiture of Shares, Reissue of Forfeited Shares
   - (c) Buy Back of Equity Shares
   - (d) Issue and Redemption of Preference Shares
   - (e) Issue and Redemption of Debentures
   - (f) Employees Stock Option Plan (ESOP), Employees Stock Option Scheme (ESOS)
   - (g) Under writing of Shares and Debentures
4. **Presentation of Financial Statements (Schedule III)**
   - (a) Part I – Form of Balance Sheet
   - (b) Part II – Form of Statement of Profit and Loss
5. **Cash Flow Statement (AS 3)**
6. **Segmental Reporting (AS 17)**
7. **Business Combinations and Corporate Restructuring**
   - (a) Accounting for Amalgamation [AS -14]
   - (b) Advanced problems for business acquisition, Amalgamation and reconstruction (excluding problems of amalgamation of inter- company holding)
   - (c) Internal Reconstruction
   - (d) Profits and Losses prior to Incorporation
8. **Accounting involved in liquidation of companies, Statement of affairs (including deficiency/surplus accounts) and Liquidator's statement of account of winding up**

SECTION C – AUDITING (40 MARKS)

9. **Auditing Concepts**
   - (a) Nature, scope and significance of Audit
   - (b) Generally Accepted Auditing Principles and Techniques
   - (c) Auditing and Assurance Standards
   - (d) Internal Check, Internal Control,
   - (e) Internal Audit – industry specific – regulated and non-regulated industries
10. **Provision relating to Audit under Companies Act**
    - (a) Auditor's qualification, disqualification, appointment, remuneration ,removal, power and duties
    - (b) Branch Audit, Joint Audit, Special Audit, Cost Audit, Secretarial Audit
    - (c) Reporting requirements under companies act , Report versus certificate , contents of the reports, qualifications in the report
    - (d) Audit of shares and debentures
    - (e) Audit of divisible profits and dividends
    - (f) Audit of Government Companies
    - (g) Interface between Statutory Auditors and Internal Auditors
    - (h) Contemporary issues in Auditor's independence – issues, tools and institutions (basic knowledge)

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Section A
Generally Accepted Accounting Principles (GAAP)

Study Note - 1

CONCEPTUAL FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

This Study Note includes

1.1 Meaning and Objective of Financial Statement
1.2 Component of Financial Statement
1.3 Frame Work
1.4 Users and their Information Needs

1.1 MEANING AND OBJECTIVE OF FINANCIAL STATEMENT

Introduction

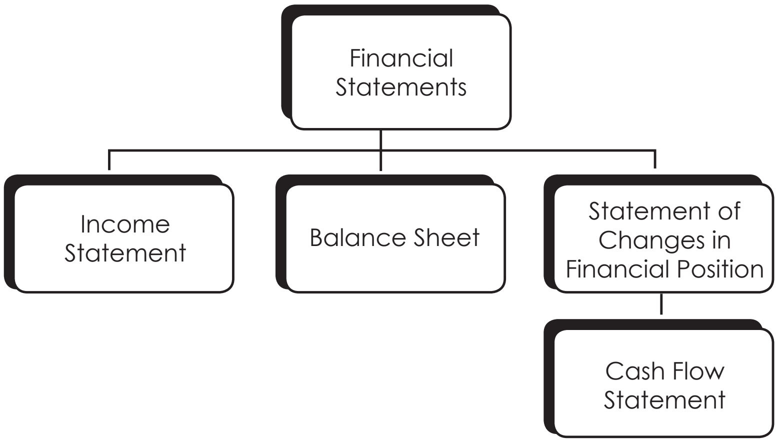
Financial statements are compilation of financial data, collected and classified in a systematic manner according to the accounting principles, to assess the financial position of an enterprise as regards to its profitability, operational efficiency, long and short – term solvency and growth potential.

Financial statements are basic and formal means through which management of an enterprise make public communication of financial information along with select quantitative details. They are structured financial representation of the financial position, performance and cash flows of an enterprise. Many users are rely on the general purpose financial statements as the major source of financial information and therefore, financial statements should be prepared and presented in accordance with their requirement. Of course, some of the users may have the power to obtain, information in addition to that contained in the financial statements. That does not undermine the dependence of the general users on the information contents of the financial statements.

Financial statements provide information about the financial position, performance and cash flows of an enterprise that is useful to wide range of users in making economic decisions. It means to show the results of the stewardship of management, or accountability of management, or the accountability of management for the resources entrusted to it.

1.2 COMPONENT OF FINANCIAL STATEMENT

Financial statements comprise a number of statements prepared at the end of each financial year to assess the various financial activities and strength of an enterprise.



Financial Statement Components	**Source /Type of Companies**
Profit and Loss Account Schedule and Notes Forming Part thereto	Under section 129 of the companies Act in accordance with the provisions of the Companies Act and the Indian GAAP, to be prepared by all the companies. As per section 133 all applicable accounting standards should be followed. Otherwise reasons of departure from accounting standards and financial effect should be disclosed. Compliance with accounting standards without any deviation is mandatory for the listed companies as per clause 50 of the Listing Agreement vide SEBI Circulars SMRP/ Policy/Cir-44/01, Aug 31,2001
Cash Flow Statement	As per clause 32 of the Listing Agreement vide SEBI circular SMD-II/Policy/cir-80/2000 February 4, 2000. Cash Flow Statement should be prepared in accordance with the requirements of AS- 3 issued by the ICAI. To be prepared by listed companies.
Consolidated Financial Statements	Applicable to listed companies as per the SEBI circular SMRP/policy/cir-44/01,Aug.31,2001 Companies Listed in a recognized stock exchange shall be mandatorily required to publish Consolidated Financial Statements in the annual report in addition to the individual financial Statements shall be mandatory. To be prepared in accordance with AS-21 and AS-23. Section 134 requires that board's Report shall include a Director's Responsibility Statement in which it is to be indicated that in the preparation of annual accounts, the applicable accounting standards are followed.

1.3 FRAME WORK

The conceptual Framework for Financial Reporting issued by the IASB has stated the following uses of the general purpose financial statements by the cross-section of users:

(a) to decide when to buy, hold or sell any equity investment,

(b) to assess the accountability of management,

(c) to assess the ability of the entity to pay and provide other benefits to its employees,

(d) to assess the security for amounts lent to the entity,

(e) to determine taxation policies,

(f) to determine distributable profits and dividends,

(g) to prepare and use national income statistics, Important shortcoming of financial statements is that they are prepared to meet the common information needs of a wide range of users. They may fall short of specific information needs of the users.

To meet the above – stated uses, financial statements provide information about an entity's assets, liabilities, equity, and income and expenses, including gains and losses, other changes in equity and cash flows. That information, along with other information in the notes, assists users of financial statements in predicting amount, timing and degree of certainty of the entity's future cash flows.

1.4 USERS AND THEIR INFORMATION NEEDS

The Framework discusses objective of financial statements, qualitative characteristics that determine the usefulness of information contained in the financial statements, definition, recognition and measure ment of the elements from which financial statements are constructed and concepts of capital and capital maintenance.

Identification of user of financial statements and their information needs are just theoretical as general purpose financial statements can not satisfy the specific information need of various user groups. The Framework has identified the following user groups and their information needs:

USERS OF FINANCIAL STATEMENTS AND THEIR INFORMATION NEEDS

1. Investors	Information need of the group primarily relates to decision making of buy, hold or sale of the entity's share. Also dividend paying ability of the entity is a matter of interest.
2. Employees	Need to know about the stability and continued profit-ability of the employer which would ensure payment of remuneration, employee opportunities and retirement benefits.
3. Lenders	Interested in debt servicing capability.
4. Suppliers and other trade creditors	Interested in information about the entity's ability in the short run to pay their dues. Of course, they are interested in long run viability of the entity, if it is their major customer.
5. Customers	Seek information about the continuation of the entity in particular if the entity is their major supplier.
6. Government and their agencies	They have manifold interests like taxation, contribution of the entity in employment generation and economic activities of the nation and also the infrastructural facilities to be provided to subserve the need of the entity commensurate with its contri- bution to the society.
7. Public	Mostly interested in employment generation and societal contribution.

Management of the entity has access to financial as well as non-financial information for the purpose of decision making. In fact, the financial statements are the outcome in financial terms of all the managerial decisions taken during the accounting period. Still the management might use the published financial information with a view to evaluate performance, financial position and cash flow of the entity. Truly speaking management use of financial statements is very low.

1.4.1 Objective of Financial Statements

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. This would guide in deciding statements, their contents and disclosures.

A set of general purpose financial statements focus on financial position, performance and cash flows of an entity which could be used by any user group to assess investment decision, employment stability or growth, debt servicing, business continuity and ability to make societal contribution. General purpose financial statements are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

A complete set of financial statements as worked out in Para 10 of IAS 1 is the outcome of the Framework which in turn is linked to subserve the information need of various user-groups. It comprises of:

(a) a statement of financial position as at the end of the period;

(b) a statement of comprehensive income for the period ; (c) a statement of changes in equity for the period;

(d) a statement of cash flows for the period;

(e) notes, comprising a summary of significant accounting policies and other explanatory information; and

(f) a statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

Notes, comprising a summary of significant accounting policies and other explanatory information are important components of financial statements as they explain various elements of financial statements. Disclosure of risks adds to the information content of the financial statements.

Earning per share information contained in the Income Statement is focused information to shareholders as regards entity's performance. Information regarding diluted earning improves the information com munique working out the effect of possible equity dilution actions. Similarly, segment reporting is intended to provide disaggregated infor mation based on operating and / or geographic segments, consolidated financial statements focus on providing aggregated financial informa tion for the entity-group as a whole, related party disclosures are intended to highlight non-market oriented transactions, if any. Thus the origination and improvement in disclosure and presentation standards have the purpose of making a set of general purpose financial statements useful to the diverse user-groups.

1.4.2 Accounting Assumption

Underlying assumptions for the preparation and presentation of financial statements are accrual and going concern. Under **accrual assumption,** the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the books of account and reported in the financial statements of the periods to which they relate. It helps in performance measurement in a better manner and identifying the financial position appropriately.

Under **going concern assumption**, the financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Therefore, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis. In case going concern basis could not be used, the entity shall disclose the basis used as well.

1.4.3 Elements of Financial Statements

Three elements relating to the Statement of Financial Position (Balance Sheet) are asset, liability and equity and two elements related to Statement of Comprehensive Income are income and expense.

Definition of elements of financial statements · An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Equity is the residual interest in the assets of the entity after deducting all its liabilities.

Income is increases in economic benefits during the accounting period in the form of inflows or enhancement of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Assets - Recognition of assets as covered in various IFRSs like IAS 16 Property, Plant and Equipment, IAS 17 Leases, IAS 38 Intangible Assets in general and concept of assets enshrined in any standard should follow the definition stated in the Framework. Features of an asset-

i. The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. Potential to contribute may be either productive (e.g., Property, Plant and Equipment) or convertibility into cash or cash equivalent (e.g., Receivables).

ii. Future economic benefit embodied in an asset flows to the entity in different manner and accordingly to be tested for asset recognition:

   - usage in the production of goods and services ;

   - exchange for other assets ;

   - use to settle a liability ;

   - Distribution to owners.

iii. Assets are not necessarily characterised by physical form (like property, plant and equipment). Copyright, trademark (intangibles), etc. also qualify as assets based on the concept of future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity.

iv. Assets signified by legal right (assets under lease) may not be with ownership right. Still they are recognized as assets based on concept of future economic benefit embodied in an asset has the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. Another example is know-how wherein the entity may not have ownership right on the technology but the right to use only which has the potential to contribute to the flow of cash and cash equivalents to the entity.

v. The assets of an entity result from past transactions or other past events. Transactions or events expected to occur in the future do not in themselves give rise to assets.

vi. There is a close association between incurring expenditure and generating assets but the two do not necessarily coincide. Incurring expenditure (development expenditure may not satisfy the test of asset) is not conclusive proof of asset creation. On the other hand, incurrence of expenditure is not an essential condition for asset recognition (asset may arise out of Government grant).

In absence of any specific standard, recognition of asset is guided by

Paras 49(a), 53-59 of the Framework.

Liabilities- An essential characteristic of a liability is that the entity has a present obligation.

1.4.4 Analysis of the term Obligation:

i. It is duty to perform in a particular manner, for example to pay interest of a loan at the end of every quarter and repay the principal on a specific date.

ii. It may be legally enforceable but that is not a necessary condition.

Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. An announcement to pay bonus to employees becomes an obligation because of normal business practice or custom although there is no legally enforceable agreement.

1.4.5 Characteristics of a Liability:

i. Normally liability arises from present obligation. But future obliga tion may also create liability if they are irrevocable. A forward contract to buy goods is irrevocable; therefore, gain or loss on such contract is evaluated and recognized as an asset or a liability.

ii. Liabilities result from past transactions or other past events. Even an irrevocable future obligation arises from past transactions or commitment (events) only.

lll. Normally liabilities are measurable in money terms. Sometimes liabilities are estimated which are termed as provisions. Frame work defines the term liability broadly that includes provisions.

iv. Settlement of liability means giving up resources embodying economic benefits. Liabilities are settled in any of the following ways-

- payment cash or transfer of other assets ;
- provision of services (services are rendered or to be rendered)
- replacement by a new obligation;
- conversion of an obligation into equity;
- extinguished by way of waiver from the creditors.

Unless specifically covered by a standard, recognition of a liability should be in accordance with Paras 49(b), 60-64 of the Framework.

Equity - Equity is the residual interest in the assets of the entity after deducting all its liabilities. It is presented in the statement of financial position in a classified manner which helps the user-groups (particularly the investors) in decision making. In a corporate entity, funds contributed by shareholders, retained earnings, reserves representing appropriations of retained earnings (capital redemption reserve) and reserves representing capital maintenance adjustments may be shown separately.

Reserves may be created in accordance with statutory requirement (for example there is a requirement of compulsory transfer to reserve for dividend payment in India) or to satisfy tax laws (for example investment reserve as per Indian Income-tax Act).

Income- Income encompasses revenue and gain. While the former arises out of ordinary activities of an entity, gain is not the outcome of the ordinary activities. Examples of revenue are (z) sale of goods, (it) rendering services, (iil) income, royalties and dividend arising out of use of entity ‘s assets by others.

Gains represent other items that meet the definition of income. They may arise in the course of ordinary activities of an entity. Gains may be realised or unrealised. Examples are profit on sale of non-current assets, fair value gain on assets, surplus on settlement of liabilities, etc. Although they are not different by nature from revenue, they are presented in the income statement as separate elements. Gains are often presented net of related expenses.

Unless specifically covered by a standard, recognition of income should be in accordance with Paras 69-77 of the Framework. However, gains may also arise from activities other than ordinary activities.

Expense - Expenses encompass expenses that arise in the course of the ordinary activities of the entity and losses. Examples of expenses that arise in the course of the ordinary activities of the entity are cost of sales, wages, repairs and depreciation. They usually take the form of an outflow or depletion of assets. On the other hand, losses do not arise in the course of the ordinary activities of the entity. They may realised or unrealized. Examples are loss on sale of non-current assets, fair value loss on assets, loss on settlement of liabilities, losses resulting from disasters such as fire and flood, etc.

Unless specifically covered by a standard, recognition of income should be in accordance with Paras 69-73 and 78-80 of the Framework.

1.4.6 Measurement Basis

Elements of financial statements, i.e. assets, liabilities, equity, income and expense, are measured using different measurement bases like historical cost, current cost, realizable (settlement) value and present value.

Under the historical cost assets are recognized at cash or cash equivalent paid or at the fair value of consideration agreed upon at the time of acquisition. Similarly, liabilities are recognized at cash or cash equivalents received against the obligation. In some cases, liabilities are recognized at cash or cash equivalents expected to be paid in futures (for example, provision for warranty claim, income-tax liability).

Current cost signifies current entry value of an asset if replaced currently. For a liability it represents undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Under the realisable (settlement) value assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values. Settlement value of a liability means undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

Under the present value assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

Various IFRSs explain the measurement bases of relevant transactions and other events. In absence of a specific guidance, an entity may follow a suitable measurement base out of historical cost, current cost, realiz able value and present value.

1.4.7 Recognition of Financial Elements

Recognition is a process of incorporating an item of asset, liability or equity in the statement of financial position (Balance Sheet) or an item of income or expense in the statement of income, or an item (like dividend, fair value gain of available for sale financial instruments) in the statement of changes in equity.

General recognition principles are explained in the following table:

RECOGNITION PRINCIPLES OF FINANCIAL STATEMENT ELEMENTS

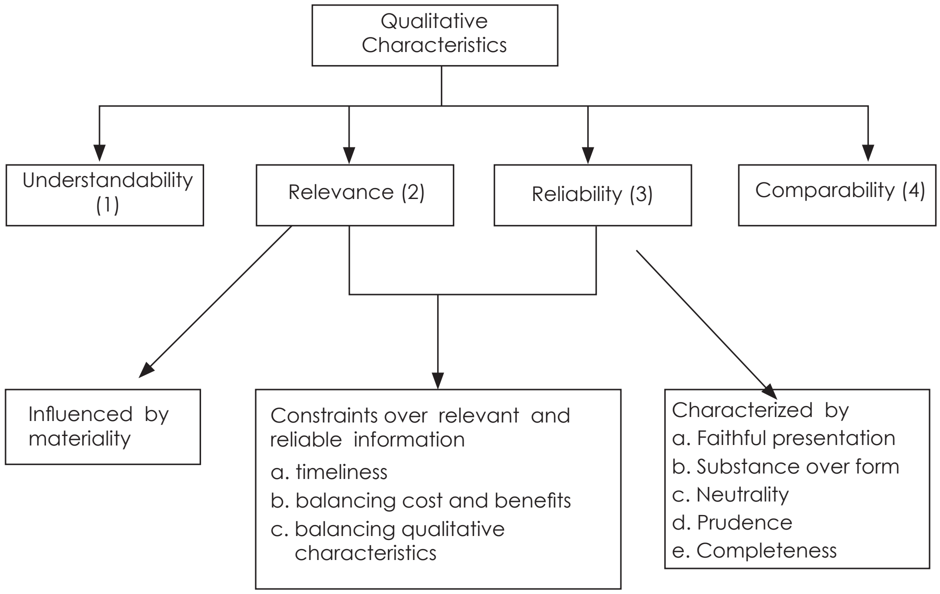
Principles	Para reference to Framework	Details
1. Fundamental principles	83	i. Economic benefits embodied in the element will flow to or from the entity ii. Cost or value can be measured reliably. Recognition of any element of financial statements shall be tested against these two fun damen - tal principles. That apart specific standard would prescribe additional recognition criteria.

Principles	Para reference to Framework	Details
2. Disclosure is no remedy for recognition failure	82	Elements of financial statement are recognized when the fundamental principles sta ted in Para 83 of the Framework or any additional criteria stated in a specific standard applicable to that element are satisf ied. Failure to recognize an element cannot be rectified by disclosure of accounting policy or by way of notes.
3. Materiality	84	Recognition of an element of financial statements should satisfy the materiality test (refer to Paras 29 and 30 of the Framework).
4. Use of probability	85	In case there exists uncertainty as regards flow of resou rce embodying economic benefit to or from the entity, the concept of probability is used for measurement of value of the transaction or other events. For example, for measuring liability arising out of warranty claim, an entity can use historical data of claim to assign probability of claim.
Reliability of measurement		
5. Estimation of cost or value	86	If a reasonable estimate of the cost or value cannot be made of an item, it is not recognised in the balance sheet or income statement. The fundamental reliability premise is that cost or value of an element should be reliably measurable. Of course, use of probability as stated in Para 85.
8. Recognition after subsequent initial recognition	87	An item may satisfy recognition test to initial failure as uncertainties attached to the failure flow of economic benefit and reliable measurement are removed because of some subsequent events.
9. Disclosure of an item which failed the recognition test	88	Disclosure is required even if an item fails recognition test which is relevant to the evaluation of financial position, performance and changes in financial position of an entity by the users of financial statements.
Recognition of assets		
10. Fundamental when principles of asset benefits recognition	89	An asset is recognised in the balance sheet it is probable that the future economic will flow to the entity and the asset has a cost or value that can be measured reliably.
	90	Asset is not recognized if it is improbable that a future economic benefit will flow beyond the current accounting period.
Recognition of liabilities		
11. Fundamental principle of recognition of liabilities	91	A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.

Principles	Para reference to Framework	Details
Recognition of Income		
12. Fundamental principle of income recognition	92	Income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measu red reliably.
13. Income should be earned	93	The practice of recognizing income when it is earned follows from the prudence that underlying economic benef it would flow to the entity and it can be reliably measured. Author's comment: Perhaps recognition of fair value change as income under IAS 39 or IAS 40 does not satisfy this test in many circumstances.
Recognition of Expense		
14. Fundamental principle of expense recognition	94	Expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably,
15. Matching of costs and revenues	95	Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process is also referred to as the matching of costs with revenues. It involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events. Examples, cost of goods sold.
16. Technique of systematic and rational allocation of expense	96	When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the in come statement on the basis of systematic and rational allocation procedures. Examples, depreciation and amortization.
17. Expenditure having no economic benefits beyond current period	97	Expenditure which does not have any economic benefits beyond current period is treated as an expense.
18. Expense arises from recognition of liability	98	Expense is recognized when liability is recognized that is not settled immediately or against which no cash and cash equivalent is received. Example, outstanding expense.

1.4.8 Qualitative Characteristics

Qualitative characteristics are the attributes that make the informa tion provided in financial statements useful to users. Four principal qualitative characteristics are presented in following figure. On an overall count, financial statements should reflect fair presentation.



Qualitative Characteristics

1. **Understandability:** Information provided in financial statements should be readily understandable by the users having reasonable know ledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.

2. **Relevance:** Information must be relevant to the decision-making needs of users. If the information can influence the economic decisions of users by helping them to evaluate past, present or future events or confirming, or correcting, their past evaluations is considered as relevant. The information has predictive as well as confirmatory role. Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance. Level of profit may be the basis of confirmation of debt service capacity, dividend payment, etc.

   Classified information like classified balance sheet has better predictive ability. Similarly, an income statement which presents operating profit and unusual items separately has better predictive ability.

   Relevance is influenced by materiality and timeliness.

3. **Reliability:** An information is reliable if it is-

   - free from material error and bias and

   - presented faithfully which it either purports to represent or could reasonably be expected to represent.

   Example: There is a lawsuit against the entity which it believes as fructuous. However, the opponent party has made a widespread cam paign that it would win the case and get a claim of ₹ 10 million from the entity. Based on this market information, the entity should not recognize a liability as this information is not free from bias. It has relevance as it may affect the profit of the entity substantially but its reliability is equally important.

   Reliability is influenced by faithful presentation, substance over form, neutrality, prudence and completeness.

4. **Comparability:** It facilitates comparison of financial statements of an entity through time in order to identify the trends in its financial position and performance. To ensure comparability IAS 1 requires consistency of presentation. Normally, an entity shall retain the presentation and classification of items in the financial statements from one period to the next. Exceptions are stated in Para 45(a) and (b) of IAS 1.

To ensure comparability IAS 1 requires disclosure of comparative information in respect of the previous period for all amounts reported in the current period's financial statements. It has to include comparative information for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements.

Materiality- Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. It depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Often separate line item or sub-item is decided based on materiality. National level law may specify materiality limit for separate disclosure of an item.

Faithful presentation - Financial information is fraught with the risk of faithful presentation not primarily because of bias but for inherent measurement difficulties. It is more so in fair value measure ment as compared to historical cost measurement. However, IFRSs have set out unbiased measurement principles, application of which will lead to faithful presentation.

Substance over form - Transaction and other events should be presented based on substance not in accordance with the legal form. Example is recognition of assets by economic benefits not by ownership.

Neutrality - Financial information should be free from bias. In case of 'earning management' or 'creative accounting' information is pre sented with an objective to achieve pre-determined result. The resultant financial statements are not reliable as they lack neutrality.

Prudence - Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. The exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions.

Completeness - The information in financial statements must 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.

Constraint on relevant and reliable information- Important con straints are (1) timeliness, (it) balance between benefit and cost, (iit) balance between qualitative characteristics.

Timeliness - A piece of information loses relevance if there is delay in the reporting of information. Normal frequency of financial reporting is one year. This is because the concept of interim financial reporting has gained ground.

However, the management is required to balance between timeliness and reliability. A premature disclosure of information without judging all aspects may turn out to be unreliable whereas too much delay in disclosure would make the disclosure redundant.

Balance between benefit and cost - The benefits derived from informa tion should exceed the cost of providing it. But the costs do not necessar ily fall on those users who enjoy the benefits. Of course, the evaluation of benefits and costs is substantially a judgmental process.

Balance between qualitative characteristics - This is aimed at achieving a balance between two or more qualitative characteristics.

True and Fair View

Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an entity. The IASB Framework does not deal with this concept. However, the application of the principal qualitative characteristics and appropriate accounting standards nor mally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly such information.

True' and 'fair' are two undefined qualitative expressions the law uses to describe a standard for external financial reporting. This lack of definition allows professional judgment and establishment of meaning through usage. These terms require an element of professional judgment by those involved in the process. They mean that in the final analysis what is true and fair is ultimately up to the courts to decide. The intent behind the legal use of such terms is related to a wider moral stance of the society.

The nature of truth, whether it is absolute or relative, whether it exists · as a reality, an incontrovertible thing, or as an abstraction, whether it is dependent or independent of the believerl observer and whether any statement can be proven or merely falsified are all aspects that have been applied to accounting theory and research. 'Fair' (and 'fairness') is also open to varying degrees of interpretation and application.

Both truth and fairness may vary according to time and place, and may be relative to the framework within which they reside. Chastney (1975) suggests in order to achieve a true and fair view financial reports should present information both impartially and in a manner that a reader can understand clearly. The AICPA 1986 definition of fairness in accounting, however, applies to the application of judgment to established rules, and is concerned with fairness in presentation rather than fairness as neutrality between different interests.

In a legal opinion sought by the UK Accounting Standards Board (ASB), Hoffman and Arden (1983), while concluding 'true and fair ew' is a legal concept, stated that the courts will treat compliance with accepted accounting principles as prima facie evidence that accounts are true and fair, and equally the converse would apply. An accounting standard upheld by the law becomes an authoritative source of law itself. Yet case law would suggest that compliance with the rules is in itself insufficient to comprise a 'true and fair view' or 'fair presentation'.

The 'true and fair view' concept is one of two competing but not mutually exclusive legal standards for financial reporting quality that have been subject to debate on their meaning, use and importance. The other is 'present fairly in conformity with generally accepted accounting principles' (GAAP). While the former is closely identified with judgment and is used in the United Kingdom, the European Union, India, Singapore, Australia and New Zealand, the latter is the standard for United States financial reporting and tends to be more rule based.

Lee (1982), Rutherford (1985) and Walton (1993) inclined towards explaining 'true and fair view' in terms of generally accepted accounting principles rather than accepting the concept as an independent quality. Such definitions depend on the acceptance that the consistent applica tion of accounting principles amounts to a 'true and fair view'. This viewpoint has been gaining ground among professional accounting bodies.

The American equivalent to 'true and fair view'- The American equivalent to true and fair view is 'present fairly in conformity with GAAP', which is also never been clearly defined. It could mean:

(1) Fairly presented and also in accordance with generally accepted accounting principles.

(2) Fairly presented because it is in accordance with generally accepted accounting principles.

American Institute of CPAs' Statement on Auditing Standards (No. 69): The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report (issued in

1991) specifies adherence to five criteria for an auditor to claim that the

financial statements are fairly presented in accordance with GAAP. These five criteria are:

(1) The accounting principles selected and applied have general acceptance.

(2) The accounting principles are appropriate in the circumstances.

(3) The financial statements, including the related notes, are informative of matters that may affect their use, understanding and interpretation.

(4) The information presented in the financial statements is classified and summarised in a reasonable manner; that is, it is not too detailed nor too condensed.

(5) The financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows, stated within a range of acceptable limits.

These criteria suggest that the AICPA looks financial statements as fairly presented because they accord with GAAP. However, to define fairness in terms of GAAP does not solve the definition as the GAAP is based on a multitude of estimations.

The IASB view - Para 13 of IAS-1 "Presentation of Financial Statements" states that-

Financial statements shall present fairly the financial position, financial performance and cash flows of an entity . Fair presentation requires the faithful presentation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of IFRS, with additional disclosures when necessary, is presumed to result in financial statements that achieve a fair presentation.

Para 15, IAS 1 further explains that virtually in all circumstances a fair presentation is achieved by compliance with applicable IFRSs. This para states three additional criteria to achieve fair presentation:

a. an entity should select and apply accounting policies in accordance with IAS 8 "Accounting Policies, Changes in Accounting Estimates and Errors".

b. an entity should present information, including accounting policies in a manner that provides relevant, reliable, comparable and under standable information.

c. an entity should provide additional disclosures when compliance with specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events, and conditions on the entity's financial position and financial perfor mance.

Indian position - Section 129 of the Companies Act requires that every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year and every profit and loss account shall give a true and fair view of the profit or loss of the company during the financial year. However, the term "true and fair" is not explained in the Companies Act.

The term "true and fair" means that accounts have been prepared-

- in accordance with the requirements of the Companies Act and other applicable legislations; and
- in accordance with generally accepted accounting principles and policies.

Schedule III to the Companies Act includes certain disclosure require ments for the preparation and presentation of financial statements. These instructions do not exhaustively cover the accounting principles and policies to be adopted on various accounting issues and the disclosure requirements for corporate financial reporting in a transparent manner. Accordingly, it becomes necessary to follow accounting standards and other pronouncements of the ICAI.

However, accounting standards and other pronouncements of the ICAI are different on many counts with the international accounting standards and accordingly, even if the accounts are prepared following Indian accounting standards and other GAAPs (Generally Accepted Accounting Principles), it is unlikely to be considered as "fair" in many developed countries including the USA, the EU and the UK

In Indian context, the financial statements shall reflect true and fair view if the following conditions are fulfilled:

- Balance Sheet is drawn up as per the requirements of Schedule III and in the form given in Part I of the said Schedule;
- Profit and Loss Account is drawn up as per the requirements of Part IIof Schedule III;
- Proper books of account are maintained as required in section 128; i.e. proper books of account are maintained with respect to-

    a. all sums of money received in respect of receipts and all sums of money paid in respect of expenditure,

b. all sales and purchases of goods by the company,

c. assets and liabilities of the company, and

d. cost records relating to utilisation of material or labour or to other items of costs in case of companies engaged in the production, processing, manufacturing or mining activities, if required by the Central Government;

Proper books of account are to be maintained following double entry system of book-keeping and accrual basis of accounting; Balance Sheet and profit and loss account are prepared following generally accepted accounting principles and policies; i.e. (i) accounting policies adopted by the company are consistent with generally accepted accounting principles and policies, (ii) financial statements reflect substance of the transactions and events that took place during the financial year, and (iii) disclosures are consistent with the accounting standards and other relevant pronounce ments of the ICAI.

Section 133 of the Companies Act, 2013 requires that every profit and loss account and balance sheet shall comply with the accounting standards.

1.4.9 Capital Maintenance

Capital maintenance concept is inherent in the profit measurement process comparing assets, liabilities and equity of two different account ing dates. However, under IFRS based accounting model, profit is measured matching expenses and income. Of course, expenses are matched with related revenue if they are directly related. For indirect expenses like depreciation and amortization, the inherent method is systematic allocation over the useful life. Various assets and liabilities are measured following a mixture of historical cost, current cost (entry value), realizable value (exit value) and present value (economic value). So income and expense are the outcome of such heterogeneous valua tion system. No specific capital maintenance concept is adhered to.

Of course, in theory there are two concepts - financial capital mainte nance and physical capital maintenance. Under financial capital main tenance concept, profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power. Under physical capital maintenance concept, profit is earned only if the physical produc tive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

In the context of IAS 29 Financial Reporting in Hyperinflationary Economies preparation of current cost financial statements is required by application of specific price index. It approximates specific current cost of assets and thereby the framework has indirectly adopted physi cal capital maintenance concept.

Study Note - 2

ACCOUNTING STANDARDS

This Study Note includes

2.1 AS 11: The Effects of Changes in Foreign Exchange Rates (Revised 2003)
2.2 AS 12: Accounting for Government Grants
2.3 AS 15: Employee Benefits
2.4 AS 19: Leases
2.5 AS 20: Earning Per Share
2.6 AS 26: Intangible Assets
2.7 AS 29: Provisions, Contingent Liabilities and Contingent Assets

Introduction

Accounting Standard refers that it is a written and policy document jacketing the features of recognition, measurement, treatment, presentation and disclosure of accounting transaction in the financial statement which is issued by the expert accounting body or by Government or other regulatory authorities. Accounting Standard in India are issued by the **Institute of Chartered Accountants of India (ICAI).**

So far **ICAI** has issued 32 accounting standards. However, AS-8 on **"Research & Development"** was withdrawn consequent to issue AS-26 **"Intangible Assets"**.

The main purpose of accounting standard is to standardize the diverse accounting policies with a view to eliminate to the extent possible the incomparability of information provided in financial statements and add reliability to such financial statements. To discuss on whether such standards are necessary in present days it will be beneficial to go through the advantages and disadvantages which they are said to be provide.

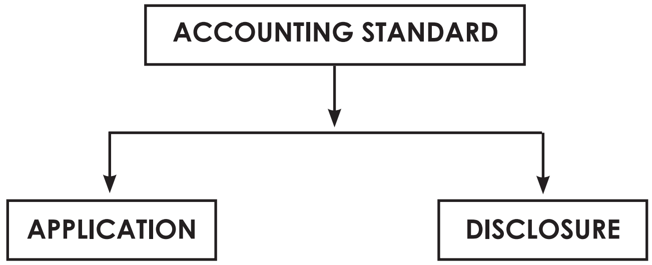
Advantages:-

1. It provides the accountancy profession with useful working rules.
2. It assists in improving quality of work performed by accountant.
3. It strengthens the accountant's resistances against the pressure from directors to use accounting policy which may be suspect in that situation in which they perform their work.
4. It ensures the various users of financial statements to get complete crystal information on more consistencies.

Disadvantages:-

1. Users are likely to think that said statements prepared using accounting standard are infallible.
2. They have been derived from social pressure which may reduce freedom.
3. The working rules may rigid or bureaucratic to some user of financial statements.

APPLICATION AND DISCLOSURE OF ACCOUNTING STANDARD



APPLICATION OF ACCOUNTING STANDARD	DISCLOSURE OF ACCOUNTING STANDARD
Accounting Standard – 2,6,7,10,11,12,13,14,15,16,19,20,21,26,28	Accounting Standard -1,3,4,5,9,12,14,17,20,21,23,24,25,27,28,29,30,31,32

2.1 AS-11: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

The statement applies mandatorily in respect of:

a) Accounting for transaction in foreign currencies

b) Translating the financial statements of foreign branches for inclusion in the financial statements of the reporting enterprise.

A transaction in a foreign currency is recorded in the financial records of an enterprise normally at the rate

a) On the date of transaction i.e. spot rate,

b) Approximate actual rate i.e. averaging the rates during the week/month in which transactions occur if there is no significant fluctuations.

c) Weighted average in the above line.

However, for interrelated transaction (by virtue of being set off against receivables and payables) it is translated with reference to the net amount on the date of transaction.

After initial recognition, the exchange difference on the reporting date of financial statement should be treated as under:

a) Monetary items like foreign currency balance, receivables, payables, loans at closing rate (in case of restriction or remittance other than temporary or when the closing rate is unrealistic, it is reported at the rate likely to be realized).

b) Non-monetary items like fixed assets, which are recorded at historical cost, should be made at the rate on the date of transaction.

c) Non-monetary items other than fixed assets are carried at fair value or net realizable value on the date which they are determined i.e. B/S date (inventories, investments in equity-shares).

Exchange difference on repayment of liabilities incurred for acquiring fixed assets should be adjusted in the carrying amount of fixed assets on reporting date. The same concept applies to revaluation as well but in case such adjustment on revaluation should result into showing the actual book value of the fixed assets/ or class of, exceeding the recoverable amount, the remaining amount of the increase in liability should be debited to Revaluation Reserve or P/L Statement in case of inadequacy/ absence of Revaluation Reserve.

Except as stated above (fixed assets) other exchange difference should be recognized as income or expense in the period in which they arise or spread over to pertaining accounting period.

Depreciation as per AS-6 should be provided on the unamortised carrying amount of depreciable assets (after taking into account the effect of exchange difference).

Disclosure under AS -11: An enterprise should disclose:

a) The amount of exchange difference included in the net profit or loss for the period.

b) The amount of exchange difference adjusted in the carrying amount of fixed assets during the accounting period.

c) The amount of exchange difference in respect of forward contracts to be recognized in the profit/ loss for one or more subsequent accounting period.

d) Foreign currency risk management policy.

Illustration 1:

Exchange Rate	
Goods purchased on 24.3.11 of US $1,00,000	₹ 46.60
Exchange rate on 31.3.2011	₹ 47.00
Date of actual payment 5.6.12	₹ 47.50

Calculate the loss/gain for the financial years 2010-11 and 2011-12.

Solution:

As per AS-11, all foreign currency transactions should be recorded by applying the exchange rate at the date of transaction. Therefore, goods purchased on 24.03.11 and corr sponding creditor would be recorded at ₹ 46.60

= 1,00,000 x 46.60 = 46,60,000

As per AS-11, at the balance sheet date all monetary items should be reported using the closing rate. Therefore, the creditors of US $1,00,000 outstanding on 31.3.11 will be reported as:

1,00,000 x 47.00= 47,00,000.

Exchange loss ₹ 40,000 = (47,00,000 – 46,60,000) should be debited in profit and loss account for 2010-11.

As per AS-11, exchange difference on settlement on monetary items should be transferred to profit and loss account as gain or loss thereof:

1,00,000 x 47.50 = 47,50,000 -47,00,000 = ₹ 50,000 should be debited to profit or loss for the year 2011-12.

Illustration 2:

Z Ltd. acquired a machine on 1.4.2010 costing US $ 1,00,000. The suppliers agreed to the following terms of payment:

1.4.2010	:	down payment 50%
1.4.2011	:	25%
1.4.2012	:	25%

The company depreciates machinery @ 10% on the Straight Line Method. The rate of exchange is steady at US $ 1= ₹ 40 upto 30.9.2011. On 1.10.11, due to an official revaluation of rates, the exchange rate is adjusted to US $ 1= ₹ 48.

Show the extracts of the relevant entries in the Profit and Loss Account for the year ending 31st March, 2012 and the Balance Sheet as on that date, showing such workings as necessary.

Working Notes:

2010-11:

1. Original Cost of the machine = $1,00,000 x ₹ 40 = ₹ 40,00,000
2. Depreciation (SLM) @ 10% = ₹ 4,00,000

2011-12:

1. Original Cost of the machine upto 30.9.2011 = ₹ 40,00,000
2. Revised cost of the machine as on 1.10.2011

Due to official revaluation of exchange rates, the US $ 1 = ₹ 48. There is a foreign exchange loss of ₹ 8 for each dollar liability. The total loss on foreign currency fluctuation was $25,000 x ₹ 8 = ₹ 2,00,000. This has to be added to the original cost of the machine. Therefore, revised cost of the machine as on 1.10.2011 is ₹ 42,00,000 (i.e. ₹ 40,00,000 + ₹ 2,00,000)

The revised cost of the machine as on 1.10.2011:	₹	₹
Original Cost on 1.4.2010	40,00,000	
Less: Depreciation:		
1.4.2010 to 31.3.2011	4,00,000	
1.4.2011 to 30.9.2011	2,00,000	6,00,000
	34,00,000	
Add: Loss on foreign exchange fluctuation as on 1.10.2007	2,00,000	36,00,000
Depreciation:		
1.4.2011 to 30.9.2011 (40,00,000 x 10/100 x 6/12)	2,00,000	
1.10.2011 to 31.3.2012 (36,00,000 x 68.5 x 12) [36,00,000 x 1/8.5 x 6/12]	2,11,765	
Total Depreciation for the year 2011-12		4,11,765

Note: As per AS-6 Revised, 'Depreciation Accounting', in case of change in historical cost due to foreign exchange fluctuation, depreciation on the revised unamortized depreciable amount should be provided prospectively over the residual life of the asset. In this case, the residual life is 8.5 years.

Profit and Loss Account (extract)

for the year ended 31st March, 2012

Particulars	₹	**Particulars**	₹
To Depreciation on Machinery	4,11,765		

Balance Sheet (extract) as at 31st March,2012

Liabilities	₹	**Assets**		₹
Current Liabilities	12,00,000	Fixed Assets		
Creditors for Supply of Machinery		Machinery (at cost)	40,00,000	
		Add: Adj.for foreign Exchange fluctuation	2,00,000	42,00,000
		Less: Accumulated Depreciation		8,11,765
				33,88,235

2.2 AS -12: ACCOUNTING FOR GOVERNMENT GRANTS

Government refers to Union/State, Govt. Agencies and similar bodies - Local, National or International.

Grants also include subsidies, cash incentive, and duty drawback either in cash or kind/benefits to an enterprise on recognition of compliance in the past or future compliance with condition attached to it.

The accounting for the grant should be appropriate to reveal the extent of benefit accrued to the enterprise during the reporting period.

For the purpose of the statement, following are not dealt with.

a) Effects of changing prices or in supplementary information

b) Government assistance other than grants.

c) Ownership participation by government.

In order to recognize the income there should be conclusive evidence that conditions attached to the grant have been or will be fulfilled to account for such earned benefits estimated on a prudent basis, even though the actual amount may be finally settled/received after the accounting period. Mere receipt would not suffice for income recognition.

AS-4 (contingencies etc) and AS-5 (Prior period etc) would be applicable as the case may be.

The accounting for Govt. grants should be based on the nature of the relevant grant:

a) In the nature of promoter's contribution as shareholder's fund (capital approach)

b) Otherwise as Income Approach to match with related cost recognizing AS-1 accrual concept disclosure.

Government grants in the form of non-monetary assets e.g. land or other resources is accounted for at the acquisition cost or recorded at nominal value if it is given free of cost.

Grants received specifically for fixed asset is disclosed in the financial statement either

a) by way of deduction from the gross block of the asset concerned, thus grant is recognized in P/L Account through reduced depreciation (in case of funding of specific asset Cost entirely, the asset should be stated at a nominal value in B/S); or

b) the grant treated as deferred revenue income and charged off on a systematic and rational basis over the useful life of the asset, until appropriated disclosed as "Deferred Govt. grant under Reserve and Surplus in the B/S (grants relating to depreciable assets should be credited to Capital Reserve and suitably credited to P/L Account to offset the cost charged to income).

Disclosure under AS-12

a) the accounting policy, method of presentation in the financial statements.

b) the nature and extent of Govt. grants recognized in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

Illustration 3:

Z Ltd. has set up its business in designated backward area which entitles it to receive as per a public scheme announced by the Government of India, a subsidy of 25% of the cost of investment. Having fulfilled the conditions laid down under the scheme, the company on its investment of ₹ 100 lakhs in capital assets during its accounting year ending on 31st March,2012, received a subsidy of ₹ 25 lakhs in January, 2012 from the Government of India. The Accountant of the company would like to record the receipt as an item of revenue and to reduce the losses on the Profit and Loss Account for the year ended 31st March, 2012. Is his action justified?

Solution:

As per AS-12, the Government grants related to depreciable fixed assets to be treated as deferred income which should be recognized in the Profit and Loss Account on a systematic and rational basis over the useful life of the asset. Such grants should be allocated to income over the periods and in proportions in which depreciation on those assets is charged.

The company has received ₹ 25 lakhs subsidy for investment in capital assets which are depreciable in nature. In view of the provisions under AS-12, the subsidy amount ₹ 25 lakhs received should not be credited to the Profit and Loss Account for the year ended 31st March, 2012. the subsidy should be recognized and credited to the Profit and Loss Account in the proportion of depreciation charge over the life of the subsidized assets.

Illustration 4:

Hero Ltd. belongs to the engineering industry. The Chief Accountant has prepared the draft accounts,taking note of the mandatory accounting standards.

"The company purchased on 1.4.2012 a special purpose machinery for ₹ 50 lakhs. It received a Central Government grant for 20% of the price. The machine has an effective life of 5 years".

Solution:

AS-12 prescribes two methods in accounting treatment of Government grants for specific fixed assets.

Method I: Government grants related to depreciable fixed assets to be treated as deferred income which is to be recognized in the Profit and Loss Account in proportion in which depreciation on those assets is charged over the useful life of the asset.

The deferred income pending its apportionment to Profit and Loss Account to be disclosed in the balance sheet separately with a suitable description,e.g. Deferred Government Grants, to be shown after "Reserves & Surplus" but before " Secured Loans"

Grants received specifically for Fixed Asset may be disclosed in the financial statement by way of deduction from the gross block of the asset concerned, thus grant is recognised in P/L Account through reduced depreciation.

In this case machinery will be recognised at ₹ 40 lakhs i.e. after deduction of ₹ 10 lakh Govt Grants. and depreciation will be calculated on that ₹ 40 lakhs.

2.3 AS-15: EMPLOYEE BENEFITS

The statement applies to benefit usually comprising of Provident Fund, Superannuation/Pension Fund, Gratuity, Leave encashment or retirement, Post retirement health and welfare schemes and other benefits provided by an employer to employees either in pursuance of legal requirement or otherwise, but does not extend to employers' obligation which cannot be reasonably estimated (e.g. ex-gratia ad-hoc on retirement).

There may be obligation on the part of the employer either against defined contribution plan or defined benefit schemes as elaborated below:

a) Defined Contribution Plans (DCP):

1) Retirement benefit is determined by contribution at agreed/specified rate to the Fund together with earnings thereof.
2) Contribution (e.g. PF) whether paid or payable for the reporting period is charged to P/L statement
3) Excess if any is treated as prepayment

b) Defined Benefit Plans (DBP):

1) Amount paid is usually determined with reference to employee's earnings and/or years of service (if the basis of contribution are determined, it will be treated as defined contribution scheme)
2) However, if the employer's responsibility is subject to specified benefits or a specified level of benefits, it is defined benefit scheme.
3) The extent of employer's obligation is largely uncertain and subject to estimation of future condition and events beyond control.

Accounting treatment for Gratuity benefit and other defined benefit schemes depends on the arrangement made by the employer:

a) No separate fund i.e. out of nonspecific own fund:

1) Provision for accruing liability in the P/L Account for the accounting period is made.

2) The provision is based on an actuarial method or some other rational method (assumption that all employers are eligible at the end of the accounting period)

b) Own separate/specific fund established through Trust:

The amount required to be contributed on actuarial basis is certified by the Actuary, and the actual contribution plus and shortfall to meet the actuarial amount is charged to P/L Account for the accounting period, any excess payment treated as prepayment.

c) Fund established through Insurer: in the same manner as in (b) above

Actual valuation may be carried out annually (cost can be easily determined for the purpose of contribution as a charge to P/L) or periodically (say, once in 3 years) where Actuary's certificate specifies contribution on annual basis during inter-valuation period.

Leave encashment is an accrued estimated liability based on employers' past experience as to such benefit actually availed off and probability of encashment in future and therefore should relate to the period in which relevant service is rendered in compliance with section 128 - accrual basis and AS-15.

Disclosure under AS-15:

a) In view of the varying practices, adequate disclosure of method of accounting for an understanding of the significance of such costs to an employer.

b) Disclosure separately made for statutory compliance or otherwise the retirement benefit costs are treated as an element of employee remuneration without specific disclosure.

c) Financial statements should disclose whether actuarial valuation is made at the end of the accounting period or earlier (in which case the date of actuarial valuation and the method used for accrual period if not based on actuary report).

Treatment of Voluntary Retirement scheme payments:

1) Termination benefits to be paid irrespective of the voluntary retirement scheme i.e. balance in P.F, leave encashment; gratuity etc.

2) Termination benefits which are payable on account of VRS i.e. monetary payment on the basis of years of completed service or for the balance period of service whichever is less and notice pay.

Expert Advisory Committee (EAC) opines in favour of treating the costs (except gratuity which should have been provided for in the respective accounting period) as deferred revenue expenditure since it is construed upon as saving in subsequent periods, on some rational basis over a period, preferably over 3 - 5 year. However, the terminal benefit is, to the extent these are not deferred should be treated as expense in the P/L Account with disclosure.

Illustration 5:

ZERO Bank has followed the policies for retirement benefits as under:

(a) contribution to pension fund is made based on actuarial valuation at the year end. In respect of employees who have opted for pension scheme.

(b) Contribution to the gratuity fund is made based on actuarial valuation at the year end.

(c) Leave encashment is accounted for on "PAY-AS-YOU-GO" method.

Comment whether the policy is in accordance with AS-15.

Solution:

(a) As the contribution to Pension Fund is made on actuarial basis every year, there fore the policy is as per AS-15, which is based on actuarial basis of accounting.

(b) As the contribution is being made on annual basis to gratuity fund on actuarial basis, the policy is in accordance with AS-15.

(c) As regard leave encashment, which is accounted for on PAY-AS-YOU-GO basis, it is not in accordance with AS-15. It should be accounted for on accrual basis.

Illustration 6:

In the context of relevant Accounting Standards, give your comment on the following matter for the financial year ending 31st March, 2012:

"Increase in pension liability on account of wage revision in 2011-12 is being provided for in 5 instalments commencing from that year. The remaining liability of ₹ 300 lakhs as redetermined in actuarial valuation will be provided for in the next 2 years"

Solution: As per AS-15, the costs arising from an alteration in the retirement benefits to employees should be treated as follows:

(i) The cost may relate to the current year of service or to the past years of service.

(ii) In case of costs relating to the current year, the same may be charged to Profit and Loss Account

(iii) Where the cost relates to the past years of service these should be charged to Profit and Loss Account as 'prior period' items in accordance with AS-5.

(iv) Where retirement benefit scheme is amended in a manner which results in additional benefits being provided to retired employees, the cost of the additional benefits should be taken as " Prior Period and Extraordinary Items" as per AS-5.

In view of the above, the method adopted for accounting the increase in pension liability is not in consonance to the provisions mentioned in AS-15.

2.4 AS -19: LEASES

Lease is an arrangement by which the "Lessor" gives the right to use an asset for given period of time to the "Lessee" on rent.

It involves two parties, a Lessor and a Lessee and an asset which is to be leased. The Lessor, who owns the asset, agrees to allow to the Lessee to use it for a specified period of time in return for periodic rent payments.

Types of lease

(a) Finance Lease – It is a lease, which transfers substantially all the risks and rewards incidental to ownership of an asset to the Lessee by the Lessor but not the legal ownership. In following situations, the lease transactions are called Finance Lease.

- The lessee will get the ownership of leased asset at the end of the lease term.
- The lessee has an option to buy the leased asset at the end of term at price, which is lower than its expected fair value at the date on which option will be exercised.
- The lease term covers the major part of the life of asset.
- At the beginning of lease term, present value of minimum lease rental covers substantially the initial fair value of the leased asset.
- The asset given on lease to lessee is of specialized nature and can only be used by the lessee without major modification.

(b) Operating Lease – It is a lease which does not transfer substantially all the risk and reward incidental to ownership.

Classification of lease is made at the inception of the lease; if at any time the Lessee and Lessor agree to change the provision of lease and it results in different category of lease, it will be treated as separate agreement.

Applicability

The Accounting Standard is not applicable to following types of lease:

- Lease agreement to explore natural resources such as oil, gas, timber, metal and other mineral rights.
- Licensing agreements for motion picture film, video recording, plays, manuscripts, patents and other rights.
- Lease agreement to use land.

Definitions

1. Guaranteed Residual value – (G.R.V.)

- In respect of Lessee: Such part of the residual value (R.V.), which is guarantee by or on behalf of the lessee.
- In respect of Lessor: Such part of the residual value, which is guaranteed by or on behalf of the lessee or by an independent third party.

For the Lessor the residual value guaranteed by the third party can arise when the asset is leased to the third party after the first lease has expired and therefore it can be called the residual value guaranteed by the third party to the Lessor.

2. Unguaranteed Residual Value (U.R.V) – The difference between residual value of asset and its guaranteed residual value is unguaranteed residual value. [R.V- G.R.V.]

3. Gross Investment (=MLP+URV) – Gross investment in lease is the sum of the following:
   - Minimum lease payment (from the standpoint of Lessor) and
   - Any unguaranteed residual value accruing to the Lessor.

4. Interest rate implicit in the lease – When the Lessor gives an asset on lease (particularly on finance lease), the total amount, which he receives over lease period by giving the asset on lease, includes the element of interest plus payment of principal amount of asset. The rate at which the interest amount is calculated can be simply called implicit rate of interest. It can be expressed as under:-

   It is the discount rate at which

   Fair Value of leased Asset =Present value of [Minimum lease payment (in respect of Lessor)]
   (At the inception of lease) + Any unguaranteed residual value accruing to the Lessor.

5. Contingent Rent – Lease Rent fixed on the basis of percentage of sales, amount of usage, price indices, market rate of interest is called contingent rent. In other words, lease rent is not fixed, but it is based on a factor other than time.

6. Minimum lease payments [MLP]
   - For Lessor = Total lease rent to be paid by lessee over the lease terms + any guaranteed residual value (by or on behalf of lessee) – contingent Rent – cost for service and tax to be paid by the reimbursed to Lessor + residual value guaranteed by third party.
   - For Lessee = Total lease rent to be paid by lessee over the lease terms + any guaranteed residual value (for lessee) – contingent rent – cost for service and tax to be paid by and reimbursed to Lessor.

7. Lease includes Hire Purchase – The definition of a 'lease' includes agreements for the hire of an asset, which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These agreements are commonly known as hire purchase agreements.

Accounting for Finance Lease – In the books of Lessee

- Leased asset as well as liability for lease should be recognized at the lower of –
  - o Fair value of the leased asset at he inception of lease or
  - o Present value of minimum lease payment from the lessee point of view.
- Apportionment of lease payment-Each lease payment is apportioned between finance charge and principal amount.
- The lessee in its books should charge depreciation on finance lease asset as per AS-6(in this case, straight line method will be followed)
- Initial direct cost for financial lease is included in asset under lease.

Accounting for Finance Lease – In the books of Lessor

- The Lessor should recognize asset given under finance lease as receivable at an amount equal to net investment in the lease and corresponding credit to sale of asset.

  Net Investment =Gross Investment – Unearned Finance Income.

  Gross Investment = Minimum lease payment from Lessor point of view + Unguaranteed residual value.

  Unearned Finance Income=Gross Investment – Present Value of Gross Investment.
- **Recognition of Finance Income**

  The Lessor should recognize the finance income based on a pattern reflecting, constant periodic return on the net investment outstanding in respect of the finance lease. In simple words interest/ finance income will be recognized in proportion to outstanding balance receivable from lease over lease period.

Accounting for Operating Lease- In the books of Lessor:

- Record leased out asset as the fixed asset in the balance sheet.
- Charge depreciation as per AS-6
- Recognize lease income in profit & loss account using straight line method. If any other method reflects more systematic allocation of earning derived from the diminishing value of leased out asset, that approach can be adopted.
- Other costs of operating lease should be recognized as expenses in the year in which they are incurred.
- Initial direct cost of the lease may be expensed immediately or deferred.

Accounting for operating lease – In the Books of Lessee

Lease payments should be recognized as an expense in the profit and loss account on a straight line basis over the lease term. If any other method is more representative of the time pattern of the user's benefit, such method can be used.

"Sale and Lease back"

A sale and lease back transaction involves the sale of an asset by vendor and leasing of the same asset back to the vendor.

Accounting treatment of Sale and Lease back

1. **If lease back is Finance Lease**
   - Any profit or loss of sale proceeds over the carrying amount should not be immediately recognized as profit or loss in the financial statements of a seller-lessee.
   - It should be deferred and amortized over lease term in proportion to the depreciation of leased asset.

Illustration 7:

H Ltd. Sells machinery, WDV of which was ₹ 400 lakhs for ₹ 500 lakhs to B Ltd. The same machinery was leased back to H Ltd. by BLtd. for 10 years resulting in finance lease. What should be the treatment of profit in the books of seller lessee (H Ltd.)?

Solution:

The profit of ₹ 100 lakhs on sale of machinery by H Ltd. (seller lessee) should not be immediately recognized in books rather it should be deferred and amortized over 10 years in proportion of the depreciation amount to be charged by the H Ltd. on the machinery.

2. If lease back is Operating Lease

Any profit or loss arising out of sale transaction is recognized immediately when sale price is equal to fair value.

(A) If Sale price" below" fair value

- Profit – i.e. carrying amount (=book value or value as per balance sheet) is less than the sale value, recognize profit immediately.
- Loss – i.e. carrying amount is more than the sale value, recognize loss immediately, provided loss is not compensated by future lease payment.
- Loss – i.e. carrying amount is more than sale price defer and amortize loss if loss is compensated by future lease payment.

(B) If Sale price "above" fair value

- If carrying amount is equal to fair value which will result in profit, amortize the profit over lease period.
- Carrying amount less than fair value will result in profit – amortize and defer the profit equal to "sale price less fair value" and recognize balance profit immediately.
- Carrying amount is more than the fair value – which will result in loss equal to – (carrying amount less than fair value), should be recognized immediately. Profit equal to – selling price less fair value – should be amortized.

Illustration 8:

H Ltd. sold machinery having WDV of ₹ 400 Lakhs to B Ltd. for ₹ 500 Lakhs and the same machinery was leased back by B Ltd. to H Ltd. The Lease back is operating lease.

Comment if –

a) Sale price of ₹ 500 lakhs is equal to fair value
b) Fair value is ₹ 600 lakhs
c) Fair value is ₹ 450 lakhs and sale price is ₹ 380 lakhs
d) Fair value is ₹ 400 lakhs and sale price is ₹ 500 lakhs
e) Fair value is ₹ 460 lakhs and sale price is ₹ 500 lakhs
f) Fair value is ₹ 350 lakhs and sale price is ₹ 390 lakhs

Solution:

a) H ltd. should immediately recognize the profit of ₹ 100 lakhs in its books.
b) Profit ₹ 100 lakhs should be immediately recognized by H Ltd.
c) Loss of ₹ 20 lakhs to be immediately recognized by H Ltd. in its books provided loss is not compensated by future lease payment.
d) Profit of ₹ 100 lakhs is to be amortized over the lease period.
e) Profit of ₹ 60 lakhs (460-400) to be immediately recognized in its books and balance profit of ₹ 40 lakhs (500-460) is to be amortized / deferred over lease period.
f) Loss of ₹ 50 lakhs (400-350) to be immediately recognized by H Ltd. in its books and profit of ₹ 40 lakhs (390-350) should be amortized / deferred over lease period.

Illustration 9:

Milind Softex Ltd. has taken the assets on lease from ABC Impex Ltd. The following information is given below:

Lease Term	= 4 years
Fair value at inception of lease	= ₹ 16,00,000
Lease Rent	= ₹ 5,00,000 p.a. at the end of year
Guaranteed Residual Value	= ₹ 1,00,000
Expected Residual Value	= ₹ 2,00,000
Implicit Interest Rate	= 14.97%

Do the accounting in the book of lease?

Solution:

Present value of minimum lease payment

Year	MLP ₹	Discount rate 14.97%	PV ₹
1	5,00,000	0.8698	4,34,900
2	5,00,000	0.7565	3,78,250
3	5,00,000	0.6580	3,29,000
4	6,00,000 (including ₹1,00,000)	0.5724	3,43,440
	21,00,000		14,85,590

Present value of minimum lease payment (₹ 14,85,590) is less than Fair value at the inception of lease (₹ 16,00,000) so the leased asset and liability should be recognized at ₹ 14,85,590.

Apportionment of finance lease: Rate of Interest 14.97%

Year	Liability ₹	MLP ₹	Finance Charge ₹	Principal Amount of reduction ₹
0	14,85,590	-	-	-
1	12,07,983	5,00,000	2,22,393	2,77,607
2	8,88,818	5,00,000	1,80,835	3,19,165
3	5,21,874	5,00,000	1,33,056	3,66,944
4	-	6,00,000	78,125	5,21,875

Books of Milind Softex

Lease Rent Account

Year	Particulars	Amount ₹	Particulars	Amount ₹
1st year	To, Bank A/c	5,00,000	By, Finance Charges A/c By, Lease liability A/c	2,22,393 2,77,607
		5,00,000		5,00,000
2nd year	To, Bank A/c	5,00,000	By, Finance Charges A/c By, Lease liability A/c	1,80,835 3,19,165
		5,00,000		5,00,000
3rd year	To, Bank A/c	5,00,000	By, Finance Charges A/c By, Lease liability A/c	1,33,056 3,66,944
		5,00,000		5,00,000
4th year	To, Bank A/c	5,00,000	By, Finance Charges A/c By, Lease liability A/c	78,126 5,21,874
		5,00,000		5,00,000

Lease Liability Account (Lessor)

Year	Particulars	Amount ₹	Particulars	Amount ₹
1st year	To, Lease Rent A/c To, Balance c/d	2,77,607 12,07,983	By, Balance b/d	14,85,590
		14,85,590		14,85,590
2nd year	To, Lease Rent A/c To, Balance c/d	3,19,165 8,88,818	By, Balance b/d	12,07,903
		12,07,903		12,07,903
3rd year	To, Lease Rent A/c To, Balance c/d	3,66,944 5,21,874	By, Balance b/d	8,88,818
		8,88,818		8,88,818
4th year	To, Lease Rent A/c	5,21,874	By, Balance b/d	5,21,874
		5,21,874		5,21,874

Extract of Profit and Loss Account

Year	Particulars	Amount ₹
1st year	To, Finance Charge To Depreciation on leased Asset under SLM	2,22,393 3,71,397
2nd year	To, Finance Charge To Depreciation on leased Asset under SLM	1,80,835 3,71,397
3rd year	To, Finance Charge To Depreciation on leased Asset under SLM	1,33,056 3,71,397
4th year	To, Finance Charge To Depreciation on leased Asset under SLM	78,125 3,71,397

Extract Balance Sheet

Year	Liability	Amount ₹	Asset	Amount ₹
1st year	Lease Liability A/c	12,07,983	Fixed Asset under Finance Lease Less: Depreciation	14,85,590 3,71,397 11,14,193
2nd year	Lease Liability A/c	8,88,818	Fixed Asset under Finance Lease Less: Depreciation	14,85,590 7,42,794 7,42,796
3rd year	Lease Liability A/c	5,21,874	Fixed Asset under Finance Lease Less: Depreciation	14,85,590 11,14,191 3,71,399
4th year	Lease Liability A/c	NIL	Fixed Asset under Finance Lease Less: Depreciation	14,85,590 14,85,590 NIL

Illustration 10:

Milind Softex Ltd. has taken the assets on lease from ABC Impex Ltd. The following information is given below:

Lease Term	= 4 years
Fair value at inception of lease	= ₹ 16,00,000
Lease Rent	= ₹ 5,00,000 p.a. at the end of year
Guaranteed Residual Value	= ₹ 1,00,000
Expected Residual Value	= ₹ 2,00,000
Implicit Interest Rate	= 14.97%

How the accounting is done in the book of lessor ?

Solution:

Lessor should recognize asset given under lease at net investment in lease.

Net investment in lease= Gross investment – unearned finance income

Gross Investment = MLP + Guarenteed residual value + Unguaranteed residual value

= ₹ 20,00,000 + ₹ 1,00,000 + ₹ 1,00,000

= ₹ 22,00,000

Unearned Finance Income= Gross Investment – present value of gross investment

Year	Value of MLP ₹	Gross investment discount factor	Present Value ₹
1	5,00,000	0.8698	4,34,900
2	5,00,000	0.7565	3,78,250
3	5,00,000	0.6580	3,29,000
4	7,00,000	0.5724	4,00,680
	22,00,000		15,42,830

Unearned Finance Income = ₹ 22,00,000 - ₹ 15,42,830 = ₹ 6,57,170

Apportionment of MLP into Capital recovery & Finance income

Year	Balance of lease receivable	Cash receipts	Finance	Capital recovery reduced from receivable
0	15,42,830	-	-	-
1	12,73,792	5,00,000	2,30,962	2,69,038
2	9,64,479	5,00,000	1,90,687	3,09,313
3	6,08,862	5,00,000	1,44,383	3,55,617
4		7,00,000	91,147	6,08,853
			6,57,179	15,42,821

The lease receivable account shown in the books of lessor will not tally with the lease liability account as shown by the leasee in his book. Difference will remain because of guaranteed residual value from the third party or/ and unguaranteed residual value from the leasee point of view.

Illustration 11:

Amit purchased a computer for ₹ 44,000 and leased out it to Sumit for four years on leases basis, after the lease period, value of the computer was estimated to be ₹ 3,000; whichhe realized after selling it in the second hand market. Lease amount payable at the beginning of each year is ₹ 22,000; ₹ 13,640; ₹ 6,820 & ₹ 3,410. Depreciation was charged @ 40% p.a. You are required to pass the necessary journal entries in the books of both Amit and Sumit.

Solution:

Journals

In the books of Amit

	Particulars		**Dr.** ₹	**Cr.** ₹
1st	**Purchase of Computers:**			
	Computer A/c	Dr.	44,000	
	To, Bank A/c			44,000
	Payment of first Year's Lease:			
	Bank A/c	Dr.	22,000	
	To, Lease Rent A/c			22,000
	Depreciation for First Year:			
	Depreciation A/c	Dr.	17,600	17,600
	To, Computer A/c			
	Transfer to Profit & Loss Account:			
	Profit & Loss A/c	Dr.	17,600	
	To, Depreciation A/c			17,600
	Lease Rent A/c	Dr.	22,000	
	To, Profit & Loss A/c			22,000
2nd	**Payment of Second Year's Lease:**			
	Bank A/c	Dr.	13,640	13,640
	To, Lease Rent A/c			
	Depreciation for Second Year:			
	Depreciation A/c	Dr.	10,560	
	To, Computer A/c			10,560
	Transfer to Profit & Loss Account:			
	Profit & Loss A/c	Dr.	10,560	
	To, Depreciation A/c			10,560
	Lease Rent A/c	Dr.	13,640	
	To, Profit & Loss A/c			13,640
3rd	**Payment of Third Year's Lease:**			
	Bank A/c	Dr.	6,820	
	To, Lease Rent A/c			6,820
	Depreciation for Third Year:			
	Depreciation A/c	Dr.	6,336	
	To, Computer A/c			6,336
	Transfer to Profit & Loss Account:			
	Profit & Loss A/c	Dr.	6,336	
	To, Depreciation A/c			6,336
	Lease Rent A/c	Dr.	6,820	
	To, Profit & Loss A/c			6,820
4th	**Payment of Fourth Year's Lease:**			
	Bank A/c	Dr.	3,410	
	To, Lease Rent A/c			3,410

	Depreciation for Fourth Year:			
	Depreciation A/c	Dr.	3,802	
	To, Computer A/c			3,802
	Transfer to Profit & Loss Account:			
	Profit & Loss A/c	Dr.	3,802	
	To, Depreciation A/c			3,802
	Lease Rent A/c	Dr.	3,410	
	To, Profit & Loss A/c			3,410
	Sale of Lease assets:			
	Bank A/c	Dr.	3,000	
	Loss on Sale A/c	Dr.	2,702	
	To, Computer A/c			5,702

In the Books of Sumit

	Particulars		**Dr.** ₹	**Cr.** ₹
	Purchase of Computer:		**No Entry**	
	Payment of First Year's Lease:			
	Lease Rent A/c	Dr.	22,000	
	To, Bank A/c			22,000
	Depreciation for First Year:		**No Entry**	
	Transfer to Profit & Loss Account:			
	Profit and Loss A/c	Dr.	22,000	
	To, Lease Rent A/c			22,000
	Payment of Second Year's Lease:			
	Lease Rent A/c	Dr.	13,640	
	To, Bank A/c			13,640
	Depreciation for Second Year:		**No Entry**	
	Transfer to Profit & Loss Account:			
	Profit and Loss A/c	Dr.	13,640	
	To, Lease Rent A/c			13,640
	Payment of Third Year's Lease:			
	Lease Rent A/c	Dr.	6,820	
	To, Bank A/c			6,820
	Depreciation for Third Year:		**No Entry**	
	Transfer to Profit & Loss Account:			
	Profit and Loss A/c	Dr.	6,820	
	To, Lease Rent A/c			6,820
	Payment of Fourth Year's Lease:			
	Lease Rent A/c	Dr.	3,410	
	To, Bank A/c			3,410
	Depreciation for Fourth Year:		**No Entry**	
	Transfer to Profit & Loss Account:			
	Profit and Loss A/c		3,410	
	To, Lease Rent A/c			3,410
	Sale of Lease Assets:		**No Entry**	

2.5 AS -20: EARNING PER SHARE

Disclosure under AS-20:

a) The applicability of the standard is mandatory with effect from accounting year commencing on or after 01-04-2001 in respect of enterprises whose equity shares or potential equity shares are listed on a recognized stock exchange in India.

b) However under Part IV of Schedule VI of the Companies' Act 2013 every company is required to disclose EPS in accordance with AS-20, whether listed on a recognized stock exchange or not.

c) Presentation of EPS is required to be made both on the basis of consolidated financial statement, as well as individual financial statements of the parent company.

d) Presentation should be made in terms of Basic and Diluted EPS on the face of 'the Profit & Loss Account for each class of equity share that has a different right to share in the net profit for the accounting period. For equity shares having different nominal value but carrying same voting rights should be covered into equivalent number of shares of the same nominal value.

e) Both Basic and Diluted EPS should be presented with equal prominence for all periods even if the amounts are negative (a loss per share).

f) In addition to above, following are also disclosed:

   1. the amount used as the numerator and a reconciliation of those amounts to the net profit/ loss for the accounting period.

   2. the weighted average number of equity shares used as the denominator and a reconciliation of those denominator to each other.

   3. the nominal value of shares along with EPS figure.

g) Disclosure may also be made of terms and conditions of contracts generating potential equity which affect the basic and diluted EPS both on the weighted average number of shares outstanding and any consequent adjustments to net profit attributable to equity shareholders, following the computation of the denominator in accordance with AS-20.

Basic EPS:

a) Basic EPS is worked out by dividing the net profit /loss for the accounting period by the equity share using weighted average number of equity shares outstanding during the same period.

b) Net profit or loss should be arrived at after considering all income and expense recognized during the period including tax expense extraordinary as reduced by preference dividend in respect of non cumulative and cumulative for the period

c) Disclosure as an alternative maybe presented for basic and diluted on the basis of earning excluding extraordinary items (net of tax expenses).

Impact of bonus element in rights issue on EPS denominator:

In a right issue the exercise price in often less than fair value of shares thus it includes a bonus element and moreover, an adjustment is needed to recompute the fair value in relation to theoretical ex-right value per share.

Diluted EPS indicates the potential variability or risk attached to the basic EPS as a consequence of the issue of potential equity shares and potential dilutive securities having significant impact on lowering EPS. However, no potential equity shares be included in the computation of any diluted per share amount in case of continuing loss from operation, even though the entity reports an overall net profit.

i) Adjustments should be made both in numerator and denominator consequent upon the conversion of potential dilution to arrive at diluted EPS in keeping with the nature of conversion including tax implication thereon in the respective year.

ii) Potential equity shares are:

a) debt instruments/preference share convertible into equity shares

b) share warrants

c) employees and other stock option plans which entitles them to receive equity shares as part of their remuneration and other similar plans

d) contingently issuable shares under contractual arrangements e.g. acquisition of a business/ assets, loan converted to equity on default

e) share application pending allotment if not statutorily required to be kept separately and is being utilized for business is treated as potential (dilutive) equity share.

Illustration 12:

Weighted avg. number of equity shares has been illustrated in AS-20 in the following line:

Accounting year: 2011-12				
Date	Description	Shares Issued (Nos)	Buyback (Nos)	O/S
01/04/2011	Op. Balance	1800	-	1800
31/08/2011	Issued for Cash	600	-	2400
31/01/2012	Buyback	-	300	2100
31/03/2012	C1. Balance	2400	300	2100

Solution:

Weighted average number

a) (1,800 x 5/12) + (2,400 x 5/12) + (2,100 x 2/12) i.e. 2,100 shares

or

b) (1,800 x 12/12) + (600 x 7/12) - (300 x 2/12) i.e. 2,100 shares

Illustration 13:

Net profit for 2010-11 : ₹ 18,00,000; Net profit for 2011-12: ₹ 60,00,000; No. of equity shares as on 31.12.11 : ₹ 20,00,000.

Bonus issued on 1-1-12 : 2 equity shares for each Equity Share outstanding at 31-12-11 i.e. ₹ 40,00,000.

Solution:

EPS for 2011-12: (₹ 60,00,000)/(20,00,000+40,00.000) = ₹ 1.00

Adjusted EPS for 2010-11 : (earliest period reported) (₹ 18,00,000) / 60,00,000 = ₹ 0.30

Illustration 14:

Compute EPS:

a) Net profit for 2010 ₹ 11,00,000

Net profit for 2011 ₹ 15,00,000

b) Nos. of shares outstanding prior to Right Issue: 5,00,000 shares as om 1-1-2011

c) Right Issue: one new share for 5 outstanding i.e. 1,00,000 new shares

d) Right price: ₹ 15

e) Last date of right option: 1st March 2011

f) Fair value prior to the right option on 1st march 2011 : ₹ 21 per equity share

Solution:

1) Theoretical ex-right fair value per share:

[(₹ 21 x 5,00,000) + (₹ 15 x 1,00,000)] / (5,00,000+ 1,00,000)

i.e. 1,20,00,000/6,00,000 = ₹ 20

2) Adjustment factor:- fair value prior to exercise of rights/theoretical ex-right value. i.e. 21/20=1.05

3) Computation of EPS:

Year 2010	Year 2011
EPS as originally reported	
₹ 11.00,000/5,00,000 shares	₹ 2.20
EPS restated for right issue	
₹ 11,00,000/(5,00,000 x ₹ 1.05)	₹ 2.10
EPS-for 2011 including rights	
₹ 15,00,000/(5,00,000x 1.05 x 2/12) + (6.00,000 x 10/12)	₹ 2.55

2.6 AS – 26: INTANGIBLE ASSETS

An intangible asset is an identifiable non-monetary asset, without physical substance held for production or supply of goods and services for rental to others or for administrative purposes.

AS-26:

(i) prescribes the accounting treatment for intangible assets that are not specifically covered in other accounting standard;

(ii) recognizes an intangible asset on fulfillment of certain criteria;

(iii) deals with deferment of expenses except in a few specific instances.

However AS -26 does not apply to:

a) Intangible assets covered by other accounting standards e.g. AS-2 (valuation of inventories), AS-7 (accounting for construction contracts), AS-22(accounting for taxes on income), leases falling within scope of AS-19, goodwill on amalgamation (AS-14) and on consolidation (AS-21).

b) Mineral rights and expenditure on the exploration .for or development and extraction of minerals, oils, natural gas and similar non-generative resources and intangible assets arising in insurance enterprises from contracts with policy holders however, computer software expenses, start up cost pertaining to above activities are covered by AS-26).

c) Discount Premium on borrowings.

AS-26 applies, among other things, to expenditure on advertisement, training, startup, R&D activities, Rights under Licensing Agreement for motion picture video recording, plays, manuscript, patents and copyrights, the criteria is that expenditure should provide future economic benefits to an enterprise.

Sometimes, an asset may incorporate both tangible and intangible component and it is practically inseparable. "Judgment is required to determine the applicability of AS-10 (fixed asset) and AS-26 (intangible asset).

Example:

(1) computer software which is integral part and without that the computer-controlled machine cannot operate - treated as fixed asset.

(2) computer software, not an integral part of related' hardware - treated as. an intangible asset,

Essential criteria for recognition of an intangible asset:

a) identifiable:- It must be separate from goodwill and the enterprise could rem. sell: exchange or distribute the future economic benefits attributable to the asset without disposing of future economic benefits that flow from other assets in the same revenue earning activity - but goodwill cannot be meaningfully transferred to a new owner without also selling the other assets or the operation of the business. e.g. patents, copyrights, license, brand name, import quota, computer software, lease hold right, marketing rights, technical know-how etc.

b) control:- The enterprise has the power to obtain the future economic benefits, flowing from the underlying resources and also can restrict the access of others I to those benefits (not necessarily legal right and may be in some other way – I market and technical knowledge may give rise to future economic benefit).

c) future economic benefits:- An enterprise should asses the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset on the basis of weight age to external evidence available at the time of initial recognition..

d) Cost can be measured reliably:

   i) Initially recognized at cost - purchase price, taxes duty and other directly attributable expenses to make the asset ready for its intended use, if acquired separately - purchase consideration in the form of cash or other monetary asset.

   ii) In exchange for shares or securities at fair value of those shares or securities.

   iii) In exchange or part exchange for another asset - as per AS-10.

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed or allocated on a reasonable and consistent basis for creating, producing and making the asset ready for its intended use, but in no case once treated as an expense, cannot be reversed for capitalization even if the essential criteria for recognition are complied with a later date.

Normally the following cost are not recognized for internally generated intangible asset:

1) selling, administrative and other general overhead unless directly attributable.

2) clearly identified inefficiencies and initial operating loses incurred before an asset achieves planned performance.

3) expenditure on training the staff to operate the asset.

Subsequent expenditure on an internally generated intangible asset after its purchase or completion is normally treated as expense unless it is assessed to generate future economic benefits over and above the originally assessed standard of performance or it can be measured and reliably attributed to the concerned intangible asset.

Amortization is the systematic allocation of the depreciable amount (cost less residual value usually "NIL" unless determined in terms of committed value by a third party or determined by active market price) of an intangible asset over its useful life (period of time for use, number of production or other similar units expected to obtain or legal restriction).

Under AS-26, useful life shall not exceed 10 years from the date the asset is available for use unless there is persuasive evidence to establish useful life longer than 10 years provided the enterprise

(a) amortizes over the best estimated useful life

(b) estimates the recoverable amount at least annually to identify the impairment loss

(c) disclose the reasons and factors in determining a longer life.

The amortization period and the amortization method should be reviewed at least at each, financial year and if the expected life is revised, the amortization period is revised accordingly but in no case it would tantamount to inappropriate deferment to later years.

AS-5 will be relevant in this regard as to what constitutes a change in accounting policy and what constitutes a change in estimate e.g. a change from straight-line to diminishing method or vice-versa would be change in accounting policy whereas reduction in the amortization period is change in accounting estimate.

Disclosure under AS-26

A) General

1. for each class of intangible asset distinguishing between internally generated and others
   - (a) useful lives and amortization rates used
   - (b) amortization method used
   - (c) gross carrying amount and the accumulated amortization including impairment loss at the beginning and end of the reporting period
   - (d) a reconciliation of the carrying amount (opening balance/addition/ disposal/impairment/ loss charged/reversed/amortization for the period and other changes)
2. class of intangible asset by grouping of a similar nature and use by the enterprise informa tion on impaired intangible asset under AS-28 change in accounting policy or accounting estimate as per AS-5 reasons for amortization beyond 10 years with list of factors considered in determining the useful life.
3. Description, the carrying amount and remaining amortization period of any individual asset what is material to the financial statement as a whole.
4. Existence and carrying amount of intangible assets whose title is restricted and the carrying amount of intangible asset pledged as security for liabilities.
5. Amount of commitments for acquisition of intangible assets.

B) R&D expenditure: R&D expense (that is directly attributable or reasonably allocated on a consistent basis) recognized as an expense during the period.

C) Other information: encouraged to disclose a description of only fully amortized intangible asset but still in use.

Specific guideline for internally generated computer software - criteria for capitalization: apart from the broad recognition principles, AS-26 provides for specific guidance on internally generated computer software.

(a) At preliminary project stage, it is not recognized as an asset since the enterprise cannot demonstrate then exists as an asset from which future economic benefit will follow (making strategic decision, determination of performance requirements alternative means to achieve specified performance requirements. determination of technology to achieve performance requirements and selection of consultant to assist in development and/or installation of the software)

(b) At development stage involving detailed program design, coding working model in operative version for all major planned function and testing to bring it to a completed version together with related documentation and training material.

At this stage the internal1y generated computer software can be recognized as an asset on satisfying

1. The technical feasibility to make it available for internal use
2. Intention to complete to perform individual functions e.g. commitment for funding the project.

3. Ability to use the software
4. Usefulness of the software to generate future economic benefit
5. Availability of technical, financial and other resources to complete the development and use
6. Reliably measure the expenditure to the software development b) cost has some connotation as described earlier in the standard.

(c) Accounting for software acquired or purchased should meet with the basic principle of AS-26 as discussed elsewhere in this standard.

For computer software considering the fact technological change and obsolescence.It is 3-5 years of useful life, which needs to be reasoned in the disclosure.

Expenditure for Website:

The expenditure for purchasing, developing, maintaining and enhancing hardware (servers, internet connection) related to web site are accounted for under AS-10 (fixed asset).

The expenditure may be incurred internally when developing enhancing and maintaining its own website in the context of planning, application and infrastructure development, graphical design and content development and operating stage which are directly attributable or allocable on a reasonable basis to creating, producing and preparing the asset for intended use. The nature of each activity should be evaluated to decide web site stage of development.

Accounting treatment and recognition:

a) planning stage expenditure are akin to research cost and recognized as expense when incurred.

b) expenditure arising onward development stage complying with the development criteria (refer to computer software) should be recognized as an Intangible asset.

Illustration 15:

On February 2012, J Ltd.bought a trademark from I Ltd. for ₹ 50 lakhs. J Ltd. retained an independent consultant, who estimated the trademark's remaining life to be 14 years. Its unamortized cost on I ltd. records was ₹ 35 lakhs. J Ltd.decided to amortize the trademark over the maximum period allowed. In J Ltd.'s Balance Sheet as on 31st December 2012, what amount should be reported as accumulated amortization?

Solution:

As per para 23 of AS-26, intangible assets should be measured initially at cost therefore. J Ltd. should amortize the trademark at its cost of ₹ 50 lakhs. The unamortized cost on the seller's books ₹ 35 lakhs is irrelevant to the buyer. Although the trademark has a remaining useful life of 14 years, intangible assets are generally amortized over a maximum period of 10 years as per AS-26. Therefore, the maximum amortization expense and accumulated amortization is ₹ 5 lakhs (₹ 50 lakhs/10).

Illustration 16:

During 2011-12, A Ltd.incurred organization costs/preliminary expenses of ₹ 40,000. What portion of the organization costs will A Ltd. defer to years subsequent to the 2011-12?

Solution:

As per para 56(a) of AS-26, organization costs /preliminary expenses are those incurred in the formation of a corporation. Since uncertainty exists concerning the future benefit of these costs in future years, they are properly recorded as an expense in 2011-12.

Illustration 17:

D Ltd. is developing a new distribution system of its material, following the costs incurred at different stages on research and development of the system:

Year ended 31.3.	Phase/Expenses	Amount (₹ In lakhs)
2008	Research	8
2009	Research	10
2010	Development	30
2011	Development	36
2012	Development	50

On 31.3.12, D Ltd. identified the level of cost savings at ₹ 16 lakhs expected to be achieved by the new system over a period of 5 years, in addition this system developed can be marketed by way of consultancy which will earn cash flow of ₹ 10 lakhs per annum. D Ltd.demonstrated that new system meet the criteria of asset recognition as on 1.4.2010.

Determine the amount/cash which will be expensed and to be capitalized as intangible assets, presuming that no active market exist to determine the selling price of product i.e. system developed. System shall be available for use from 1.4.2012.

Solution:

As per AS-26, research cost of ₹ 18 lakhs to be treated as an expense in respective year ended 31st March 2008 and 2009 respectively.

The development expenses can be capitalized from the date the internally generated assets (new distribution system in this given case) meet the recognition criteria on and from 1.4.2010. Therefore, cost of ₹ 30 + 36+ 50 = ₹ 116 lakhs is to be capitalized as an intangible asset.

However, as per para 62 of AS-26, the intangible asset should be carried at cost less accumulated amortization and accumulated impairment losses.

At the end of 31st March, 2012, D Ltd. should recognize impairment loss of ₹ 22.322 lakhs (= 116 - 93.678) and carry the new distribution system at ₹ 93.678 lakhs in the Balance Sheet as per the calculation given below:

Impairment loss is excess of carrying amount of asset over recoverable amount. Recoverable amount is higher of two i.e. value in use(discounted future cash inflow) and market realizable value of asset.

The calculation of discounted future cash flow is as under assuming 12% discount rate.

(₹ Lakhs)

Year	Cost Savings	Inflow by introducing the system	Total cash inflow	Discounted at 12%	Discounted cash flow
2013	16	10	26	0.893	23.218
2014	16	10	26	0.797	20.722
2015	16	10	26	0.711	18.486
2016	16	10	26	0.635	16.51
2017	16	10	26	0.567	14.742
					93.678

No amortization of asset shall be done in 2012 as amortization starts after use of asset which is during the year 2012-13.

2.7 AS 29: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

The objective of this Standard is also to lay down appropriate accounting for contingent assets.

This standard is not applicable to:

- Financial instruments carried at fair value
- Insurance enterprises
- Contract under which neither party has performed any of its obligations or both parties have partially performed their obligation to an equal extent
- AS 7,AS 15,AS 19 and AS 22.

A provision is a liability which can be measured only by using a substantial degree of estimation.

A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

A contingent liability is:

(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation that arises from past events but is not recognized because:

  (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation;

  or

  (ii) a reliable estimate of the amount of the obligation cannot be made.

A contingent asset is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the enterprise.

Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

Possible obligation - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

A restructuring is a programme that is planned and controlled by management, and materially changes either:

(a) the scope of a business undertaken by an enterprise; or

(b) the manner in which that business is conducted.

Past Event - A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

Best Estimate: The amount recognized as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value.

Risks and Uncertainties: The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

Future Events: Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

Disclosure:

For each class of provision, an enterprise should disclose:

(a) the carrying amount at the beginning and end of the period;

(b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (i.e. incurred and charged against the provision) during the period; and

(d) unused amounts reversed during the period.

An enterprise should disclose the following for each class of provision:

(a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

(b) an indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, as addressed in paragraph 41; and

(c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Illustration 18:

There is a income tax demand of ₹ 2.5 lakhs against the company relating to prior years against which the company has gone on appeal to the appellate authority in the department. The ground of appeal deals with the points covering ₹ 1.8 lakhs of the demand. State how the matter will have to be dealt with in the financial account for the year.

Solution:

A provision of ₹ 0.7 lakhs and a contingent liability of ₹ 1.8 lakhs should be provided in the financial accounts for the year.

Illustration 19:

A company follows a policy of refunding money to the dissatisfied customers if they claim within 15 days from the date of purchase and return the goods. It appears from the past experience that in a month only 0.10% of the customers claim refunds. The company sold goods amounting to ₹ 20 lakhs during the last month of the financial year. Is there any contingency?

Solution:

There is a probable present obligation as a result of past obligating event. The obligating event is the sale of the product. Provision should be recognized as per AS-29. The best estimate for provision is ₹ 2,000 (₹ 20 lakhs x 0.1%).

MISCELLANEOUS ILLUSTRATIONS ON ACCOUNTING STANDARDS

AS-11: The Effects of changes in Foreign Exchange Rates

Illustration 20 :

M Ltd acquired a machine on 2nd April 2012 costing USD 2,00,000. The Suppliers agreed to the following terms of payment: On 2nd April 2012- 50% down payment, on 3rd April 2013-25% and on 2nd April 2014-25%.

The Company depreciates Machinery at 10% on SLM Basis. The Exchange Rate on various dates of payment are:

2nd April 2012-----₹ 48.80	31st March 2013 - ₹ 47.50
3rd April 2013-----₹ 47.41	31st March 2014- ₹ 43.39
2nd April 2014------₹ 43.77	31st March 2015- ₹ 45.25

Show the extracts of relevant entries in the P&L Account for the year ending 31st March 2013, 2014 and 2015 and the Balance Sheet on that date, showing necessary workings.

1. **Machinery Account**: Gross Block and Depreciation be shown under Fixed Assets in the Balance Sheet.

Financial year ending	31st March 2013	31st March 2014	31st March 2015
Gross Block at WDV	2,00,000 x 48.80 = 97,60,000	87,84,000	78,08,000
Less: Depreciation at 10%	9,76,000	9,76,000	9,76,000
Net Block at WDV	**87,84,000**	**78,08,000**	**68,32,000**

Note: No adjustments will be made in the carrying amount of Fixed Assets/ Depreciation due to exchange differences, since the Fixed Assets constitutes a Non- Monetary Item.

2. **Foreign Currency Loan Account:** To be shown in the **Liability** side of the Balance Sheet.

Financial Year ending 31st March 2013

Particulars	₹	Particulars	₹
To Bank-Down payment - (USD1,00,000 x 48.80) To P&L A/c - Exchange Diff. on Closing Balance (48.80-47.50) x USD 1,00,000 To Balance c/d- (USD1,00,000 x 47.50)	48,80,000 1,30,000 47,50,000	By Assets A/c- Cost (USD 2,00,000 x 48.80)	97,60,000
	97,60,000		**97,60,000**

Financial year ending 31st March 2014

Particulars	₹	Particulars	₹
To Bank – (USD 50,000 x 47.41) To P&L A/c – Exchange Difference in Settlement (47.50-47.41) x USD 50,000 To P& L A/c-Exchange Diff on Closing Balance (47.50-43.39) x USD 50,000 To Balance C/d – USD 50,000 x 43.39	23,70,500 4,500 2,05,500 21,69,500	By Balance B/d USD 1,00,000 x 47.50	47,50,000
	47,50,000		**47,50,000**

Financial Year ending 31st March 2015

Particulars	₹	Particulars	₹
To Bank - USD 50,000 x 43.77	21,88,500	By Balance b/d – (USD 50,000 x 43.39)	21,69,500
		By P&L A/c- Exchange Diff in Settlement (43.77-43.39) x USD 50,000	19,000
	21,88,500		**21,88,500**

Note: The rate on 31st March 2015 is not relevant since the loan is fully cleared / settled by that date.

3. **P & L Account**: The Exchange Differences noted in the Loan Liability A/c shall be debited / credited to the P& L A/c for each of the years. Depreciation will also be charged. The summary is as under:

Financial year ending	31st March 2013	31st March 2014	31st March 2015
Depreciation	Debit 9,76,000	Debit 9,76,000	Debit 9,76,000
Exchange Differences	Credit 1,30,000	Credit 2,10,000	Debit 19,000

Illustration 21:

'A' bought a Forward Contract for three months of USD 1,00,000 on 1st December 2011 at USD = ₹ 47.10 when the Exchange Rate was USD = ₹ 47.02. On 31st December 2011, when he closed his books, the Exchange Rate was USD = ₹ 47.15. On 31st January 2012, he decided to sell the Contract at ₹ 47.18 per Dollar. Show how the profits from the Contract will be recognized in the books. Give the full accounting treatment assuming that the above transaction is on "non-speculative basis."

Also discuss the accounting treatment, if the above transaction is on "speculative basis". On the assumption that on 31st December 2011, the 2 months Forward Rate is USD = ₹ 48.

[Note: The answer has been given on the assumption that 'A' is a Small and Medium-Sized Entity, and AS-30 "Financial Instruments- Recognition and Measurement' is not applicable to him.]

In the books of A

Situation A: If the above Forward Contract has been entered on "**non- speculative"** basis.

Date	Particulars		Dr. (₹)	Cr. (₹)
01.12.11	Foreign Currency Receivable A/c (1,00,000 USD x ₹47.02 Spot Rate) Forward Contract Deferred Premium A/c [1,00,000USD x (₹47.10-₹47.02)] To Forward Contract Payable A/c (1,00,000USD x ₹47.10 Fwrd Rate) (Being 3 months Forward Contract entered into for 1,00,000 USD)	Dr. Dr.	47,02,000 8,000	47,10,000
31.12.11	Foreign Currency Receivable A/c [1,00,000USD x (₹47.15- ₹47.02] To Profit and Loss A/c (Being the re-statement of FC Receivable to Reporting Date Rate, Gain adjusted.)	Dr.	13,000	13,000
31.12.11	Profit and Loss A/c To Forward Contract Deferred Premium A/c (Being the amortization of Forward Contract Premium ₹ 8,000 for 3 months, now transferred to P&L proportionately for 1 month period)	Dr.	2,667	2,667
31.01.12	Forward Contract Payable A/c Bank A/c [1,00,000 USD x (₹47.18 - ₹47.10)] To Foreign Currency Receivable A/c To Profit and Loss A/c (difference Gain adjusted) (Being settlement of Forward Contract)	Dr. Dr.	47,10,000 8,000	47,15,000 3,000
31.01.12	Profit and Loss A/c To Forward Contract Deferred Premium A/c (Being the amortization of balance Forward Contract Premium)	Dr.	5,333	5,333
31.12.11	Forward Contract Asset Receivable A/c [1,00,000 USD x (₹48.00 - ₹47.10)] To Profit and Loss A/c (Being adjustment of difference between Contract Forward Rate and B/S Date Rate of Forward Contract for remaining maturity period, Gain credited to P & L)	Dr	90,000	90,000

31.01.12	Profit and Loss A/c (balancing figure) Dr Bank A/c [1,00,000 USD x (₹47.18-₹47.10)] Dr To Forward Contract Asset Receivable A/c(reversal of B/S recognized amt) (Being settlement of Forward Contract, loss adjusted to P &L A/c)	82,000 8,000	90,000

Illustration 22 :

TC Ltd. imported material of US($) 1,00,000 from M/s X of London and booked a forward cover for the same. Details of the transaction and forward cover are as under:

Date of transaction 30-11-2011	
Exchange rate on 30-11-2011	₹ 41.40
Exchange rate on 31-3-2012	₹ 41.60
Settlement date 30-6-2012	
Exchange rate on 30-6-2012	₹ 42.00

Forward cover

Date of inception 01-01-2012	
Exchange rate on 1-1-2012	₹ 41.50
Forward Rate	₹ 41.70
Forward rate for 3 months on 31-3-2012	₹ 41.85
Amount of forward cover	US $ 1,00,000

Pass the journal entries assuming that the forward cover was taken for managing risk.

Solution:

In the books of TC Ltd.

Journal entries **(Amt.in ₹ lakhs)**

Date	Particulars	Dr	Cr
30.11.2011	Purchase A/c Dr. To M/s X A/c (Entry passed for recording purchases)	41.40	41.40
1.1.2012	Forward Contract Receivable ($) Dr. Deferred Premium Dr. To Forward contract Payable (₹) (Entry for entering forward exchange contract)	41.50 0.20	41.70
1.1.2012	Premium on Forward Contract Dr. To Deferred Premium (Amortization of forward premium for 3 months)	0.10	0.10
31.3.2012	Difference in Exchange Dr. To M/s X (Booking exchange loss on foreign currency creditors at Balance Sheet Date)	0.20	0.20
31.3.2012	Forward Contract Receivable ($) Dr. To Exchange Gain on Forward Contract Entry for booking exchange gain on forward exchange contract)	0.10	0.10
31.3.2012	Profit & Loss A/c Dr. To Premium on Forward Contract To Difference in Exchange (Entry for transferring the premium and loss in exchange to Profit & Loss A/c)	0.30	0.10 0.20

31.3.2012	Exchange Gain on Forward Contract Dr. To Profit & Loss A/c (Transfer of exchange gain on forward contract to Profit & Loss A/c)	0.10	0.10
30.6.2012	Premium on Forward Contract Dr. To Deferred Premium (Amortization of balance premium)	0.10	0.10
30.6.2012	Difference in Exchange Dr. To M/s X (Booking of exchange loss on settlement date on creditor)	0.40	0.40
30.6.2012	Forward Contract Receivable ($) Dr. To Exchange Gain of Forward Contract (Booking of exchange gain loss on forward exchange contract)	0.40	0.40
30.6.2012	Forward Contract Payable (₹) Dr. To Bank (Payment made to bank on settlement date of forward exchange contract)	41.70	41.70
30.6.2012	Forward Contract Received A/c (US $) Dr. To Forward Contract receivable A/c (US $ received against forward exchange contract)	42.00	42.00
30.6.2012	M/s X Dr. To Forward Contract Received A/c (US $ paid to M/s X of London)	42.00	42.00

Illustration 23:

UPC Ltd. purchased fixed assets for US $ 50lakhs costing ₹ 1825 lakhs on 1.4.2011 and the same was fully financed by the foreign currency loan [i.e.US Dollars] repayment in five equal instalments annually. [Exchange rate at the time of purchase was 1 US Dollar = ₹ 36.50]. As on 31.3.2012 the first installment was paid when 1 US Dollar fetched ₹41.50. The entire loss on exchange was included in cost of goods sold etc. UPC Ltd. normally provides depreciation on fixed assets at 20% on WDV basis.

Solution:

In this case AS-11 (pre-revised 1994) shall be applicable on Accounting for effects of changes in Foreign Exchange Rates, as the transaction in foreign currency has been entered into by the reporting enterprises before 1.4.2012. Exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets, should be adjusted in the carrying amount of the respective fixed assets. The carrying amount of such fixed assets to the extent not already so adjusted or otherwise accounted for , also to be adjusted to account for any increase or decrease in the liability of enterprise, as expressed in the reporting currency by applying the closing rate, for making payments towards the whole or a part of the cost of the assets of for repayment of the whole or a part of the monies borrowed by the enterprise from any person directly or indirectly, in foreign currency specifically for the purpose of acquiring those assets.

Thus the entire exchange loss due to variation of ₹ 50 lakhs on 31-3-2012 on payment of US $ 10 lakhs should be added to the carrying amount of fixed assets and not to the cost of goods sold.

Further, depreciation on the unamortized depreciable amount should also be provided, in accordance with AS-6 on Depreciation Accounting.

Calculation Exchange loss:

Foreign currency loan = $\frac{₹\ 1825 \text{ lakh}}{₹\ 36.50 \text{ lakh}}$ = 50 lakhs US Dollars

Exchange loss on outstanding loan on 31-3-2012 = 40 lakhs US $ X (41.50-36.50) = ₹ 200 lakhs should also be added to cost of fixed asset with corresponding credit to outstanding loan.

Calculation of additional depreciation on account of increase in the depreciable amount of fixed assets = 20% of ₹ 250 lakhs = ₹50 lakhs

Illustration 24 :

India Ltd. (Delhi) has a branch in Sydney, Australia. At the end of 31st March, 2012 the following ledger balances have been extracted from the books of the Sydney office:

Particulars	Sydney (Australia dollars thousands)	
	Debit	**Credit**
Plant & Machinery (Cost)	200	-
Depreciation on Plant & Machinery (Accumulated)	130	-
Debtors/Creditors	60	30
Stock (1-4-2011)	20	-
Cash/Bank balances	10	-
Purchases/ Sales	20	123
Goods sent to branch	5	
Wages & Salaries	45	
Rent	12	
Office Expenses	18	
Commission Receipts		100
Branch/H.O. Current A/c		7
	390	**390**

The following information is also available:

Goods sent by H.O. ₹ 100 thousand, Branch Account in H.O. ₹120 thousand.

Stock at 31-3-2012, Sydney Branch Australian $ 3,125. You are required to convert the Branch Trial Balance into rupees:

Use the following rate of exchange:

Opening rate A$ = ₹ 20 ; Closing rate A$ = ₹ 24 ; Average rate A$ = ₹ 22 which approximate the actual exchange rate ; For fixed Assets A$ = ₹18

Required- Translate the branch Trial balance if it is classified as-

(a) Integral foreign operation; (b) Non-integral foreign operation.

	Conversion rate Per $	Dr	Cr
Plant & Machinery (Cost)	₹ 18	3,600	-
Plant & Mach. Dep. reserve	₹ 18	-	2,340
Debtors/Creditors	₹ 24	1,440	720
Opening Stock	₹ 20	400	-
Cash & Bank Balances	₹ 24	240	-
Purchases /Sales	₹ 22	440	2,706
Goods received from H.O		100	-
Wages & Salaries	₹ 22	990	-
Rent	₹ 22	264	-
Office Expenses	₹ 22	396	-

Commission Receipts	₹ 22	-	2,200
H.O. Current Account		-	120
		7,870	**8,086**
Exchange loss (Balance figure) (as per AS-11)		**216**	
		8,086	**8,086**

Solution: (a) As per AS-11 the Sydney Branch Trial Balance is to be converted as under. If it is classified as integral foreign operation.

Sydney Brach Trial Balance as on 31-3-2012 (₹ 000)

As per AS-11(revised), the exchange loss should be written off in profit and loss for the year .

(b) If branch foreign operation is classified as non- integral foreign operation.

Sydney Branch Trial Balance as on 31-3-2012 (₹ 000)

	Conversion rate Per $	**Dr.**	**Cr.**
Plant & Machinery (cost)	₹ 24	4,800	-
Plant & Mach. Dep .reserve	₹ 24	-	3,120
Debtors/Creditors	₹ 24	1,440	720
Opening Stock	₹ 20	400	-
Cash & Bank Balances	₹ 24	240	-
Purchases/ Sales	₹ 22	440	2,706
Goods received from H.O		100	
Wages & Salaries	₹ 22	990	-
Rent	₹ 22	264	-
Office Expenses	₹ 22	396	-
Commission Receipts	₹ 22	-	2,200
H.O. Current Account			120
		9,070	**8,866**
Exchange profit (Balance figure) (as per AS-11)			**204**
		9070	**9070**

As per AS-11 (revised) difference would be credited to foreign currency translation reserve.

Illustration 25 :

AD Softex (India) Ltd. entered into purchase of forward contract as under:

Amt. of foreign currency	US $ 100000
Date of entering in forward cover	28-2-2013
Exchange rate of this date	₹ 47.00 per US $
Forward Rate	₹ 48
Period of forward cover	3 months (31-5-2013)
Spot Rate on reporting date (31-3-2013)	₹ 47.75
Forward Rate available at the reporting date For the remaining maturity of the contract	₹47.50

Forward cover has been entered into for sole purchase of managing risk associated with change of exchange rate for payment to supplier against purchase.

Required:

a) Calculate the forward premium/discount

b) Accounting for such forward premium/discount.

c) Calculate the exchange difference on 31-3-2013 (reporting date)

d) If the forward contract entered into is for speculation, what is the profit/loss for the period?

Solution:

(a) As per AS-11 forward premium is to be calculated as under:

(Forward contract rate less spot rate on the date of entering forward contract)

= (48.00 - 47.00) = 1 x 1, 00,000 = ₹1, 00,000 is premium paid for forward contract.

(b) This premium should be amortized as expense over the life of the contract in absence of clear cut method of amortization in AS-11, it is better to amortize on straight-line method over three months. One month for the reporting period 31-3-2013 = 1,00,000/3 = ₹ 33,333.33

Two months for the next accounting period (April and May 2013) = 1,00,000/3 x 2 = 66,666.66
(c) Exchange difference on reporting date 31-3-2013
Rate at the inception of forward contract ₹47 per USD
Rate on the reporting date ₹47.75 per US $

Difference (47.75-47.00) = 0.75 x 100,000 = ₹ 75,000 credited to Profit and Loss A/c as exchange gain on forward contract.

(d) If the forward contract is for speculation -

The forward contract value should be marked to market on the reporting date

Rate of forward contract ₹48.00 per US$

Forward contract available for remaining period of maturity on the reporting date = ₹47.50 per US $ (Current market value)

If forward contract is marked to market there will be a loss of ₹ 50,000 as under:

Difference (48.00-47.50) x 1,00,000 = ₹50,000 (loss)

This loss should be debited to profit and loss account for the period ended 31-3-2013.

Illustration 26:

XYZ Ltd imported a machine on 04.01.2007 for Euros 12,000, on deferred payment basis, payment in six equal annual instalments at every financial year end, commencing from 31.03.2007 onwards. Use AS-11 provisions and determines the exchange differences and carrying amounts of the liability at the end of each financial year, if the following exchange rates are given. One Euro equal Indian Rupees on---

04.01.2007	31.03.2007	31.03.2008	31.03.2009	31.03.2010	31.03.2011	31.03.2012
₹ 50.4872	₹ 45.5208	₹ 41.8463	₹ 41.0175	₹ 42.6400	₹ 51.4400	₹ 53.1000

1. Computation of Carrying Amounts of Liability

Financial year ending	EURO Amount due	Closing Rate (₹ per Euro)	Carrying Amount in (₹)
31.3.2007	10,000	45.5208	4,52,208
31.3.2008	8,000	41.8463	3,34,770
31.3.2009	6,000	41.0175	2,46,105
31.3.2010	4,000	42.6400	1,70,560
31.3.2011	2,000	51.4400	1,02,880
31.3.2012	Nil	53.1000	Nil

2. **Computation of Exchange Differences**

Fin. Year ending	Due to Settlement	Due to Reporting
31.3.2007	2,000 x (50.4872-45.5208) = 9,933 Gain	10,000 x (50.4872-45.5208) = 49,664 Gain
31.3.2008	2,000 x (45.5208-41.8463) = 7,349 Gain	8,000 x (45.5208-41.8463) = 29,396 Gain
31.3.2009	2,000 x (41.8463-41.0175) =1,658 Gain	6,000 x (41.8463-41.0175) = 4,973 Gain
31.3.2010	2,000 x (41.0175 -42.6400) = 3,245 Loss	4,000 x (41.0175-42.6400) = 6,490 Loss
31.3.2011	2,000 x (42.6400-51.4400) = 17,600 Loss	2,000 x (42.6400-51.4400) = 17,600 Loss
31.3.2012	2,000 x (51,4400-53.1000) = 3,320 Loss	Nil

Note: Exchange differences Gain is credited to P&L Account , while Loss is debited to P&L Account.

AS 12: ACCOUNTING FOR GOVERNMENT GRANTS

Illustration 27:

T Ltd. presented the following information:

How will you treat the following in the Balance Sheet of T Ltd.?

T Ltd. purchased a piece of land for ₹ 10,00,000 for which it received a grant from the Govt. amounting to ₹ 3,00,000.

Solution:

As per AS 12, Accounting for Govt. Grants, grants related to non-depreciable (Land is a non-depreciable asset) assets should be credited to Capital Reserve.

Thus (i) When the land was purchased

Land A/c Dr.

To Bank A/c

(ii) When the Govt. grant received

Bank A/c Dr.

To Capital Reserve

So, Balance Sheet of T Ltd. took the following form:

Balance Sheet (extract)

as at...................

Liabilities	Amount ₹	Assets	Amount ₹
Capital Reserve	3,00,000	Land	10,00,000

Illustration 28:

Z Ltd presented the following particulars. How will you deal with the following:

Z Ltd. received some Govt. grant as the compensation for the payment of wages of 100 workers who were found surplus (not needed) by Z Ltd.

Solution:

As per para 6.5, AS 12, Government grants may become receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period. Such a grant is recognised in the income statement of the period in which it becomes receivable, as an extraordinary item if appropriate. Thus, in this case, the Govt. grant which was received should be credited to income statement/Profit and Loss Account of Z Ltd.

Illustration 29:

How the Govt. grants related to specific fixed assets should be presented in the Balance Sheet as per AS 12?

Solution:

As per para 8.2, 8.3 and 8.4 of AS 12, Govt. grants related to specific fixed assets should be presented in the Balance Sheet by two following forms:

Either the grant is shown as a deduction from the gross value of the assets concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of reduced depreciation charges. Where the grant equals the whole, or virtually the whole, of the cost of the assets, the asset is shown in the Balance Sheet at a normal value.

OR

Grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportion in which depreciation on related assets is charged. Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet pending its apportionment to Profit and Loss Account.

Illustration 30:

Z Ltd. presented the following particulars; How will you deal with the following?

The selling price of a product of Z Ltd. is ₹ 15, the same can be sold in the open market for ₹ 10 per unit provided a Govt. grant of ₹ 15 is received.

Solution:

As per para 15, AS 12, Government grants related to revenue should be recognised on a systematic basis in the Profit and Loss Statement over the period necessary to match them with the related costs which they are intended to compensate. Such grant should either be shown separately under 'Other Income', or deducted in reporting the related expenses.

Thus, it becomes clear from the above that the amount of subsidiary it received should either be credited to the Statement of Profit and Loss or the same may be deducted from related costs which appear in the debit side of the income statement.

Illustration 31:

L Ltd. presented the following particulars. How will you deal with the following? L Ltd. applied for a Govt. grant to set up a new factory premises amounting to ₹ 20,00,000 which has been sanctioned/approved. The amount had not been received by L Ltd. But the factory premise was completed within the year.

Solution:

Accrual basis of Accounting is followed for recording the transactions related to Govt. grants. As such, the same may be treated as an accrued income and should be recorded in the books and will appear in the assets side of Balance Sheet.

Illustration 32:

How will you deal with the following?

R Ltd. received ₹ 10,00,000 as Govt. grants during the period ended 2009-10. There were certain conditions which should be fulfilled by R Ltd. Unfortunately R Ltd. did not satisfy the conditions for which the whole amount, during the period 2012-13, was refundable although ₹ 8,00,000 appeared in the books as deferred credit.

Solution:

As per para 11.2, AS 12, the amount refundable in respect of a Government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

As per 11.1, AS 12, Government grant sometimes becomes refundable because certain conditions are not fulfilled. A Government grant that becomes refundable is treated as an extraordinary item.

Thus, in the present case, refundable Govt. Grant amounting to ₹ 10,00,000 should first be adjusted against unamortised deferred charges of ₹ 8,00,000. The rest of ₹ 2,00,000 should be charged to the statements of profit and loss as an extraordinary item as per the above paras.

Illustration 33:

How will you deal with the following?

During the year 2012-13, Hydro Ltd received Government grant for ₹ 5,00,000 as promoter's contributions. 10% of the said grant became refundable as the prescribed conditions were not fulfilled by Hydro Ltd.

Solution:

As per para 10.1 of AS 12, the grants should be treated as capital reserve which can neither be distributed as dividend nor considered as deferred income. Thus, in the present case, as the entire amount of ₹ 5,00,000 had already been credited to Capital Reserve 10% of grant (₹ 5,00,000 x 10%) ₹ 50,000 should be refunded for which Capital Reserve Account should be debited.

Illustration 34 :

Extra Ltd. received a grant of ₹ 2 crores from the Central Govt. for the purpose of a special machinery during 2008-09. The cost of machinery was ₹ 20 crores and had a useful life of 9 years. During 2012-13, the grant has become refundable due to non-fulfillment of certain conditions attached to it.

Assuming the entire grant was deducted from the cost of Machinery in the year of acquisition, state, with reasons, the accounting treatment to be followed in the year 2012-13.

Solution:

As per para 11.3, AS 12, the amount refundable in respect of a Govt. grant related to a specific fixed asset is recorded by increasing the book value of the asset and depreciation on the revised book value is provided prospectively over the residual useful life of the asset.

In the present case, in the year 2012-13, book value of machinery will be increased by ₹ 2 crores. Therefore, deprecations on machinery will be computed as:

Deprecation (on straight line method)

$$= \frac{\text{Cost Price} - \text{Grant Received} - \text{Scrap Value}}{\text{Estimated life}}$$

$$= \frac{₹\ 20\text{ crores} - ₹\ 2\text{ crores} - \text{Nil}}{9\text{ years}}$$

= ₹ 2 crores

∴ Total depreciation for 4 years (2008 - 2009) to 2011-12) @ ₹ 2 crores = ₹ 8 crores.

Revised Book Value = Book Value in 2012-13 (₹ 18 crores – ₹ 8 crores) = ₹ 10 crores

Add: Grant Refunded = 2 crores

Revised Book Value = ₹ 12 crores

$$\therefore \text{ Revised Annual Depreciation} = \frac{\text{Revised Book Value}}{\text{Rest useful life}} = \frac{₹\ 12 \text{ crores}}{5 \text{ years}}$$

$$= ₹\ 2.4 \text{ crores}$$

During the next four years, depreciation will be charged a ₹ 2.4 crores per year and book value of machinery as on 2012-13 will be ₹ 12 crores.

Illustration 35:

On 1.4.2009, EPF Ltd. received Govt. grant of ₹ 300 lakhs for acquisition of a machinery costing ₹ 1,500 lakhs. The grant was credited to the cost of assets. The life of the machinery is 5 years. The machinery is depreciated at 20% on WDV basis. The company had forfeited the grant in May 2012 due to non-fulfillment of certain conditions. How would you deal with this refund of grant in the books of EPF Ltd.?

Solution:

As per para 11.3, AS 12, Accounting for Govt. Grants, the amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriated by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value is provided prospectively over the residual useful life.

Thus, in the present case, the treatment of Government grant which had to be refunded, will be computed as:

First Alternative

		(₹ in lakhs)
On 1.4.2009	Cost of Purchase of Machinery (₹ 1,500 - Grant ₹ 300)	1,200.00
On 31.3.2010	Less: Depreciation @ 20%	240.00
1.4.2010	WDV	**960.00**
31.3.2011	Less: Depreciation @ 20% on WDV	192.00
1.4.2011	W DV	**768.00**
31.3.2012	Less: Depreciation @ 20% on WDV	153.60
1.4.2012	WDV	**614.40**
May 2012	Add: Refund of Grant	300.00
	Revised Book Value	**914.40**

As per para 11.3, AS 12, Depreciation on revised book value will be ₹ 457.20 i.e. $\left(\frac{₹\ 914.40}{\text{Rest of life i.e., 2 years}}\right)$ for 31.03.2013 and 31.03.2014, respectively.

Second Alternative:

The refunded amount of ₹ 300 lakhs may be debited against Capital Reserve.

Illustration 36:

Shyam Management Institute furnishes you the following information in respect of Development Fund in the year 2012-13:

Particulars	(₹ in lakhs)
Govt. grant received for construction of Building	50
Private grants for acquisition of Land	30
Transfer from unrestricted fund for purchase of furniture	10
Income from fixed deposit (Fixed deposit for one year ₹ 40 lakhs)	2
Cost of Land	10
Advance payment made for acquisition of further land	5
Furniture purchased	1
Payment made to contractors for construction of Building	12

Prepare a Statement of changes in balance of Development Fund for the year 2012-13 and Balance Sheet for the Development Fund as on 31.03.2013.

Solution:

(a) Statement of changes in Balance of Development Fund.

Particulars		(₹ in lakhs)
Government grant		50
Private grant		30
Transfer from unrestricted fund		10
Income from fixed deposit		2
Less: Payments:		92
Cost of Land	10	
Furniture Purchased	1	11
		81

(b) Balance Sheet for the Development Fund as at 31.03.2013

Liabilities	Amount ₹ lakhs	Assets	Amount ₹ lakhs
Development Fund Balance	81	Advance Payment of Land	5
		Fixed Deposits	40
		Construction of Building	12
		Cash at Bank	24*
	81		81

Balance of Cash and Bank Receipts

Particulars		(₹ in lakhs)
Government grant		50
Private grant		30
Transfer from unrestricted fund		10
Income from fixed deposit		2
		92
Less: Payments:		
Land	10	
Advance for Land	5	
Fixed Deposit	40	
Furniture	1	68
Contractors	12	
		24

Illustration 37:

How would you show the following in the Balance Sheet of KK Ltd:

KK Ltd. got a plot of land as Government grant from Basirhat Municipality on 1.1.2010. The terms and conditions of the grant was that a school building should be constructed within a period of 3 years for local children. The construction cost of the building amounted to ₹ 10,00,000 — ₹ 2,00,000 to be issued in 2010, ₹ 3,00,000 in 2011 and ₹ 5,00,000 in 2012.

Solution:

The construction cost of the building amounted to ₹ 10,00,000 although the land was received cost-free. The entry for the purpose will simply be:

Land and Building A/c Dr.

To Bank A/c

K K Ltd.

Balance Sheet (Extract) as at……………………..

Particulars	2010 ₹	2011 ₹	2012 ₹
Land & Building	2,00,000	5,00,000	10,00,000

Illustration 38:

Sagar Ltd. belongs to the engineering industry. The Chief Accountant has prepared the draft accounts for the year ended 31.3.2013.

You are required to advice the company on the following items from the viewpoint of finalisation of accounts taking note of the mandatory accounting standards.

The company purchased on 1.4.2011 a special-purpose machinery for ₹ 25 lakhs. It received a Central Govt. grant for 20% of the price. The machine has an effective life of 10 years.

Solution:

As per para 8.2, 8.3 and 8.4, AS 12, two methods of presentation in financial statements of grant related to specific fixed assets are regarded as acceptable alternatives:

Under the first alternative, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of reduced depreciation charges.

Under the second alternative, grants related to depreciable assets are treated as deferred incomes which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the period and in the proportion in which depreciation on related assets is charged.

The deferred income is suitably disclosed in the Balance Sheet pending its apportionment to profit and loss account. It is shown after Reserves and Surplus but before 'Secured Loans' with a suitable description, e.g., Deferred Govt. Grant.

Illustration 39:

A limited company has set up its business in a desiginated backward area which entitles it to receive, as per a public scheme, announced by the Govt. of India, a subsidy of 15% of the cost of investment. Having fulfilled all the conditions laid down under the scheme, the company, on its investment of ₹ 100 lakhs in capital assets during its accounting year ending on 31.3.2013, received a subsidy of ₹ 15 lakhs in January 2013 from the Govt. of India. The accountant of the company would like to record the receipt as an item of revenue and to reduce the losses on the Profit and Loss Account for the year ended 31.3.2013.

Is his action justified? Discuss.

Solution:

As per para 8.4, AS 12, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. *Such* allocations of income is usually made over the periods and in the proportion in *which* depreciation on related assets is charged.

Thus, in the present case, the subsidy amounting to ₹ 15 lakhs which had been received for the acquisition of capital asset is a depreciable one in character. As per above provisions the above subsidy should not be credited to Profit and Loss Account for the period ended 31.3.2013; rather, the said amount of subsidy should be credited to Profit and Loss Account as a recognised one in proportion to depreciation charges.

Illustration 40:

AM Ltd. received a Govt. grant amounting to ₹ 1,00,000 in the period 2011-12 which is revenue in nature and which was a subsidy against selling of goods among the BPL Cardholders at a reduced amount. AM Ltd. recognised the subsidy in the books of accounts. After a careful examination in 2012-13, it was found that the company violated the agreement as it did not sell the item among the BPL cardholders at a subsidised price for which the amount of grant had been refunded.

How will you deal with the problem as per AS 12?

Solution:

As per para 6.3, AS 12, a contingency related to a Govt. Grant arising after the grant has been recognised is treated in accordance with Accounting Standard (AS 4)-Contingencies and Events Occurring After the Balance Sheet Date**.** However, in this case, the deferred credit balance must be shown as a current liability if there is any possibility to refund the grant. But if it materialises in future, the same must be disclosed.

Illustration 41:

P Ltd. bought a plant for ₹ 8,00,000 during the period 2009-10. It received a Govt. grant amounting to ₹ 3,00,000. The useful life of the plant was 5 years, having no residual value. P Ltd. had to refund the grant due to non-fulfillment of certain terms and conditions during the period 2012-13.

How will you treat the same?

Solution:

As per para 11.3, AS 12, the amount refundable in respect of a Govt. grant related to a specific fixed asset is recorded by increasing the book value of the assets or by reducing the Capital Reserve or the deferred income balance by the amount refundable.

In the first alternative, where the book value of the assets is increased, depreciation on the revised book value is to be provided prospectively over the residual useful life of the asset.

Second alternative is to reduce the capital reserve or deferred income balance, as appropriate, by amount refundable.

Thus, in this case:

First Alternative

	₹
2009-10: Cost of Plant (₹ 8,00,000 – ₹ 3,00,000	5,00,000
Depreciation for 3 years @ ₹ 1,00,000 x3	
(Dep. = $\frac{₹\ 5,00,000}{5\ \text{years}}$)	3,00,000
	2,00,000
Add: Refund of Grant	3,00,000
Revised Book Value	5,00,000
$\therefore$ Annual Depreciation will be = $\frac{\text{Revised Book Value}}{\text{Rest of life}} = \frac{₹\ 5,00,000}{2\ \text{years}}$	= ₹ 2,50,000

So, from 2012-13, annual depreciation will be ₹ 2,50,000.

Second Alternative

The refundable amount may be debited to Capital Reserve. Or, If the grant was treated as a deferred income, the same should be eliminated.

Illustration 42:

Top & Top Ltd. has set up its business in a designated backward area which entitles the company to receive from the Govt. of India a subsidy of 20% of the cost of investment. Having fulfilled all the conditions under the scheme, the company, on its investments of ₹ 50 crores in capital assets, received ₹ 10 crores from the Govt. in January 2013 (accounting period being 2012-13). The company wants to treat this receipt as an item of revenue and thereby reduce the losses on Profit and Loss Account for the year ended 31st March 2013. Keeping in view the relevant Accounting Standard, discuss whether the action is justified or not.

Solution:

As per para 8.4 of AS 12, Accounting for Govt. Grants, grants related to depreciable asset are treated as deferred income which is recognised in the Profit and Loss statement on a systematic and rational basis over the useful life of the asset. Grants related to non-depreciable assets are credited to Capital Reserve and there is usually no charge to income in respect of such assets. Para 10.1 states that where the Govt. Grants are of the nature of promotions contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in respect thereof, the grants are treated as Capital Reserve. In the present case, however, the Govt. grant which was received by the company should be treated as promoter's contributions and, hence, should be transferred to Capital Reserve as Capital receipt and should never be treated as revenue income.

Illustration 43:

A university receives two grants-one from the Ministry of Human Resource to be used for AIDS Research. The grant is for ₹ 45,00,000 which includes ₹ 3,00,000 to cover indirect expenses incurred in administering the grant. The second grant of ₹ 35,00,000 received from a reputed trust is to be used to set up a centre to conduct seminars on AIDS-related matters from time to time. During the year, it also received ₹ 5,00,000 worth of equipments donated by a well-wisher to be used for AIDS research. During the year 2012-13, the university spent ₹ 32,25,000 of the Govt. grant and incurred ₹ 3,00,000 overhead expenses, ₹ 28,00,000 were spent from the grant received from the Trust.

Show the necessary journals entries.

Solution:

As per para 6.1, AS 12, Government grants available to the enterprise are considered for inclusion in accounts:

(i) where there is reasonable assurance that the enterprise will comply with the conditions attached to them; and

(ii) where such benefits have been earned by the enterprise and it is reasonably certain that the ultimate collection will be made.

Mere receipt of a grant is not necessarily a conclusive evidence that conditions attaching to the grant have been or will be fulfilled.

Bearing in mind the above provision, the entries will be:

In the Books of ....University

Journal

Date	Particulars	L/F	Amount ₹	Amount ₹
	Bank A/c Dr. To Govt. Grant A/c (Govt. Grant received)		45,00,000	45,00,000
	Bank A/c Dr. To Trust A/c (Amount received from Trust as grant)		35,00,000	35,00,000
	Equipment A/c Dr. To Capital Reserve A/c (Equipment received as donation)		---	---
	Expenses A/c Dr. To Bank A/c (Expenses incurred out of Govt. grant)		32,25,000	32,25,000
	Seminar Expenses A/c Dr. To Bank A/c (Seminar expenses incurred)		28,00,000	28,00,000
	Government Grant A/c Dr. To Profit and Loss A/c (Expenses incurred transferred to P&L A/c)		35,25,000	35,25,000
	Government Grant A/c Dr. To Profit and Loss A/c (An amount equal to depreciation charged transferred to P&L A/c)		---	---

***Considered as the nominal price**

AS 15:

Illustration 44:

The fair value of plan assets at the beginning and end of the year were ₹2,800 and ₹3,086 respectively. The employer's contribution to the plan during the year as ₹290. Benefit payments to retirees were ₹320. Calculate the actual return on plan assets.

Solution:

The actual return is computed as follows:

Particulars	Amount ₹
Fair value of plan assets (beginning of year)	2,800
Plus: Employer Contribution	290
Plus: Actual Return	?
Less: Benefit Payments	(320)
Fair value of plan assets (ending of year)	3,086

The actual return equal to ₹316

Alternatively, the following formula may be used to derive the actual return:

Actual return = Fair value of asset (end of year) – Fair value of assets (beginning of the year) – Employer contributions + Benefit payments

Actual return = ₹3,086 – ₹2,800 – ₹290 + ₹320 = ₹316

Illustration 45:

The following data apply to a company's defined benefit pension plan for the year:

Particulars	Amount ₹
Fair market value of plan assets (beginning of year)	4,00,000
Fair market value of plan assets (end of year)	5,70,000
Employer Contribution	1,40,000
Benefit Paid	1,00,000

Calculate the actual return on plan assets.

Solution:

The actual return is computed as follows:

Particulars	Amount ₹	Amount ₹
Fair market value of plan assets (end of year)		5,70,000
Less: Fair market value of plan assets (beginning of year)		4,00,000
Change in plan assets		1,70,000
Adjusted for		
Employer Contributions	1,40,000	
Less: Benefit Paid	1,00,000	40,000
Actual return on plan assets		1,30,000

Illustration 46:

Based on the following information, calculate the actual return on pension plan assets:

Particulars	Amount ₹	Amount ₹
Benefit payments	1,00,000	
Contribution	1,30,000	
Fair market value of plan assets		
End of year		6,00,000
Beginning of year		4,00,000

Solution:

The actual return on pension plan assets follows:

Particulars	Amount ₹	Amount ₹
Change in fair market value of plan assets (6,00,000 – 4,00,000)		2,00,000
Adjustments:		
Employer Contribution	1,30,000	
Less: Benefit payments	1,00,000	30,000
Actual return on plan assets		1,70,000

Illustration 47 :

A company reports the following information regarding pension plan assets. Calculate the fair value of plan assets at the end of the year.

Particulars	Amount ₹
Fair market value of plan assets (beginning of year)	7,00,000
Employer Contribution	1,00,000
Actual return on plan assets	50,000
Benefit payments to retirees	40,000

Solution:

The actual return on pension plan assets follows:

Particulars	Amount ₹
Fair market value of plan assets (beginning of year)	7,00,000
Employer Contribution	1,00,000
Actual return	50,000
Benefit payments	(40,000)
Fair market value of plan assets (end of year)	8,10,000

Illustration 48 :

What should be disclosed for defined contribution pension plans?

Solution:

An enterprise should disclose-

(i) The amount recognized as an expense for defined contribution plan.

(ii) Where required by AS-18, "Related Party Disclosure" an enterprise discloses information about contributions to defined contribution plans for key management personnel.

Illustration 49:

What are the components of pension expenses for defined benefit pension plan?

Solution:

The components of pension expenses for defined benefit pension plan are:

- Current service cost;
- Interest cost;
- Actuarial gains and losses;
- Past service cost;
- The effect of any curtailment re-settlements;
- Effect of recognition of over funding (assets) of defined benefit plan at lower of over funding amount and present value of any economic benefits available in the plan or reduction in future contribution to the plan;
- Expected return on any plan assets or any re-imbursement rights.

Illustration 50:

How are actuarial gains or losses on pension plans accounted for?

Solution:

Actuarial gains and losses should be recognized immediately in the statement of profit and loss and income or expenses.

Illustration 51:

At the commencement of the year 2012, Milestones Ltd. estimates expected long-term return on plan assets as follows:

Interest and dividend income (after tax) receivable by the fund 9% per annum

Realized and unrealized gain or plan assets (after tax) 2% per annum

Administrative costs 1% per annum

Expected rate of return (after tax) 10% per annum

The fair value of the plan assets as at 01.01.2012 was ₹ 15,000. During the year ₹ 4,000 is contributed to the fund and ₹ 2,000 is paid out of the fund towards employee benefits. The fair value of assets as at 31.12.2012 is ₹ 18,500. Calculate the actual return, expected return and actuarial gains (loss).

Solution:

Actual and Expected Return and Actuarial Gain or loss

Particulars	Amount ₹	Amount ₹
Fair Value as on 01.01.2012		15,000
Contribution during the period	4,000	
Payment towards employee benefits	(2,000)	2,000
Total (a)		17,000
Fair value as on 31.12.2012 (b)		18,500
Actual return on plan assets (c)	(b-a)	
Expected return on plan assets (d)	0.10 x 15,000=1,500	1,500
	0.10/2 x 2,000= 100	1,600
Actuarial loss (d-c)		**100**

In calculating the expected return on plan assets, the rate of expected return is applied on the net increase in plan assets due to contribution and payments during the current period for six month. In practice, the date of each contribution to and payment from the fund should be considered in calculating expected return on plan assets.

Illustration 52:

Indigo Ltd. discontinues a business segment. Under the agreement with employee's union, the employees of the discontinued segment will earn no further benefit. This is a curtailment without settlement, because employees will continue to receive benefits for services rendered before discontinuance of the business segment. Curtailment reduces the gross obligation for various reasons including change in actuarial assumptions made before curtailment. In this, if the benefits are determined based on the last pay drawn by employees, the gross obligation reduces after the curtailment because the last pay earlier assumed is no longer valid.

Assuming the following:

(a) Immediately before the curtailment, based on current actuarial assumption, the gross obligation was estimated at ₹ 2,000.

(b) The fair value of plan assets on the date was estimated at ₹ 1,700.

(c) The unamortized past service cost was ₹ 60.

(d) Curtailment reduces the obligation by ₹ 200, which is 10% of the gross obligation.

Indigo Ltd. estimates the share of unamortized service cost that relates to the part of the obligation that is eliminated at 10% of ₹ 60 or at ₹ 6. Calculate the gain from curtailment

Solution:

Gain from curtailment is estimated as under

Reduction in gross obligation	₹ 200
Less: Proportion on unamortized past service cost	6
Gain from curtailment	**₹ 194**

The liability to be recognized after curtailment in the balance sheet is estimated as under

Particulars	Amount ₹
Reduced gross obligation Less: Fair value of plan assets Less: Unamortised past service cost	1,800 1,700 100 54
Liability to be recognized in the balance sheet	46

Illustration 53:

A Company has its share capital divided into shares of ₹ 10 each. On 1st April, 2011, it granted 10,000 employees' stock options at ₹ 40, when the market price was ₹ 130. The options were to be exercised between 16th December, 2011 and 15th March, 2012. The employees exercised their options for 9,500 shares only; the remaining options lapsed. The company closes its books on 31st March every year. Show the Journal Entries.

Solution:

Journal Entries

Date	Particulars	Dr. Amount ₹	Cr. Amount ₹
1-4-2011	Employee Compensation Expenses A/c Dr. To, Employee Stock Option Outstanding A/c (Being grant of 10,000 stock options to employees at ₹ 40 when market price ₹ 130.)	9,00,000	 9,00,000
16-12-2011 to 15-03-2012	Bank A/c Dr. Employee stock option outstanding A/c Dr. To, Equity Share Capital A/c To, Securities Premium A/c (Allotment to employees of ₹ 9,500 equity shares of ₹ 10 each at a premium of ₹ 120 per share in exercise of stock option by employees)	3,80,000 8,55,000	 95,000 11,40,000
16-03-2012	Employee stock option outstanding A/c Dr. To, Employees compensation expenses A/c (Entry for lapse of stock option for 500 shares)	45,000	 45,000
31.03.2012	Profit and Loss A/c Dr. To, Employee Compensation Expense A/c (Transfer of expenses to profit and loss account)	8,55,000	 8,55,000

Illustration 53:

R Ltd. (the leassee) acquired machinery on lease from S Ltd. (the Lessor) on January1,2010. The lease term covers the entire economic life of the machinery i.e. 3 years. The fair value of the machinery on January 1,2010 is ₹3,50,000. The lease agreement requires the lessee to pay an amount of ₹1,50,000 per year beginning on December 31,2010. The lessee has guaranteed a residual value of ₹11,400 on December 31,2012 to the lessor. The lessor however estimates that the machinery will have a salvage value of only ₹10,000 on December 31,2012. The implicit rate of interest is 15% p.a. Compute the value of machinery to be recognized by the lessee and also the finance charges every year on the basis of AS-19. PV Factor of 15% in three years is 2.283.

Solution:

As per para 11 of AS-19. At the inception of a finance lease, the lessee should recognize the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of leased asset exceeds the present value of minimum lease payments from the standpoint of the lessee, the amount recorded, as an asset and liability should be the present value of minimum lease payments from the standpoint of the lessee. In this case fair value of the machinery is ₹3,50,000 and the net present value of minimum lease payment from the minimum lease payment is not less than the fair value, then the machinery will be recognized by the lessee at ₹3,50,000.

Present value of minimum lease payment:

Annual lease rental X P.V Factor + Present value of Guaranteed residual value

= ₹1,50,000 X (0.8695 +0.7561 +0.6575) +11,400 X 0.6575

=₹(3,42,465 +7,496) = Payment ₹3,49,961. Rounded off to ₹3,50,000

Year	Finance Charges ₹	Payment ₹	Reduction in Outstanding Liability ₹	Outstanding Liability ₹
Year 1(January 1)	-	-	-	3,50,000
(Dec.31)	52,500	1,50,000	97,500	2,52,500
Year 2 (Dec.31)	37,875	1,50,000	1,12,125	1,40,375
Year 3(Dec.31)	21,056	1,50,000	1,28,944	11,431

Illustration 54:

DA Ltd. availed a lease from Indigo Ltd. on following terms:

- A lease for a tenor of 3 years, in the beginning of year 2011 for equipment costing ₹7,00,000 and which has an expected useful life of 5 years. The fair market value is also ₹7,00,000.
- 3 equal annual payments are made at end of each year.
- The property reverts back to the lessor on termination of the lease.
- The unguaranteed residual value is estimated at ₹75,000 at the end of year 2013.
- IRR = 10%.
- The present value of ₹1 due at the end of 3rd year at 10% rate of interest is 0.7513.
- The present value of annuity of ₹1 due at the end of 3rd year at 10% IRR is ₹2.4868

(i) State with reason whether the lease constitute finance lease.

(ii) Calculate unearned finance income.

Solution:

(i) **Computation of Annual payment to the lessor**

PV of residual value (₹)	= 75,000 x 0.7513	= 56,348
PV of lease payments (₹)	= 7,00,000 – 56,348	=6,43,652
Annual payments (₹)	= 6,43,652 /2.4868	= 2,58,817

The present value of lease payments i.e., ₹6,43,652 equals 92% of the fair market value i.e., ₹7,00,000. As the present value of minimum lease payment substantially covers the initial fair value of the leased assets and leased term (3 years) covers the major part of the life of asset (5 years). Therefore, it constitutes a finance lease.

(ii) Computation of unearned finance income	₹
Gross investment in the lease [₹ (3 x 2,58,817) + 75,000]	8,51,451
Less: Cost of leased property	7, 00,000
Unearned finance income	1, 51,451

Illustration 55:

On January 1,2012, M Ltd. sold equipment to N Ltd. for ₹12,28,920. The carrying amount of the equipment on that date was ₹2,00,000. The sale was a part of the package under which N Ltd. leased the asset to M Ltd. for a ten-year term. The economic life of the asset is estimated at 10 years. The minimum lease rents payable by the lessor has been fixed at ₹2,00,000 payable annually beginning December 31, 2012. The incremental borrowing interest rate of M Ltd. is estimated at 10% per annum. Calculate the net effect on the Profit and Loss Account?

Solution:

The PV of minimum lease payments at 10% discount rate = ₹2,00,000 x 6.1446 = ₹12,28,920

M Ltd. should recognize the asset and the liability at ₹12,28,920

The excess of sale over carrying amount = ₹ (12,28,920 – 2,00,000) = ₹10,28,920

Assume that M Ltd. has decided to charge depreciation on straight line basis. AS-19 requires M Ltd. to:

a. Recognize depreciation at ₹1,22,892 per annum for 10 years.

b. Allocated excess of ₹10,28,920 over the lease term at the rate of ₹1,02,892 per annum.

The net effect is a debit of (₹1,22,892 -1,02,892) or ₹20,000 per annum to the profit and loss account for 10 years, as covered under the lease term.

Had there been no sale and lease back transaction, the profit and loss account for each year covered in the lease term would have been charged by (₹2,00,000/10) or ₹20,000, towards depreciation. Thus, the sale and lease back transaction has no impact on profit or loss to be reported by the lessee (vendor in the sale transaction) over the lease period.

The deferred income (excess) should be presented as a deduction from the carrying amount of the asset. Thus, the asset should be presented by M Ltd. in its balance sheet dated December 31,2012 as follows:

	₹
Gross Block	12,28,920
Less: Accumulated depreciation	1,22,892
Net Block	11,06,028
Less : Deferred Income	9,26,028
Net Block	1,80,000

In effect, the carrying amount of the equipment does change with the sale and lease back transaction. In substance, the sale and lease back transaction is a borrowing transaction resulting in recognition of a liability in the Balance Sheet and recognition of interest expense in the profit and loss account.

Illustration 56:

A Ltd. leased a machinery to B Ltd. on the following terms:

	(₹ in lakhs)
Fair value of the machinery	20.00
Lease term	5 years
Lease Rental per annum	5.00
Guaranteed Residual value	1.00
Expected Residual value	2.00
Expected Rate of Return	15%

Depreciation is provided on Straight line Method @10% per annum. Ascertain unearned financial income and necessary entries may be passed in the books of the Lessee in the First year.

Solution:

Present value of MLP (for lessee)

Year	MLP ₹	Discount Rate	PV ₹
1	5,00,000	0.8696	4,34,800
2	5,00,000	0.7561	3,78,050
3	5,00,000	0.6575	3,28,750
4	5,00,000	0.5718	2,85,900
5	6,00,000	0.4972	2,98,320
			17,25,820

Note:

It has been assumed that the lease rent is paid at the end of the year. Present value of MLP is less than fair value of ₹20,00,000, so the leased asset and liability should be recognized at ₹17,25,820 in the books of lessee (B Ltd)

Calculation of unearned finance income

Unearned finance income = Gross investment – PV of Gross Investment.

For the Lesser

Year	MLP ₹	Discount Rate	P.V ₹
1	5,00,000	0.8696	4,34,800
2	5,00,000	0.7561	3,78,050
3	5,00,000	0.6575	3,28,750
4	5,00,000	0.5718	2,85,900
5	7,00,000	0.4972	3,48,040
	27,00,000		17,75,540

Unearned Finance Income =₹(27,00,000-17,75,540) = ₹9,24,460

Apportionment of MLP into finance charge and principal amount at the end of the year.

Year	Liability ₹	MLP ₹	Finance Charge ₹	Principal ₹
0	17,25,820	-	-	-
1	14,84,693	5,00,000	2,58,873	2,41,127
2	12,07,397	5,00,000	2,22,704	2,77,296
3	12,07,397	5,00,000	1,81,110	3,18,890
4	8,88,507	5,00,000	1,33,276	3,66,724
5		6,00,000	78,267	5,21,733

Entries in the books of B Ltd. (lessee) in first year

Particulars	Dr. (₹)	Cr. (₹)
Machinery (leased) A/c Dr. To lease liability	17,25,820	 17,25,820
Depreciation A/c Dr. To Machinery A/c	1,72,582	 172,582
Lease Liability A/c Dr. (A Ltd.) Finance Charge Dr. To Bank	2,41,127 2,58,873	 5,00,000
Profit & Loss A/c Dr. To Depreciation A/c To Finance Charges	4,31,455	 1,72,582 2,58,873

Illustration 57:

An Equipment is leased for 3 years and its useful life is 5 years. Both the cost and the fair market value of the equipment are ₹3,00,000. The amount will be paid in 3 instalments and at the termination of lease lessor will get back the equipment. The unguaranteed residual value at the end of 3 years is ₹40,000. The (internal rate of return) IRR of the investment is 10%. The present value of annuity factor of ₹1 due at the end of 3rd year at 10% IRR is 2.4868. The present value of ₹1 due at the end of 3rd year at 10% rate of interest is 0.7513.

(i) State with reason whether the lease constitute finance lease

(ii) Calculate unearned finance income.

Solution:

As per the question, IRR of the investment is 10%

Investment in lease is ₹ 3,00,000

If IRR is 10% that means P.V. of minimum lease payment (MLP) from lessor point of view plus unguaranteed residual value is equal to ₹ 3,00,000.

P.V. of unguaranteed residual value - (40,000 x 0.7513) = ₹ 30,052

P.V. of M.L.P. should be ₹(3,00,000 -30,052) = ₹ 2,69,948

As at the beginning of lease period the P.V. of M.L.P cover substantially the initial fair value i.e., 2,69,948/3,00,000 = 90% approx.

Moreover lease period covers major part of the lease of the asset

Hence, it is a finance lease.

Calculation of annual lease payment to the lessor	=	2,69,948/2.4868	= ₹1,08,552
Gross investment in lease – 1,08,552 x 3	=	₹ 3,25,657	
Unguaranteed residual value -		₹ 40,000	
		₹ 3,65,657	
Less: P.V. of Gross investment in lease		₹ 3,00,000	
Unearned finance income		₹ **65,657**	

AS 20: EARNINGS PER SHARE

Illustration 58:

Briefly discuss how do you calculate diluted earning per share as per AS 20.

Solution:

As per paras 26, 27, and 30 of AS 20:

For the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period.

The amount of net profit or loss should be adjusted by the following after taking into account any attributable change in tax expense for the period:

(a) any dividends on dilutive potential equity shares which have been deducted in arriving at the net profit attributable to equity shareholders as calculated in accordance with paragraph 11;

(b) interest recognised in the period for the dilutive potential equity shares; and

(c) any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

After the potential equity shares are converted into equity shares the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred (or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders.

Illustration 59:

M Ltd. presented the following particulars for the period ended 31st March 2012, from which you are requested to calculate the diluted earnings per share:

Particulars	Amount
Net Profit earned for the year 2011-12 (₹)	20,00,000
No of equity shares outstanding at the end of the period	10,00,000
No. of 12% Convertible Debentures of ₹ 100 each to be convertible into 10 equity shares	25,000
Income Tax Rate is	30%

Solution:

Interest to be paid to 12% Convertibles Debentureholders

Particulars	Amount ₹
No. of Debentures x Value per Debenture = 25,000 x ₹ 100	25,00,000
∴ Interest = ₹ 25,00,000 x $\frac{12}{100}$	3,00,000
Tax on the said interest = ₹ 3,00,000 x 30%	90,000

Adjusted Net Profit

Particulars	Amount ₹
Net Profit	20,00,000
Add: Debenture Interest	3,00,000
	23,00,000
Less: Tax on Debenture Interest @30%	90,000
Adjusted Net Profit	22,10,000

Ordinary Earning per Share = $\dfrac{\text{Net Profit}}{\text{No. of Equity Shares}} = \dfrac{₹\ 20,00,000}{10,00,000} = ₹\ 2.00$

Diluted Earnings per Share =

No. of additional equity shares for conversion of debentures will be 25,000 x 10 = 2,50,000 Shares.

$\therefore$ Diluted Earnings per Share = $\dfrac{\text{Adjusted Net Profit}}{(\text{No. of Equity Shares + Convertible Equity Shares})}$

$= \dfrac{₹\ 22,10,000}{(10,00,000 + 2,50,000)} = ₹\ 1.768$

Illustration 60:

X Ltd. presented the following particulars for the period ended 31st March 2012, from which you are requested to compute (a) Ordinary EPS, and (b) Diluted EPS:

Particulars	Amount ₹
Net Profit for the period	50,00,000
No. of equity shares – 10,00,000 shares of ₹ 10 each outstanding	1,00,00,000
Fair value of equity shares during the period	40
Exercisable Options were:	
(a) Under Stock Option Scheme (ESOS) during the period Weighted Average No. of Shares	2,00,000
(b) Under ESOS during the period exercise price for shares	30

Solution:

(a) **Ordinary EPS**

Ordinary EPS = $\dfrac{\text{Net Profit for the period}}{\text{No. of Equity Shares}} = \dfrac{₹\ 50,00,000}{10,00,000} = ₹\ 5.00$

(b) **Diluted EPS**

Diluted EPS = $\dfrac{\text{Net Profit for the period}}{\text{Total No. of Equity Shares}^*} = \dfrac{₹\ 50,00,000}{10,50,000} = ₹\ 4.76$

*Computation of total no. of equity shares after exercise of Option Scheme No of equity Shares

No. of existing equity shares		10,00,000
Shares under ESOS	2,00,000	
Less: No. of Shares which should have		
been issued at fair value$\left(2,00,000 \times \frac{30}{40}\right)$	1,50,000	50,000
		10,50,000

Illustration 61:

R Ltd. furnished the following particulars on 01.01.2011, from which you are asked to ascertain the basic EPS:

R Ltd. issued 2,00,000 equity shares of ₹ 10 each, fully paid ₹ 20,00,000. Issue of right share among existing shareholders: one for one of ₹ 25 each on 1.7.2012.

On 31.12.2011 the basic reported EPS was ₹ 2.50 and market price of the share prior to right issue was ₹ 40. Net Profit (After Tax) for 2011 ₹ 2,50,000 for 2012 ₹ 3,00,000.

Solution:

Theoretical Ex-Right Price

$$= \frac{\text{Fair value of all outstanding shares immediately prior to exercise of right} + \text{Total amount received from exercise of rights}}{\text{No. of shares outstanding prior to Exercise of right} + \text{No. of shares issued in the exercise}}$$

$$= \frac{(2,00,000 \times ₹\ 40) + (2,00,000 \times ₹\ 25)}{20,000 + 20,000}$$

$$= \frac{₹\ 80,000 + ₹\ 50,00,000}{40,000}$$

$$= ₹\ 32.50$$

Adjustment Factor

$$= \frac{\text{Fair value per share immediately prior to exercise of rights}}{\text{Theoretical Ex-right fair value per sahre}}$$

$$= \frac{₹\ 40.00}{₹\ 32.50} = 1.23$$

Computation of Earnings per Share

	31.3.2011	31.3.2012
Basic EPS (already given) EPS restated for 2011 for right issue EPS for the year 2012 including Right Issue	₹ 2.50	
$= \dfrac{₹\ 3,00,000}{(2,00,000 \times 1.23 \times \frac{6}{12}) + (2,00,000 \times \frac{6}{12})}$	$= \dfrac{2,50,000}{2,46,000}$	
$= \dfrac{₹\ 3,00,000}{1,23,000 + 1,00,000}$	= ₹1.02	= ₹1.35

Illustration 62:

A Co. Ltd. supplied the following information:

You are required to compute the basic earning per share – Accounting year 1.1.2012 – 31.12.2012.

(i) Net Profit year 2012 = ₹ 20,00,000; 2013 = ₹ 30,00,000

(ii) No. of shares outstanding prior to right issue = 10,00,000 shares

(iii) Right Issue

 (a) One new share for each four outstanding i.e., 2,50,000 shares

 (b) Right Issue Price ₹ 20

 (c) Last date of exercising right – 31.03.2013

(iv) Fair rate of one equity share prior to exercise of rights on 31.3.2013 – ₹ 25.

Solution:

Calculation of Theoretical Ex-Right Price

$$= \frac{\text{Fair value of all outstanding shares immediately prior to exercise of right} + \text{Total amount received from exercise of rights}}{\text{No. of shares outstanding prior to Exercise of right} + \text{No. of shares issued in the exercise}}$$

$$= \frac{(10,00,000 \times ₹\ 25) + (2,50,000 \times ₹20)}{10,00,000 + 2,50,000} = \frac{₹\ 3,00,00,000}{₹\ 12,50,000} = ₹\ 24$$

Adjustment Factor

$$= \frac{\text{Fair value per share immediately prior to exercise of rights}}{\text{Theoretical Ex-right fair value per sahre}} = \frac{₹\ 25}{₹\ 24} = 1.04$$

Computation of Earnings per Share

		2012 ₹	2013 ₹
EPS for 2012	$= \frac{\text{Net Profit attributable to eq. shareholders}}{\text{No. of equity shares}}$ $= ₹ \frac{20,00,000}{10,00,000}$	2.00	---
EPS restated for 2012 for right issue	$= ₹ \frac{20,00,000}{10,00,000 \times 1.04} = \frac{20,00,000}{10,04,000}$	1.92	---
EPS for 2013 including Right Issue	$= \frac{₹30,00,000}{(10,00,000 \times ₹\ 1.04 \text{x} \frac{3}{12}) + (12,50,000 \text{x} \frac{9}{12})}$ $= \frac{30,00,000}{2,60,000 + 9,37,500} = \frac{₹30,00,000}{11,97,500}$		2.51

Illustration 63:

In April 2012, a Ltd. Company issued 1,20,000 equity shares of ₹ 100 each. ₹ 50 per share was called-up and paid by all shareholders. The remaining ₹ 50 was called-up on 1.9.2012. All shareholders paid the sum in Sept. 2012 except one shareholder having 24,000 shares. The net profit for the year ended 31.3.2013 is ₹ 2,64,000, after dividend on preference shares and dividend distribution tax of ₹ 64,000.

Compute basic EPS for the year ended 31.3.2013 as per AS 20.

Solution:

Computation of Basic Earnings per Share

$$\text{Basic EPS} = \frac{\text{Net Profit (attributable to equity shareholders)}}{\text{Weighted Average No. of Equity Shares outstanding}} = \frac{₹2,64,000}{88,000 \text{ shares}} = ₹\ 3$$

* As per para 19 of AS 20, Earning per Share, partly paid equity shares are treated as a fraction of equity shares to the extent that they were entitled to participate in dividends relating to fully paid equity shares during the reporting period. It has been assumed that the partly paid shares are entitled to participate in the dividends to the extent of amount actually paid:

Particulars	₹
Weighted Average No. of Shares (1,20,000 x $\frac{1}{2}$ x $\frac{5}{12}$)	25,000
Original issue	
(1,20,000 – 24,000) i.e. 96,000 x $\frac{7}{12}$	56,000
24,000 x $\frac{1}{2}$ x $\frac{7}{12}$	7,000
∴ Weighted No. of Shares	88,000

Illustration 64:

(a) Explain the concept of Weighted Average Number of equity shares outstanding during a period. State how you would compute, based on AS 20, the weighted average number of equity shares in the following case:

Date	Particulars	Amount ₹
1st April 2011	Balance of equity shares	3,60,000
31st Aug. 2011	Equity shares issued for cash	1,20,000
1st Feb. 2012	Equity share bought back	60,000
31st March 2012	Balance of equity shares	4,20,000

(b) Compute adjusted earnings per share based on the following information: Accounting year: 1st April to 31st March

Particulars	Amount
Net Profit 2010-11	₹ 3,60,000
Net Profit 2011-12	₹12,00,000
No. of equity shares outstanding until Dec. 2011	4,00,000

Bonus issue on 1st Jan. 2012, 2 equity shares for each equity share outstanding at 31.12.2011. Your answer should be based on AS 20.

Solution:

(a) As per para 15 of AS 20, for the purpose of calculating basic earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period.

Weighted number of equity shares

Particulars	No. of Shares
$3,60,000 \times \frac{5}{12}$	1,50,000
(3,60,000 + 1,20,000) ₹ 4,80,000 x $\frac{5}{12}$	2,00,000
(4,80,000 – 60,000) ₹ 4,20,000 x $\frac{2}{12}$	70,000
	4,20,000

(b) Adjusted earnings per share

Fourth paid

$$2010\text{-}11 = \frac{₹3,60,000}{12,00,000} = ₹\ 0.30$$

$$2011\text{-}12 = \frac{₹12,00,000}{12,00,000} = ₹\ 1.00$$

AS 26: INTANGIBLE ASSETS

Illustration 65:

How is software acquired for internal use accounted for under AS 26?

Solution:

As per paras 10 and 11 of Appendix A to the AS 26, the cost of a software acquired for internal use should be recognised as an asset if it meets the recognition criteria prescribed in paragraphs 20 and 21 of the Statement.

The cost of a software purchased for internal use comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities) and any directly attributable expenditure on making the software ready for its use. Any trade discounts and rebates are deducted in arriving at the cost. In the determination of cost, matters stated in paragraphs 24 to 34 of the Statement need to be considered, as appropriate.

Recognition criteria as per paras 20 and 21:

"An intangible assets should be recognised if, and only if:

(a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) the cost of the assets can be measured reliably."

An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over its useful life of the asset.

Illustration 66:

State how you will deal with the following matters in the account for the year ended 31.3.2012: The company has spent ₹ 45 lakhs for publicity and research expenses on one of its new consumer product which was marketed in the accounting year 2011-12 but proved to be a failure.

Solution:

As per para 41 of AS 26, Intangible Assets:

No intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.

So, in this case, the whole expenses which were incurred for publicity and research and which was found to be unsuccessful should be recognised as an expense for the year 2011-12. The same should be adjusted against current year's statement of Profit and Loss.

Illustration 67:

What are the Costs that are to be included in Research and Development costs as per AS 8?

Solution:

Note: After the introduction of AS 26 w.e.f. 1.4.2003, AS 8 becomes inoperative. So, answer must be given as per AS 26.

As per paras 41 and 43 of AS 26, no intangible assets arising from research (or from the research phase of an internal project) should be recognised in the research phase. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.

Examples of research activities are:

(a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternative for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Moreover, as per paras 45 and 46 of 26:

In the development phase of a project, an enterprise can, in some instances, identify an intangible asset and demonstrate that future economic benefits from the asset are probable. This is because the development phase of a project is further advanced than the research phase.

Examples of development activities are:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

(b) the design of tools, jigs, moulds and dies involving new technology;

(c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and

(d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

Illustration 68:

Decide when research and development cost of a project can be deferred to future periods as per AS 26.

Solution:

As per paras 41 and 44 of AS 26, no intangible asset arising from research should be recognised. The expenditure incurred on account of research or development phase can be deferred to the subsequent years if an enterprise can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) its ability to measure the expenditure attributable to the intangible asset during its development reliably.

Illustration 69:

A pharma company spent ₹ 33 lakhs during the accounting year ended 31.3.2012 on research project to develop a drug to treat 'AIDS'. Experts are of the view that it may take four years to establish whether the drug will be effective or not, and, even if found effective, it may take two or three more years to produce the medicine, which can be marketed. The company wants to treat the expenditure as deferred revenue expenditure.Comment.

Solution:

As per para 44 of AS 26, an intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) its ability to measure the expenditure attributable to the intangible asset during its development reliably.

From the above it becomes clear in this case that it is not possible for the company to satisfy all the above conditions and, hence, the entire amount of the expenditure should be treated as expense when it is incurred. In short, no intangible asset arising from research (or from research phase of an internal project) should be recognised. So expenditure on research should be recognised as an expense when it is incurred (para 41).

Illustration 70:

Prava Ltd., in the past three years, spent ₹ 75,00,000 to develop a drug to treat cancer, which is charged to Profit and Loss A/c since they did not meet AS 8 criteria for capitalisation. In the current year, approval of the concerned Govt. Authority, has been received. The company wishes to capitalise ₹ 75,00,000 and disclose it as a prior period item. Is it correct? Give reasons for your answer.

Solution:

As per paras 58 and 59 of AS 26, expenditure on an intangible item that was initially recognised as an expense by a reporting enterprise in previous annual financial statements or interim financial reports should not be recognised as part of the cost of an intangible asset at a later date.

Similarly, subsequent expenditure on an intangible asset, after its purchase or its completion, should be recognised as an expense when it is incurred unless:

(a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and

(b) the expenditure can be measured and attributed to the asset reliably.

Thus, from the above, it becomes clear that AS 26 prohibits reinstating the expenditure as recognised expenses. So, the company cannot capitalise the amount of ₹ 75,00,000 as it has already been adjusted against Profit and Loss Account in the previous accounting periods.

Illustration 71:

SN Ltd. launched a project for producing product P in Oct. 2010. The company incurred ₹ 20 lakhs towards Research and Development expenses up to 31.3.2012. Due to prevailing market conditions, the management came to the conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The management, hence, wants to defer the expenditure write-off to future years.

Advise the company as per applicable Accounting Standard.

Solution:

As per para 41 of AS 26, expenditure on research should be recognised as an expense when it is incurred. Moreover, as per para 44 of the said Standard, an intangible asset arising from development should be recognised if, and only if, an enterprise can demonstrate all the conditions laid down in para 44. Similarly, as per para 87 of AS 26, an intangible asset should be derecognised on disposal or when no future economic benefits are expected from its use and subsequent disposal.

In the present case, it is needless to say that the expenses amounting to ₹ 20 lakhs, which was incurred for research and development, should be written-off in the current year i.e., year ending March 2012.

So, the management cannot defer the expenditure to be written-off in future years.

Illustration 72:

An intangible asset appears in Balance Sheet of C Ltd. at ₹ 16 lakhs as on 31.3.2004. The asset was acquired for ₹ 40 lakhs in April 1991. The company has been amortising the asset value on Straight Line Basis. The policy is to amortise it for 20 years.

Do you advise the company to amortize the entire asset value in the books of the company as on 31.3.2004?

Solution:

We know that AS 26 came into effect on or after 1.4.2003 and was mandatory in nature.

As per para 67 of AS 26, if there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than 10 years then, in the circumstances, no adjustment is needed as on 1.4.2003.

Para 63 states that the depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of the useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when that asset is available for use.

As such, in the present case, as the amortisation period has already been expired on 1.4.2003, as per para 63, ₹ 16 lakhs should be eliminated along with an adjustment to be made with the opening balance of revenue reserve as on that date.

Illustration 73:

A company had deferred research and development cost of ₹ 150 lakhs. Sales expected in the subsequent years are:

Year	Sale (₹ in lakhs)
I	400
II	300
III	200
IV	100

You are asked to suggest how research and development cost should be charged to P & L A/c.

If at the end of III year it is felt that no further benefit will accrue in the IV year, how the unamortized expenditure would be dealt with in the accounts of the company?

Solution:

(i) It has been assumed that the entire cost of ₹ 150 lakhs is development cost which should be allocated on the basis of sale as:

Year	Sale (₹ In lakhs)
I	$= \frac{400}{1,000} \times 150 =$ ₹ 60
II	$= \frac{300}{1,000} \times 150 =$ ₹ 45
III	$= \frac{200}{1,000} \times 150 =$ ₹ 30
IV	$= \frac{100}{1,000} \times 150 =$ ₹ 15

As per para 41 of AS 26, expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred. As such, the expenditure has been deferred to the subsequent years assuming that the company can demonstrate all the conditions as mentioned in para 44 of AS 26. Similarly, as per para 87 of AS 26, an intangible asset should be derecognised (eliminated from the Balance Sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal. Thus, the remaining unrealised amount of ₹ 45 lakhs should be written-off as an expense at the end of III year.

(ii) If at the end of III year, it is felt that no further benefit will accrue in IV year, in that case the entire unamortised amount of ₹ 45 lakhs (i.e., ₹ 150 - ₹ 60 - ₹ 45) should be treated as an expense.

Illustration 74:

What will be the treatment of the following in the final statement of accounts for the year ended 31.3.2012, of a limited company?

In 2010-11, the company has spent and carried forward in the books a total of ₹ 5,00,000 on developing a cure for cancer. During the current year, i.e., 2011-12, it is decided to terminate this product, as test results in the current year have proved adverse.

Solution:

As per para 87 of AS 26, an intangible asset should be derecognised on disposal or when no future economic benefits are expected from its use and subsequent disposal. As per para 88 of AS 26, gains or losses arising from the retirement or disposal of an intangible asset should be recognised as income or expense in the Statement of Profit and Loss.

In this case, however, the company decided ultimately to discontinue the product due to adverse test result. As such, the entire amount of ₹ 5 lakhs should be treated as an expense which should be adjusted against current year's P&L A/c.

Illustration 75:

R Ltd. acquired a patent at a cost of ₹ 80,00,000 for a period of 5 years and the product life-cycle is also 5 years. The company capitalised the cost and started amortising at ₹ 10,00,000 p.a. After two years it was found that the product life cycle may continue for another 5 years from then. The net cash flow from the product during these 5 years are expected to be ₹ 36,00,000; ₹ 46,00,000; ₹ 44,00,000; ₹ 40,00,000; and ₹ 34,00,000.

Find out the amortisation cost of the patent for each of the years.

Solution:

Total cost of the patent is ₹ 80,00,000.

Amortisations for 1st 2 years @ ₹ 10,00,000 x 2 = ₹ 20,00,000

Unamortised amount of ₹ 60,00,000 (i.e. ₹ 80,00,000 - ₹ 20,00,000) to be written-off for next 5 years as per net cash flows of the product (assuming that the company got it renewed after 5 years) which is calculated as:

Year	Net Cash Flow ₹	Amortisation Amount ₹
3rd year	36,00,000	$= \frac{60,00,000}{₹2,00,00,000}$ x ₹ 36,00,000 = 10,80,000
4th year	46,00,000	$= \frac{60,00,000}{₹2,00,00,000}$ x ₹ 46,00,000 = 13,80,000
5th year	44,00,000	$= \frac{60,00,000}{₹2,00,00,000}$ x ₹ 44,00,000 = 13,20,000
6th year	40,00,000	$= \frac{60,00,000}{₹2,00,00,000}$ x ₹ 40,00,000 = 12,00,000
7th year	34,00,000	$= \frac{60,00,000}{₹2,00,00,000}$ x ₹ 34,00,000 = 10,20,000
	2,00,00,000	60,00,000

AS 29 – PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Illustration 76:

Moon Ltd. Has entered into a Sale Contract of ₹ 6 crores with Y Ltd. During Financial Year 2012-2013. The Profit on this Transaction is ₹1.5 crore. The delivery of goods is to take place during the first month of financial year 2013-2014. IN case of failure of Moon Ltd. To deliver within the schedule, a compensation of ₹ 1 crores is to be paid to Y Ltd. Moon Ltd. Planned to manufactured the goods dueing the last month of the Financial Year 2012-2013. As on Balance Sheet date 31.03.2012, the goods were not manufactured and it was unlikely that Moon Ltd. Will be in a position to meet the Contractual Obligation.

(i) Should Moon Ltd. Provide for Contingency as per AS-29?

(ii) Should provisions be measured as the excess of compensation to be paid over the profit ?

Solution:

The company has not yet manufactured the product, and hence cannot recognize the sale transaction as at 31st March 2013. Sale and the resultant profit cannot be recognized unless and until the product is ready and delivered to the customer. (Assuming transfer in property in goods takes place at the time of delivery, and not before). It is unlikely that Moon Ltd. Will be in a position to meet the contractual obligation, and it is more likely to pay the compensation. Such payment is also quantifiable.

Moon Ltd. Should create a provision for the compensation payable, and not just disclose as a contingent liability, it is an obligation out of a past event. Provision should be measured at the total compensation and not at the excess over the profit, since profit can be booked only independently in the next year, upon actual occurrence of the sale transaction.

Illustration 77:

Sanjeev Ltd. Was under audit for the year ended 31st March. An appeal filed by Sanjeev Ltd. Against the demand of Excise Duty of ₹25 crores was pending before the Supreme Court for which neither provision was made nor was disclosed in the notes to the Financial Statement. On 15th July (i.e. subsequent to the Balance Sheet date), the Auditor came to know through paper reports that the point involved in the appeal of Sanjeev Ltd. Was adjudicated by the Supreme Court in the case of some other assessee, which is in favour of the Department of Excise Duty. The Auditor insisted that provision be made of ₹25 crores in the Financial Statements. The Management was of the view that since its own case is still pending, no provision is called for. It was also of the view that the event does not have any effect on the financial position of the Company on the Balance Sheet date. Is the Management's view correct?

Solution:

As per AS-29, a provision should be recognized if the following conditions are satisfied –

(i) Present obligation as a result of past event – Excise Duty demand is already made on the Company. Hence present obligation exists at the Balance Sheet date.

(ii) Outflow of resources to settle the obligation is probable – Additional evidence arising after Balance Sheet date lead to the conclusion that the outflow is probable i.e. more likely than not.

(iii) Reliable estimate of the amount - ₹ 25 crores is the amount of the liability

Since all the conditions for recognition of a provision are satisfied, the Provision should be recognized for the year ending 31st March. If the amount is material, separate disclosure is also required. The Management's contention is not tenable.

Illustration 78:

Ravan Ltd. Was involved in wage negotiation with trade unions of their organization as on 31st March 2013. Wage revision proposals could be finalized only after obtaining the final approval from the Head Office of the Company located at Chennai. The final approval was granted on 15th April 2013 w.e.f.

1st April 2011. The settlement covered period from 01.04.2011 to 31.03.2013. the liability upto 31st March 2013 was disclosed on account of the above settlement in the notes forming part of the Accounts. As an Auditor, you may advise whether such disclosure is proper.

Solution:

As per AS-29, a provision should be recognized if the following conditions are satisfied –

(i) Present obligation as a result of past event – Wage revision is for the period covered by Financial Statements, i.e. 2012-2013, and consists of the Company's present obligation.

(ii) Outflow of resources to settle the obligation is probable – Post Balance Sheet date events (i.e. sanction from H.O.) that the payment of revised wages is probable, i.e. more likely than not.

(iii) Reliable estimate of the amount – Though not quantified in the question, wage payable on the revised scale can be estimated reliable.

Since all the conditions for recognition of a provision are satisfied, the Provision should be recognized for the year ending 31st March 2013. Also, under AS-5, when items of Income and Expenses within Profit. Loss from ordinary activities are of such size, nature or incidence, that their disclosure is relevant to explain the performance of the Enterprise for the period, they should be disclosed separately. Since the company has only disclosed the fact and not created any provision, the treatment given by the company is not correct.

Illustration 79:

Paras Ltd. Is in the process of finalizing its Accounts for the year ended 31st March 2013. The company seeks your advice on the following :

(i) The Company's Sales Tax Assessment for the A.Y. 2010-2011 has been completed on 10th February 2013 with a demand of ₹ 2 crores. The company paid the entire due under protest without prejudice to its right of appeal. The company files its appeal before the Appellate Authority wherein the grounds of appeal cover Tax on additions made in the Assessment Order for a Sum of ₹ 1.75 crore.

(ii) The company has entered into a Wage Agreement in April 2013 whereby Labour Union has accepted a revision in wage from July 2012. The agreement provided that the hike till April 2013 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September 2013.

Solution:

Since the company is not appealing against the addition of ₹ 0.25 crores, the same should be provided for in its Accounts for the year ended on 31st March 2013. The amount paid under protest can be kept under the head "Loans and Advances" and disclosed along with the contingent liability of ₹ 1.75 crores.

The arrears for the period from July 2012 to March 2013 are required to be provided for in the Accounts of Company for the year ended on 31st March 2013.

Illustration 80:

Dhara Ltd. Has not included in the Balance Sheet as on 31.03.2012, a sum of ₹ 1.20 crores being amount in the arrears of salaries and wages payable to the staff for the last 2 years as a result of successful negotiation which were going on during the last 18 months and concluded on 30.04.2012. the Auditor wants to sign the said Balance Sheet and give the audit report on 31.05.2012. The auditor came to know the result of the negotiation on 15.05.2012.

Solution:

The obligation requires a provision for outstanding expenses under AS-29. The facts have become known to the Auditor before the date of issue of the Audit report and before the date the Financial

Statements are issued, under SA-560. The Auditor should request the Management to create provision for ₹1.20 crores. If not done, he should qualify his Audit Report.

Illustration 81:

Mala Ltd. Took a factory premises on lease on 01.04.2010 for ₹ 2,50,000 per month. The lease is operating lease. During March 2011, Mala Ltd. relocates its operation to a new factory building. The lease on the factory premises continues to be live upto 31.12.2013. The Lease cannot be cancelled and cannot be sub-let to another user. The auditor insists that lease rent of balance 33 months upto 31.12.2013 should be provided in the accounts for the year ending 31.03.2011. Mala Ltd. Seeks your advice.

Solution:

"Onerous Contract" is a contract in which the unavoidable costs of meeting the obligation under the contract exceeds the economic benefits expected to be received under it.

In the given case, the Operating Lease Contract has become onerous, as the economic benefit of lease contract for next 33 months up to 31.12.2013 will be nil. However, the Lessee, Mala Ltd. Has to pay lease rent of ₹ 82,50,000 (i.e. ₹ 2,50,000 p.m. for next 33 months). Therefore, provision on account of ₹ 82,50,000 is to be made in the accounts for the year ending 31.03.2011, in accordance with AS-29 requirements.

Illustration 82:

An asset does not meet the requirements of environment laws which have been recently enacted. The asset has to be destroyed as per the law. The asset is carried in the Balance Sheet at the year end at ₹ 5,00,000. The estimated cost of destroying the asset is ₹ 50,000. How is the asset to be accounted for ?

Solution:

Fixed assets should be eliminated from the Financial Statements on disposal, or when no further benefit is expected from its use or disposal. So, the fixed asset should be eliminated from the Financial Statements, as it is proposed to be destroyed as per law.

Cost of destroying the asset of ₹ 50,000 should be accounted for as and when incurred. A provision for the same should not be created since it is an obligation from a future event i.e. destruction of the asset.)

Illustration 83:

A public interest Litigation (PIL) has been filed before Supreme Court on the environmental influences of air, noise and water pollution caused by certain manufacturing industries. The matter has been heard by the court and proceedings show that the court will direct such industries to install suitable pollution control equipments. However, till the date the accounts have been approved by the Board of Directors of a company, no such order has come from the court. The company feels that no provisioning or disclosure is required as the Court order has not been served on the company. Is this justifiable?

Solution:

As per AS – 29 a provision should be recognized if the following conditions are satisfied:

Condition (1)	**Condition (2)**	**Condition (3)**
Present obligation as a result of past event.	**Outflow of resources** to settle the obligation is probable.	Reliable **estimate** of the amount
Environment pollution and filling of PIL thereon is the past event, on which there is a **present obligation.**	**Outflow of resources** settle the obligation,i.e. cost of installation of pollution control equipments, is **probable.**	Provision should be made for the **best estimate** of the cost of installing pollution control equipments.

Note: Obligation event is the pollution caused, because of the virtual certainty that the Supreme court will direct such industries to install suitable pollution control equipments.

Treatment and Conclusion: Since all the conditions for recognition of provision are satisfied, a provision should be recognized for the above financial year. The company's contention not to make any provision or disclosure, violates AS-29 requirements.

Illustration 84 :

S Ltd. had made an appeal before the Income Tax Appellate Tribunal on its Income Tax Assessment. The case was lost and accordingly a demand notice for ₹ 25 lakhs was received towards the Company's tax liability. The company has however, preferred an appeal in High Court before the end of the financial year, which is pending as on the Balance Sheet Date and also till the approval of Financial Statements by their Board of Directors. The Company has not provided for the liability and also feels that no disclosure is required comment.

Solution:

As per AS – 29 a provision should be recognized if the following conditions are satisfied:

Condition (1)	Condition (2)	Condition (3)
Present obligation as a result of past event.	**Outflow of resources** to settle the obligation is probable.	Reliable **estimate** of the amount
Liability for income tax existed on the balance sheet date, as per the Tribunal order. There is a **present obligation.**	There will be **Outflow of resources** settle the obligation, if the company does not win the case in High Court.	Tax Liability is ascertained at ₹ 25 laks, as per the Demand Notice.

Note: Merely because an appeal has been made before the Higher appellate authorities, the character of the obligation is not lost.

Treatment and Conclusion: Since all the conditions for recognition of provision are satisfied, a provision for tax Liability ₹ 25 should be recognized for the above financial year. The company's contention not to make any provision or disclosure, violates AS-29 requirements.

Section B
Accounts of Joint Stock Companies

Study Note - 3

ACCOUNTING FOR SHARES AND DEBENTURES

This Study Note includes

3.1 Share Capital
3.2 Follow on Public Offer & Right Issue
3.3 Buy-back of Shares
3.4 Issue & Redemption of Preference Shares
3.5 Debentures-Issue and Redemption
3.6 Employee Stock Option Plan (ESOP), Employees Stock Option Scheme (ESOS)
3.7 Underwriting of Shares and Debentures

Meaning of a Company - Introduction

A company is a voluntary and autonomous association of certain persons with capital divided into numerous transferable shares formed to carry out a particular purpose in common. It is an artificial person created by law to achieve the object for which it is formed. Section 2(20) of the Companies Act, 2013 defines a company as "Company formed and registered under this Act or an existing company." An existing company means a company formed and registered under any of the former Companies Acts. Thus it is an abstract person, invisible, intangible and existing only in contemplation of law. It can hold, purchase or sell both movable and immovable property, incur and pay debts, open a bank account in its own name and sue and be sued in the same manner as an individual. Law creates it and law only can dissolve it. Its existence is altogether independent of the life of its members. Members may come and go but the company would go on for ever. Transferability of shares has given perpetual succession to a company. Death, insanity or insolvency of a member or any member will not affect the existence of the company at all. A company is a legal entity quite distinct and separate from the persons who are its members. A company cannot ordinarily buy its own shares. A shareholder is not the agent of the company. He cannot incur any debt so as to bind the company. They cannot bind the company by their acts. The same person can be a shareholder and a creditor of the company. The ownership is divorced from management because a joint stock company is' managed by a Board of Directors elected by the shareholders (i.e. owners).

Characteristics of a Company

The main characteristics of a company are:

(i) It is a distinct legal person existing independent of its members

(ii) Liability of the members is limited to the extent of the face value of shares held by them.

(iii) It has a perpetual succession, i.e, the members of the company may keep on changing from time to time but this does not affect the company's continuity.

(iv) The shares of a company are freely transferable except in case of a Private limited Company.

(v) A company being a legal person is capable of owing, enjoying and disposing of the property in its own name.

(vi) A company, being a separate body can sue and be sued in its own name.

(vii) Though a company is an artificial person yet it acts through human beings who are called directors of the company. There is a divorce between ownership and the management.

(viii) It is a voluntary association of persons usually for profit.

Statutory Books

Statutory books are those which a limited company is under statutory obligation to maintain at its registered office. The main statutory books are:

(i) Register of Investments held and their names

(ii) Register of charges

(iii) Register of Members

(iv) Register of debenture holders

(v) Annual returns

(vi) Minutes books

(vii) Register of contracts

(viii) Register of Directors

(ix) Register of shareholdings of the directors

(x) Register of loans to companies under the same management

(xi) Register of Investment in the shares of other companies.

Books of Account

Every company is required to keep at its registered office books of account.

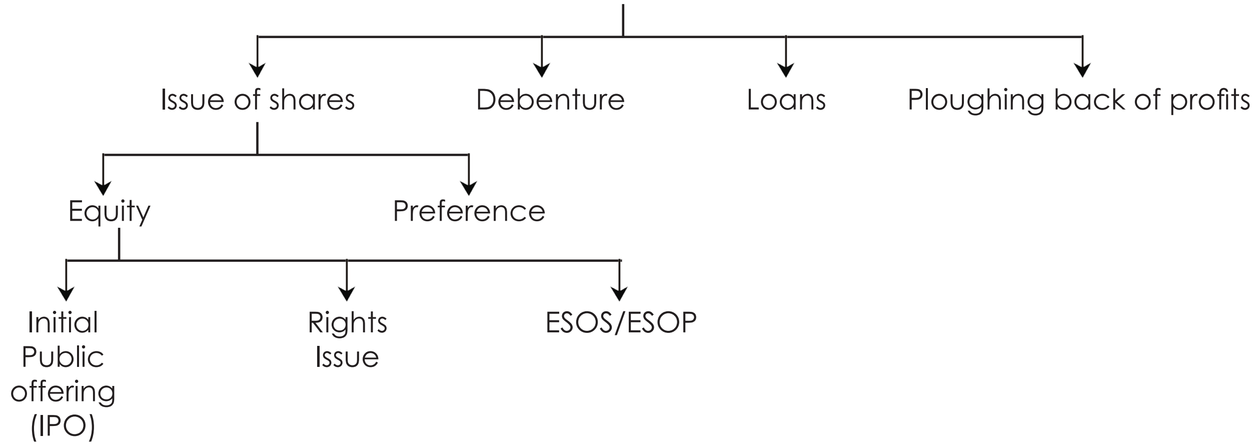
These books are to be maintained in such a way so as to disclose

(a) The sums of money received and expended by the company and the matter in respect of which the receipt and expenditure has taken place.

(b) All sales and purchases of goods of the company.

(c) All assets and liabilities of the company.

Long term Sources of Finance



3.1 SHARE CAPITAL

No trading concern can run without capital. The divisions of share capital are:

(i) Nominal or Authorized Capital. The amount of capital with which the company intends to be registered is called registered capital. It is the maximum amount which the company is authorized to raise by way of public subscription. There is no legal limit on the extent of the amount of authorized capital.

(ii) Issued Capital. That part of the authorized capital which is offered to the public for subscription is called issued capital.

(iii) Subscribed Capital. That part of the issued capital for which applications are received from the public is called the subscribed capital.

(iv) Called up Capital. The amount on the shares which is actually demanded by the company to be paid is known as called up capital.

(v) Paid up Capital. The part of the called up capital which is offered and is actually paid by the members is known as paid up capital. The sum which is still to be paid is known as calls in arrears.

Publication of Authorized, Subscribed and Paid-Up Capital [Section 60]

(1) Where any notice, advertisement or other official publication, or any business letter, billhead or letter paper of a company contains a statement of the amount of the authorised capital of the company, such notice, advertisement or other official publication, or such letter, billhead or letter paper shall also contain a statement, in an equally prominent position and in equally conspicuous characters, of the amount of the capital which has been subscribed and the amount paid-up.

(2) If any default is made in complying with the requirements of sub-section (1), the company shall be liable to pay a penalty of ten thousand rupees and every officer of the company who is in default shall be liable to pay a penalty of five thousand rupees, for each default.

Issue of Application Forms for Securities [Section 33]

(1) No form of application for the purchase of any of the securities of a company shall be issued unless such form is accompanied by an abridged prospectus.

Provided that nothing in this sub-section shall apply if it is shown that the form of application was issued—

(a) in connection with a bona fide invitation to a person to enter into an underwriting agreement with respect to such securities; or

(b) in relation to securities which were not offered to the public.

(2) A copy of the prospectus shall, on a request being made by any person before the closing of the subscription list and the offer, be furnished to him.

(3) If a company makes any default in complying with the provisions of this section, it shall be liable to a penalty of fifty thousand rupees for each default.

Refund of Application Money

(1) If the stated minimum amount has not been subscribed and the sum payable on application is not received within the period specified therein, then the application money shall be repaid within a period of fifteen days from the closure of the issue and if any such money is not so repaid within such period, the directors of the company who are officers in default shall jointly and severally be liable to repay that money with interest at the rate of fifteen percent per annum.

(2) The application money to be refunded shall be credited only to the bank account from which the subscription was remitted.

Allotment of Securities by Company [Section 39]

(1) No allotment of any securities of a company offered to the public for subscription shall be made unless the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on application for the amount so stated have been paid to and received by the company by cheque or other instrument.

(2) The amount payable on application on every security shall not be less than five per cent. of the nominal amount of the security or such other percentage or amount, as may be specified by the Securities and Exchange Board by making regulations in this behalf.

(3) If the stated minimum amount has not been subscribed and the sum payable on application is not received within a period of thirty days from the date of issue of the prospectus, or such other period as may be specified by the Securities and Exchange Board, the amount received under sub-section (1) shall be returned within such time and manner as may be prescribed.

(4) Whenever a company having a share capital makes any allotment of securities, it shall file with the Registrar a return of allotment in such manner as may be prescribed.

(5) In case of any default under sub-section (3) or sub-section (4), the company and its officer who is in default shall be liable to a penalty, for each default, of one thousand rupees for each day during which such default continues or one lakh rupees, whichever is less.

Calls on Shares

Out of the face value of the shares, 5% is payable with application, some money will be paid on allotment and rest money will be paid as and when calls are made by the company. Generally the prospectus gives the dates of different calls alongwith the amount of the calls by shareholders. In case it is not given in the prospectus, the directors have the discretion to call it in one call or more than one call. For this a resolution of the Board of Directors must be passed and a notice is sent to the shareholders with a request to pay the amount of the call. As soon as a call notice is sent, its particulars are entered in a separate book known as Share Call Book, a specimen of which is given on the next page.

Journal Entries for Issue of Shares

(1) On Receipt of Application Money

Bank A/c Dr.

To Share Application A/c

(2) For excess share application money refunded :

Share Application A/c Dr.

To Bank A/c

(3) For Share application money transferred to share capital

Share Application A/c Dr.

To Share Capital A/c

To Securities Premium A/c (if application money includes premium)

(4) For Share allotment Money due :

Share Allotment A/c Dr.

To Share Capital A/c

To Securities Premium (if issued at a premium)

(5) For Share allotment money received :

Bank A/c Dr.

Calls-in-Arrear A/c Dr. (if allotment money not received)

To Share Allotment A/c

To Calls-in-Advance A/c (if call money received in advance alongwith allotment)

(6) For Share Call money due :

Share Call A/c Dr.

To Share Capital A/c

(7) For Call money received :

Bank A/c Dr.

Call-in-Arrear A/c Dr. (if call money not received)

Calls-in-Advance A/c Dr. (adjustment of share call money received earlier)

To Share Call A/c

Note : For every subsequent calls, entry no. (6) & (7) share have to be recorded.

(8) For forfeiture of shares :

Share Capital A/c Dr. (No. of shares forfeited × Called up value per share)

Securities Premium A/c Dr. (if issued at a premium and premium not received)

To Calls-in-Arrear A/c (amount not received on forfeited shares)

To Shares Forfeited A/c (amount received on forfeited shares)

(9) For reissue of forfeited shares

Bank A/c Dr. (No. of Shares Reissued × Reissue Price/Share)

Shares Forfeited A/c Dr. (No. of shares × Further discount on reissue)

To Share Capital A/c (No. of shares Reissued × Paid up value per share)

To Securities Premium A/c (if reissued at a premium)

(10) For transferring profit on reissue of forfeited shares

Shares Forfeited A/c Dr.. (Profit on Forfeiture— Further discount on reissue of such forfeited share)

To Capital Reserve

Note :

If part of the forfeited shares are reissued, then profit shall have to be calculated proportionately as follows :

Profit on Reissue of Forfeited Shares :

$$\frac{\text{Total Profit on forfeiture of shares}}{\text{No. of shares forfeited}} \times \text{No. of Shares Reissued} \quad = \text{xxx}$$

(–) Further discount on reissue	= (x)
Transfer to Capital Reserve	= xxx

Illustration 1:

PK Ltd. made an issue of 10,00,000 equity shares of ₹ 10 each, payable ₹ 2 on application, ₹ 4 on allotment and ₹ 4 on call. All the shares are subscribed and amounts duly received. Pass journal entries to give effect to these.

Solution:

P K Ltd.

Journals

Particulars		Dr. ₹ '000	Cr. ₹ '000
Bank A/c	Dr.	2000	
To Equity Share Application A/c			2000
(Share application money on 10,00,000 equity shares @ ₹ 2 each received)			
Equity Share Application A/c	Dr.	2,000	
To Equity Share Capital A/c			2,000
(Share application money transferred to share capital account as per Board's resolution no. ……………. dated ………)			
Equity Share Allotment A/c	Dr.	4,000	
To Equity Share Capital A/c			4,000
(Share Allotment due on 10,00,000 shares @ ₹ 4 per share as per Board's resolution no. ……… dated……)			
Bank A/c	Dr.	4,000	
To Equity Share Allotment A/c			4,000
(Allotment money received)			
Equity Share First and Final Call A/c	Dr.	4,000	
To Equity Share Capital A/c			4,000
(Share 1st and Final Call due on 10,00,000 shares @ ₹ 4 share as per Board's resolution no. ……… dated……)			
Bank A/c	Dr.	4,000	
To Equity Share First and Final Call A/c			4,000
(For shares First and Final Call money received on 10,00,000 shares @ ₹ 4 per share)			

When Both Preference and Equity Shares are Issued

When a company issues both preference and equity shares then it is desirable that the entries for application money, allotment money and calls money should be separately passed for each type of share capital. The word Equity or Preference must invariably be used in all the circumstances.

Issue of Shares for Purchase of Assets

If the shares have been allotted to any person or firm from whom the company has purchased any asset, the following entry will be passed:

Asset Account Dr.

To Share Capital Account

(Being ... shares allotted……in consideration of purchase of an asset for the company)

This fact should also be disclosed in the Balance Sheet while showing the issued, subscribed and paid up capital.

Issue of Shares at Premium

A company may issue shares at a premium, i.e., at a value greater than its face value. The power to issue shares at a premium need not be given in the Articles of Association. Premium so received shall be credited to a separate account called Securities Premium Account.

Section 52 of the Companies Act, 2013 gives the purposes for which share premium account may be applied by the company. These are:

(i) For the issue of fully paid bonus shares to the members of the company;

(ii) For writing off preliminary expenses of the company;

(iii) For writing off the expenses of the commission paid or discount allowed on any issue of shares or debentures of the company; and

(iv) For providing premium payable on the redemption of any redeemable preference shares or debentures of the company.

Illustration 2:

AB & Co. Ltd. issued 5,00,00,000 Equity shares of ₹ 10 each at a premium of ₹ 4 per share payable ₹ 1 per share on application, ₹ 6 per share on allotment (including premium), ₹ 3 on first call and the balance on final call. The shares were all subscribed and all money due was received except the first call money on 1,00,000 shares and the Final call money on 1,50,000 shares.

Give the Cash Book and Journal entries to record the above transactions.

Solution:

Dr. **CASH BOOK** **Cr.**

	₹ in Lakh		₹ in Lakh
To Equity Share Application	500	By Balance c/d	6,991
To Equity Share Allotment	3,000		
To Equity Share 1st Call	1,497		
To Equity Share Final Call	1,994		
	6,991		6,991

Journals

		₹ in Lakh	₹ in Lakh
Equity Share Application A/c	Dr.	500	
To Equity Share Capital A/c			500
Equity Share Allotment A/c	Dr.	3,000	
To Equity Share Capital A/c			1,000
To Securities Premium A/c			2,000
Equity Share First Call A/c	Dr.	1500	
To Equity Share Capital A/c			1500
Calls in Arrear A/c	Dr.	3	
To Equity Share First Call A/c			3
Equity Share Final Call A/c	Dr.	2,000	
To Equity Share Capital A/c			2,000
Calls in Arrear A/c	Dr.	6	
To Equity Share Final Call A/c			6

Prohibition on Issue of Shares at Discount [Section 53]

(1) Except as provided in section 54, a company shall not issue shares at a discount.

(2) Any share issued by a company at a discounted price shall be void.

(3) Where a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

NO SHARES CAN BE ISSUED AT A DISCOUNT

Adjustment of Excess Money towards the Amount due on the Allotment and Calls

Sometimes a Company may not allot all the shares for which applications have been received. Because of over subscription, allotment is either made of less number of shares or on pro-rata basis. For example, if the company offered 100,00,000 shares of ₹ 10 each but applications for 2,00,00,000 shares were received by company. The directors sent letters of regret to applicants of 50,00,000 shares and applicants of 150,00,000 shares were allotted the 100,00,000 shares on pro-rata basis. In such a case, application money of 50,00,000 shares will be adjusted either on allotment and on calls, if there is still surplus money after adjusting the allotment and call money due from shareholders it will be refunded in cash.

Forfeiture of Shares

When a shareholder fails to pay calls, the company, if empowered by its articles, may forfeit the shares. If a shareholder has not paid any call on the day fixed for payment thereof and fails to pay it even after his attention is drawn to it by the secretary by registered notice, the Board of Directors pass a resolution to the effect that such shares be forfeited. Shares once forfeited become the property of the company and may be sold on such terms as directors think fit. Upon forfeiture, the original shareholder ceases to be a member and his name must be removed from the register of members.

Surrender of Shares

After the allotment of shares, sometimes a shareholder is not able to pay the further calls and returns his shares to the company for cancellation. Such voluntary return of shares to the company by the shareholder himself is called surrender of shares. Surrender of shares has no separate accounting treatment but it will be like that of forfeiture of shares. The same entries (as are passed in case of forfeiture of shares) will be passed in case of surrender of shares.

Reissue of Forfeited Shares

Forfeited shares may be reissued by the company directors for any amount but if such shares are issued at a discount then the amount of discount should not exceed the actual amount received on forfeited shares. The purchaser of forfeited reissued shares is liable for payment of all future calls duly made by the Company.

When all Forfeited Shares are not Issued

When all forfeited shares are not issued, i.e., only a part of such shares is issued, it is desirable to spread the amount of shares forfeited account on all such forfeited shares and of the amount relating to that part of forfeited shares which has been reissued, discount on reissue of shares should be deducted from such amount and the balance is transferred to capital reserve being capital profit. The amount relating to that part of shares forfeited account which has not been reissued should be shown on the liabilities side of Balance Sheet as Shares Forfeited Account.

Illustration 3:

A Company invited the public to subscribe for 10,000,000 Equity Shares of ₹ 100 each at a premium of ₹ 10 per share payable on allotment. Payments were to be made as follows: On application ₹ 20; on allotment ₹ 40; on first call ₹ 30 and on final call ₹ 20.

Applications were received for 13,000,000 shares; applications for 2,000,000 shares were rejected and allotment was made proportionately to the remaining applicants. Both the calls were made and all the moneys were received except the final call on 300,000 shares which are forfeited after due notice. Later 200,000 of the forfeited shares were re-issued as fully paid at ₹ 85 per share. Pass Journal entries.

Solution:

Journals

Particulars		₹ '000	₹ '000
Bank A/c	Dr.	2,60,000	
To Equity Share Application Account			2,60,000
(Share application money received on 13,000,000 equity shares @ ₹ 20 each)			
Equity Share Application A/c	Dr.	40,000	
To Bank Account			40,000
(Application for 2,000,000 rejected)			
Equity Share Application A/c	Dr.	2,20,000	
To Equity Share Capital A/c			2,00,000
To Equity Share Allotment A/c			20,000
(Share application money transferred to share capital account and excess money used for share allotment.)			
Equity Share Allotment A/c	Dr.	4,00,000	
To Equity Share Capital A/c			3,00,000
To Security Premium A/c			1,00,000
(Share Allotment due on 10,000,000 shares @ ₹ 40 per share as per the resolution of the Board of Directors)			
Bank A/c	Dr.	3,80,000	
To Equity Share Allotment A/c			3,80,000
(Allotment money received)			
Equity Share first call A/c	Dr.	3,00,000	
To Equity Share Capital A/c			3,00,000
(First call money due)			
Bank A/c	Dr.	3,00,000	
To Equity Share First call A/c			3,00,000
(First call money received)			
Equity Share Final Call A/c	Dr.	2,00,000	
To Equity Share Capital A/c			2,00,000
(Share Final Call due)			

Particulars		₹ '000	₹ '000
Bank A/c	Dr.	1,94,000	
To Equity Share Final Call A/c			1,94,000
(Final Call money received except 300,000 Shares)			
Equity Share Capital A/c	Dr.	30,000	
To Equity Sh. Final Call A/c			6,000
To Forfeited share A/c			24,000
(300,000 shares forfeited for non payment of final call money)			
Bank A/c	Dr.	17,000	
Forfeited Shares A/c	Dr.	3,000	
To Equity Share Capital A/c			20,000
(200,000 shares reissued @ ₹ 85)			
Forfeited Shares A/c	Dr.	13,000	
To Capital Reserve A/c			13,000
(Being the Profit on Re-issue of 2,00,000 shares)			

Working:

1 . On 3,00,000 forfeited shares, the total amount forfeited is ₹ 24,000.

	₹ '000
For 2,00,000 such shares the amount will be	
(2,00,000/3,00,000) x 24,000 =	16,000
Less: Discount on Reissue	3,000
Transferred to Capital Reserve	13,000

Balance of Forfeited share account will be shown in balance sheet as 'Forfeited Share Account" in liability side.

Illustration 4:

Give journal entries for the following:

a) PK Ltd. forfeited 10,000 equity shares of ₹ 10 each for non payment of first call of ₹ 2 and final call of ₹ 3 per share. These shares were reissued at a discount of ₹ 3.50 per share.

b) KP Ltd. forfeited 20,000 equity shares of ₹ 15 each (including ₹ 5 per share as premium), for non payment of final call of ₹ 3 per share. Out of these 10,000 shares were reissued at a discount of ₹ 4 per share.

c) KP Ltd. forfeited 15,000 equity shares of ₹ 15 each (including ₹ 5 per share as premium), for non payment of allotment money ₹ 8 (including premium money) and first & final call of ₹ 5 per share. Out of these 10,000 shares were reissued at ₹ 14 per share.

d) PK Ltd. forfeited 10,000 equity shares of ₹ 10 each issued at a discount of Re 1 per share, for non payment of first call of ₹ 2 and final call of ₹ 3 per share. Out of these 6,000 shares were reissued at ₹ 8 per share and the balance shares were re-issued at ₹ 7 per share.

Solution:

Journal Entries

	Particulars		Dr. ₹	Cr. ₹
a)	Equity Share Capital Account	Dr.	100,000	
	To Equity Sh. First Call Account			20,000
	To Equity Sh. Final Call Account			30,000
	To Forfeited share Account			50,000
	(10,000 shares forfeited for non payment of first and final call money)			
	Bank Account	Dr.	65,000	
	Forfeited Share Account	Dr.	35,000	
	To Equity Share Capital Account			100,000
	(Reissue of 10,000 sh. @ ₹ 6.50 each)			
	Forfeited Share Account	Dr.	15,000	
	To Capital Reserve Account			15,000
	(Balance of Forfeited share Account transferred)			
b)	Equity Share Capital Account	Dr.	200,000	
	To Equity Sh. Final Call Account			60,000
	To Forfeited share Account			140,000
	(20,000 shares forfeited for non payment of final call money)			
	Bank Account	Dr.	60,000	
	Forfeited Share Account	Dr.	40,000	
	To Equity Share Capital Account			100,000
	(Reissue of 10,000 sh. @ ₹ 6 each)			
	Forfeited Share Account	Dr.	30,000	
	To Capital Reserve Account			30,000
	(Balance of Forfeited share A/c relating to 10,000 shares transferred)			
c)	Equity Share Capital Account	Dr.	150,000	
	Securities Premium Account	Dr.	75,000	
	To Equity Sh. Allotment Account			120,000
	To Equity Sh. First & Final Call Account			75,000
	To Forfeited share Account			30,000
	(15,000 shares forfeited for non payment of allotment and first and final call money)			
	Bank Account	Dr.	140,000	
	To Security Premium Account			40,000
	To Equity Share Capital Account			100,000
	(Reissue of 10,000 sh. @ ₹ 15 each)			
	Forfeited Share Account	Dr.	20,000	
	To Capital Reserve Account			20,000
	(Balance of Forfeited share A/c on 10,000 shares transferred)			
d)	Equity Share Capital Account	Dr.	100,000	
	To Discount on issue of shares Account			10,000
	To Equity Sh. First Call Account			20,000
	To Equity Sh. Final Call Account			30,000
	To Forfeited share Account			40,000
	(10,000 shares forfeited for non payment of first and final call money)			

Particulars			Dr. ₹	Cr. ₹
	Bank Account	Dr.	48,000	
	Discount on issue of shares Account	Dr.	6,000	
	Forfeited Share Account	Dr.	6,000	
	To Equity Share Capital Account			60,000
	(Reissue of 6,000 sh. @ ₹ 8 each)			
	Forfeited Share Account	Dr.	18,000	
	To Capital Reserve Account			18,000
	(Balance of Forfeited share A/c on 6,000 shares transferred)			
	Bank Account	Dr.	28,000	
	Discount on issue of shares Account	Dr.	4,000	
	Forfeited Share Account	Dr.	8,000	
	To Equity Share Capital Account			40,000
	(Reissue of 4,000 sh. @ ₹ 7 each)			
	Forfeited Share Account	Dr.	8,000	
	To Capital Reserve Account			8,000
	(Balance of Forfeited share A/c on 4,000 shares transferred)			

Illustration 5:

X Ltd. issued 10,000 Equity shares of ₹ 10 each at a premium of ₹ 2 per share, payable : ₹ 3 on application (including premium of ₹ 1); ₹ 4 on allotment (including the balance of premium) and the balance in a call. Public subscribed for 12,000 shares. Excess application money was refunded. One shareholder Mr. A holding 50 shares paid the call money alongwith allotment. Another Mr. B failed to pay allotment & call on 30 shares.

These shares were forfeited after the call and 25 of those were reissued at ₹ 9 each.

Pass Journals Entries.

X Ltd.

Journal Entries (without narration)

Particulars			Dr. ₹	Cr. ₹
(1)	Application Money Received:			
	Bank A/c	Dr.	36,000	
	To Equity Shares Application A/c (12000×3)			36,000
(2)	Refund of excess application money:			
	Equity Share Application A/c	Dr.	6,000	
	(2000×3) To Bank A/c			6,000
(3)	Transfer of share application to Share Capital:			
	Equity Shares Application A/c (10,000×3)	Dr.	30,000	
	To Equity Shares Capital A/c (10000×2)			20,000
	To Securities Premium A/c (10,000×1)			10,000
(4)	Allotment Money Due:			
	Equity Shares allotment A/c (10000×4)	Dr.	40,000	
	To Equity Share Capital A/c (10000×3)			30,000
	To Securities Premium A/c (10000×1)			10,000
(5)	Allotment Money Received:			
	Bank A/c [9,970×4 + 50×5]	Dr.	40,130	
	Calls-in-Arear A/c (30×4)	Dr.	120	
	To Equity Share Allotment A/c			40,000
	To Calls-in-Advance A/c (50×5)			250

	Particulars		Dr. ₹	Cr. ₹
(6)	Share Call Money Due:			
	Equity Share First & Final call A/c (10,000×5)	Dr.	50,000	
	To Equity Share Capital A/c			50,000
(7)	Call Money Received, Adjustment of Calls-in-Advance:			
	Bank A/c (9,920×5)	Dr.	49,600	
	Calls-in-Arrear A/c (30×5)	Dr.	150	
	Calls-in-Advance A/c	Dr.	250	
	To Equity Shares First & Final Call A/c			
	(Received with Allotment, now adjusted)			50,000
(8)	Forfeiture of Shares:			
	Equity Share Capital A/c (30×10)	Dr.	300	
	Securities Premium A/c (30×1)	Dr.	30	
	To Calls-in-Arrear A/c			270
	To Shares forfertime A/c			60
(9)	Reissue of Forfeited Shares:			
	Bank A/c (25×9)	Dr.	225	
	To Equity Shares Capital A/c (25×10)	Dr.	25	
	(Shares forfertime A/c (25×1)			250
(10)	Transfer of Profit on Reissue of Forefeited shares			
	Shares forfertime A/c	Dr.	25	
	To Capital Reserve A/c			25

Note : Proportionate Profit on reissue :

Profit on forfeiture ₹ 60

Therefore, Proportionate profit on 25 shares (those are reissued)

= 60/30 ×25 = 50

Less : Discount on Reissue (25×1) = 25

Transfer to Capital Reserve = 25

Ilustration 6:

B Ltd. issued 5,000 Equity shares of ₹ 100 each at par, payable as follows :

on Application : ₹ 25; on Allotment: ₹ 40; on Call: the balance.

Public subscribed for 4,800 shares and allotment was made in full. One shareholder holding 25 shares failed to pay the allotment and calls. These were forfeited and 20 of those shares were reissued at ₹ 88 each.

Pass journal entries.

Solution :

B Ltd.

Journal Entries

	Particulars		Dr. ₹	Cr. ₹
(1)	Bank A/c	Dr.	1,20,000	
	To Equity Share Application A/c			1,20,000
	(Being equity share application money received on 4,800 shares @ ₹ 25 per share)			

	Particulars		Dr. ₹	Cr. ₹
(2)	Equity shares Application A/c	Dr.	1,20,000	
	To Equity Share Capital A/c			1,20,000
	(Being share application money transferred to share capital as per Board's resolution no... dated.......)			
(3)	Equity Share Allotment A/c (4800×40)	Dr.	1,92,000	
	To Equity Share Capital A/c			1,92,000
	(Being allotment money due on 4800 shares @ ₹ 40 per share, as per Board's resolution no.......dated........)			
(4)	Bank A/c (4775×40)	Dr.	1,91,000	
	Calls-in-Arrear A/c (25×40)	Dr.	1,000	
	To Equity Share Allotment A/c			1,92,000
	(Being shares allotment money received except on 25 Shares)			
(5)	Equity Share First & Final Call A/c	Dr.	1,68,000	
	To Equity Share Capital A/c			1,68,000
	(Being share call money due on 4,800 shares) @ ₹ 35 per share as per Board's resolution no....... dated.......)			
(6)	Bank A/c (4775×35)	Dr.	1,67,125	
	Calls-in-Arrear A/c (25×25)	Dr.	875	
	To Equity Share First & Final Call A/c			1,68,000
	(Being share call money received except on 25 shares)			
(7)	Equity Shares Capital A/c (25×100)	Dr.	2,500	
	To Calls-in-Arrear A/c (1000+875)			1,875
	To Shares Forfeited A/c (25×25)			625
	(Being 25 shares forfeited as per Board's resolution no..... dated.......)			
(8)	Bank A/c (20×88)	Dr.	1760	
	Shares Forfeited A/c (20×12)	Dr.	240	
	To Equity Share Capital A/c (20×100)			2,000
	(Being 20 forfeited Shares reissued at ₹ 88 each, as per Board's resolution no........ dated.......)			
(9)	Shares Forfeited A/c	Dr.		
	To Capital Reserve A/c		460	
	(Being profit on reissue of forfeited share transferred to Capital Reserve)			460

Note : Profit on Reissue of Forfeited Shares :

Amount received on Forfeiture ₹ 625

Therefore, Proportionate amount of forfeiture on 20 shares :

= {(625 / 25) x 20}	= 500
Less : Further discount on reissue (20×2)	= 240
	= 260

Illustration 7:

B Ltd issued 2,000 shares of ₹ 100 each at a premium of 10% payable as follows:

On application ₹ 20 (1st April 2014). On allotment ₹ 40 (including premium) (1st June 2014). On First Call ₹ 30 (1st July 2014). On Second & Final call ₹ 20 (1st Aug 2014).

Applications were received for 1,800 shares and the directors made allotment in full. One shareholder to whom 40 shares were allotted paid the entire balance on his share holdings with allotment money and another share holder did not pay allotment and 1st call money on his 60 shares but which he paid with final call. Interest should be received @5% p.a. on calls-in-arrears and interest should be paid @ 6% p.a. on calls in Advance (as per Articles of the company).

Required: Calculated the amount of interest paid and received on calls -in- advance and calls in arrears respectively on 1st Aug. 2014.

Solution:

Calculation of Interest on Calls-in-advance	
On ₹ 1200 (i.e. 40 x ₹ 30) for 2 months @ 6% p.a.	₹ 12
On ₹ 800 (i.e. 40 x ₹ 20) for 4 months @ 6% p.a.	₹ 16
	₹ 28
Calculation of Interest on Calls-in-arrears	
On ₹ 2400 (i.e. 60 x ₹ 40) for 4 months @ 5% p.a.	₹ 40
On ₹ 1800 (i.e. 60 x ₹ 30) for 2 months @ 5% p.a.	₹ 15
	₹ 55

Illustration 8:

A limited Company was registered with a capital of ₹ 5,00,000 in share of ₹ 100 each and issued 2,000 such shares at a premium of ₹ 20 per share, payable as ₹ 20 per share on application, ₹ 50 per share on allotment (including premium) and ₹ 20 per share on first call made three months later. All the money payable on application, and allotment were duly received but when the first call was made, one shareholder paid the entire balance on his holding of 30 shares, and another shareholder holding 100 shares failed to pay the first call money.

Required: Give Journal entries to record the above transactions.

Solution:

Journal

Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
Bank A/c	Dr.		40,000	
To Share Application A/c				40,000
[Being the issue of 2,000 shares and application money received @ ₹ 20 per share]				
Share Application A/c	Dr.		40,000	
To Share Capital A/c				40,000
[Being the transfer of application money on 2,000 shares @ ₹ 20 per share to Share Capital A/c)				

Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
Share Allotment A/c	Dr.		1,00,000	
To Share Capital A/c				60,000
To Securities Premium A/c				40,000
(Being the allotment mony on 2,000 shares @ ₹ 50 including premium made due)				
Bank A/c	Dr.		1,00,000	
To Share Allotment A/c				1,00,000
(Being the allotment money on 2,000 shares)				
@ ₹ 50 per share received)				
Share First Call A/c	Dr.		40,000	
To Share Capital A/c				40,000
(Being the first call mony on 2,000 shares @ ₹ 20 per share made due)				
Bank A/c	Dr.		38,900	
To Share First Call A/c				38,000
To Call-paid-in-advance A/c				900
(Being the first call money on 1,900 shares @ ₹ 20 per share and share Second call money on 30 shares @ ₹ 30 per share received)				

Illustration 9:

B Ltd purchase the assets of ₹ 10,80,000 from C Ltd. The cosideration was payable in fully paid equity shares of ₹ 100 each.

Required: Show the necessary journal entries in books of B Ltd. assuming that —

a) Such shares are issued at par

b) Such shares are issued at premium of 20%

Solution:

Journal

Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
Entry in all cases				
Sundry Assets A/c	Dr.		10,80,000	
To C Ltd.				10,80,000
[Being the purchase of assets from Y Ltd. as per agreement dated...)				
Case (a) When Shares are issued at par				
C Ltd.	Dr.		10,80,000	
To Equity Share Capital A/c				10,80,000
(Being the issue of 10,800 shares at par to C Ltd. as per agreement dated...)				

Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
Case (b) When Shares are issued at a premlum of 20%			
C Ltd. Dr.		10,80,000	
To Equity Share Capital A/c			9,00,000
To Securities Premium A/c			1,80,000
(Being the issue of 9,000 shares at 20% premium to C Ltd. as per Board's Resolution no.......... dated..........)			

Working Note: Calculation of No. of Shares to be issed in different cases

	At Par	At a Premium
A. Amount to be paid (₹)	10,80,000	10,80,000
B. Issue Price Per Share (₹)	100	120
C. No. of Shares tobe issued (A/B)	10,800	9,000

Illustration 10:

D Ltd. issued 2,000 shares of ₹ 100 each credited as fully paid to the promoters for their services and issued 1,000 shares of ₹ 100 each credited as fully paid to the underwriters for their underwriting services. Journalise these transactions.

Solution:

Journal

Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
Goodwil A/c Dr.		2,00,000	
To Share Capital A/c			2,00,000
(Being the issue of 2,000 shares of ₹ 100 each at par to promoters as per Board's Resolution no.......... dated..........)			
Underwriting Commission A/c Dr.		1,00,000	
To Underwriter's A/c			1,00,000
(Being the Underwriting commission due on shares)			
Underwriter's A/c Dr.		1,00,000	
To Share Capital A/c			1,00,000
(Being the the issue of 1,000 shares of ₹ 100 each at par to Underwriters as per the Board's Resolution no.......... dated..........)			

Illustration 11:

On 1st May 2014 Superman Ltd. issued 5,000 Equity Shares of ₹ 100 each payable as follows:

	₹		₹	
On application	20	On 1st Call	20	(Last date fixed for payment 31st July)
On allotment	30	On Final Call	30	(Last date fixed for payment 30th August)

Applications were received on 15th May 2014 for 6,000 shares and allotment was made on 1st June 2014. Applicants for 2,500 shares were allotted in full, those for 3,000 shares were allotted 2,500 shares and applications for 500 shares were rejected.

Balance of amount due on allotment was received on 15th June.

The calls were duly made on 1st July, 2014 and 1st August 2014 respectively. One shareholder did not pay the 1st Call money on 150 shares which he paid with the final call together with interest at 5% p.a. Another shareholder holding 100 shares did not pay the final call money till end of the accounting year which ends on 31st October.

Required: Show the Cash Book and Journal Entries.

Solution:

Journal Proper

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
1.6.14	Equity Share Application A/c	Dr.		1,10,000	
	To Equity Share Capital A/c				1,00,000
	To Share Allotment A/c				10,000
	(Being the transfer of application money @ ₹ 20 per share on 5,000 shares transferred to Share Capital A/c and @ ₹ 20 on 500 t/f to Share Allotment A/c)				
1.6.14	Equity Share Allotment A/c	Dr.		1,50,000	
	To Equity Share Capital A/c				1,50,000
	(Being allotment money due on 5000 shares @ ₹ 30 per share				
1.7.14	Equity Share First Call A/c	Dr.		1,00,000	
	To Equity Share Capital A/c				1,00,000
	(Being 1st call money due on 5000 shares @ ₹ 20 per share				
1.8.14	Calls-in-Arrear A/c	Dr.		3,000	
	To Equity Share first call A/c				3,000
	(Being the non receipt of 1st call money on 150 equity shares @ ₹ 20 each transfered to calls-in-Arrear A/c)				
1.8.14	Equity Share Final Call A/c	Dr.		1,50,000	
	To Equity Share Capital A/c				1,50,000
	(Being final call money due on 5000 shares @ ₹ 30 per share				

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
30.8.14	Shareholders A/c Dr.		25	
	To Interest on calls-in-arrear			25
	(Being the interest due on first call on ₹ 300 @ 5% for two months, assumed payment made on 30.8.12			
1.9.14	Calls-in-Arrear A/c Dr.		3,000	
	To Equity Share Final Call A/c			3,000
	(Being the transfer to calls-in-Arrear A/c final call money on 100 equity shares @ ₹ 30 per shares)			
31.10.14	Shareholders A/c Dr.		25	
	To Interest on Calls-in-Arrears A/c			25
	(Being the interest due on ₹ 3,000 @ 5% for two months)			

Dr. **Cash Book (Bank Column)** Cr.

Date	Particulars	₹	Date	Particulars	₹
15.5.14	To Equity Share Application A/c (Application money @ ₹ 20 per share on 6,000 shares)	1,20,000	1.6.14	By Equity Share Application A/c (Refund of application money @ ₹ 20 per share on 500 shares rejected)	10,000
15.6.14	To Equity Share Allotment A/c (Balance of allotment money)	1,40,000	31.10.14	By Balancec/d	4,97,025
31.07.14	To Equity Share 1st Call A/c (1st Call money on 4,850 shares)	97,000			
30.08.14	To Equity Share Final A/c (Final call money on 4,900 Shares)	1,47,000			
30.08.14	To Calls-in-Arrear (Arrear of 1st Call money @ ₹ 20 per Share on 1,50 Shares)	3,000			
1.9.14	Shareholders A/c (Interest on ₹ 3,000 for two months @ 5% p.a.)	25			
		5,07,025			5,07,025

Statement of shares applied, alloted and amounts adjusted

Catetories	A	B	C
(a) Applied (No.of shares)	2,500	3,000	500
(b) Alloted (No.of shares)	2,500	2,500	Nil
(c) Application money received [(a) x ₹ 20 per share]	50,000	60,000	10,000
(d) Application money required [(b) x ₹ 20 per share]	50,000	50,000 (Refunded)	
(e) Excess Application money to be adjusted with allotment [(c)- (d)]	Nil	10,000	—
(f) Allotment money due [(b) x ₹ 30 per share]	75,000	75,000	—
(g) Amount received on allotment [(f) -(e)]	75,000	65,000	—

Illustration 12: Priyanka Industries Ltd. has an authorised capital ₹ 2,00,000 divided into shares of ₹ 100 each. Of these, 600 shares were issued as fully paid for payment of machinery purchased from Z Ltd. 800 shares were subscribed for by the public and during the first year ₹ 50 per share was called up payable ₹ 20 on application, ₹ 10 on allotment, ₹ 10 on the first call and ₹ 10 on second call. The amounts received in respect of these shares were as follows:-

On 600 Shares	Full amount called up
On 125 Shares	₹ 40 Per Share " "
On 50 Shares	₹ 30 Per Share " "
On 25 Shares	₹ 20 Per Share " "

The directors forfeited the 75 shares, on which less than ₹ 40 per share had been paid.

Required: Give Journal Entries recording the above transactions (including cash transactions) and show how Share Capital would appear in the Balance-Sheet of the Company, in accordance with Part 1 of Schedule III to the Companies Act.

Solution:

Journals

Particulars		L.F.	Dr. (₹)	Cr. (₹)
Machinery A/c	Dr.		60,000	
To Z Ltd.				60,000
(Being the purchase of machinery from Z Ltd. as per agreement dated...)				
Z Ltd.	Dr.		60,000	
To Share Capital A/c				60,000
(Being the issue of 600 shares at par)				
Bank A/c	Dr.		16,000	
To Share Application A/c				16,000
(Being the application money received)				
Share Application A/c	Dr.		16,000	
To Share Capital A/c				16,000
(Being the application money adjusted)				
Share Allotment A/c	Dr.		8,000	
To Share Capital A/c				8,000
(Being the allotment money due)				

Particulars		L.F.	Dr. (₹)	Cr. (₹)
Bank A/c	Dr.		7,750	
To Share Allotment A/c				7,750
(Being the allotment money received on 775 shares)				
Share First Call A/c	Dr.		8,000	
To Share Capital A/c				8,000
(Being the first call due)				
Bank A/c	Dr.		7,250	
To Share First Call A/c				7,250
(Being the first call received on 725 shares)				
Share Second Call A/c	Dr.		8,000	
To Share Capital A/c				8,000
(Being the second call due)				
Bank A/c	Dr.		6,000	
To Share Second Call A/c				6,000
(Being the second call received on 600 shares)				
Share Capital A/c	Dr.		3,750	
To Forteited Share A/c				2,000
To Share Allotment A/c				250
To Share First Call A/c				750
To Share Second Call A/c				750
(Being 75 shares forteited as per Board's resolution dated...)				

Solution:

Name of the Company: Priyanka Industries Ltd.

Balance Sheet as at:

Ref No.		Particulars	Note No.	Current Year Reporting Period	Previous Year Reporting Period
				₹	₹
I		**EQUITY AND LIABILITIES**			
1.		**Shareholders Funds**			
		(a) Share capital	1	97,000	
2		**Share application money pending allotment**		Nil	
3		**Non-current liabilities**		Nil	
4		**Current Liabilities**		Nil	
		Total(1+2+3+4)		97,000	
II		**ASSETS**			
1.		**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets	2	60,000	
2		**Current assets**			
		(a) Cash and cash equivalents	3	37,000	
		Total(1+2)		97,000	

Notes to the Accounts

Note 1. Share Capital	**Current Year**	**Previous Year**
Authorized Capital		
2,000 Equity share of ₹100 each	2,00,000	
Total	2,00,000	
Issued Capital		
1,400 shares of ₹ 100 each	1,40,000	
Total	1,40,000	
Subscribed Capital		
600 Shares of ₹ 100 each	60,000	
725 shares of ₹ 100 each out of ₹ 50 paid	36,250	
	96,250	
Less. Calls Unpaid	1,250	
	95,000	
Add: Forfeited Shares	2,000	
Total	97,000	

Note 2. Tangible Assets	Current Year	Previous Year
Machinery	60,000	
Total	60,000	

Note 3. Cash and Cash Equivalents	Current Year	Previous Year
Cash at Bank	37,000	
Total	37,000	

Illustration 13: SOS Limited issued a prospectus inviting applications for 6,000 shares of ₹ 10 each at a premium of ₹ 2 per share, payable as follows;

On application ₹ 2 per share; On allotment ₹ 5 per share (including premium): On 1st call ₹ 3 per share; On Second and Final Call ₹ 2 per share.,

Applications were receive for 9,000 shares and allotment was made prorata to the applicants of 7,500 shares, the remaing applicants were refused allotment. Money overpaid on applications were applied towards sums due on allotment.

D to whom 100 shares were allotted, failed to pay the allotment money and on his subsequent failure to pay the first call, his shares were forfeited. Z,the holder of 200 shares, failed to pay both the calls, and his shares were forfeited after the second and final call.

Of the shares forfeited 200 shares were sold to C credited as fully paid up for ₹ 8.50 per share, the whole of D's shares being included.

Solution:

Cash Book (Bank Column)

Particulars	₹	**Particulars**	₹
To Share Capital: (₹ 2 on 9,000 shares)	18,000	By Share Application A/c	3,000
To Share Allotment A/c (allotment money received)	26,550	By Balance c/d	71,750
To Share 1st Call A/c (₹ 3on 5,700 shares)	17,100		
To Share 2nd & Final Call A/c	11,400		
To Share Capital A/c (₹ 8.50 on 200 shares)	1,700		
	74,750		74,750

Journals

Particulars		L.F.	Dr. (₹)	Cr. (₹)
Share Application A/c	Dr.		12,000	
To Share Capital				12,000
(Being Share application money transferred to Share Capital Account)				
Share Application A/c	Dr.		3,000	
To Share Allotment A/c				3,000
(Being Share application money at ₹ 2 on 1,500 shares adjusted against allotment.)				
Share Allotment A/c	Dr.		30,000	
To Share Capital A/c				18,000
To Securities Premium A/c				12,000
[Being the allotment money due]				
Share First Call A/c	Dr.		18,000	
To Share Capital A/c				18,000
[Being the first call money due]				
Share Capital A/c	Dr.		800	
Securities Premium A/c	Dr.		200	
To Forefeited Share A/c				250
To Share Allotment A/c				450
To Share First Call A/c				300
[Being 100 shares of ₹ 10 each, ₹ 8 per Share called up, forfeited for non payment of allotment and first call]				
Share Second and Final Call A/c	Dr.		11,800	
To Share Capital A/c				11,800
[Being the second and final call money due on 5,900 Shares]				
Share Capital A/c	Dr.		2,000	
To Forfeited Share A/c				1,000
To Share First Call A/c				600
To Share Final Call A/c				400
[Being 200 shares of ₹ 10 each forfeited for non-payment of first and final call]				
Forfeited Share A/c	Dr.		300	
To Share Capital A/c				300
[Being 200 shares re-issued]				
Forfeited Share A/c	Dr.		450	
To Capital Reserve A/c				450
[Being the transfer of profit on re-issue]				

Working Notes: (i) Calculation of the amount due but no paid on allotment in Case of D.
No. of applied Shares by Mr. D. (100 x 7500/6,000) 125

Total money sent on application by Mr. D. (125 x 2)		₹ 250
Excess application money [₹ 250 - (100 x ₹ 2)]		₹ 50
Total amount due on allotment (100 x ₹ 5)		₹ 500
Amount due but not paid on allotment (₹ 500 — ₹ 50)		₹ 450
(ii) Calculation of allotment money received later on Total allotment money due		₹ 30,000
Less (a) Already received	₹ 3,000	
(b) Not received (as per note 1)	₹ 450	3,450
		26,550

Illustration 14: Alpha Ltd issued a prospectus inviting applications for 2,000 shares of ₹ 10 each at a premium of ₹ 2 per share, payable as follows:

On Application ₹ 2 On Allotment ₹ 5 (including premium)
On First Call ₹ 3 On Second & Final Call ₹ 2

Applications were received for 3,000 shares and *pro rata* allotment was made on the applications for 2,400 shares. It was decided to utilise excess application money towards the amount due on allotment.

Mohit, to whom 40 shares allotted, failed to pay the allotment money and on his subsequent filure to pay the first call, his shares were forfeited.

Jagat, the holder of 60 shares failed to pay the two calls and on his such failure, his shares were forfeited.

Of the shares forfeited, 80 shares were sold to Rishav credited as fully paid for ₹ 9 per share, the whole of Mohit's shares being included.

Required: Give Journal Entries to record the above trasactions (including cash transactions)

Solution:

Journals

Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
Bank A/c	Dr.		6,000	
To Share Application A/c				6,000
[Being the application money received on 3,000 shares)				
Share Application A/c	Dr.		6,000	4,000
To Share Capital A/c				
To Bank A/c				1,200
To Share Allotment A/c				800
[Being the application money received on 3,000 shares]				
Share Allotment A/c	Dr.		10,000	
To Share Capital A/c				6,000
To Securities Premium A/c				4,000
[Being the allotment money due]				

Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
Bank A/c	Dr.		9,016	
To Share Allotment A/c				9,016
[Being the remaining allotement money received on 1,960 shares]				
Share First Call A/c	Dr.		6,000	
To Share Capital A/c				6,000
[Being the first call money due]				
Bank A/c	Dr.		5,700	
To Share First Call A/c				5,700
[Being the first call money received on 1,900 shares @ ₹ 3 per share]				
Share Capital A/c	Dr.		320	
Securities Premium A/c	Dr.		80	
To Share Allotment A/c				184
To Share First Call A/c				120
To Forfeited Share A/c				96
[Being 40 shares forfeited for non-payment of full allotment money and the first call money]				
Share Second & Final Call A/c	Dr.		3,920	
To Share Capital A/c				3,920
[Being the second and final call due on 1,960 share]				
Bank A/c	Dr.		3,800	
To Share Second and Final Call A/c				3,800
[Being the second and final call received on 1,900 shares]				
Share Capital A/c	Dr.		600	
To Share First Call A/c				180
To Share Second and Final Call A/c				120
To Forfeited Shares A/c				300
[Being 60 shares forfeited for non-payment on the first call and final call]				
Bank A/c	Dr.		720	
Forfeited Shares A/c	Dr.		80	
To Share Capital A/c				800
[Being the reissued of 80 shares @ ₹ 9 as fully paid up]				
Forfeited Shares A/c	Dr.		216	
To Capital Reserve A/c				216
[Being the transfer of profit on re-issue]				

Working Notes: (i) Calculation of the amount due but not paid on allotment in Case of Mohit

	₹
Total No. of shares applied by Mohit (40 × 2,400/2,000) 48	
Total money sent on application by Mohit (48 × ₹ 2)	96
Excess application money [₹ 96 – (40 × ₹ 2)]	16
Total amount due on allotment (40 × ₹ 5)	200
Amount due but not paid on allotment (₹ 200 – ₹ 16)	184

(ii) Calculation of allotment money received later on

Total allotment money due (2,000 × ₹ 5)		10,000
Less: (a) Already received	₹ 800	
(b) Not received (as per note 1)	₹ 184	984
		9,016

(iii) Since the question is silent as to the utilization of ₹ 16 (received from Mohit) between share capital and securities premium, it has been assumed that the entire excess of ₹ 16 is exclusively for share capital and hence credited to Forfeited Shares Account in full.

Illustration 15: Nivedita Fertilisers Ltd. issued a prospectus invitng applications for 20,000 shares of ₹ 10 each at a premium of ₹ 2 per share, paybale as follows:

On Application	3 (including ₹ 1 premium)
On Allotment	4 (including ₹ 1 premium)
On First Call	3
On Second & Final Call	2

Applications were received for 30,000 shares and *pro rata* allotment was made on the applications for 24,000 shares. It was decided to utilise excess application money towards the amlount due on allotment.

Arunavo, to whom 400 shares were allotted, failed to pay the allotment money and on his subsequent failure to pay the first call, his shares were forfeited.

Victor, who applied for 720 failed to pay the two calls and on his such failure, his shares were forfieted. Of the shares forfeited, 800 shares were sold to Srijita credited as fully paid for ₹ 9 per share, the whole of Arunavo's shares being included.

Required: Give Journal Entries to record the above trasactions (including cash transactions)

Solution:

Journals

Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
Bank A/c	Dr.		90,000	
To Share Application A/c				90,000
(Being the application money received on 30,000 shares)				
Share Application A/c	Dr.		90,000	
To Share Capital A/c				40,000
To Securities Premium A/c				20,000
To Bank A/c				18,000
To Share Allotment A/c				12,000
(Being the application money adjusted and surplus refunded)				
Share Allotment A/c	Dr.		80,000	
To Share Capital A/c				60,000
To Securities Preimum A/c				20,000
(Being the allotment money due)				

Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
Bank A/c Dr.		66,640	
To Share Allotment A/c			66,640
(Being the remaining allotment money received on 19,600 shares)			
Share First Call A/c Dr.		60,000	
To Share Capital A/c			60,000
(Being the first call money due)			
Bank A/c Dr.		57,000	
To Share First Call A/c			57,000
(Being the first call money received on 19,000 shares @ ₹ 3 per shares)			
Share Capital A/c Dr.		3,200	
Security Premium A/c Dr.		400	
To Share Allotment A/c			1,360
To Share First Call A/c			1,200
To Forfeited Shares A/c			1,040
(Being 400 shares forfeited for non-payment of full allotment money and the first call money)			
Share Second and Final Call A/c Dr.		39,200	
To Share Capital A/c			39,200
(Being the second and final call due on 19,600 shares)			
Bank A/c Dr.		38,000	
To Share Second and Final Call A/c			38,000
(Being the second and final call received on 19,000 shares)			
Share Capital A/c Dr.		6,000	
To Share First Call A/c			1,800
To Share Second and Final Call A/c			1,200
To Forfeited Shares A/c			3,000
(Being 600 shares forfeited for non-payment of the first call and final call)			
Bank A/c Dr.		7,200	
Forfeited Shares A/c Dr.		800	
To Share Capital A/c			8,000
[Being the reissue of 800 shares @ ₹ 9 as fully paid up)			
Forfeited Shares A/c Dr.		2,240	
To Capital Reserve A/c			2,240
[Being the transfer of profit on re-issue)			

Working Notes: (i) Calculation of the amount due but not paid on allotment in Case of Arunavo

Total No.of shares applied by Arunavo (400x24,000/20,000)	480 Shares
Total money sent on application by Arunavo (480 x ₹ 3)	₹ 1440
Excess applicaiton money [₹ 1440 - (₹ 400 x ₹ 3)	₹ 240
Total amount due on allotment (₹ 1600 - ₹ 240)	₹ 1360

(ii) Calculation of allotment money received latter on		(₹)
Total allotment money due (20,000 x ₹ 4)		80,000
Less: (a) Already received (4,000 x 3)	12,000	
(b) Not received (as per note I)	1,360	13,360
		66,640

(iii) Since the question is silent as to the utilization of ₹ 240 (received from Arunavo) between share capital and Securities premium, it has been assumed that the entire excess of ₹ 240 is exclusively for share capital and hence credited to Forfeited Shares Account in full.

Illustration 16: Hero Limited issued 10,000 equity shares of ₹ 100 each at premium of ₹ 25 per share. Under the terms of the isue, the shares were to be paid for as follows:

	₹
2015 January 1, on application (including ₹ 25 premium on issue per share)	50
February 1, on allotment	50
April 1, balance of	25

The issue was over subscribed. The applications received are summarised below:

	A	*B*	*C*
Number of applicants in categories	40	20	1
Applied for by each applicant in the three categories	200	2000	8000
Issued to each applicant	100	200	2000

One of the conditions of the issue was that amounts over-paid on application were to be retained by the company and used in redudction of further sums due on shares allotted. All surplus contributions were refunded on 15th February, 2014.

Ramesh who had subscribed 100 on an application for 200 shares was unable to meet the claim due on April 1. On May 5, the directors forfeited his shares. All other shareholders paid the sums requested on the due dates. On June 10, 2014 the directors re-issued the forfeited shares as fully paid to Mohan, on receiving a payment of ₹ 10,500.

(a) To prepare a statement as on February 1, 2014, showing the over-payment, under-payment to in respect of category of applicants: and

(b) To show how the above transactions would appear in the journal of the company.

Solution:

(a)

Hero Ltd.
Statement of Shares Applied, Allotted and Amounts Adjusted

Particulars	Categeries		
	A	**B**	**C**
(a) Applied (Nos.)	8,000	40,000	8,000
(b) Allotted (Nos.)	4,000	4,000	2,000
	₹	₹	₹
(c) Application money Received (Applied (Application per share)	4,00,000	20,00,000	4,00,000
(d) Application Money required (Alloted × Application per share)	2,00,000	2,00,000	1,00,000
(e) Excess Application Money to be Adjusted with Allotment [c-d]	2,00,000	18,00,000	3,00,000
(f) Allotment Money Due (Alloted × Allotment per share)	2,00,000	2,00,000	1,00,000
(g) Balance of Excess Application Money for Adjustment with calls [e-f]	Nil	16,00,000	2,00,000
(h) Call Money Due (Allotment × Call per share)	1,00,000	1,00,000	50,000
(i) Excess/(Shortage) In case of shortage, the shareholders will deposit the dues.	(1,00,000)	15,00,000	1,50,000

(b)

Journals

2015	Particulars	L.F.	Dr. (₹)	Cr. (₹)
Jan. 01	Bank A/c Dr.		28,00,000	
	To Equity Share Application A/c			28,00,000
	(Application money received on 56,000 shares @ ₹ 50 per share)			
Feb. 01	Equity Share Application A/c Dr.		5,00,000	
	To Equity Share Capital A/c			2,50,000
	To Securities Premium A/c			2,50,000
	(Being application money on 10,000 shares transferred to share Capital and Securities Premium vide Board's resolution no........ dated........)			
	Equity Share Application A/c Dr.		16,50,000	
	To Bank A/c			16,50,000
	(Being excess application money refunded of vide Board's resolution no........ dated........)			

2015	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Allotment A/c Dr.		5,00,000	
	To Equity Share Capital A/c			5,00,000
	(Being allotment money due on 10,000 shares @ ₹ 50 per share vide Board's resolution no........ dated........)			
	Equity Share Application A/c Dr.		5,00,000	
	To Equity Share Allotement A/c Dr.			5,00,000
	(Being excess of Equity share application money adjusted with allotment)			
	Equity Share First & Final Call A/c Dr.		2,50,000	
	To Equity Share Capital A/c			2,50,000
	(Being first & final call money due on 10,000 shares @ ₹ 25 per share vide Board's resolution no........ dated........)			
Apr. 01	Bank A/c Dr.		97,500	
	Calls in Arrear A/c Dr.		2,500	
	Equity Share Application A/c Dr.		1,50,000	
	To Equity Share First & Final Call A/c			2,50,000
	(Being amount received and adjusted, except a holder of 100 share who failed to pay the call)			
May 05	Equity Share Capital A/c Dr.		10,000	
	To Shares Forfeited A/c			7,500
	To Calls in Arrear A/c			2,500
	(Being 100 shares held by Ramesh forfeited for non-payment of call @ ₹ 25 per share vide Board's resolution no........ dated........)			
June 10	Bank A/c Dr.		10,500	
	To Equity Share Capital A/c			10,000
	To Securities Premium A/c			500
	(Being 100 forfeited shares resissued at ₹ 10,500)			
	Share Forfeited A/c Dr.		7,500	
	To Captial Reserve A/c			7,500
	(Being balance of shares forfeited transferred to captial reserve)			

3.2 FOLLOW ON PUBLIC OFFER & RIGHTS ISSUE

Follow on Public Offer (FPO)

An issuance of stock following a company's Initial Public Offer is called a Follow on Public Offer. A company opts for the FPO route when it wishes to raise additional capital from the shareholders and new investors. An FPO is essentially a stock issue of supplementary shares made by a company that is already publicly listed and has gone through the IPO process.

FPOs are popular methods for companies to raise additional equity capital in the capital markets through a stock issue. Public companies can also take advantage of an FPO issuing an offer for sale to investors, which is made through an offer document. FPOs should not be confused with IPOs, as IPOs are the initial public offering of equity to the public while FPOs are supplementary issues made after a company has been established on an exchange. FPO is when an already listed company makes either a fresh issue of securities to the public or an offer for sale to the public, through an offer document. An offer for sale in such scenario is allowed only if it is made to satisfy listing or continuous listing obligations.

A follow-on offering (often but incorrectly called secondary offering) is an issuance of stock subsequent to the company's initial public offering. A follow-on offering can be either of two types (or a mixture of both): dilutive and non-dilutive. A secondary offering is an offering of securities by a shareholder of the company (as opposed to the company itself, which is a primary offering). A follow on offering is preceded by release of prospectus similar to IPO: a Follow-on Public Offer (FPO).

For example, Google's initial public offering (IPO) included both a primary offering (issuance of Google stock by Google) and a secondary offering (sale of Google stock held by shareholders, including the founders).

Difference between Initial Public Offer and Follow on Public Offer

- IPO is made when company seeks to raise capital via public investment while FPO is subsequent public contribution.
- First issue of shares by the company is made through IPO when company first becoming a publicly traded company on a national exchange while Follow on Public Offering is the public issue of shares for an already listed company.

Types of Follow on Public Offer

Dilutive follow on public offer- This offer is made in case of selling more equity in the company, following which, the board of directors will increase the share of the float, i.e., the total number of shares which are publicly owned and available for trading. This additional cash which arises from the increase in float can be used to pay off company's debt or it can be utilized for expanding the company's business. Dilutive follow on public offer is a dilution of earnings on each share. This happens because new shares are added which are eventually sold by the company, increasing the outstanding shares in the market. While some may consider this offer a positive sign for the company as it may be beneficial for the shareholders, some might be of the view that it is not a favourable move as regards short term goals.

One example of a type of follow-on offering is an at-the-market offering (ATM offering), which is sometimes called a controlled equity distribution. In an ATM offering, exchange-listed companies incrementally sell newly issued shares into the secondary trading market through a designated broker-dealer at prevailing market prices. The issuing company is able to raise capital on an as-needed basis with the option to refrain from offering shares if unsatisfied with the available price on a particular day.

Non-dilutive follow on public offer- In order to diversify the earnings of the company, the shares which are privately held by the company are put up for sale in the market by its directors or another authority involved in the company's management. Since there are no new shares being introduced in the market, only these privately held shares are sold. Hence, there is no dilution of shares to the existing share holders. This procedure does not lead to any benefit for the shareholders and the company. In fact, this process leads to a commanding position for outside institutions in the company. This is also known as the secondary market offering.

As with an IPO, the investment banks who are serving as underwriters of the follow-on offering will often be offered the use of a greenshoe or over-allotment option by the selling company.

RIGHT ISSUE

Where at any time, a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares shall be offered to persons who, at the date of the offer, are holders of equity shares of the company in proportion, as nearly as circumstances admit, to the paid-up share capital on those shares by sending a letter of offer subject to the following conditions, namely:—

(i) the offer shall be made by notice specifying the number of shares offered and limiting a time not being less than fifteen days and not exceeding thirty days from the date of the offer within which the offer, if not accepted, shall be deemed to have been declined;

(ii) unless the articles of the company otherwise provide, the offer aforesaid shall be deemed to include a right exercisable by the person concerned to renounce the shares offered to him or any of them in favour of any other person; and the notice referred to in clause (i) shall contain a statement of this right;

(iii) after the expiry of the time specified in the notice aforesaid, or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, the Board of Directors may dispose of them in such manner which is not dis-advantageous to the shareholders and the company.

Valuation of Rights

Usually a company offers rights issue at a price which is lower than the market price of the shares so that existing *(i.e.,* old) shareholders may get the monetary benefit of being associated with the company for a long time. Existing shareholders who have been offered right shares and do not want to purchase these offered shares may renounce their right shares in favour of some other persons within the specified period as mentioned earlier. In such a case, the existing shareholders can make a profit by selling his right to such other person. This right can be valued in terms of money as below:

(a) Calculate the market value of shares which an existing shareholder is required to have in order to get fresh shares.

(b) Add to the above price paid for the fresh shares.

(c) Find out the average price of existing shares and fresh shares.

(d) The average price of the share should be deducted from the market price and the difference thus ascertained is value of right.

Illustration 17.

A Company is planning to raise funds by making rights issue of equity shares to finance its expansion. The existing equity share capital of the company is ₹ 50,00,000. The market value of its share is ₹ 42. The company offers to its shareholders the right to buy 2 shares at ₹ 11 each for every 5 shares held. You are required to calculate:

(i) Theoretical market price after rights issue;

(ii) The value of rights; and

(iii) Percentage increase in share capital.

Solution:

	₹
Market value of 5 shares already held by a shareholder @ ₹ 42	210
Add: Price to be paid by him for acquiring 2 more shares @ ₹ 11 per share	22
Total price of 7 shares after rights issue	232

(i) Therefore, theoretical market price of one share, (i.e., 232/7) = 33.14

(ii) Value of Rights = Market Price - Theoretical Market Price= ₹ 42 - ₹ 33.14. = ₹ 8.86

(iii) Percentage Increase in Share Capital

Present Capital	50,00,000
Rights Issue ₹ 50,00,000 × 2/5	20,00,000
% Increase In Share Capital (20,00,000/50,00,000) × 100	40%

3.3 BUY-BACK OF SHARES

Restrictions on Purchase by Company or giving of Loans by it for Purchase of its Shares [Section 67]

(1) No company limited by shares or by guarantee and having a share capital shall have power to buy its own shares unless the consequent reduction of share capital is effected under the provisions of this Act.

(2) No public company shall give, whether directly or indirectly and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of, or in connection with, a purchase or subscription made or to be made, by any person of or for any shares in the company or in its holding company.

(3) Nothing in sub-section (2) shall apply to—

   (a) the lending of money by a banking company in the ordinary course of its business;

   (b) the provision by a company of money in accordance with any scheme approved by company through special resolution and in accordance with such requirements as may be prescribed, for the purchase of, or subscription for, fully paid-up shares in the company or its holding company, if the purchase of, or the subscription for, the shares held by trustees for the benefit of the employees or such shares held by the employee of the company;

   (c) the giving of loans by a company to persons in the employment of the company other than its directors or key managerial personnel, for an amount not exceeding their salary or wages for a period of six months with a view to enabling them to purchase or subscribe for fully paid-up shares in the company or its holding company to be held by them by way of beneficial ownership.

   Provided that disclosures in respect of voting rights not exercised directly by the employees in respect of shares to which the scheme relates shall be made in the Board's report in such manner as may be prescribed.

(4) Nothing in this section shall affect the right of a company to redeem any preference shares issued by it under this Act or under any previous company law.

(5) If a company contravenes the provisions of this section, it shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years and with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

Power of Company to Purchase its Own Securities [Section 68]

(1) Notwithstanding anything contained in this Act, but subject to the provisions of sub-section (2), a company may purchase its own shares or other specified securities hereinafter referred to as buy-back) out of—

   (a) its free reserves;

   (b) the securities premium account; or

   (c) the proceeds of the issue of any shares or other specified securities:

   Provided that no buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

(2) No company shall purchase its own shares or other specified securities under sub-section (1), unless—

(a) the buy-back is authorised by its articles;

(b) a special resolution has been passed at a general meeting of the company authorising the buy-back.

Provided that nothing contained in this clause shall apply to a case where—

(i) the buy-back is, ten per cent. or less of the total paid-up equity capital and free reserves of the company; and

(ii) such buy-back has been authorised by the Board by means of a resolution passed at its meeting;

(c) the buy-back is twenty-five per cent. or less of the aggregate of paid-up capital and free reserves of the company:

Provided that in respect of the buy-back of equity shares in any financial year, the reference to twenty-five per cent. in this clause shall be construed with respect to its total paid-up equity capital in that financial year;

(d) the ratio of the aggregate of secured and unsecured debts owed by the company after buy-back is not more than twice the paid-up capital and its free reserves:

Provided that the Central Government may, by order, notify a higher ratio of the debt to capital and free reserves for a class or classes of companies;

(e) all the shares or other specified securities for buy-back are fully paid-up;

(f) the buy-back of the shares or other specified securities listed on any recognized stock exchange is in accordance with the regulations made by the Securities and Exchange Board in this behalf; and

(g) the buy-back in respect of shares or other specified securities other than those specified in clause (f) is in accordance with such rules as may be prescribed.

Provided that no offer of buy-back under this sub-section shall be made within a period of one year reckoned from the date of the closure of the preceding offer of buy-back, if any.

(3) The notice of the meeting at which the special resolution is proposed to be passed under clause (b) of sub-section (2) shall be accompanied by an explanatory statement stating—

(a) a full and complete disclosure of all material facts;

(b) the necessity for the buy-back;

(c) the class of shares or securities intended to be purchased under the buy-back;

(d) the amount to be invested under the buy-back; and

(e) the time-limit for completion of buy-back.

(4) Every buy-back shall be completed within a period of one year from the date of passing of the special resolution, or as the case may be, the resolution passed by the Board under clause (b) of sub-section (2).

(5) The buy-back under sub-section (1) may be—

(a) from the existing shareholders or security holders on a proportionate basis;

(b) from the open market;

(c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

(6) Where a company proposes to buy-back its own shares or other specified securities under this section in pursuance of a special resolution under clause (b) of sub-section (2) or a resolution

under item (ii) of the proviso thereto, it shall, before making such buy-back, file with the Registrar and the Securities and Exchange Board, a declaration of solvency signed by at least two directors of the company, one of whom shall be the managing director, if any, in such form as may be prescribed and verified by an affidavit to the effect that the Board of Directors of the company has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year from the date of declaration adopted by the Board.

Provided that no declaration of solvency shall be filed with the Securities and Exchange Board by a company whose shares are not listed on any recognised stock exchange.

(7) Where a company buys back its own shares or other specified securities, it shall extinguish and physically destroy the shares or securities so bought back within seven days of the last date of completion of buy-back.

(8) Where a company completes a buy-back of its shares or other specified securities under this section, it shall not make a further issue of the same kind of shares or other securities including allotment of new shares under clause (a) of sub-section (1) of section 62 or other specified securities within a period of six months except by way of a bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares.

(9) Where a company buys back its shares or other specified securities under this section, it shall maintain a register of the shares or securities so bought, the consideration paid for the shares or securities bought back, the date of cancellation of shares or securities, the date of extinguishing and physically destroying the shares or securities and such other particulars as may be prescribed.

(10) A company shall, after the completion of the buy-back under this section, file with the Registrar and the Securities and Exchange Board a return containing such particulars relating to the buy-back within thirty days of such completion, as may be prescribed.

Provided that no return shall be filed with the Securities and Exchange Board by a company whose shares are not listed on any recognised stock exchange.

(11) If a company makes any default in complying with the provisions of this section or any regulation made by the Securities and Exchange Board, for the purposes of clause (f) of sub-section (2), the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees, or with both.

Disclosure Requirements relating to Buy-Back of Shares or Other Securities in Explanatory Statement to be Annexed to the Notice of the General Meeting

The explanatory statement to be annexed to the notice of the general meeting pursuant to section 102 in relation to buy-back of shares or other securities by the private companies and unlisted public companies shall contain the following disclosures, namely:-

(a) the date of the board meeting at which the proposal for buy-back was approved by the board of directors of the company;

(b) the objective of the buy-back;

(c) the class of shares or other securities intended to be purchased under the buy-back;

(d) the number of securities that the company proposes to buy-back;

(e) the method to be adopted for the buy-back;

(f) the price at which the buy-back of shares or other securities shall be made;

(g) the basis of arriving at the buy-back price;

(h) the maximum amount to be paid for the buy-back and the sources of funds from which the buy-back would be financed;

(i) the time-limit for the completion of buy-back;

(j) (i) the aggregate shareholding of the promoters and of the directors of the promoter, where the promoter is a company and of the directors and key managerial personnel as on the date of the notice convening the general meeting;

(ii) the aggregate number of equity shares purchased or sold by persons mentioned in sub-clause (i) during a period of twelve months preceding the date of the board meeting at which the buy-back was approved and from that date till the date of notice convening the general meeting;

(iii) the maximum and minimum price at which purchases and sales referred to in sub-clause (ii) were made along with the relevant date;

(k) if the persons mentioned in sub-clause (i) of clause (j) intend to tender their shares for buy-back –

(i) the quantum of shares proposed to be tendered;

(ii) the details of their transactions and their holdings for the last twelve months prior to the date of the board meeting at which the buy-back was approved including information of number of shares acquired, the price and the date of acquisition;

(l) a confirmation that there are no defaults subsisting in repayment of deposits, interest payment thereon, redemption of debentures or payment of interest thereon or redemption of preference shares or payment of dividend due to any shareholder, or repayment of any term loans or interest payable thereon to any financial institution or banking company;

(m) a confirmation that the Board of directors have made a full enquiry into the affairs and prospects of the company and that they have formed the opinion-

(i) that immediately following the date on which the general meeting is convened there shall be no grounds on which the company could be found unable to pay its debts;

(ii) as regards its prospects for the year immediately following that date, that, having regard to their intentions with respect to the management of the company's business during that year and to the amount and character of the financial resources which will in their view be available to the company during that year, the company shall be able to meet its liabilities as and when they fall due and shall not be rendered insolvent within a period of one year from that date; and

(iii) the directors have taken into account the liabilities(including prospective and contingent liabilities), as if the company were being wound up under the provisions of the Companies Act, 2013.

(n) a report addressed to the Board of directors by the company's auditors stating that-

(i) they have inquired into the company's state of affairs;

(ii) the amount of the permissible capital payment for the securities in question is in their view properly determined;

(iii) that the audited accounts on the basis of which calculation with reference to buy back is done is not more than six months old from the date of offer document; and

(iv) the Board of directors have formed the opinion as specified in clause (m) on reasonable grounds and that the company, having regard to its state of affairs, shall not be rendered insolvent within a period of one year from that date.

Prohibition for Buy-Back in Certain Circumstances [Section 70]

(1) No company shall directly or indirectly purchase its own shares or other specified securities –

(a) through any subsidiary company including its own subsidiary companies;

(b) through any investment company or group of investment companies; or

(c) if a default, is made by the company, in the repayment of deposits accepted either before or after the commencement of this Act, interest payment thereon, redemption of debentures or preference shares or payment of dividend to any shareholder, or repayment of any term loan or interest payable thereon to any financial institution or banking company.

Provided that the buy-back is not prohibited, if the default is remedied and a period of three years has lapsed after such default ceased to subsist.

(2) No company shall, directly or indirectly, purchase its own shares or other specified securities in case such company has not complied with the provisions of sections 92, 123, 127 and section 129.

SEBI Guidelines.

The Securities and Exchange Board of India, has issued the following guidelines with regard to buy-back of shares or other specified securities by companies, having been empowered to do so by the Companies (Amendment) Act, 1999. These guidelines came into effect from 14-11-1998.

Modes of Buy-Back.

Buy-back is permissible:

(a) from the existing security holders on a proportionate basis through the tender offer; or

(b) from the open market through

1. Book-building process,

2. stock exchange;

(c) from odd lots, that is to say, where the lot of securities of a public company whose shares are listed on a recognized stock exchange is smaller than such marketable lot as may be specified by the stock exchange: or

(d) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

Where a company proposes to buy-back its own shares. it shall after passing the special resolution or resolution of its Board of Directors make a public announcement in at least one English National Daily one Hindi National Daily and Regional Language Daily with wide circulation at the place where the registered office of the company is located.

The public announcement shall specify a date which shall be the 'specified date' for the purposes of determining the names of the shareholders to whom the letter of offer shall be sent. The specified date cannot be earlier than 30 days and not later than 42 days from the date of such public announcement. The letter of offer shall be despatched not earlier than 21 days from the submission of its draft with SEBI through the merchant banker. The date of opening of the offer shall not be earlier than 7 days or later than 30 days after the specified date. Companies buying back through the tender offer have to open an escrow account.

A company cannot buy-back its shares from any person:

(a) through negotiated deals whether on or off the stock exchange; or

(b) through spot transactions; or

(c) through any private arrangements.

Price at which shares shall be bought back has to be determined by shareholders through a special resolution. A copy of their resolution has to be filed with the SEBI as well as the stock exchanges where the shares of the company are listed, within 7 days from the date of passing the resolution. Companies buying back through stock exchanges should disclose purchases daily. Buy-back offer shall remain open for not less than 15 days and not more than 30 days. The verification of shares bought back has to be completed within 15 days of the closure of the offer and payments made within 7 days. The onus of complying with the SEBI guidelines is on the merchant banker who has to file a 'due diligence certificate' with the SEBI.

Escrow Account

Regulation 10(1) of the Securities and Exchange Board of India provides that a company shall, as and by way of security for performance of its obligations on or before the opening of the offer of re-purchase, deposit in an escrow account such sum as is specified in 10(2), that is:

(i) If the consideration payable does not exceed ₹ 100 crores, 25% of the consid eration;

(ii) If the consideration payable exceeds ₹ 100 crores, 25% up to ₹ 100 crores, and 10% thereafter.

Escrow account means an account in which money is held until a specified duty is performed, i.e., till the consideration for buy-back of shares is paid to the shareholders. This account consists of cash deposited with a scheduled commercial bank, or bank guarantee in favour of the merchant banker, or deposit of acceptable securities with appropriate margin, with the merchant banker, or combination of these.

Advantages of buy-back.

Buy-back have the following advantages:

(i) A company with capital, which cannot be profitably employed, may get rid of it by resorting to buy-back, and re-structure its capital.

(ii) Free reserves which are utilized for buy-back instead of dividend enhance the value of the company's shares and improve earnings per share.

(iii) Surplus cash may be utilized by the company for buy-back and avoid the payment of dividend tax.

(iv) Buy-back may be used as a weapon to frustrate any hostile take-over of the company by undesirable persons.

Accounting for buy-back.

Buy-back of shares is just the opposite of issue of shares. Just as shares may be issued at par, at a premium, even buy-back may be at par, at a premium or at a discount. The basis of accounting for buy-back is Section 68 of the Amended Companies Act. This Section not only permits a company to buy-back or redeem its equity shares, but also specifies the sources from out of which re-purchase is to be effected.

According to this Section, a company may buy-back its shares or other specified securities from out of

1. Its free reserves, or
2. The securities premium account, or
3. The proceeds of any shares or other specified securities like employees' stock option.

However, no buy-back of shares shall be made out of the proceeds of an earlier issue of the same kind of shares. This Section also lays down that all the shares or other specified securities for buy-back are fully paid up.

As per to Section 69, When a company purchases its own shares out of free reserves. then a sum equal to the nominal value of the shares so purchased shall be transferred to the capital redemption reserve account and details of such transfer should be disclosed in the balance sheet.

Determination of quantum for buy-back. Sec. 68 of Company Act, 2013

The maximum number of shares to be bought back is determined as the least number of shares arrived by performing the following tests:

(1) Share outstanding test

(2) Resource test

(3) Debt-Equity Ratio test.

(1) Share Outstanding test:

(a) Ascertain the number of shares

(b) 25% of the number of shares is eligible for buy back with the approval of shareholders.

(2) Resource test:

(a) Ascertain sharehooders fund (Capital + Free Reserves)

(b) No. of shares held for buyback

$$= \frac{\text{Shareholders funds}}{\text{Buy back price}}$$

Free Reserve includes Securities Premium, General

Reserve, Revenue Reserves, Profit & Loss A/c (Cr. Balance)

excludes Revaluation Reserve, any other specific reserves.

Accounting — Buy back of Shares

(i) Shares held for buy-back

Equity Share Capital A/c Dr.

Premium on Buyback A/c Dr.

To Equity Shareholders A/c

or Shares bought back A/c

(ii) Adjustment of premium on buyback

Securities Premium A/c Dr.

General Reserve A/c Dr.

To Premium on Buyback A/c

(iii) Transfering reserves to the extent of capital redeemed

Reserves A/c Dr.

Profit Loss A/c Dr.

To Capital Redemption Reserve

(iv) On buy-back of shares

Equity Shareholders A/c Dr.

or Shares bought back A/c Dr.

To Bank A/c

Illustration 18.

(Buy-back at par)

X Co. Ltd. buys back its own 2,00,000 equity shares of ₹ 10 each at par. The company has sufficient profits otherwise available for dividend besides general reserve. No fresh issue of shares is made for this purpose. The shares are fully paid up.

Journalise the transactions.

Solution:

In the Books of X Co. Ltd.

Journal Entries

Date	Particulars		Debit ₹	Credit ₹
	Equity Share Capital A/c	Dr.	20,00,000	
	To Bank A/c			20,00,000
	(Buying-back 2,00,000 equity shares of ₹ 10 each, at par)			
	General Reserve A/c	Dr.	20,00,000	
	To Capital Redemption Reserve A/c			20,00,000
	(Transfer of nominal value of shares bought back)			

Illustration 19.

(Where shares are partly paid up).

The BCG Co. Ltd. resolved by a special resolution to buy-back 2,00,000 of its equity shares of the face value of ₹ 10 each on which ₹ 8 has been paid up. The general reserve balance of the company stood at ₹ 50,00,000 and no fresh issue of shares was made.

Journalize the transactions.

Solution:

In the Books of BCG Co. Ltd.

Journal Entries

Date	Particulars		Debit ₹	Credit ₹
	Equity Share Final Call A/c	Dr.	4,00,000	
	To Equity Share Capital A/c			4,00,000
	(Final call of ₹2 per share due on 2,00,000 equity shares as per Board resolution)			
	Bank A/c	Dr.	4,00,000	
	To Equity Share Final Call A/c			4,00,000
	(Final call money on2,00,000 shares received)			
	Equity Share Capital A/c	Dr.	20,00,000	
	To Equity Shareholders A/c			20,00,000
	(Amount due to equity shareholders transferred to their account for Buy Back)			

	Equity Shareholders A/c Dr.	20,00,000	
	To Bank A/c		20,00,000
	(Payment to shareholders towards buy-back)		
	General Reserve A/c Dr.	20,00,000	
	To Capital Redemption Reserve A/c		20,00,000
	(Transfer of nominal value of shares Bought-back.)		

Illustration 20

(Where shares are bought-back at a premium)

The share capital of Beta Co. Ltd consists of 1,00,000 equity shares of ₹ 10 each, and 25,000 preference shares of ₹ 100 each, fully called up. Its securities premium account shows a balance of ₹ 40,000 and general reserve of ₹ 7,00,000. The company decides to buy-back 20,000 equity shares of ₹ 12 each.

Pass the necessary journal entries.

Solution.

In the Books of Beta Co. Ltd.

Journal Entries

Date	Particulars	Debit ₹	Credit ₹
	Equity Share Capital A/c Dr.	2,00,000	
	Securities Premium A/c Dr.	40,000	
	To Equity Shareholders A/c		
	(Amount due to equity shareholders for buying-back of 20,000 equity shares)		2,40,000
	Equity Shareholders A/c Dr.	2,40,000	
	To Bank A/c		2,40,000
	(Payment to shareholders on account of buy-back)		
	General Reserve A/c Dr.	2,00,000	
	To Capital Redemption Reserve A/c		2,00,000
	(Transfer of nominal amount of equity shares Bought-back.)		

Illustration 21.

(Where shares are bought-back at a discount)

The PTC Co. Ltd. has a share capital of ₹ 15,00,000, comprising 1,00,000 equity shares of ₹ 10 each and 50,000 8% preference shares of ₹ 10 each, both of which fully called up and paid up. The company has sufficient general reserve to its credit to enable it to comply with the legal formalities connected with buy-back of shares. It decides to buy-back 20% of its equity share capital at ₹ 9 per share. Record the transactions in the books of the company.

Solution:

In the Books PTC Co. Ltd.

Journal Entries

Date	Particulars		Debit ₹	Credit ₹
	Equity Share Capital A/c	Dr.	2,00,000	
	To Equity Shareholders A/c			1,80,000
	To Capital Reserve A/c			20,000
	(Amount due to equity shareholders for buy-back of 20,000 shares @ ₹ 9)			
	Equity Shareholders A/c	Dr.	1,80,000	
	To Bank A/c			1,80,000
	(Payment to equity shareholders the amount due to them)			
	General Reserve A/c	Dr.	2,00,000	
	To Capital Redemption Reserve A/c			2,00,000
	(Transfer of nominal amount of shares bought-back)			

Illustration 22.

(Fresh issue of shares for purposes of buy-back).

Alpha Co. Ltd. has a paid up equity share capital of ₹ 20,00,000 in 2,00,000 shares of ₹ 10 each. It resolved to buy-back 50,000 equity shares at ₹ 15 per share. For this purpose. it issued 20,000 12% preference shares of ₹ 10 each, at par, payable along with application. The company has to its credit ₹ 2,50,000 in securities premium account and ₹ 10,00,000 in the general reserve account. The company utilized the general reserve. Pass the necessary journal entries.

Solution:

In the Books of Alpha Co. Ltd.

Journal Entries

Date	Particulars		Debit ₹	Credit ₹
	Bank A/c	Dr.	2,00,000	
	To Preference Share Application A/c			2,00,000
	(Application money on 20,000 preference shares at ₹ 10 each)			
	Preference Share Application A/c	Dr.	2,00,000	
	To Preference Share Capital A/c			2,00,000
	(Transfer of application money to preference share capital account on shares being allotted)			

	Equity Share Capital A/c Dr.		5,00,000	
	Securities Premium A/c Dr.		2,50,000	
	To Equity Shareholders A/c			7,50,000
	(Amount due to equity shareholders consequent upon buy-back of 50,000 Shares at ₹ 15)			
	Equity Shareholders A/c Dr.		7,50,000	
	To Bank A/c			7,50,000
	(Payment to equity shareholders for amount due to them)			
	General Reserve A/c Dr.		3,00,000	
	To Capital Redemption Reserve A/c			3,00,000
	(Transfer of the nominal value of shares bought back.)			

Illustration 23.

(Buy-back at a premium and issue of bonus shares)

On 31st March, 2015 following was the balance sheet of Ispat Ltd.:

(₹ in lakhs)

Liabilities	₹	**Assets**	₹
Equity share capital		Machinery	3,600
(fully paid-up shares of ₹ 10 each)	2,400	Furniture	452
Securities Premium	350	Investments	148
General Reserve	930	Stock	1,200
Profit and Loss Account	340	Debtors	520
12% Debentures	1,500	Cash at bank	740
Sundry Creditors	750		
Sundry Provisions	390		
	6,660		6,660

On 1st April, 2015. the company announced the buy-back of 25% of its equity shares @ ₹ 15 per share. For this purpose, it sold all of its investments for ₹ 150 lakhs and issued 2,00,000 14% preference shares of ₹ 100 each at par the entire amount being payable with application.

The issue was fully subscribed. The company achieved the target of the buy-back. Later, the company issued one fully paid-up equity share of ₹ 10 by way of bonus share for every four equity shares held by the equity shareholders.

Show journal entries for all the transactions including cash transactions.

Solution:

In the Books of Ispat Ltd.
Journal Entries

(₹ in lakhs)

Date	Particulars		Debit ₹	Credit ₹
	Bank A/c	Dr.	150	
	To Investments A/c			148
	To Profit and Loss A/c			2
	(Sale of investments & Profit transfered)			
	Bank A/c	Dr.	200	
	To 14% Preference Share Application A/c			200
	(Application money received on 2,00,000 preference shares at ₹ 100 each)			
	14% Preference Share Application A/c	Dr.	200	
	To 14% Preference Share Capital A/c			200
	(Allotement of preference shares to all applicants			
	Equity Share Capital A/c	Dr.	600	
	Securities Premium A/c	Dr.	300	
	To Equity Shareholders A/c			900
	(Amount due to shareholders for buying back of 25% of equity share capital @ ₹ 15 each)			
	Equity Shareholders A/c	Dr.	900	
	To Bank A/c			900
	(Payment made against money due to equity shareholders)			
	General Reserve A/c	Dr.	400	
	To Capital Redemption Reserve A/c			400
	(Nominal value of shares bought back and not by fresh issue transferred.)			
	Capital Redemption Reserve A/c	Dr.	400	
	Securities Premium A/c	Dr.	50	450
	To Bonus to Shareholders A/c			
	(Issue of bonus shares of one for every four Equity shares)			
	Bonus to Shareholders A/c	Dr.	450	
	To Equity Share Capital A/c			450
	(Convertion of bonus shares into equity shares)			

Illustration 24.

K Ltd. furnishes you with the following Balance Sheet as at 31st March, 2015:

(₹ in Crores)

Sources of Funds		
Share capital:		
Authorised		100
Issued:		
12% redeemable preference shares of ₹ 100 each fully paid	75	
Equity shares of ₹ 10 each fully paid	25	100
Reserves and surplus		
Capital reserve	15	
Share Premium	25	
Revenue reserves	260	300
		400
Funds employed in:		
Fixed assets: cost	100	
Less: Provision for depreciation	100	nil
Investments at cost (Market value ₹ 400 Cr.)		100
Current assets	340	
Less: Current liabilities	40	300
		400

The company redeemed preference shares on 1st April 2015. It also bought back 50 lakh equity shares of ₹ 10 each at ₹ 50 share. The payments for the above were made out of the huge bank balances, which appeared as a part of Current assets.

You are asked to:

i. Pass journal entries to record the above

ii. Prepare balance sheet

iii. Value equity share on net asset basis.

Solution:

Part I - Journal entries in the books of K Ltd.

(₹ in Crores)

	Particulars		Debit	Credit
a.	Redemption of Preference Shares on 1st April 2015			
	i. Due Entry:			
	12% Preference Share capital A/c	Dr.	75	
	To Preference Share Holders A/c			75
	ii. Payment Entry:			
	Preference Shareholders A/c	Dr.	75	
	To Bank A/c			75

b.	Shares bought back: i. On buy back Shares bought back A/c Dr. To Bank A/c (50 lakhs shares × ₹ 50 per share) ii. On Cancellation Equity Share capital A/c (50 Lakhs × ₹ 10) Dr. Security premium A/c (50 Lakhs × ₹ 40) Dr. To Shares bought back A/c iii. Transfer to Capital Redemption Reserve Revenue reserve A/c Dr. To Capital Redemption Reserve A/c (Being creation of capital redemption reserve to the extent of the face value of preference shares redeemed and equity shares bought back)	 25 5 20 80	 25 25 80

Part-II: Balance Sheet of M/s. K Ltd. after reconstruction:

Balance Sheet of M/s. K Ltd. as at 1.4.2015 (₹ in crores)

Solution:

Name of the Company: K Ltd.

Balance Sheet as at: 01.04.2015 **(₹ in crores)**

Ref No.	Particulars	Note No.	Current Year Reporting Period	Previous Year Reporting Period
			₹	₹
I	**EQUITY AND LIABILITIES**			
1.	**Shareholder's Fund**			
	(a) Share capital	1	20	
	(b) Reserves and surplus	2	280	
2	**Share application money pending allotment**		Nil	
3	**Non-current liabilities**		Nil	
4	**Current Liabilities**		Nil	
	(a)Other current liabilities		40	
	Total(1+2+3+4)		**340**	
II	**ASSETS**			
1.	Non-current assets			
	(a) Fixed assets			
	(i) Tangible assets	3	100	
	(b) Non-current investments (Market value of Investment)			
2	**Current assets**	4	240	
	Total(1+2)		**340**	

Notes to the Accounts

(₹ **in crores)**

Note 1. Share Capital	**Current Year (₹)**	**Previous Year (₹)**
Authorized Capital		
Equity share	100	
Total	100	
Issued Capital , Subscribed and Paid Up capital		
200 lakhs of ₹ 10 each	20	
Total	20	
12% Pref. Shares		
Share Capital	75	
Less: Redeemable	75	
Total	Nil	

Note 2. Reserve and Surplus	**Current Year**	**Previous Year**
Capital Reserve	15	
Capital Redemption Reserve	80	
Share Premium (25-20)	5	
Revenue Reserve (260-80)	180	
Total	280	

Note 3. Tangible Assets	**Current Year**	**Previous Year**
Fixed Assets	100	
Less: Provision for Depreciation	100	
Total	Nil	

Note 4. Cash and Cash Equivalent	**Current Year**	**Previous Year**
Current Assets	340	
Less: bank payment for redemption and buy back	(100)	
Total	240	

Current assets treated as cash and cash equivalent.

Part - III - Net Asset Value of Equity Shares

(₹ in crores)

	Particulars	**Amount**	**Amount**
a.	i. Fixed assets	Nil	
	ii. Investments (at market value)	4,00	
	iii. Current assets	2,40	6,40
b.	Less : Current liabilities		(40)
	Net assets available for equity share holders		6,00
c.	No. of equity shares outstanding		2
d.	Value per equity share of ₹10 each = (600÷2)		₹ 300

Illustration 25.

The following was the balance sheet of Diamond Ltd. as at 31st March, 2015.

Liabilities	₹ in lakhs
10% Redeemable Preference Shares of ₹ 10 each, fully paid up	2,500
Equity Shares of ₹ 10 each fully paid up	8,000
Capital Redemption Reserve	1,000
Securities Premium	800
General Reserve	6,000
Profit and Loss Account	300
9% Debentures	5,000
Sundry creditors	2,300
Sundry Provisions	1,000
	26,900

Assets	₹ in lakhs
Fixed assets	14,000
Investments	3,000
Cash at Bank	1,650
Other Current assets	8,250
	26,900

On 1st April, 2015 the company redeemed all of its preference shares at a premium of 10% and bought back 25% of its equity shares @ ₹ 15 per share. In order to make cash available, the company sold all the investments for ₹ 3,150 lakh and raised a bank loan amounting to ₹ 2,000 lakhs on the security of the company's plant.

Pass journal entries for all the above mentioned transactions including cash transactions and prepare the company's balance sheet immediately thereafter..

Solution:

Journal Entries

	Particulars		Debit ₹	Credit ₹
1.	Bank A/c	Dr.	3,150	
	To Investment A/c			3,000
	To Profit and Loss A/c			150
	(Being sale of investments and profit thereon)			
2.	Bank A/c	Dr.	2,000	
	To Bank Loan A/c			2,000
	(Being loan taken from bank)			
3.	10% Redeemable preference Share capital A/c	Dr.	2,500	
	Premium on redemption of preference shareholder A/c	Dr.	250	
	To Preference shareholder A/c			
	(Being redemption of preference shares)			2,750
4	Preference shareholders A/c	Dr.	2,750	
	To Bank A/c			2,750
	(Being payment of amount due to preference shareholders)			

	Particulars		Debit ₹	Credit ₹
5.	Securities premium A/c To Premium on redemption of preference share A/c (Being use of securities premium to provide premium on redemption of preference shares)	Dr.	250	 250
6.	Equity Share Capital A/c Securities premium A/c [800 - 250] General reserves A/c [(200×15) - 2000 - 550] To Equity shareholders A/c (being buy back of equity shares) Note : Balance of General Reserve [6,000 - 450] = ₹ 5,550.	Dr. Dr. Dr.	2,000 550 450	 3,000
7.	General Reserves A/ c To Capital redemption reserve A/c (2000 + 2500) (Being creation of capital redemption reserve to the extent of the face value of preference share redeemed and equity shares bought back). Note: Balance in General reserve as on 01.04.2012 (5,550 - 4500) = ₹ 1,050.	Dr.	4,500	 4,500
8.	Equity shareholders A/c To Bank A/c (Being payment of amount due to equity shareholders). Note : Cash at Bank [1650+3150+2000-2750-3000] = ₹ 1,050	Dr.	3,000	 3,000

Balance Sheet of Diamond Ltd., as on 01.04.2015

Balance Sheet as at: 01.04.2015 **(₹ in lakhs)**

Ref No.	Particulars	Note No.	Current Year Reporting Period	Previous Year Reporting Period
			₹	₹
I	**EQUITY AND LIABILITIES**			
1	**Shareholders' Funds**			
	(a) Share capital	1	6,000	
	(b) Reserves and surplus	2	7,000	
2	**Share application money pending allotment**		Nil	
3	**Non-current liabilities**		Nil	
	(a) Long-term borrowings	3	7,000	
4	**Current Liabilities**			
	(a) Trade payables		2,300	
	(b) Short-term provisions	4	1,000	
	Total(1+2+3+4)		23,300	
II	**ASSETS**			
1.	**Non-current assets**			
	(a) Fixed assets			
	(i) Tangible assets	5	14,000	
2	**Current assets**			
	(a) Cash and cash equivalents		1,050	
	(b) Other current assets		8,250	
	Total(1+2)		**23,300**	

Notes to the Accounts

(₹ in Lakhs)

Note 1. Share Capital	**Current Year (₹)**	**Previous Year (₹)**
Issued Capital , Subscribed and Paid Up capital		
Equity Shares of ₹ 10 each	6,000	
Total	6,000	

Note 2. Reserve and Surplus	**Current Year**	**Previous Year**
Capital Redemption Reserve (1,000+4,500)	5,500	
General Reserve	1,050	
Profit and Loss(300+150)	450	
Total	7,000	

Note 3. Long Term borrowings	**Current Year**	**Previous Year**
9% Debenture	5,000	
Bank Loan	2,000	
Total	7,000	

Note 4. Short Term Provisions	**Current Year**	**Previous Year**
Sunday Provision	1,000	
Total	1,000	

Note 4. Tangible Assets	**Current Year**	**Previous Year**
Fixed Assets	14,000	
Total	14,000	

Illustration 26.

XYZ Ltd. has the following capital structure on of 31st March 2015.

Particulars	**₹ in Crores**
a. Equity Share capital (Shares of ₹ 10 each)	300
b. Reserves :	
General reserve	270
Security Premium	100
Profit and Loss A/c	50
Export Reserve (Statutory reserve)	80
c. Loan Funds	800

The shareholders have on recommendation of Board of Directors approved vide special resolution at their meeting on 10th April 2015 a proposal to buy back maximum permissible equity shares considering the huge cash surplus following A/c of one of its divisions.

The market price was hovering in the range of ₹ 25 and in order to induce existing shareholders to offer their shares for buy back, it was decided to offer a price of 20% above market.

Advice the company on maximum number of shares that can be bought back and record journal entries for the same assuming the buy back has been completed in full within the next 3 months.

If borrowed funds were ₹ 1200 crores, and 1500 crores respectively would your answer change?

Solution:

Maximum shares that can be bought back

		Situation I	Situation II	Situation III
a.	Shares outstanding test (WN # 1)	7.5	7.5	7.5
b.	Resources test (WN # 2)	6	6	6
c.	Debt Equity ratio test (WN # 3)	10.67	4	—
d.	Maximum number of shares for buy back - LEAST of the above	6	4	—

	Particulars		Situation I		Situation II	
			Debit	Credit	Debit	Credit
a.	Shares bought back A/c	Dr.	180		120	
	To Bank A/c			180		120
	[Being purchase of shares from public]					
b.	Share capital A/c	Dr.	60		40	
	Security premium A/c	Dr.	100		80	
	General reserve A/c (balancing figure)	Dr.	20		—	
	To Shares bought back A/c			180		120
	[Being cancellation of shares bought on buy back]					
c.	General reserves A/c	Dr.	60		40	
	To Capital redemption reserve A/c			60		40
	[Being transfer of reserves to capital redemption reserve to the extent capital is redeemed]					

Note : Under situation III, the company does not qualify the debt equity ratio test. Therefore the company cannot perform the buy back of shares

WORKING NOTES :

WN # 1: Shares outstanding test

	Particulars	Amount
a.	No. of shares outstanding	30 crores
b.	25% of shares outstanding	7.5 crores

WN # 2: Resources test

(₹ in Crores)

	Particulars	Amount
a.	Paid up capital	300
b.	Free reserves	420
c.	Shareholders fund (a+b)	720
d.	25% of shareholders fund	180
e.	Buyback price per share	₹ 30
f.	Number of shares that can be bought back	6 Crores

WN # 3: Debt Equity ratio test:

(₹ in Crores)

	Particulars	Situation I	Situation II	Situation III
a.	Borrowed Funds	800	1.200	1.500
b.	Minimum equity to be maintained after buy back in the ratio 2:1	400	600	750
c.	Present equity	720	720	720
d.	Maximum possible dilution in equity	320	120	—
e.	Maximum shares that can be bought back @ ₹ 30/- per share	10.67	4	—

3.4 ISSUE & REDEEMPTION OF PREFERENCE SHARES

Introduction

Preference shares that can be redeemed by the company in accordance with the terms of issue are called Redeemable Preference shares. However the Articles of the company must have the provision in this regard.

The terms of issue generally stipulate the time of redemption and whether the redemption will be at par or premium.

Irredeemable preference shares, on the other hand, are those preference shares which can not be redeemed except the event of the company being wound up.

Issue and Redemption of Preference Shares [Section 55]

(1) No company limited by shares shall, after the commencement of this Act, issue any preference shares which are irredeemable.

(2) A company limited by shares may, if so authorised by its articles, issue preference shares which are liable to be redeemed within a period not exceeding twenty years from the date of their issue subject to such conditions as may be prescribed.

Provided that a company may issue preference shares for a period exceeding twenty years for infrastructure projects, subject to the redemption of such percentage of shares as may be prescribed on an annual basis at the option of such preferential shareholders.

Provided further that -

(a) Out of the profits of the company or out of the proceeds of a fresh issue of shares made for the purposes of such redemption;

(b) Redeemed of fully paid share only;

(c) If redeemed out of the profits of the company, then a sum equal to the nominal amount of the shares to be redeemed, transfer to the Capital Redemption Reserve Account; and

(d) (i) in case of a companies on which provision of section 133 is apply, the premium, if any, payable on redemption shall be provided for out of the profits of the company, before the shares are redeemed.

If premium is payable on redemption of any preference shares issued on or before the commencement of this Act by any such company shall be provided for out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.

(ii) in a case not falling under sub-clause (i) above, if the premium is payable on redemption shall be provided for out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.

(3) Where a company is not in a position to redeem any preference shares or to pay dividend, if any, on such shares in accordance with the terms of issue (such shares hereinafter referred to as unredeemed preference shares), it may, with the consent of the holders of three-fourths in value of such preference shares and with the approval of the Tribunal on a petition made by it in this behalf, issue further redeemable preference shares equal to the amount due, including the dividend thereon, in respect of the unredeemed preference shares, and on the issue of such further redeemable preference shares, the unredeemed preference shares shall be deemed to have been redeemed.

Provided that the Tribunal shall, while giving approval under this sub-section, order the redemption forthwith of preference shares held by such persons who have not consented to the issue of further redeemable preference shares.

(4) The capital redemption reserve account may be applied by the company for issue of fully paid bonus shares.

Issue and Redemption of Preference Shares by Company in Infrastructural Projects

A company engaged in the setting up and dealing with of infrastructural projects may issue preference shares for a period exceeding twenty years but not exceeding thirty years, subject to the redemption of a minimum ten percent of such preference shares per year from the twenty first year onwards or earlier, on proportionate basis, at the option of the preference shareholders.

Illustration 27.

T Ltd. furnishes you with the following Balance Sheet as at 31st March, 2015 :

(₹ in Lakhs)

Equity shares of ₹ 10 each fully paid	400	
12% redeemable preference shares of ₹ 100 each fully paid	200	
Reserves and surplus:		
- Capital reserve	15	
- Share Premium	25	
-Revenue reserves	260	300
		900
Funds Employed in :		
Fixed assets less depreciation		560
Current assets	540	
Less : Current liabilities	200	340
		900

The company redeemed preference shares on 1st April 2015 at a premium of 10%. You are required to pass journal entries to record the above

Solution :

Part I - Journal entries in the books of T Ltd. (₹ in Lakhs)

Particulars		Debit	Credit
i. Due Entry:			
12% Preference Share capital A/c	Dr.	200	
Premium on redemption of preference share A/c	Dr.	20	
To Preference Share Holders A/c			220
ii. Payment Entry:			
Preference Shareholders A/c	Dr.	220	
To Bank A/c			220
iii. Premium on redemption of preference Share			
Securities Premium A/c	Dr.	20	
To Premium on redemption of preference share A/c			20
iv. Transfer to Capital Redemption Reserve Account			
Revenue reserve A/c	Dr.	200	
To Capital Redemption Reserve A/c			200
(Being creation of capital redemption reserve to the extent of the face value of preference shares redeemed and equity shares bought back)			

Sec. 55 was intended to cover the period of transition and will have no significance after the companies fulfill the requirements stated therein.

CAPITAL REDEMPTION RESERVE

(A) Transfer to capital redemption reserve account is allowed from these profits.

(i.e Profits otherwise available for dividend)

1. General reserve
2. Reserve fund
3. Dividend equalisation fund
4. Insurance fund
5. Workmen's compensation fund
6. Workmen's accident fund
7. Voluntary debenture redemption account
8. Voluntary debenture sinking fund
9. Profit and loss account.

(B) Transfer to capital redemption reserve account is not allowed from these profits.

(i.e Profits otherwise not available for dividend)

1. Securities premium account
2. Forfeited shares account
3. Profit prior to incorporation
4. Capital reserve
5. Development rebate reserve

Proceeds of fresh issue.

The word 'proceeds' used in the present context implies the amount received excluding the amount of share premium, if shares are issued at premium; but the net amount received if shares are issued either at par or at discount.

Though there remains the controversy over the meaning of the term but a closer examination of the provisions and intentions of the company law reveals that, the word 'proceeds of shares' does not include the amount of premium if shares are issued at premium but stands for the actual amount received if shares are issued at par or at discount. This may be clearer from the following example:

A company is to redeem its preference shares of (say) ₹ 10,00,000. If the company decides to redeem these shares by making an equivalent issue of fresh shares at (say) 10% discount, the company, on the one hand, gets ₹ 9,00,000 in cash from the fresh issue and on the other hand pays ₹ 10,00,000 for redeeming shares. Though the liability side of the balance sheet apparently discloses that shares have been properly replaced because new shares of ₹ 10,00,000 will appear at face value, it does not amount to a replacement of assets utilized in the redemption of redeemable preference shares.

This is particularly significant, considering an extreme case, when by chance the company goes into liquidation immediately after the redemption of preference shares, and when the financial position of the company is as bad as not to be able to pay back its creditors in full. In such a case it does mean the repayment of capital in priority over the creditors to the extent of ₹ 1,00,000 which is the amount of discount. If 'proceeds' were interpreted as the amount actually received, preference shares would have been redeemed only to the extent of ₹ 9,00,000 which is properly replaced by a fresh issue.

However, if shares are issued at premium the total amount received including the amount of premium cannot be taken to purport 'proceeds' in the sense in which the Act has used this word. The amount of premium is to be deducted from the total proceeds for arriving at the 'proceeds of a fresh issue' for the purpose of this section. This is based on the following premises:

(i) The proceeds of premium, although represented by tangible assets, do not provide any protection to the third party as proceeds of premium may not be kept intact like proceeds of the share capital until the repayment of all creditors because the premium has been allowed to be used (not share capital) for the following four purposes under Sec. 52 of the Companies Act, 2013:

  a) in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares;

  b) in writing off the preliminary expenses of the company;

  c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company, or

  d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

  The utilization of the premium for the above purposes distinguishes it from the proceeds of share capital which is made available only to creditors in the event of liquidation.

(ii) If proceeds of premium be allowed to be included in the total proceeds for the redemption purpose, the capital redeemed will be replaced partly by share capital and partly by security premium. If this interpretation of the proceeds is taken to be correct, the security available to the creditors may be reduced after some time by the amount of premium as the utilization of premium is open for specified purposes under the provisions of the Act itself.

(iii) Sec. 52 further states that security premium if used for any other purpose except for that stated in Sec. 52, will amount to reduction of share capital. This logically means that security premium account is not treated as paid up capital of the company only when it is used for the four purposes. The protection provided by the security premium thus, is only incidental and uncertain.

(iv) Besides, the above negative approach, the Act clearly states that it premium account is used for any purpose other than the four purposes stated in Sec. 52, it amounts to reduction of capital. Under such circumstances, if security premium is used for the redemption purpose which is outside the scope of the four purposes, it must amount to a reduction of capital.

Accounting Entries Necessary for Redemptions and issue of Bonus shares

Transaction	**Journal Entry**	
1. Due for redemption (a) at a premium (b) at Par	Red. Pref. Share Capital A/c Premium on Redemption A/c To Red. Pref. Shareholders A/c Red. Pref. Share Capital A/c To Red. Pref. Shareholders A/c	Dr. Dr. Dr.
2. Sale of Investment, if any, for fund. P/L on Sale transferred to P/L A/c	Bank A/c To Investments A/c To Profit and Loss A/c (Sale of investments & Profit transferred)	Dr.
3. Fresh Issue for Fund, If any, a> at par (b) at a premium (c) at a discount	Bank A/c To Equity Share Capital A/c Bank A/c To Equity Share Capital A/c To Securities Premium A/c Bank A/c Discount on issue of shares To Equity Share Capital A/c	Dr. Dr. Dr. Dr.
4. Transfer of Premium on Redemption.	Securities Premium A/c , or Profit and Loss A/c To Premium on Redemption A/c	Dr. Dr.
5. Payment to Shareholders	Red. Pref. Shareholders A/c To Bank A/c	Dr.
6. Nominal value of shares Redeemed, not by fresh issue of shares.	General Reserve A/c Profit and Loss A/c To Capital Redemption Reserve A/c	Dr. Dr.
7. Issue of bonus shares (a) At a premium (b) At Par	Capital Redemption Reserve A/c Securities Premium A/c To Bonus to Shareholders A/c Capital Redemption Reserve A/c To Bonus to Shareholders A/c	Dr. Dr. Dr.
8. Conversion of bonus shares into equity shares	Bonus to Shareholders A/c To Equity Share Capital A/c	Dr.
9. Conversion of Red. Pref. Share into other shares	Red. Pref. Share Capital A/c To pref. / Equity share capital A/c	Dr.

Illustration 28. Find out in each case what amount shall be transferred to capital redemption reserve account:

	Redeemable preference shares redeemed	Fresh issue of share capital
a.	₹ 10,00,000 at par	₹ 10,00,000 at par
b.	₹ 10,00,000 at 5% premium	₹ 800,000 at par
c.	₹ 10,00,000 at par	₹ 800,000 at 10% premium
d.	₹ 10,00,000 at 5% premium	₹ 800,000 at 10% premium

Solution:

For (a)	Nil.
For (b), (c) and (d)	₹ 2,00,000

Explanation:

Amount utilized from the existing sources towards the nominal value of the preference shares redeemed, should be transferred to Capital Redemption Reserve Account. So, in the above case, the difference of nominal value of shares redeemed and amount received from nominal value of fresh issue is the transferable amount.

In case of (a) the total requirement is met up by fresh issue.

In cases of (b), (c) and (d): ₹10,00,000 – ₹ 8,00,000 (from nominal value of fresh issue) i.e. ₹ 2,00,000

Illustration 29. The Balance Sheet of Pixel Ltd. as on 31.12.2014 is given below:

Liabilities	₹ in Lakh	Assets	₹ in Lakh
Share Capital:		Fixed Assets	140
10,00,000 Equity shares of		Investments	40
₹ 10 each	100	Stock	46
1,00,000 Redeemable Pref.		Debtors	30
shares of ₹100 each	100	Bank	30
Less: Call-in-arrears on	(4)		
20,000 shares			
Security premium account	15		
Reserve	30		
Profit and Loss account	15		
Creditors	30		
	286		286

On 1st Jan 2015, fixed assets costing ₹ 40 Lakh were sold for ₹ 32 Lakh. It was decided that on 1st Feb 2015, company issued sufficient number of equity shares at par so as to finance redemption and to leaving a balance of ₹ 10 Lakh in the reserve. All the payments were made except to a holder of 10,000 shares who could not be traced. The company also made bonus issue to the existing equity shareholders in the ratio of 1: 10 as on 31.12.2014. You are required to pass the necessary journal entries.

Solution

Workings:

Requirement of Fund for Redemption

	No.	Rate	₹ in Lakhs
Pref Shares	1,00,000	100	100
Calls in Arrear	20,000	100	20
Bal. to be redeemed	80,000		80
Prem on redemption		20%	16
Total Fund requirement			96

Sources	Nominal Value	Premium	Total
Requirement	80	16	96
Securities Prem. A/c		15	15
P/L A/c	6	1	7
General Reserve	20		20
Balance fund requirement (From fresh issue)	60		60
New Issue	60		

Actual payment made = (80,000-10,000)*120 = ₹ 84 Lakh

Transfer to Capital Redemption Reserve	₹ in Lakh	₹ in Lakh
From P/L A/c		
Balance	15	
Less: Loss on Sale of Assets	8	
Balance	7	
Less: Used for Premium on Redemption of Pref. Shares	1	6
From General Reservet		20
Total		26

In the books of Pixel Ltd.
Journal entries

Journal Entry		Dr. ₹ in Lakh	Cr. ₹ in Lakh
Bank A/c	Dr.	32	
Profit and Loss A/c	Dr.	8	
To Fixed Assets A/c			40
(Sale of Fixed Assets, Loss transferred)			
Bank A/c	Dr.	60	
To Equity Share Capital A/c			60
(Issue of new shares)			
Red. Pref. Share Capital A/c	Dr.	80	
Premium on Redemption A/c	Dr.	16	
To Red. Pref. Shareholders A/c			96
(Amount due on Redemption)			
General Reserve A/c	Dr.	20	
Profit and Loss A/c	Dr.	6	
To Capital Redemption Reserve A/c			26
(Transfer)			
Securities Premium A/c	Dr.	15	
Profit and Loss A/c	Dr.	1	
To Premium on Redemption A/c			16
(Transfer)			
Red. Pref. Shareholders A/c	Dr.	84	
To Bank A/c			84
(Payment to Pref. Shareholders)			
Capital Redemption Reserve A/c	Dr.	16	
To Bonus to Shareholders A/c			16
(Bonus declared)			
Bonus to Shareholders A/c	Dr.	16	
To Equity Share Capital A/c			16
(Conversion of Bonus Shares to Equity Shares)			

SWEAT EQUITY SHARES

Issue of Sweat Equity Shares [Section 54]

Notwithstanding anything contained in section 53, a company may issue sweat equity shares of a class of shares already issued, if the following conditions are fulfilled, namely:—

(a) the issue is authorised by a special resolution passed by the company;

(b) the resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;

(c) not less than one year has, at the date of such issue, elapsed since the date on which the company had commenced business; and

(d) where the equity shares of the company are listed on a recognised stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

The rights, limitations, restrictions and provisions as are for the time being applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank pari passu with other equity shareholders.

Disclosure Requirement in Director's Report in relation to Issue of Sweat Equity Shares

The Board of Directors shall disclose in the Directors' Report for the year in which such shares are issued, the following details of issue of sweat equity shares namely:-

(i) the class of director or employee to whom sweat equity shares were issued;

(ii) the class of shares issued as Sweat Equity Shares;

(iii) the number of sweat equity shares issued to the directors, key managerial personnel or other employees showing separately the number of such shares issued to them , if any, for consideration other than cash and the individual names of allottees holding one percent or more of the issued share capital;

(iv) the reasons or justification for the issue;

(v) the principal terms and conditions for issue of sweat equity shares, including pricing formula;

(vi) the total number of shares arising as a result of issue of sweat equity shares;

(vii) the percentage of the sweat equity shares of the total post issued and paid up share capital;

(viii) the consideration (including consideration other than cash) received or benefit accrued to the company from the issue of sweat equity shares;

(ix) the diluted Earnings Per Share (EPS) pursuant to issuance of sweat equity shares

Special Resolution (Regulation 5)

1. For the purposes of passing a special resolution under clause (a) of sub-section (1) of section 54 of the Companies Act, 2013 the explanatory statement to be annexed to the notice for the general meeting pursuant to section 102 of the Companies Act, 2013 shall contain the following disclosures

    a. The total number of shares to be issued as sweat equity.

    b. The current market price of the shares of the company.

c. The value of the intellectual property rights or technical know how or other value addition to be received from the employee or director along with the valuation report / basis of valuation.

d. The names of the employees or directors or promoters to whom the sweat equity shares shall be issued and their relationship with the company.

e. The consideration to be paid for the sweat equity.

f. The price at which the sweat equity shares shall be issued.

g. Ceiling on managerial remuneration, if any, which will be affected by issuance of such sweat equity.

h. A statement to the effect that the company shall conform to the accounting policies as specified by the Board.

i. Diluted Earnings Per Share pursuant to the issue of securities to be calculated in accordance with International Accounting Standards / standards specified by the Institute of Chartered Accountants of India.

2. The issue of sweat equity shares to promoters shall be subject to the additional requirements specified in SEBI Regulations (Regulation 6)

1. The issue of sweat equity shares to promoters, should be approved by simple majority of the shareholders in General Meeting.

- Provided that for passing such resolution, voting through postal ballot as specified under Companies (Passing of the resolution by Postal Ballot) Rules 2001 shall also be adopted.
- Provided further that the promoters to whom such Sweat Equity Shares are proposed to be issued shall not participate in such resolution.

2. Each transaction of issue of Sweat Equity shall be voted by a separate resolution.

3. The resolution for issue of Sweat Equity shall be valid for a period of not more than twelve months from the date of passing of the resolution.

4. For the purposes of passing the resolution, the explanatory statement shall contain the disclosures as specified in the Schedule (Listed under Regulation 5.1 above)

Pricing of Sweat Equity Shares (Regulation 7)

1. The price of sweat equity shares shall not be Shares. less than the higher of the following:-

a. The average of the weekly high and low of the closing prices of the related equity shares during last six months preceding the relevant date; or

b. The average of the weekly high and low of the closing prices of the related equity shares during the two weeks preceding the relevant date.

2. If the shares are listed on more than one stock exchange, but quoted only on one stock exchange on the given date, then the price on that stock exchange shall be considered.

3. If the share price is quoted on more than one stock exchange, then the stock exchange where there is highest trading volume during that date shall be considered.

4. If shares are not quoted on the given date, then the share price on the next trading day shall be considered.

Valuation of intellectual Property (Regulation 8.1)

The valuation of the intellectual property rights Property. or of the know-how provided or other value addition mentioned in Explanation II of sub-section (1) of Section 54 of the Companies Act, 2013 shall be carried out by a merchant banker.

1. The merchant banker may consult such experts and valuers, as he may deem fit having regard to the nature of the industry and the nature of the property or other value addition

2. The merchant banker shall obtain a certificate from an independent Chartered Accountant that the valuation of the intellectual property or other value addition is in accordance with the relevant accounting standards.

Accounting Treatment (Regulation 9.1)

Where the sweat equity shares are issued for a non – cash consideration, such non-cash consideration shall be treated in the following manner in the books of account of the company:-

a. where the non-cash consideration takes the form of a depreciable or amortizable asset, it shall be carried to the balance sheet of the company in accordance with the relevant accounting standards; or

b. where clause (a) is not applicable, it shall be expensed as provided in the relevant accounting standards.

Placing of Auditors Certificate before Annual General Meeting.(Regulation 10)

In the general meeting subsequent to the issue of sweat equity, the Board of Directors shall place before the shareholders, a certificate from the auditors of the company that the issue of sweat equity shares has been made in accordance with the Regulations and in accordance with the resolution passed by the company authorizing the issue of such Sweat Equity Shares.

Ceiling on Managerial Remuneration.(Regulation 11)

The amount of Sweat Equity shares issued shall be treated as part of managerial remuneration for the purposes of sections 197 of the Companies Act, 2013 if the following conditions are fulfilled:

i. the Sweat Equity shares are issued to any director or manager; and,

ii. they are issued for non-cash consideration, which does not take the form of an asset which can be carried to the balance sheet of the company in accordance with the relevant accounting standards.

Lock-in of sweat equity shares (Regulation 12.1)

The Sweat Equity shares shall be locked in for a period of three years from the date of allotment. The Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000, on public issue in terms of lock-in and computation of promoters' contribution shall apply if a company makes a public issue after it has issued sweat equity.

Listing (Regulation 13)

The Sweat Equity issued by a listed company shall be eligible for listing only if such issue are in accordance with these regulations.

Applicability of Takeover (Regulation 14)

Any acquisition of Sweat Equity Shares shall be subject to the provision of Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

General Obligations - Obligations of the Company (Regulation 15)

The company shall ensure that -

a. The Explanatory Statement to the notice for general meeting shall contain certain disclosures as are specified under clause (b) of Sub-section (1) of Section 54 of the Companies Act, 2013 and sub-regulation (1) of Regulation 5.

b. Auditor's certificate as required under Regulation 10 shall be placed in the general meeting of shareholders.

c. The company shall within seven days of the issue of sweat equity, issue or send statement to the recognized stock exchange, disclosing :

   (i) number of sweat equity shares ;

   (ii) price at which the sweat equity shares are issued ;

   (iii) total amount invested in sweat equity shares ;

   (iv) details of the persons to whom sweat equity shares are issued; and,

   (v) the consequent changes in the capital structure and the shareholding pattern after and before the issue of sweat equity.

Action against intermediaries (Regulation 16)

The Board may, on failure of the merchant banker to comply with the obligations under these regulations or failing to observe due diligence in respect of valuation of intellectual property or value addition, initiate action against the merchant banker in terms of Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992.

Accounting treatment:

Case 1

Tinku Ltd. allotted 500 sweat equity shares of ₹100 each to its Directors at a discount of 6%.

Bank A/c	Dr.	47,000	
Discount on issue of Shares (Sweat Equity) A/c	Dr.	3,000	
To Equity Share Capital (Sweat Equity) A/c			50,000

(Being allotment of 500 sweat equity shares of ₹100 each to Directors at a discount of 6%, balance amount of ₹ 94 per share duly received)

Case 2

Balance amount was duly received. 800 sweat equity shares of ₹100 alloted to employees at par in consideration of technical know-how.

Technical Know-how A/c	Dr.	80,000	
To Equity Share Capital (Sweat Equity) A/c			80,000

(Being allotment of 800 sweat equity shares of ₹100 each to employees at par, in consideration of technical know-how)

3.5 DEBENTURES-ISSUE AND REDEMPTION

INTRODUCTION

"Debenture" includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.

A commercial definition of the debenture is an acknowledgement of a debt in writing, given under the seal of the company, containing a contract for the repayment of the principal sum at a specified date and for the payment of interest (usually half yearly) at a fixed rate until the principal sum is repaid. It may or may not give a charge on the assets of the company as a security for the loan.

A debenture like a share is also a movable property transferable in the manner provided in the Articles of the company.

Requirement

The long-term requirements of capital are raised by any company primarily through issue of shares and debentures. While the shareholders are essentially the owners of the enterprise, those who buy debentures are creditors for long-term funds and do not enjoy voting rights. In brief all securities other than shares issued by a company will come under the term debentures.

According to the guidelines issued by the Controller of Capital Issues, the objects of the issue can be among other things:

1) Setting up of new projects;
2) Expansion or diversification of existing projects;
3) Normal capital expenditure for modernization;
4) To augment long-term resources of the company for working capital requirements;
5) Merger /Amalgamation of companies in pursuance of schemes approved by banks, financial institutions and/or any legal authority;

Differences between Shares and Debentures

	SHARES	DEBENTURES
Definition	An instrument to acknowledge the ownership of the company	An instrument to acknowledge the creditors of the company
Status	A shareholder is the owner and a member of the company.	A debenture holder is not a member but a creditor.
Return	A shareholder may receive dividend only when a company makes a profit.	A debenture holder has a right to interest even if the company does not make profit.
Rate of return	Dividend rate can vary depending on the profit position.	Debenture carries a fixed rate of interest.
Accounting treatment	Dividend is given out of appropriable profit and not chargeable to Profit and Loss account.	Debenture interest is chargeable to Profit and Loss account.
Redemption	In the case of shares, the concept of redemption does not apply. However as per the recent change in the companies Act, a company can buy back shares in accordance with the provisions in the Act.	Debentures are normally redeemable although a company can issue perpetual debentures
Voting rights	A shareholder has voting rights.	A debenture holder cannot have voting rights.
Status at the time of winding up	At the time of winding up share holders have the least priority regarding the return of amount due to them.	At the time of winding up debenture holders have a priority over the share holders regarding the return of amount due to them

Types of Debentures

Debentures can be classified according to permanence, security, priority, convertibility and records point of view.

(1) **Permanence point of view.**

(a) Redeemable debentures:

Debentures, which are redeemed or the payment of which is made after a specified time, are called as Redeemable Debentures.

These are redeemable-

i. At the expiry of a specified period either at par or at premium;

ii. By purchasing in the open market at any time at the price prevailing in the market; and

iii. By annual drawings.

(b) Irredeemable debentures.

When the issuing company does not fix any date by which they should be redeemed and the holders of such debentures cannot demand payment from the company so long as it is a going concern. Usually such debentures are repayable after a long period of time or on winding up of the company.

(2) **Priority point of view.**

a. First debentures:

Those debentures, which are repaid before other debentures are paid out, are called First debentures.

b. Second debentures:

Those debentures, which are paid after the payment towards the first debenture, are called Second debentures.

c. Convertible debentures:

Those debentures, which are given the option to convert the debentures fully or partly into equity shares after a specified time, are called Convertible debentures. If the debentures are fully converted, then it is called as 'Fully Convertible Debentures'. Those which are partly convertible are called 'Partly Convertible Debentures'. The non-convertible portion of the debenture is also called 'Khoka' in market circles.

Conversion may be at par or premium.

d. Non-convertible debentures:

The holders of which have no right to convert them into equity shares. These are called Non-convertible debentures.

(3) **Security point of view.**

(a) Naked debentures:

Those debentures which are not secured, is called, naked debentures. Companies having very good standing are able to issue debentures of this type. They are not very common.

(b) Mortgage debentures:

Debentures, which are secured either on a particular asset [called fixed charge] or on the general assets of the company [called floating charge], is called Mortgage debentures.

Accounting for Debentures.

There are three stages of accounting for debentures:

(i) When debentures are issued;

(ii) When provision for its redemption is made; and

(iii) When ultimately debentures are redeemed. A detailed study of each stage is made in the following pages.

1. ISSUE OF DEBENTURES

Debenture [Section 71]

(1) A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption.

Provided that the issue of debentures with an option to convert such debentures into shares, wholly or partly, shall be approved by a special resolution passed at a general meeting.

(2) No company shall issue any debentures carrying any voting rights.

(3) Secured debentures may be issued by a company subject to such terms and conditions as may be prescribed.

(4) Where debentures are issued by a company under this section, the company shall create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account shall not be utilised by the company except for the redemption of debentures.

(5) No company shall issue a prospectus or make an offer or invitation to the public or to its members exceeding five hundred for the subscription of its debentures, unless the company has, before such issue or offer, appointed one or more debenture trustees and the conditions governing the appointment of such trustees shall be such as may be prescribed.

(6) A debenture trustee shall take steps to protect the interests of the debenture-holders and redress their grievances in accordance with such rules as may be prescribed.

(7) Any provision contained in a trust deed for securing the issue of debentures, or in any contract with the debenture-holders secured by a trust deed, shall be void in so far as it would have the effect of exempting a trustee thereof from, or indemnifying him against, any liability for breach of trust, where he fails to show the degree of care and due diligence required of him as a trustee, having regard to the provisions of the trust deed conferring on him any power, authority or discretion.

Provided that the liability of the debenture trustee shall be subject to such exemptions as may be agreed upon by a majority of debenture-holders holding not less than three-fourths in value of the total debentures at a meeting held for the purpose.

(8) A company shall pay interest and redeem the debentures in accordance with the terms and conditions of their issue.

(9) Where at any time the debenture trustee comes to a conclusion that the assets of the company are insufficient or are likely to become insufficient to discharge the principal amount as and when it becomes due, the debenture trustee may file a petition before the Tribunal and the Tribunal may, after hearing the company and any other person interested in the matter, by order, impose such restrictions on the incurring of any further liabilities by the company as the Tribunal may consider necessary in the interests of the debenture-holders.

(10) Where a company fails to redeem the debentures on the date of their maturity or fails to pay interest on the debentures when it is due, the Tribunal may, on the application of any or all of the debenture-holders, or debenture trustee and, after hearing the parties concerned, direct, by

order, the company to redeem the debentures forthwith on payment of principal and interest due thereon.

(11) If any default is made in complying with the order of the Tribunal under this section, every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than two lakh rupees but which may extend to five lakh rupees, or with both.

(12) A contract with the company to take up and pay for any debentures of the company may be enforced by a decree for specific performance.

(13) The Central Government may prescribe the procedure, for securing the issue of debentures, the form of debenture trust deed, the procedure for the debenture-holders to inspect the trust deed and to obtain copies thereof, quantum of debenture redemption reserve required to be created and such other matters.

Issue of Secured Debenture

The company shall not issue secured debentures, unless it complies with the following conditions, namely:-

(a) An issue of secured debentures may be made, provided the date of its redemption shall not exceed ten years from the date of issue.

Provided that the following classes of companies may issue secured debentures for a period exceeding ten years but not exceeding thirty years,

(i) Companies engaged in setting up of infrastructure projects;

(ii) ‘Infrastructure Finance Companies’ as defined in clause (viia) of sub-direction (1) of direction 2 of Non-Banking Financial (Non-deposit accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

(iii) ‘Infrastructure Debt Fund Non-Banking Financial companies’ as defined in clause (b) of direction 3 of Infrastructure Debt Fund Non-Banking Financial Companies (Reserve Bank) Directions, 2011.

(b) such an issue of debentures shall be secured by the creation of a charge, on the properties or assets of the company, having a value which is sufficient for the due repayment of the amount of debentures and interest thereon;

(c) the company shall appoint a debenture trustee before the issue of prospectus or letter of offer for subscription of its debentures and not later than sixty days after the allotment of the debentures, execute a debenture trust deed to protect the interest of the debenture holders ; and

(d) the security for the debentures by way of a charge or mortgage shall be created in favour of the debenture trustee on-

(i) any specific movable property of the company (not being in the nature of pledge); or

(ii) any specific immovable property wherever situate, or any interest therein.

SEBI Regulations on Issue of Debentures

1. **Credit rating.** It is compulsory in the case of all issues of debenture. If a company has obtained more than one rating, all such ratings must be disclosed. If the issue exceeds ₹ 200 crores, rating must be obtained from two agencies.

2. **Put and call options.** If FCDs are to be converted before 18 months, they are considered as quasi-equity. If conversion is after 18 months but before 36 months, it is treated as deferred equity. In the case of deferred equity, the conversion will be optional in the hands of debenture holder. In the case of conversion beyond 36 months, it must be made optional with both put and call options.

3. **Security for debentures.** If secure debentures are issued, a company must obtain certificate from the bankers that the assets are free from encumbrances or no objection certificate from the bank/financial institution for creating a second charge or *pari passu* charge as per terms of offer of debentures. Normally security must be created within 6 months. If security is not created, within 12 months, a penal interest at 2% is payable to debenture holders. If the security is not created, within 18 months, a meeting of the debenture holders must be called with 21 days notice to explain the reasons for delay in creating the security and the expected date by which security will be created.

   Trustees to debentures will supervise the creation of security. If security is not created, the debentures will be unsecured. As stated earlier in such a situation, the debentures will be treated as fixed deposits which makes it incumbent to satisfy the requirements of Sec. 73 & 74.

4. **Debenture trustees.** If the maturity of debentures is more than 18 months, the company has to appoint debenture trustees to safeguard the interests of the debenture holders. The trustees should have requisite powers for protecting the interests of the debenture holders including their rights to nominate a director on the board in consultation with institutional debenture holders.

The debenture trustees must also ensure the compliance of the following:

(a) Lead financial institutions / investment institutions should monitor the progress in respect of debentures raised for project finance/modernization/ expansion/ diversification/ normal capital expenditure.

(b) The lead bank must monitor debentures raised for working capital funds.

(c) Obtain a certificate from the company's auditors during the implementation period of the projects and in the case of debentures for working capital at the end of each accounting year.

(d) Debenture issues by companies belonging to the groups for financing replenishing of funds or acquiring shares in other companies should not be permitted.

(e) The trustees must supervise the implementation of the conditions regarding creation of security for the debentures and debenture redemption reserve.

Accounting Aspects of Issue

Accounting aspects of issue of debenture may be studied from three different sides.

(1) What would be the consideration?

  (a) Issued for cash

  (b) Issued for consideration other than cash

  (c) Issued as collateral security

(2) What would be the issue price?

  (a) Issued at par

  (b) Issued at premium

  (c) Issued at discount

(3) How the redemption be made.

  (a) Redeemed at par

  (b) Redeemed at premium

  (c) Redeemed at discount

Combining (2) and (3), the following are the options of issue.

(a) Issued at par and redeemable at par

(b) Issued at discount and redeemable at par

(c) Issued at premium and redeemable at par

(d) Issued at premium and redeemable at premium

(e) Issued at par and redeemable at premium

(f) Issued at discount and redeemable at premium

The accounting entries for the above six combinations are given in the table below.

	Transaction	Account	
		Debited	**Credited**
A.	Issued at par and redeemable at Par	Bank	Debentures
B.	Issued at discount and redeemable at par	Bank Discount on issue of debentures	Debentures
C.	Issued at premium and redeemable at par	Bank	Debentures Security Premium
D.	Issued at premium and redeemable at premium	Bank Loss on issue of debenture	Debentures A/c Security Premium Prem. on redemption of debentures.
E.	Issued at par and redeemable at premium	Bank Loss on issue of debentures	Debentures Prem. on redemption of debentures
F.	Issued at discount and redeemable at premium	Bank Loss on issue of Debentures **	Debentures Prem. on redemption of debentures

** Loss on issue of debentures includes discount on issue and Premium on redemption.

Illustration 30:

Journalize the following transactions. Narration is not required:

Issue of 12% 1,00,000 debentures of ₹ 100 each

1. at par and redeemable at par.
2. at 10% discount and redeemable at par.
3. at 10% premium and redeemable at par.
4. at 10% premium and redeemable at a premium of 5%.
5. at par and redeemable at a premium of 5%.
6. at 10% discount and redeemable at a premium of 5%.

Solution:

Journal

	Particulars		Debits ₹ '000	Credits ₹ '000
1.	Bank Account	Dr.	10,000	
	To 12% Debentures Account			10,000
2.	Bank Account	Dr.	9,000	
	Discount on Issue of Debentures Account	Dr.	1,000	
	To 12% Debentures Account			10,000

3.	Bank Account	Dr.	11,000	
	To 12% Debentures Account			10,000
	To Securities Premium Account			1,000
4.	Bank Account	Dr.	11,000	
	Loss on issue of debenture	Dr.	500	
	To 12% Debentures Account			10,000
	To Securities Premium Account			1,000
	To Prem. on redemption of debentures			500
5.	Bank Account	Dr.	10,000	
	Loss on issue of Debentures Account	Dr.	500	
	To 12% Debentures Account			10,000
	To Prem. on redemption of Debentures			500
6.	Bank Account	Dr.	9,000	
	Loss on Issue of Debentures Account **	Dr.	1,500	
	To 12% Debentures Account			10,000
	To Prem. on redemption of Debentures			500

** This amount includes ₹ 1,000 discount on issue of debentures and ₹ 500 premium on redemption.

Issue for Consideration other than Cash

In this case debentures are issued for consideration other than cash. Examples are allotment of debentures for assets purchased or technical services received. There is no receipt of cash in these transactions for the allotment of debentures. The following are the accounting entries:

Illustration 31:

(For consideration other than cash).

The XYZ Company Ltd. took over assets of ₹ 230 Lakh and liabilities of ₹ 30 Lakh of PQR Company Ltd. for the purchase consideration of ₹ 220 Lakh. The XYZ Company Ltd. paid the purchase consideration issuing debentures of ₹ 100 each at 10% premium. Give journal entries in the books of the XYZ Company Ltd.

Solution:

Journal of XYZ Company Ltd.

Date	Particulars		₹ in lakh	₹ in lakh
	Sundry Assets	Dr.	230	
	Goodwill	Dr.	20	
	To Liabilities			30
	To PQR Company			220
	(Being purchase of assets and liabilities of ompany)			
	PQR Company	Dr.	220	
	To Debentures			200
	To Securities Premium			20
	(Being issue of debentures at 10% premium)			

Debentures issued as Collateral Security

(a) This is the third type of consideration for which company issues debentures. Issue of debentures as a collateral security means issue of debentures as a subsidiary or secondary security, that is, a security in addition to the prime security. Secondary security is to be realized only when the prime security fails to pay the amount of loan. Debentures issued as a collateral security can be dealt with in two ways in the books:

a. First Method

No entry is made in the books. On the liability side of the balance sheet below the item of loan a note that it has been secured by the issue of debentures is to be given. This is shown in the balance sheet as follows:

b. Second method

Sometimes issue of debentures as collateral security is recorded by making a journal entry as follows:

Debenture suspense account	Dr.	(This appears on the assets side)
To Debenture account		(This appears on the liabilities side)

When the loan is paid the above entry is cancelled by means of a reverse entry.

Discount on issue of Debenture

When debentures are issued at discount, it is prudent to write off the loss during the life of debentures.

REDEMPTION OF DEBENTURES

Meaning

Redemption of debentures is the process of discharging the liability on account of debentures in accordance with the terms of redemption stated in the debenture trust deed. Discharge of debenture liability is usually by paying cash to the debenture holders. But this can take other forms such as conversion or rollover. In the case of conversion debentures are converted into preference shares or equity shares. Rollover refers to the issue of new debentures, in exchange for the old ones. Both conversion and rollover are subject to detailed SEBI guidelines.

When a company issues debentures it must also plan the resources required for such redemption. This can be done by setting aside profits every year and investing them wisely in investments outside, so that there will be no liquidity problem at the time of redemption. Alternatively the company can take an insurance policy by paying regular premium, so that the policy matures coinciding with the time of redemption. With the amount received on the maturity of policy the company faces no problem in carrying out the redemption. These are the two ways in which a company can make provisioning for redemption of debentures. The question of provisioning was earlier left to the discretion of company and many companies did provisioning routinely, as a matter of financial prudence. Now under the SEBI guidelines, the matter is no more a matter of discretion or financial prudence. SEBI guidelines provide for compulsory provisioning and also restrictions on the payment of dividends till debentures are redeemed. We will first deal with SEBI guidelines before proceeding with the accounting aspects of creating sinking fund for redemption of debentures.

SEBI on Creation of Debenture Redemption Reserve (DRR)

1. A company has to create DRR in case of issue of debentures with maturity of more than 18 months.
2. The issuer must create DRR in accordance with the provisions given below.
    a. If debentures are issued for project finance DRR can be created upto the date of commercial production.
    b. The DRR in respect of debentures issued for project finance may be created either in equal installments or higher amounts if profits so permit.
    c. In the case of PCDs, DRR must be created for the non-convertible portion of debenture issues on the same lines as applicable for fully non-convertible debenture issue.
    d. In respect of convertible issues by new companies, the creation of DRR must commence from the year the company earns profits for the remaining life of debentures.
    e. DRR shall be treated as part of general reserve for consideration of bonus issue proposals and for price fixation related to post-tax return.
    f. Company must create DRR equivalent to 50% of the amount of debenture issue before debenture redemption commences. Only after the company has actually redeemed 10% of

the debenture liability, drawal from DRR is permissible only after the company has actually redeemed 10% of the debenture liability.The requirement of creation of DRR is not applicable to issue of debt instruments by infrastructure companies.

Restrictions on Dividends

(a) In the case of new company, distribution of dividends shall require the approval of trustees to the issue of debentures and lead institution, if any.

(b) In the case of existing companies prior permission-of the lead institution for declaring dividend exceeding 20% or as per the loan covenants is necessary if the company does not comply with institutional condition regarding interest and debt coverage ratio.

(c) Dividends may be distributed out of profits of particular year only after transfer of requisite amount in DRR. If residual profits are inadequate to distribute reasonable dividends, company may distribute dividend out of general reserve.

As mentioned already the two modes of provisioning are (1) the sinking fund method, and (2) the insurance policy method.

It is always prudent for a company to save money for redeeming debentures on the due date. In the absence of such a provision it becomes difficult for the company to find lumpsum amount to repay the debt. This can be done by adopting any of the two methods explained below:

Sinking fund method

Under this method the amount is invested in first class securities with secured and fixed return. Accumulation of interest becomes compounded resulting to produce the amount required to redeem the debentures on the due date. This method of providing for funds is also called debenture redemption fund method. The sinking fund method for redeeming a loan is different from sinking fund method for replacing an asset in the following ways:

1. Sinking fund created for replacing an asset is in the nature of accumulated depreciation, while sinking fund created for repaying loan is in the nature of accumulated profits. It is for this reason that sinking fund's balance (after the redemption of loan) is transferred to general reserve, while that for an asset is transferred to asset account.
2. Annual installment set aside for the replacement of an asset is a charge and is debited to profit and loss account, while that for the redemption of a loan is an appropriation and is debited to profit and loss appropriation account.

Accounting entries for making the provision for the redemption of debentures are as follows:

First year

1. Profit and Loss Appropriation A/c Dr.

    To Sinking Fund A/c

    (Setting aside the required amount based on sinking fund table)

2. Sinking Fund Investment A/c Dr.

    To Bank A/c

    (Investment of amount set aside)

Second and subsequent years

1. Bank A/c Dr.

    To Sinking fund interest A/c

    (Interest on sinking fund investment received.)

2. Sinking fund interest A/c Dr.

    To Sinking fund A/c

    (Transfer of interest account to sinking fund.)

3. Profit and loss appropriation A/c Dr.

To Sinking fund A/c

(Setting aside the required amount based on sinking fund table)

4. Sinking fund investment A/c Dr.

To Bank A/c

(Investment of amount set aside and the amount of interest received.)

Last year:

1. Bank A/c Dr.

To Sinking fund interest A/c

(Interest on sinking fund investment received.)

2. Sinking fund interest A/c Dr.

To Sinking fund A/c

(Transfer of interest account to sinking fund.)

3. Profit and loss appropriation A/c Dr.

To Sinking fund A/c

(Setting aside the required amount based on sinking fund table)

At the time of sale of investments and redemption

1. Bank A/c Dr.

To Sinking fund investment A/c

(Amount received from sale of investment)

2. Sinking fund A/c Dr.

To Sinking fund investment A/c

(Loss on sale)

3. Sinking fund investment A/c Dr.

To Sinking fund A/c

(Profit on sale)

4. Sinking fund A/c Dr.

To General reserve

(Transfer of balance of sinking fund account)

5. Debentures A/c Dr.

To Bank A/c

(Redemption of debentures)

It may be noted that in the final year the amount appropriated from the profits of the company and the amount received as interest on sinking fund investment are not invested, as the amount would be needed on the following day for the redemption of debenture.

Non cumulative sinking fund.

A non-cumulative sinking fund differs from the cumulative type of sinking fund only in one respect: in non-cumulative sinking fund, interest received on sinking fund investment is not re-invested, nor is it transferred to sinking fund. Interest on sinking fund investment is treated as a simple profit and is kept in the business without earmarking its use and the amount is transferred to profit and loss account.

Nevertheless, a careful study of the two types of funds will reveal that there is no difference between the two methods. In a non-cumulative type of fund, the appropriation from the profits is more but the excess burden on the profits is corrected by the transfer of interest on the investment to profit and loss account. While in the case of a cumulative type of sinking fund method, the appropriation from the profit is less, but that amount is made up by crediting to sinking fund the amount of interest earned on investment.

Insurance policy method

Under this method, an insurance policy for the required amount is to be taken for the redemption of debentures at the end of a fixed period. Under this system, the premium is paid regularly in installments and the insurance company, in its turn, returns the total accumulated money at the expiry of the period. Money so received is used for redeeming debentures. This method differs from the sinking fund method only in respect of interest on investment. Unlike sinking fund method, the insurance company does not give any interest on the installments received. Entries in respect of insurance policy are as follows:

Each year

1. Profit and loss appropriation A/c Dr.
   To Debenture redemption fund A/c
   (Appropriation of the amount of premium of the policy)
2. Debenture redemption policy A/c Dr.
   To Bank A/c
   (Payment of premium on the policy)

Premium in the policy is always paid in advance so, it must be paid even in the last year.

At the time of realization of policy and redemption

1. Bank A/c Dr.
   (amount of policy taken)
   To Debenture redemption policy A/c
   (Amount at which policy account stands)
   To Debenture redemption fund A/c
   (Difference in the two amounts.)
2. Debenture redemption fund A/c Dr.
   To General Reserve
   (Transfer of Balance)

DIFFERENT METHODS OF REDEMPTION OF DEBENTURES

Though discharge of debenture liability is usually by paying cash to the debenture holders for which either of the two methods mentioned above be followed to meet the cash requirement at the time of redemption.

However, following are the other methods by which the liability on debentures may be extinguished.

Conversion

The conversion of debentures means the debentures are converted into preference shares or equity shares.

For the purpose of conversion debentures are to be classified as fully convertible debentures (FCDs), partly convertible debentures (PCDs), and non-convertible debentures (NCDs). A company cannot issue FCDs having a conversion period of more than 36 months, unless the conversion is made optional with a put and call option. If conversion takes place 18 months after the date of allotment but before 36^{th} months, any conversion in part or whole of the debenture is optional in the hands of the debenture holder. If he does not exercise the option it will effectively become an NCD. FCDs with conversion period less than 12^{th} months are treated as quasi-equity and are treated at par with equity.

FCDs are fully convertible into equity shares either at par or premium. The premium to be charged at conversion must be predetermined and announced in the prospectus. In the case of PCDs it comprises two parts, namely the convertible portion and the non-convertible portion.. It is only the convertible portion that would be converted into shares.

In the case of NCDs the liability will be discharged by payment of cash or rollover. A company can also convert NCDs at a later date into equity shares but it should be at the option of debenture holder.

Rollover

Rollover means the issue of new debentures in the place of old ones. Rollover must be with the written consent of the debenture holder. If he does not given written consent, his claim must be settled in cash. Also whenever the debenture liability is rolled over company must obtain fresh credit rating. Fresh trust must be executed at the time of rollover. Also fresh security must be created in respect of rolled over debentures. Subject to the conditions listed rollover can be done without change in the' interest rate if the non-convertible portion of PCDs/ NCDs of a listed company exceeds ₹ 50 lakhs.

Sources of redemption

From the point of view of sources redemption may be carried out with the help of any of the following sources:

1. Out of capital,
2. Out of profits,
3. Conversion or rollover (already discussed), and
4. Out of provision in the nature of sinking fund.

We shall now consider each case.

Redemption out of capital

SEBI guidelines require the setting up of a 'Debenture Redemption Reserve when profits are available and the debentures are issued for a period beyond 18 months. If the debentures are for a period less than 18 months or profits are not available for capital redemption, debentures may be redeemed from out of capital. When redemption is carried from out of capital only entries are made for redemption and no entry will be made to transfer profits to 'Debenture Redemption Reserve.

Illustration 32:

A company issued 100,000 15% debentures of ₹ 100 each at par redeemable at a premium of 15%. After 8 years the company served notice of redemption and redeemed all debentures as per the terms of issue. You are required to make entries at the time of issue and at the time of redemption.

Solution:

Journal

Date	Particulars		Dr ₹ '000	Cr ₹ '000
1st year	Bank account	Dr.	10,000	
	Loss on issue of debentures A/c	Dr.	1,500	
	To 15% Debentures A/c			10,000
	To Premium on redemption A/c			1,500
8th year end	15% Debentures account	Dr.	10,000	
	Premium on redemption A/c	Dr.	1,500	
	To Debenture Redemption A/c			11,500
	Debenture redemption account	Dr.	11,500	
	To Bank account			11,500

Redemption from out of Profits

Now it is mandatory to set up 'Debenture Redemption Reserve'. Earlier companies could redeem debentures from out of profits without a formal setting up of 'Debenture Redemption Reserve'. It was the directors who used to decide as to whether the redemption is from capital or profits.

After carrying out the entire redemption the amount to the credit of debenture redemption reserve will be transferred to general reserve account.

Illustration 33:

A Company issued 100,000 debentures of ₹ 100 each redeemable at the end of 10th year, but reserves the right to redeem earlier from the end of 5th year. The company decides at the end of 5th year to redeem 20,000 debentures out of profits it has made.

Pass necessary journal entries relating to redemption.

Solution

Date	Particulars		Dr ₹ '000	Cr ₹ '000
5th year end	Debentures A/c	Dr.	2,000	
	To Debenture redemption A/c			2,000
	Debenture redemption A/c	Dr.	2,000	
	To Bank account			2,000
	Profit/ loss appropriation A/c	Dr.	2,000	
	To Debenture Redemtion Reserve A/c			2,000

Conversion or rollover

In the case of conversion debentures are converted into equity or preference shares. In the case of rollover old debentures or replaced by the issue of new debentures. The new shares may be issued at par or premium.

Additional accounting entries for conversion or rollover are as below:

Transaction	Debited	Credited
Conversion into shares at par	Deb.redemption/ Deb. Holders a/c	Equity/ Preference share capital
Conversion into shares at premium	do	Share capital Security prem.
Rollover at par	do	New debentures
Rollover at premium	do	New debentures
		Security prem.

Illustration 34:

On April 1, 2014 PT Ltd. issued 25,00,000 12% fully convertible debentures of ₹ 100 each at par. The debenture holders were given the call option to convert the debentures into ₹ 10 equity shares at a premium of ₹ 40 per share on or after July 1, 2018. On April 1, 2019, debenture holders holding 10,00,000 debentures exercised their option. Pass the necessary journal entries.

Solution

Date	Particulars		Dr ₹ in lakh	Cr ₹ in lakh
1-4-2014	Bank A/c	Dr.	2,500	
	To 12% Convertible debentures			2,500
	(Issue of 25,00.000 convertible debentures of ₹ 100 each)			
1-4-2014	12% Convertible debentures A/c	Dr.	1,000	
	To Equity share capital A/c			200
	To Security Premium A/c			800
	(Conversion of 10.00,000 deb. each, into two eq. shares of ₹ 10 at a premium of ₹ 40 each)			

Illustration 35:

Beta Ltd. had issued 11% 5,00,000 debentures of ₹ 100 each redeemable on 31st March 2015 at a premium of 5%.

The company offered three options to debenture holders as under:

(i) 13% Preference shares of ₹ 10 each at ₹ 10.50

(ii) 14% debentures of ₹ 100 at par.

(iii) Redemption in cash.

The options were accepted as under.

Option (i) by holders of 1,00,000 debentures.

Option (ii) by holders of 1,00,000 debentures.

Option (iii) by holders of 3,00,000 debentures.

The company carried out the redemption. Pass the necessary journal entries.

Date	Particulars		Dr ₹ in lakh	Cr ₹ in lakh
	11% Debentures A/c	Dr.	500	
	Premium on redemption of debentures A/ c	Dr.	25	
	To Debenture Holder A/c			525
	Debenture holders account	Dr.	105	
	To 13% Preference share capital account			100
	To Securities premium account			5
	Debenture holders A/c	Dr.	105	
	To 14% Debenture A/c			105
	Debenture holders A/c	Dr.	315	
	To Bank A/c			315

When to be redeemed?

Time of redemption can be classified in the following three ways:

1. Redemption by annual drawings even before the maturity of debentures.
2. Purchases *of* debentures from the open market and canceling them immediately *or* later.
3. Redemption only on maturity.

Redemption by Annual Drawings

SEBI guidelines state that the issuing company shall redeem the debentures as per the offer document. A company at the time *of* issue may provide for staggered redemption. This can be done in two ways. The redemption may be certain amount *of* each debenture with a schedule so that redemption may be completed over a time frame. The other way is to select certain number of debentures every year and redeem them fully. The debentures to be redeemed are selected by drawing a lot annually. This method is known as 'Redemption by Annual Dr.awings'. Again whether the redemption is at par, premium *or* discount, depend on the terms *of* offer.

Nowadays it is also common for companies to have a call option which gives them the right to redeem the debentures at a pre-determined price. This gives them the right to cancel but not the obligation to cancel.

Purchase and Cancellation of Own Debentures

Debentures may also be cancelled before the expiry of the period by purchasing them from the open market at market price, which may be at premium or discount to the book value. It is certainly advantageous to buy when they are selling in the market at a discount. Cancellation of debentures may be done immediately or later. In some cases such debentures may also be reissued. This method of redemption is known as 'purchase and cancellation of own debentures'.

For purchase and cancellation of own debentures, the company have to consider the following parameters.

(1) The company may cancel such debentures immediately or carry them as an investment and cancel at a later date.

(2) Where they are immediately cancelled, a debenture liability is extinguished to the extent of par value of the debentures cancelled. From the date of cancellation, interest is not payable on cancelled debentures.

Since the debenture liability cancelled is more than the amount paid for such debentures, profit on cancellation of debentures should be recorded. If there is a Sinking Fund, such profit is transferred to the Sinking Fund.

(3) When debentures are carried as an investment, debenture liability is shown as before and at the same time, 'Investment in own Debentures' or simply 'Own Debentures' appears on the assets side of the balance sheet, till they are cancelled.

(4) In the case of own debentures, interest on own debentures must be reckoned as income or set-off against the gross interest payable on the whole of debentures.

(5) If debentures are purchased between two interest dates, and not immediately after payment of interest, then the price paid for debentures depends on the quotation.

Accounting Entries

Transaction	DR	CR
(1) Purchase of own Debenture	Own Debentures	Bank
(2) Cancellation of own debentures	Debentures	Own Debentures
(3) Profit on cancellation	Debentures	Profit on Cancellation of Debentures/Sinking Fund

Transaction	DR	CR
(4) Loss on cancellation	Sinking Fund/Loss on Cancellation	Own Debentures
(5) Reissue (or sale) of own debentures	Bank	Own debentures
(6) Profit on re-issue	Own Debentures	Profit and Loss A/c
(7) Loss on re-issue	Profit and Loss A/c	Own Debentures
(8) Interest on own debentures	Profit and Loss A/c	Sinking Fund

Illustration 36:

On 1st April, 2014 A Ltd. made an issue of 10,00,000 14% debentures of ₹ 100 each at ₹ 98 per debenture. According to the terms of issue, commencing from 2016, the company should redeem 10000 debentures either by purchasing them from the open market or by drawing lots at par at the company's option. Profit, if any, on redemption is to be transferred to capital reserve. The company's accounting year ends on 31st March. Interest is payable on 30th Sep and 31st March.

During 2014-15, the company wrote off 20% of debenture discount account.

During 2017-18, the company purchased and cancelled the debentures as given below:

(i) ₹ 200,00,000 at ₹ 95 per debenture on 30th September, and

(ii) ₹ 300,00,000 at ₹ 97 per debenture on 31st March.

Give the journal entries in the books of A Ltd. for both the years

Date	Particulars		Dr. ₹ in lakh	Cr. ₹ in lakh
1-4-14	Bank A/c	Dr.	980	
	Dis. on issue of debentures A/c	Dr.	20	
	To 14 % Debentures A/c			1000
30-9-14	Debentures interest A/c		70	
	To Bank A/c			70
31-3-15	Debentures interest A/c	Dr.	70	
	To Bank A/c			70
31-3-15	Profit and loss A/c	Dr.	144	
	To Debenture interest A/c			140
	To Dis. on issue of Debentures A/c			4
30-9-16	Debentures interest A/c	Dr.	70	
	To Bank A/c			70
30-9-17	Own debentures A/c	Dr.	190	
	To Bank A/c			190
30-9-17	14 % Debentures A/c	Dr.	200	
	To Own debentures A/c			190
	To Capital Reserve A/c			10
	Debentures interest A/c	Dr.	56	
	To Bank A/c			56
31-3-18	Own debentures A/c	Dr.	291	
	To Bank A/c			290
	14 % Debentures A/c	Dr.	300	
	To Own debentures A/c			291
	To Capital Reserve A/c			9
	Profit and loss A/c	Dr.	126	
	To Debenture interest A/c			126

ISSUE OF DEBENTURES AT PAR

Illustration 37:

B Ltd. issued ₹ 1,000 10% Debentures of ₹ 1000 each payable:

₹ 200 on application; ₹ 400 on allotment; and the balance two months after allotment. The public applied for 1,400 debentures. Applications of 900 debentures were accepted in full; applicants for 200 debentures were allotted 100 debentures and the remaining applications were rejected. All money were duly received.

Required: Journalise the transactions.

Solution:

Journal of *B* Ltd.

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.		2,80,000	
	To Debenture Application A/c				2,80,000
	(Being the Receipt of application money on 1,400 debentures)				
	Debentures Application A/c	Dr.		2,80,000	
	To 10% Debentures A/c				2,00,000
	To Debentures Allotment				20,000
	To Bank A/c				60,000
	(Being the application money adjusted and surplus refunded)				
	Debentures Allotment A/c	Dr.		4,00,000	
	To 10% Debentures A/c				4,00,000
	(Bening the Amount due on allotment on 10,000 debentures)				
	Bank A/c	Dr.		3,80,000	
	To Debentures Allotment A/c				3,80,000
	(Being the Balance of the amount due on allotment received)				
	Debenture Call A/c	Dr.		4,00,000	
	To 10% Debentures A/c				4,00,000
	(Being the Amount due on call)				
	Bank A/c	Dr.		4,00,000	
	To Debenture Call A/c				4,00,000
	(Being the Amount due on call received)				

ISSUE OF DEBENTURES AT A PREMIUM

Illustration 38:

Z Ltd. issued 2,500, 10% Debentures of ₹ 100 each a premium of 10% payable ₹ 20 on application, ₹ 50 on allotment (including premium) and the balance on first & final call. The public applied for 3,500 debentures. Applications for 2,250 debentures were accepted in full, application for 500 were allotted 250 debentures and remaining applications were rejected. All moneys were duly received.

Required: Journalise these transactions.

Solution:

Journal of Z Ltd.

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.		70,000	
	To Debenture Application A/c				70,000
	(Being application money received on 3,500 debentures)				
	Debentures Application A/c	Dr.		70,000	
	To 10% Debentures A/c				50,000
	To Debentures Allotment A/c				5,000
	To Bank A/c				15,000
	(Being the application money adjusted and the surplus refunded)				
	Debenture Allotment A/c	Dr.		1,25,000	
	To 10% Debentures A/c				1,00,000
	To Securities Premium A/c				25,000
	(Being the Amount due on allotment @ ₹ 50 on 2,500 debentures)				
	Bank A/c	Dr.		1,20,000	
	To Debentures Allotment A/c				1,20,000
	(Being the Balance of the amount due on allotment received)				
	Debentures Call A/c	Dr.		1,00,000	
	To 10% Debentures A/c				1,00,000
	(Being the Amount due on Call @ ₹ 40 on 2,500 debentures)				
	Bank A/c	Dr.		1,00,000	
	To Debentures Call A/c				1,00,000
	(Being the Amount due on call received)				

ISSUE OF DEBENTURES AT A DISCOUNT

Illustration 39:

A Ltd. issued 750, 12% Debentures of ₹ 1000 each at a discount of 10% payble ₹ 200 on application, ₹ 400 on allotment and ₹ 300 on first and final call. The public applied for 1,050 debentures. Application for 675 debentures were accepted in full, applicants for 150 debentures were allotted 75 debentures and the remaining applications were rejected. All moneys were duly received.

Required: Journalise these transactions.

Solution:

Journal of *A* Ltd.

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.		2,10,000	
	To Debenture Application A/c				2,10,000
	(Being the Receip of application money on 1,050 debentures)				
	Debentures Application A/c	Dr.		2,10,000	
	To 12% Debentures A/c				1,50,000
	To Debentures Allotment A/c				15,000
	To Bank A/c				45,000
	(Being the application money adjusted and surplus refunded)				
	Debentures Allotement A/c	Dr.		3,00,000	
	Discount on issue of Debentures A/c	Dr.		75,000	
	To 12% Debentures A/c				3,75,000
	(Being the amount due on allotment @ ₹ 500 on 750 debentures)				
	Bank A/c	Dr.		2,85,000	
	To Debentures Allotment A/c				2,85,000
	(Being the Balance of the amount due on allotment received)				
	Debentures Call A/c	Dr.		2,25,000	
	To 12% Debentures A/c				2,25,000
	(Being the Amount due on debentures @ ₹ 300 on 750 debentures)				
	Bank A/c	Dr.		2,25,000	
	To Debenture Call A/c				2,25,000
	(Being the Amount due on call received)				

ISSUE OF DEBENTURES FOR CONSIDERATION OTHER THAN CASH

Illustration 40: Z Ltd. took over the assets of ₹ 6,00,000 and liabilities of ₹ 80,000 of C Ltd. for an agreed purchase consideration of ₹ 5,40,000 to be satisfied by the issue of 10% Debentures of ₹ 1,000 each.

Required: Show the necessary journal entries in the books of Z Ltd, assuming that—

Case (a) Such Debentures are issued at par;

Case (b) Such Debentures are issued at 20% premium; and

Case (c) Such Debentures are issued at 10% discount;

Solution:

In the Books of Z Ltd.

Journal

Particulars		L.F.	Dr. (₹)	Cr. (₹)
Entry in all cases				
Sundry Assets A/c	Dr.		6,00,000	
Goodwill A/c	Dr.		20,000	
To Sundry Liabilities A/c				80,000
To C Ltd.				5,40,000
(Being the purchase of assets and liabilities from B Ltd. as per agreement dated...)				
Case (a) If Debentures are issued at par				
C Ltd.	Dr.		5,40,000	
To 15% Debentures A/c				5,40,000
(Being the issue of 5,400 debentures at par to B Ltd. as per Board's resolution dated....)				
Case (b) If Debentures are issued at 20% premium				
C Ltd.	Dr.		5,40,000	
To 10% Debentures A/c				4,50,000
To Securities Premium A/c				90,000
(Being the issue of 4,500 debentures at a premium of 20% to B Ltd. as per Board's resolution dated...)				
Case (c) If Debentures are issued at 10% discount				
C Ltd.	Dr.		5,40,000	
Discount on Issue of Debentures A/c	Dr.		60,000	
To 10% Debentures A/c				6,00,000
(Being the issue of 6,000 debentures at a discount of 10% to B Ltd. as per Board's resolution dated...)				

Working Notes:

(i) The amount by which the purchase consideration exceeds the value of the net assets (i.e. the difference between the agreed value of the assets taken over and the agreed amount of liabilities taken over) has been debited to Goodwill Account.

(ii) Calculation of No. of Debentures to be issued in each case.

Particulars	At 20%	At 10% Premium	At Par Discount
A. Issue Price per Debenture (₹)	120	90	100
B. Purchase Consideration (₹)	5,40,000	5,40,000	5,40,000
C. No. of Debentures to be issued (B/A)	4,500	6,000	5,400

DEBENTURES ISSUED AS COLLATERAL SECURITY

Illustration 41:

C Ltd. secured a loan of ₹ 8,00,000 from the Axis Bank by issuing 1,000, 12% Debentures of ₹ 1000 each as collateral security.

Required: How will you treat the issue of such debentures ?

Solution:

I. First Method

An Extract of Balance Sheet of C Ltd. as at...

Liabilities	₹	Assets	₹
Secured Loans: Loan from Canara Bank (Secured by the issue of 1,000, 12% Debentures of ₹ 1000 each as collateral security)	10,00,000		

II. Second Method

Journal of C Ltd.

Particulars		L.F.	Dr. (₹)	Cr. (₹)
Debentures Suspense A/c	Dr.		10,00,000	
To 12% Debentures A/c				10,00,000
(Being the issue of 1,000, 12% debentures of ₹ 1000 each as collateral security for a loan from a bank as per Board's resolution dated...)				

An Extract of Balance Sheet of C Ltd. as at...

Liabilities	₹	Assets	₹
Secured Loans:		Misecellaneous Expenditures:	
1,000, 12% Debentures of		Debentures Suspense	10,00,000
₹ 1000 each (Issued as collateral security)	10,00,000		
Loan from Axis Bank			
(Secured by the issue of 1,000, 12% debentures of ₹ 1000 each as collateral security)	10,00,000		

ISSUE OF DEBENTURES UNDER DIFFERENT TERMS OF REDEMPTION

Illustration 42:

Given Journal entries in each of the following alternative cases assuming the face value of a debenture being ₹ 100.

(a) A debenture issued at ₹ 100 repayable at ₹ 100

(b) A debenture issued at ₹ 95 repayable at ₹ 100

(c) A debenture issued at ₹ 105 repayable at ₹ 100

(d) A debenture issued at ₹ 100 repayable at ₹ 105

(e) A debenture issued at ₹ 95 repayable at ₹ 105

(f) A debenture issued at ₹ 90 repayable at ₹ 95

Solution:

Journal

	Particulars		L.F.	Dr. (₹)	Cr. (₹)
(a)	Bank A/c	Dr.		100	
	To Debentures A/c				100
	(Being the issue of debentures at par)				
(b)	Bank A/c	Dr.		95	
	Discount on Issue of Debentures A/c	Dr.		5	
	To Debentures A/c				100
	(Being the issue of debentures at 5% discount)				
(c)	Bank A/c	Dr.		105	
	To Debentures A/c				100
	To Securities Premium A/c				5
	(Being the issue of debentures at 5% premium)				
(d)	Bank A/c	Dr.		100	
	Loss on Issue of Debentures A/c	Dr.		5	
	To Debentures A/c				100
	To Premium on Redemption of Debentures A/c				5
	(Being the issue of debenture at par but redeemable at 5% premium)				
(e)	Bank A/c	Dr.		95	
	Loss on Issue of Debentures A/c	Dr.		10	
	To Debtures A/c				100
	To Premium on Redemption of Debentures A/c				5
	(Being the issue of debenture at 5% discount which are redeemable at 5% premium)				
(f)	Bank A/c	Dr.		90	
	Discount on Issue of Debentures A/c	Dr.		10	
	To Debentures A/c				100
	(Being the issue of debentures at 10% discount)				

TREATMENT OF DISCOUNT ON ISSUE OF DEBENTURES

Illustration 43:

On 01.04.14, P Ltd. issued 1,000, 15% Debentures of ₹ 100 each at a discount of 10% redeemable at par.

Required: Show the Discount on Issue of Debentures A/c if (a) such debentures are redeemable after 4 years, and (b) such debentures are redeemable by equal annual drawings in 4 years. A Ltd. follows financial year as its accounting year.

Solution:

(a) When such debentures are redeemable after 4 years:

A.	Total discount allowed (₹ 1,00,000 × 10/100)	= ₹ 10,000
B.	Period for which debentures are held	= 4 Years
C.	Amount of discount to be written off to P & L A/c every year (A/B)	= ₹ 2,500

Dr. **Discount on Issue of Debentures Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
01.04.14	To 15% Debentures A/c	10,000	31.03.15	By P & L A/c	2,500
				By Balance c/d	7,500
		10,000			10,000
01.04.15	To Balance b/d	7,500	31.03.16	By P & L A/c	2,500
				By Balance c/d	5,000
		7,500			7,500
01.04.16	To Balance b/d	5,000	31.03.17	By P & L A/c	2,500
				By Balance c/d	2,500
		5,000			5,000
01.04.17	To Balance b/d	2,500	31.03.18	By P & L A/c	2,500
		2,500			2,500

(b) When such debentures are redeemable by equal annual drawings in 4 years:

Statement Showing the Debentures Discount to be Written off Each Year

Year ended on A	Face Value of Deb. used B	Period of Use (Month) C	Product D = B×C D	Ratio E	Amount of Discount to be w/o 10,000×E/10
31.03.15	1,00,000	12 months	12,00,000	4	4,000
31.03.16	75,000	12 months	9,00,000	3	3,000
31.03.17	50,000	12 months	6,00,000	2	2,000
31.03.18	25,000	12 months	3,00,000	1	1,000

Dr. **Discount on Issue of Debentures Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
01.04.14	To 15% Debentures A/c	10,000	31.03.15	By P & L A/c	4,000
				By Balance c/d	6,000
		10,000			10,000
01.04.15	To Balance b/d	6,000	31.03.16	By P & L A/c	3,000
				By Balance c/d	3,000
		6,000			6,000
01.04.16	To Balance b/d	3,000	31.03.17	By P & L A/c	2,000
				By Balance c/d	1,000
		3,000			3,000
01.04.17	To Balance b/d	1,000	31.03.18	By P & L A/c	1,000
		1,000			1,000

REDEMPTION OUT OF PROFIT

Illustration 44:

Y Ltd. issued 500, 15% Debentures of ₹ 1000 each at 8% discount repayable asunder:

Year end	Nominal Value of debentures to be redeemed
2	₹ 50,000
3	₹ 1,00,000
4	₹ 1,50,000
5	₹ 2,00,000

Required: Calculate the amount of discount to be written off each year assuming that the company closes its accounts on calender year basis.

Solution:

Statement Showing the Debenture Discount to be Written off Each Year

Year A	Face Value of Deb. (in lakhs) B	Period of Use (Month) C	Product D = B×C	Ratio E	Amount of Discount to be w/o ₹ 40,000 × E/40
1	5.00	12	60.00	10	10,000
2	5.00	12	60.00	10	10,600
3	4.50	12	54.00	9	9,000
4	3.50	12	42.00	7	7,000
5	2.00	12	24.00	4	4,000

TREATMENT OF LOSS ON ISSUE OF DEBENTURES

Illustration 45:

On 01.01.2015 E Ltd. issued 500, 10% Debentures of ₹ 100 each, at a discount of 10% redeemable at a premium of 10%.

Required: Show the 'Loss on Issue of Debentures A/c', if (i) such debentures are redeemable after 4 years, and (ii) such debentures are redeemable by equal annual drawings in 4 years. E Ltd. follows calendar year as it accounting year.

Solution:

Loss on Issue at Discount = 10%; Loss on Redemption at premium = 10%

∴Total Loss = 20%

(a) When such debentures are redeemable after 4 years:

A.	Total Loss (₹ 50,000 × 20/100)	= ₹ 10,000
B.	Period for which debentures are held	= 4 Years
C.	Amount of discount to be written off to P & L A/c every year (A/B)	= ₹ 2,500

Dr. **Loss on Issue of Debentures Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
01.01.15	To 10% Debentures A/c	5,000	31.12.15	By P & L A/c	2,500
	To Premium on redemption	5,000		By Balance c/d	7,500
		10,000			10,000
01.01.16	To Balance b/d	7,500	31.12.16	By P & L A/c	2,500
				By Balance c/d	5,000
		7,500			7,500
01.01.17	To Balance b/d	5,000	31.12.17	By P & L A/c	2,500
				By Balance c/d	2,500
		5,000			5,000
01.01.18	To Balance b/d	2,500	31.12.18	By P & L A/c	2,500
		2,500			2,500

(b) When such debentures are redeemable by equal annual drawings in 4 years:

Statement Showing the Debentures Discount to be Written Off Each Year

Year ended on A	Face Value of Deb. used B	Period of Use (Month) C	Product D = B × C D	Ratio E	Amount of Discount to be w/o 10,000 × E/10
31.03.15	1,00,000	12 months	6,00,000	4	4,000
31.03.16	75,000	12 months	4,50,000	3	3,000
31.03.17	50,000	12 months	3,00,000	2	2,000
31.03.18	25,000	12 months	1,50,000	1	1,000

Dr. **Discount on Issue of Debentures Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
01.01.15	To 10% Debentures A/c	5,000	31.12.15	By P & L A/c	4,000
	To Premium on redemption	5,000		By Balance c/d	6,000
		10,000			10,000
01.01.16	To Balance b/d	6,000	31.12.16	By P & L A/c	3,000
				By Balance c/d	3,000
		6,000			6,000
01.01.17	To Balance b/d	3,000	31.12.17	By P & L A/c	2,000
				By Balance c/d	1,000
		3,000			3,000
01.01.18	To Balance b/d	1,000	31.12.18	By P & L A/c	1,000
		1,000			1,000

SINKING FUND METHOD

Illustration 46:

On 1st April 2014. H Ltd. issued 442, 10% Debentures of ₹ 1000 each at a discount of 10% redeemable at a premium of 5% after 4 years. It was decided to create a Sinking Fund for the purposes of accumulating sufficient funds to redeem the Debentures and to invest in some radily convertible securities yielding 10% interest p.a. Reference to the table shows that ₹ 1.00 p.a. at 10% compound interest amounts to ₹ 4.641 in 4 years. Investments are to be made in the Bonds of ₹ 1000 each available at par.

On 31st March 2018, the investments realised ₹ 3,40,000 and debentures were redeemed. The bank balance as on that date was ₹ 50,000.

Required: Prepare Debenture Redemption Fund Account and Debenture Redemption Fund Investments Account for 4 years.

Solution:

DRF = Debenture Redemption Fund, DRFI = Debenture Redemption Fund Investment

Dr. **Discount on Issue of Debentures Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
31.03.15	To Balance c/d	1,00,000	31.03.15	By P & L App. A/c	1,00,000
31.03.16	To Balance c/d	2,10,000	01.04.15	By Balance b/d	1,00,000
			31.03.16	By Interest on DRFI A/c	10,000
				By P & L App. A/c	1,00,000
		2,10,000			2,10,000
31.03.17	To Balance c/d	3,31,000	01.04.16	By Balance b/d	2,10,000
31.03.17				By Interest on DRFI A/c	21,000
				By P & L App. A/c	1,00,000
		3,31,000			3,31,000
31.03.18	To Loss on issue of		01.04.17	By Balance b/d	3,31,000
	Debentures			By Interest on DRFI A/c	33,100
	(premium)	22,100		By P & L App. A/c	91,000
	To Debenture			By Debenture Red.	
	Redemption			Fund Investment A/c	
	Reserve A/c	4,52,000		(profit)	19,000
		4,74,100			4,74,100

Dr. **Debentures Redemption Fund Investment (DRFI) Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
31.03.15	To Bank A/c	1,00,000	31.03.15	By Balance c/d	1,00,000
01.04.15	To Balance b/d	1,00,000	31.03.16	By Balance c/d	2,10,000
31.03.16	To Bank A/c	1,10,000			
		2,10,000			2,10,000
01.04.16	To Balance b/d	2,10,000	31.03.17	By Balance c/d	3,31,000
31.03.17	To Bank A/c	1,21,000			
		3,31,000			3,31,000
01.04.17	To Balance b/d	3,31,000	31.03.18	By Bank A/c	3,50,000
31.03.18	To Debenture			(Sales)	
	Redemption				
	Fund A/c (Profit)	9,000			
		3,50,000			3,50,000

Working Note:

(i) Calculation of the amount of profit set aside

		₹
a.	Face Value of Debentures	4,42,000
b.	Premium Premium Payable on Redemption	22,100
c.	Depreciable Cost (A + B)	4,64,100
d.	Value of annuity per Re 1	4,641
e.	Annual amount to be charged (C/D)	1,00,000

(ii) Calculation of the amount of investments and interest

Year a	Opening Balance b	Interest c = b×10/100	Saving d	Investments e = c + d	Closing Balance f = b + e
2014-15	—	—	1,00,000	1,00,000	1,00,000
2015-16	1,00,000	10,000	1,00,000	1,10,000	2,10,000
2016-17	2,10,000	21,000	1,00,000	1,21,000	3,31,000
2017-18	3,31,000	33,100	1,00,000	—	—

INSURANCE POLICY METHOD

Illustration 47:

On 01.01.2015, Hello Ltd. issued 500, 15% Debentures of ₹ 300 each at a discount of 10%, redemable at a premium of 10% after 4 years. It was decided to take out an Insurance Policy to provide the necessary funds for the redemption of the debentures. The annual premium for the policy, payable on 1st January every year, was ₹ 40,000. The sum assured of the policy was ₹ 1,65,000.

Required: Give the necessary journal entries. *[Ignore Debenture Interest*]

Solution:

Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
01.01.15	Bank A/c	Dr.		1,35,000	
	Discount on Issue of Debentures A/c	Dr.		15,000	
	Loss on Issue of Debentures A/c	Dr.		15,000	
	To 15% Debenture A/c				1,50,000
	To Premium on Redemption of Deb. A/c				15,000
	(Being the issue of debentures at a discount of 10% and redeemable at 10% premium)				
	Debentures Redemption Fund Policy A/c	Dr.		40,000	
	To Bank A/c				40,000
	(Being the payment of annual premium)				
Dec. 31	Profit & Loss Appropriation A/c	Dr.		40,000	
	To Debenture Redemption Fund A/c				40,000
	(Being the transfer to profit to DRF A/c)				
Dec. 31	Profit & Loss A/c	Dr.		3,750	
	To Discount on Issue of Debentures A/c				3,750
	(Being the discount on issue of debentures w/off)				
01.01.16 Jan. 1, 16	Debenture Redemption Fund Policy A/c	Dr.		40,000	
	To Bank A/c				40,000
	(Being the payment of annual premium)				

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
Dec. 31	Profit & Loss Appropriation A/c	Dr.		40,000	
	To Debenture Redemption Fund A/c				40,000
	(Being the transfer to profit to DRF A/c)				
Dec. 31	Profit & Loss A/c	Dr.		3,750	
	To Discount on Issue of Debentures A/c				3,750
	(Being the discount on issue of debentures w/off)				
01.01.17	Debenture Redemption Fund Policy A/c	Dr.		40,000	
	To Bank A/c				40,000
	(Being the payment of annual premium)				
Dec. 31	Profit & Loss Apprication A/c	Dr.		40,000	
	To Debenture Redemption Fund A/c				40,000
	(Being the transfer to profit to DRF A/c)				
Dec. 31	Profit & Loss A/c	Dr.		3,750	
	To Discount on Issue of Debentures A/c				3,750
	(Being the discount on issue of debentures w/off)				
01.01.18	Debenture Redemption Fund Policy A/c	Dr.		40,000	
	To Bank A/c				40,000
	(Being the payment of annual premium)				
Dec. 31	Profit & Loss Appropriation A/c	Dr.		40,000	
	To Debenture Redemption Fund A/c				40,000
	(Being the transfer of profit to DRF A/c)				
	Profit & Loss A/c	Dr.		3,750	
	To Discount on Issue of Debentures A/c				3,750
	(Being the discount on issue of debentures w/off)				
	Bank A/c	Dr.		1,65,000	
	To Debenture Redemption Fund Policy A/c				1,65,000
	(Being the receipt of policy amount on maturity)				
	Debenture Redempion Fund Policy A/c	Dr.		5,000	
	To Debenture Redemption Fund A/c				5,000
	(Being the transfer to profit on the policy to DRF A/c)				
	15% Debentures A/c	Dr.		1,50,000	
	Premium on Redemption of Debenures A/c	Dr.		15,000	
	To Debentureholders A/c				165,000
	(Being the amount due on redemption)				
	Debentureholders' A/c	Dr.		1,65,000	
	To Bank A/c				165,000
	(Being the payment made to Debenureholders)				
	Debenture Redemption Fund A/c	Dr.		15,000	
	To Loss on Issue of Debentures A/c				15,000
	(Being the loss on Issue of debentures written off against the balance in DRF A/c)				
	Debenture Redemption Fund A/c	Dr.		1,50,000	
	To Debenture Redemption Reserve A/c				1,50,000
	(Being the transfer of nominal value of debentures redeemed to Debenture Redemption Reserve A/c)				

REDEMPTION BY CONVERSION

Illustration 48:

On 1st January, 2015, CARGO Ltd. issued 2,000, 10% Debentures of ₹ 250 each at ₹ 225 each. Debenture-holders were given an option to get their debentures converted into equity shares of ₹ 50 each at a premium of ₹ 25 per share. On 31st December, 2015, one year's interest had accrued on these debentures which was not paid. A holder of 200 debentures informed that he wanted to exercise the option for conversion of debenures into equity shares. The company, therefore, accepted his re quest and redeemed these 200 debentures by issuing him equity shares. The interest, however, on these 200 debentures was paid to the debentureholder. Pass the necessary journal entries.

Solution:

Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
01.01.15	Bank A/c	Dr.		4,50,000	
	Discount on Issue of Debentures A/c	Dr.		50,000	
	To 10% Debentures A/c				5,00,000
	(Being the Debentures issued at 10% discount)				
31.12.15	Interest on Debentures A/c	Dr.		50,000	
	To Outstanding Interest on debentures A/c				50,000
	(Being the Interest due on debentures)				
	10% Debenture A/c	Dr.		50,000	
	To Discount on issue of Debentures A/c				5,000
	To Debentureholders' A/c				45,000
	(Being the amount due to debenture-holders)				
	Debentureholders' A/c	Dr.		45,000	
	To Equity Share Capital A/c				30,000
	To Securities Premium A/c				15,000
	(Being the issue of 600 Equity Shares of ₹ 50 each at a premium of 25%)				
	Outstanding Interest on Debentures A/c	Dr.		50,000	
	To Bank A/c				50,000
	(Being the Interest paid to the Debentures holders)				

Illustration 49:

On 01.01.2015, Hudco Ltd. issued 1,000, 15% Convertible Debentures of ₹ 200 each at a discount of 5% redeemable at par after 4 years by coverting their holdings into equity shares of ₹ 100 each at a premium of 25%. As per terms of issue, the holders of these Debentures also have an option to convert their holdings as aforesaid at any time after 6 months but within 3 years. On 31.12.2015, a holder of 250 Debentures notified his intention to exercise the option.

Requirements: (a) Give Journal entries as on 01.01.2015, 31.12.2015 and on 31.12.2016 (ignoring interest), and (b) Prepare the Balance Sheet as on 31.12.2016 (showing related items only).

Solution:

Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
01.01.15	Bank A/c	Dr.		1,90,000	
	Discount on Issue of Debentures A/c	Dr.		10,000	
	To 15% Debenture A/c				2,00,000
	(Being the issue of 1,000 debentures at a discount of 5%)				
31.12.15	15% Debentures A/c	Dr.		50,000	
	To Discount on Issue Debentures A/c				2,500
	To Equity Shares Capital A/c				38,000
	To Securities Premium A/c				9,500
	(Being the issue of 380 shares at 25% premium to a holder of 500 Debentures as per Board Resolution dated....)				
31.12.16	15% Debentures A/c	Dr.		1,50,000	
	To Equity Share Capital A/c				1,20,000
	To Secuirities Premium A/c				30,000
	(Being the issue of 1,200 share @ 25% premium to the holders of 1,500 Debentures as per Board's Resolution dated...)				

An Extract of Balance Sheet as at 31st December 2016

Liabilities	₹	Assets	₹
Share Capital:		**Miscellaneous Expenditure:**	
Equity Shares of ₹ 100		Discount on Issue of Debentures	7,500
each fully paid up	38,000		
Reserves & Surplus:			
Securities Premium	9,500		
Securied Loans:			
750, 15% Debentures of			
₹ 200 each	1,50,000		

Working Notes:

(i) It has been assumed that no portion of Discount on Issue of Debentures has yet been written off.

(ii) Calculation of No. of Shares to be issued on 31.12.2016.

a.	Normal Value of Debentures to be converted (250 × 200)	₹	50,000
b.	Less: Reversal of Discount @ 5%	₹	2,500
c.	Amount actually received (a – b)	₹	47,500
d.	Issued price of an Equity Share (₹ 100 + 25%)	₹	125
e.	No. of Shares to be issued (c/d)		380

New Shares have been issued exactly equal to be amount actually received (i.e., Net of discount) at the time of issue of Debentures, otherwise it would amount to an issue of shares at discount indirectly without complying with the provision of Sec. 53 of the Companies Act, 2013.

(iii) Calculation of No. of Shares to be issued on 31.12.2016.

a. Nominal Value of Debenturres to be converted	₹	1,50,000
b. Issue Price of an Equity Share (₹ 100 + 25%)	₹	125
c. No. of Equity Shares to be issued (a/b)		1,200

Since the debentures are due for redemption and the conversion of debentures into shares is on the basis of terms and conditions mutually agreed upon at the time of issue for redemption, even the debentures originally issued at a discount can be converted into shares.

CUM INTEREST AND EX-INTEREST TRANSACTIONS

Illustration 50:

On 01.01.2015 S Ltd. had 2,000, 12% Debentures of ₹ 100 each. On 01.05.2015 the company purchased 400 own Debentures at ₹ 97 cum-interest in the open market. Interest on debenture is payable on 30th June and 31st Dec. each year.

Required: Give the necessary journal entires assuming (a) that the own Debentures purchased were cancelled immediately and (b) the the own Debentures purchased were retained as investments till 31.12.2015 on which date they were cancelled.

Solution:

(a) If own Debentures were cancelled immediately on date of purchase.

Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2015					
May 01	12% Debentures A/c	Dr.		40,000	
	Debentures Interest A/c	Dr.		1,600	
	To Bank A/c				38,800
	To Capital Reserve A/c				2,800
	(Being 400 debentures cancelled by purchase @ ₹ 97 cum-interest)				
June 30	Debentures Interest A/c	Dr.		9,600	
	To Bank A/c				9,600
	(Being the interest paid on ₹ 1,60,000 @ 12% p.a. for 6 months)				
Dec. 31	Debenture Interest A/c	Dr.		9,600	
	To Bank A/c				9,600
	(Being the interest paid on ₹ 1,60,000 @ 12% p.a. for 6 months)				
Dec. 31	Profit & Loss A/c	Dr.		20,800	
	To Debenture Interest A/c				20,800
	(Being the transfer of debenture interest to P & L A/c)				
Dec. 31	Profit & Loss Appropriation A/c	Dr.		37,200	
	To Debenture Redemption Reserve A/c				37,200
	(Being the transfer of an amount equivalent to the cash sum applied (towards principal) in redeeming the debentures to DRR out of profits)				

(b) If own debentures were cancelled on 31.12.2015.

Journal of X Ltd.

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
May 01	Own Debentures A/c	Dr.		37,200	
	Debentures Interest A/c				1,600
	To Bank A/c				38,800
	(Being the purchase of 400 debentures @ ₹ 97 cum-interest)				
June 30	Debentures Interest A/c	Dr.		10,400	
	To Interest on Own Debentures A/c				800
	To Bank A/c				9,600
	(Being the Interest paid/credited on ₹ 1,60,000 debentures held by outsiders for 6 months & on ₹ 40,000 own debentures for 2 months)				
Dec. 31	Debenture Interest A/c	Dr.		12,000	
	To Bank A/c				9,600
	To Interest on Own Debentures A/c				2,400
	(Being the interest paid/credited on ₹ 1,60,000 debentures held by outsiders and ₹ 40,000 own debentures for 6 months)				
Dec. 31	Profit & Loss A/c	Dr.		24,000	
	To Debenture Interest A/c				24,000
	(Being the transfer of debenture interest to P & L A/c)				
Dec. 31	Interest on Own Debentures A/c	Dr.		3,200	
	To Profit & Loss A/c				3,200
	(Being the transfer of interest on own debentures to P & L A/c)				
Dec. 31	12% Debentures A/c	Dr.		40,000	
	To Own Debentures A/c				37,200
	To Capital Reserve A/c				2,800
	(Being the cancellation of 200 own debentures)				
Dec. 31	Profit & Loss Appropriation A/c	Dr.		37,200	
	To Debenture Redemption Reserve A/c				37,200
	(Being the transfer of an amount equivalent to the cash sum applied in redeming the debentures)				

3.6 EMPLOYEE STOCK OPTION PLAN (ESOP), EMPLOYEES STOCK OPTION SCHEME (ESOS)

Issue of Employee Stock Options

A company, other than a listed company, which is not required to comply with Securities and Exchange Board of India Employee Stock Option Scheme Guidelines shall not offer shares to its employees under a scheme of employees' stock option (hereinafter referred to as "Employees Stock Option Scheme"), unless it complies with the following requirements, namely:-

(1) the issue of Employees Stock Option Scheme has been approved by the shareholders of the company by passing a special resolution.

Explanation: For the purposes of clause (b) of sub-section (1) of section 62 and this rule ''Employee'' means-

(a) a permanent employee of the company who has been working in India or outside India; or

(b) a director of the company, whether a whole time director or not but excluding an independent director; or

(c) an employee as defined in clauses (a) or (b) of a subsidiary, in India or outside India, or of a holding company of the company or of an associate company but does not include-

(i) an employee who is a promoter or a person belonging to the promoter group; or

(ii) a director who either himself or through his relative or through any body corporate, directly or indirectly, holds more than ten percent of the outstanding equity shares of the company.

(2) The company shall make the following disclosures in the explanatory statement annexed to the notice for passing of the resolution-

(a) the total number of stock options to be granted;

(b) identification of classes of employees entitled to participate in the Employees Stock Option Scheme;

(c) the appraisal process for determining the eligibility of employees to the Employees Stock Option Scheme;

(d) the requirements of vesting and period of vesting;

(e) the maximum period within which the options shall be vested;

(f) the exercise price or the formula for arriving at the same;

(g) the exercise period and process of exercise;

(h) the Lock-in period, if any ;

(i) the maximum number of options to be granted per employee and in aggregate;

(j) the method which the company shall use to value its options;

(k) the conditions under which option vested in employees may lapse e.g. in case of termination of employment for misconduct;

(l) the specified time period within which the employee shall exercise the vested options in the event of a proposed termination of employment or resignation of employee; and

(m) a statement to the effect that the company shall comply with the applicable accounting standards .

(3) The companies granting option to its employees pursuant to Employees Stock Option Scheme will

have the freedom to determine the exercise price in conformity with the applicable accounting policies, if any.

(4) The approval of shareholders by way of separate resolution shall be obtained by the company in case of-

(a) grant of option to employees of subsidiary or holding company; or

(b) grant of option to identified employees, during any one year, equal to or exceeding one percent of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant of option.

(5) (a) The company may by special resolution, vary the terms of Employees Stock Option Scheme not yet exercised by the employees provided such variation is not prejudicial to the interests of the option holders.

(b) The notice for passing special resolution for variation of terms of Employees Stock Option Scheme shall disclose full of the variation, the rationale therefor, and the details of the employees who are beneficiaries of such variation.

(6) (a) There shall be a minimum period of one year between the grant of options and vesting of option:

Provided that in a case where options are granted by a company under its Employees Stock Option Scheme in lieu of options held by the same person under an Employees Stock Option Scheme in another company, which has merged or amalgamated with the first mentioned company, the period during which the options granted by the merging or amalgamating company were held by him shall be adjusted against the minimum vesting period required under this clause;

(b) The company shall have the freedom to specify the lock-in period for the shares issued pursuant to exercise of option.

(c) The Employees shall not have right to receive any dividend or to vote or in any manner enjoy the benefits of a shareholder in respect of option granted to them, till shares are issued on exercise of option.

(7) The amount, if any, payable by the employees, at the time of grant of option-

(a) may be forfeited by the company if the option is not exercised by the employees within the exercise period; or

(b) the amount may be refunded to the employees if the options are not vested due to non-fulfillment of conditions relating to vesting of option as per the Employees Stock Option Scheme.

(8) (a) The option granted to employees shall not be transferable to any other person.

(b) The option granted to the employees shall not be pledged, hypothecated, mortgaged or otherwise encumbered or alienated in any other manner.

(c) Subject to clause (d), no person other than the employees to whom the option is granted shall be entitled to exercise the option.

(d) In the event of the death of employee while in employment, all the options granted to him till such date shall vest in the legal heirs or nominees of the deceased employee.

(e) In case the employee suffers a permanent incapacity while in employment, all the options granted to him as on the date of permanent incapacitation, shall vest in him on that day.

(f) In the event of resignation or termination of employment, all options not vested in the employee as on that day shall expire. However, the employee can exercise the options granted to him which are vested within the period specified in this behalf, subject to the terms and conditions under the scheme granting such options as approved by the Board.

(9) The Board of directors, shall, inter alia, disclose in the Directors' Report for the year, the following details of the Employees Stock Option Scheme:

(a) options granted;

(b) options vested;

(c) options exercised;

(d) the total number of shares arising as a result of exercise of option;

(e) options lapsed;

(f) the exercise price;

(g) variation of terms of options;

(h) money realized by exercise of options;

(i) total number of options in force;

(j) employee wise details of options granted to;-

(i) key managerial personnel;

(ii) any other employee who receives a grant of options in any one year of option amounting to five percent or more of options granted during that year.

(iii) identified employees who were granted option, during any one year, equal to or exceeding one percent of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant;

(10) (a) The company shall maintain a Register of Employee Stock Options in Form No. SH.6 and shall forthwith enter therein the particulars of option granted under clause (b) of sub-section (1) of section 62.

(b) The Register of Employee Stock Options shall be maintained at the registered office of the company or such other place as the Board may decide.

(c) The entries in the register shall be authenticated by the company secretary of the company or by any other person authorized by the Board for the purpose.

(11) Where the equity shares of the company are listed on a recognized stock exchange, the Employees Stock Option Scheme shall be issued, in accordance with the regulations made by the Securities and Exchange Board of India in this behalf.

The Institute of Chartered Accountants of India has issued guidance note on Accounting for Employee Share-based payments. The Guidance Note has suggested the following guidelines for accounting of ESOPs:

- Some employers use share-based payments as a part of remuneration package for their employees. Such payments generally take the terms of Employee Stock Option Plans (ESOPs). The guidance not recognizes that there are two methods of accounting for employee share-based payments viz. **the fair value method** and **the intrinsic value method** and permits as an alternative the intrinsic value method with fair value disclosures.
- An enterprise should recognize as an expense (except where service received qualifies to be included as part of the cost of an asses) the services received in an equity-settled employee share-based payments plan when it receives the services, with a corresponding credit to an appropriate equity account, say, 'Stock Option Outstanding Account'. This account is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as recommended in the Guidance Note.

- If the shares or stock options granted vest immediately, the employee is not required to complete a specified period of service before becoming unconditionally entitled to those instruments. In the absence of evidence to the contrary, the enterprise should presume that services rendered by the employees as a consideration for the instruments have been received. In this case, on the grant date, the enterprise should recognize services received in full with a corresponding credit to equity account.
- If the shares or stock options granted do not vest until the employee completes a specified period of service, the enterprise should presume that the services to be rendered by the employee as consideration for those instruments would be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time proportion basis, with a corresponding credit to the equity account.
- An enterprise should measure the fair value of shares or stock options granted at the grant date, based on market prices if available, taking into account the terms and conditions upon which those shares or stock options were granted. If market prices are not available, the enterprise should estimate the fair value of the instruments granted using a valuation technique to estimate what the price of those instruments granted using a valuation technique to estimate what the price of those instruments would have been on the grant date in an arm's length transaction between knowledgeable, wiling parties. The valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments (e.g. **use of an option pricing model for valuing stock option**) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price.

(A) Accounting during the vesting period

Illustration 51:

At the beginning of year 1, an enterprise grants 300 options to each of its 1,000 employees. The contractual life (comprising the vesting period and the exercise period) of options granted is 6 years. The other relevant terms of the grant are as below:

Vesting Period	3 years
Exercise Period	3 years
Expected Life	5 years
Exercise Price	₹ 50
Market Price	₹ 50
Expected forfeitures per year	3%

The fair value of options, calculated using an option-pricing model, is ₹ 15 per option. Actual forfeitures, during the year 1, are 5% and at the end of year 1, the enterprise still expects that actual forfeitures would average 3% per year over the 3-yaer vesting period. During the year 2, however, the management decides that the rate of forfeitures is likely to continue to increase, and the expected forfeiture rate for the entire award is changed to 6% per year. It is also assumed that 840 employees have actually completed 3 years vesting period.

Suggested Accounting Treatment

Year 1

1. At the grant date, the enterprise estimates the fair value of the options expected to vest at the end of the vesting period as below

   Number of options expected to vest
   = 300 ×1,000 × 0.97 × 0.97 × 0.97 = 2,73,802 options

   Fair value of options expected to vest
   = 2,73,802 options × ₹ 15 = ₹ 41,07,030

2. At the balance sheet date, since the enterprise still expects actual for forfeitures to average 3% per year over the 3 year vesting period, no change is required in the estimates made at the grant date. The enterprise, therefore, recognize one-third of the amount estimated at (1) above (i.e. ₹ 41,07,030/3) towards the employee services received by passing the following entry:

Employee Compensation Expenses A/c	Dr. ₹ 13,69,010	
To Stock Options Outstanding A/c		₹ 13,69,010
(Being compensation expenses recognized in respect of the ESOP)		

3. Credit balance in the 'Stock Option Outstanding A/c' may be disclosed in the balance sheet under a separate heading, between 'Share Capital' and 'Reserve and Surplus'.

Year 2

1. At the end of the financial year, management has changed its estimate of expected forfeiture rate from 3% to 6% per year. The revised number of options expected to vest is 2,49,175 (3,00,000 × 0.94 × 0.94 × 0.94). Accordingly the fair value of revised options expected to vest is ₹ 37,37,625 (2,49,175 × ₹15). Consequent to the change in the expected forfeitures, the expenses to be recognized during the year are determined as below:

Revised total fair value	₹ 37,37,625
Revised cumulative expenses at the end of the year 2 = (₹ 37,37,625 × 2/3)	₹ 24,91,750
Expenses already recognized in year 1	₹ 13,69,010
Expenses to be recognized in year 2	₹ 11,22,740

2. The enterprise recognizes the amount determined at (1) above (i.e. ₹ 11,22,740) towards the employee services received by passing the following entry:

3. Credit balance in the 'Stock Option Outstanding A/c' may be disclosed in the balance sheet under separate heading between 'Share Capital' and 'Reserve and Surplus'.

Year 3

1. At the end of financial year, the enterprise would examine its actual forfeitures and make necessary adjustment, if any, to reflect expenses for the number of options that actually vested. Considering that 840 employees have completed three years vesting period, the expenses to be recognized during the year is determined as below:

   Number of options actually vested = 840 × 300 = 2,52,000

Fair value of options actually vested = (₹ 2,52,000 × ₹15)	₹37,80,000
Expenses already recognized	₹ 24,91,750
Expenses to be recognized in year 3	₹ 12,88,250

2. The enterprise recognize the amount determined at (1) above towards the employee service received by passing the following entry:

Employee compensation expenses A/c	Dr. ₹ 12,88,250	
To Stock Options Outstanding A/c		₹ 12,88,250
(Being compensation expenses recognized in respect of the ESOP)		

3. Credit balance in the 'Stock Option Outstanding A/c' may be disclosed in the balance sheet under separate heading between 'Share Capital' and 'Reserve and Surplus'.

(B) Accounting at the time of exercise / expiry of the vested options:

Continuing the above example, the following further facts are provided:

(a) 200 employees exercise their rights to obtain shares vested in them in pursuance of the ESOP at the end of year 5 and 600 employees exercise their rights at the end of year 6.

(b) Rights of 40 employees expire unexercised at the end of the contractual life of the option, i.e. at the end of the year 6.

(c) Face value of one share of the enterprise is ₹ 10.

Suggested Accounting Treatment

1. On exercise of right to obtain shares the enterprise issues shares to the respective employees on receipt of the exercise price. The shares so issued are considered to have been issued on a consideration comprising the exercise price and corresponding amount standing to the credit of the Stock Options Outstanding Account. In the present case, the exercise price is ₹ 50 per share and the amount of compensation expenses recognized in the 'Stock Options outstanding A/c' is ₹ 15 per option. The enterprise, therefore, considers the shares to be issued at a price of ₹ 65 per share.

2. The amount to be recorded in the 'Share Capital A/c' and the 'Securities Premium A/c' upon issuance of the shares, is calculated as below:

Particulars	Exercise Date year end 5	Exercise Date year end 6
Number of employees exercising option Number of shares issued on exercise @ 300 per employee	200 60,000	600 1,80,000
Exercise price received @₹ 50 per share Corresponding amount recognized in the 'Stock Options outstanding A/c' @₹15 per option	₹ 30,00,000 ₹ 9,00,000	₹ 90,00,000 ₹ 27,00,000
Total Consideration	₹ 39,00,000	₹ 1,17,00,000
Amount to be recorded in 'Share Capital A/c' @10 per share Amount to be recorded in 'Securities Premium A/c' @ ₹ 55 per share	₹ 6,00,000 ₹ 33,00,000	₹ 18,00,000 ₹ 99,00,000
Total	₹ 39,00,000	₹ 1,17,00,000

3. The enterprise passes the following entries at the end of year 5 and year 6, respectively, to record the shares issued to the employees upon exercise of options vested in them in pursuance of the Employee Stock Option Plan:

Year 5

Bank A/c	Dr. ₹ 30,00,000	
Stock Options Outstanding A/c	Dr. ₹ 9,00,000	
To Share Capital A/c		₹ 6,00,000
To Securities Premium A/c		₹ 33,00,000
(Being shares issued to the employees against the options vested in them in pursuance of the Employee Stock Option Plan)		

Year 6

Bank A/c	Dr. ₹ 90,00,000	
Stock Options Outstanding A/c	Dr. ₹ 27,00,000	
To Share Capital A/c		₹ 18,00,000
To Securities Premium A/c		₹ 99,00,000
(Being shares issued to the employees against the options vested in them in pursuance of the Employee Stock Option Plan)		

4. At the end of year 6, the balance of ₹ 1,80,000 (i.e. 40 employees × 300 options × ₹15 per option) standing to the credit of the Stock Options Outstanding A/c, in respect of vested options expiring unexercised, is transferred to general reserve by passing the following entry:

Stock Options Outstanding A/c	Dr. ₹ 1,80,000	
To General Reserve		₹ 1,80,000
(Being the balance standing to the credit to the Stock Options Outstanding A/c, in respect of vested options expired unexercised, transferred to the General Reserve)		

(C) Intrinsic Value Method

Accounting for employee share-based payments plans dealt with in above example, is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee share-based payment plans. Intrinsic value, in the case of listed company, is the amount by which the quoted market price of the underlying share exceed the exercise price of an option price for example, an option with an exercise price of ₹ 100 on an equity share whose current quoted market price is ₹ 125, has an intrinsic value of ₹ 25 per share on the date of its valuation. If the quoted market price is not available on the grant date then the share price nearest to that date is taken. In the case of non-listed companies. Since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer.

The accounting treatment suggested in above example is based on the fair vale method. In case the enterprise follows the intrinsic value method instead of fair value method, it would not recognize any compensation expenses since the market price of the underlying share at the grant date is the same as exercise price and the intrinsic value of the options is nil. However, in case the market price of the underlying share at the grant date is more than the exercise price, say, ₹ 52 per share, then the difference of ₹ 2 between the market value and the exercise price would be intrinsic value of the option. In such a case, the enterprise would treat the said intrinsic value as compensation expenses over the vesting period.

EMPLOYEES STOCK OPTION SCHEME (ESOS)

ESOP means a scheme under which the company grants option (a right but not an obligation) to an employee to apply for shares of the company at a pre-determined price. This right is exercisable by the employee, during the specified period. Section 2(37) of the Companies Act, 2013 states that the "employee stock option" means the option given to the whole time director, officers or employees of a company which gives such directors, officers of employees the benefit or right to purchase or subscribe at a future date, the securities offered by the company at a pre-determined price. The SEBI has issued guidelines for ESOS of listed companies. These guidelines are also applicable for Employee Stock Purchase Scheme (ESPS) which means a scheme under which the company offers shares to employee as part of public issue or otherwise.

Accounting for ESOP – The option discount (which is also known as fair value or accounting value of options) granted to employees during the accounting period should be treated as compensation to employees. Option discount means the excess of the market value of the share at the date of grant of the option under ESOS over the exercise price of the option (including upfront payment, if any). The option discount should be amortised on a straight-line basis over the vesting period i.e., the period over which option is exercisable. The journal entries are as follows:

- At the time of grant of option

  Deferred Employee Compensation Expense A/c Dr.

  To Employees Stock Options Outstanding A/c

- At the time of amortization of option discount

  Employee Compensation Expense A/c Dr.

  To Deferred Employee Compensation Expense A/c

- At the time of exercise of option

Bank A/c	Dr. (amount received from employee)
Employee Stock Option Outstanding A/c	Dr. (option discount)
To Equity Share Capital A/c	(face value of shares issued)
To Securities Premium A/c	(excess of fair value of shares over face value)

- In case of lapse of option – In case of lapse of option due to lapse of period of option or by virtue of the employee not conforming to the vesting conditions:

  (i) The lapsed option should be debited to employee stock option outstanding account, and

  (ii) Credited to employee compensation expense (with the portion of the option discount already written off) and deferred employee compensation expenses with the unamortized portion of option discount i.e., the portion not written off on the date of lapse. The entry is as under:

  Employee Stock Option Outstanding A/c Dr.

  To Employee Compensation Expense A/c

  To Deferred Employee Compensation Expense A/c

In the balance sheet, employee stock option outstanding (Cr. Balance) and deferred employee compensation (Dr. balance) will be adjusted in net worth or shareholders' equity.

Even company that has passed a resolution for ESOS under SEBI Guidelines, shall comply with the accounting policies specified in Schedule I.

Disclosure in the Director's Report – The Board of Directors shall inter alia, disclosure either in the Director's Report or in the annexure to the Director's Report, the following details of the ESOS:

a. Options granted;

b. The pricing formula;

c. Options vested;

d. Options exercised;

e. The total number of shares arising as a result of exercise of option;

f. Options lapsed;

g. Variation of terms of options;

h. Money realized by exercise of options;

i. Total number of options in force;

j. Employee-wise details of options granted to:

   (i) Senior managerial personnel;

   (ii) Any other employee who receives a grant in any one year of option amounting to 5% or more of option granted during that year;

   (iii) Identified employees who were granted option, during any one year, equal to or exceeding 1% of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant;

k. 'diluted earnings per share' pursuant to issue of shares on exercise of option calculated in accordance with IAS-33.

Illustration 52:

Paras Engineering Ltd. Granted 2,000 options on 1st May 2014 at ₹ 60 when the market price was ₹ 150. The vesting period is two years.

You are required to :

(i) Calculate the value of options

(ii) Calculate the amount to be amortised every year.

(iii) Pass necessary journal entries for the year 2014-15 and 2015-16.

Solution:

(i) Value of options = Number of Options Granted x (Market Price – Exercise Price)

= 2,000 x (₹ 150 – 60) = ₹ 1,80,000

(ii) Vesting period is two years. This value of options shall be amortised on a straight line basis over the vesting period. Therefore, the amount to be amortised every year = ₹ 1,80,000 / 2 = ₹ 90,000

In the books of Paras Engineering Ltd.

Journal

Date	Particulars	L.F.	₹	₹
31.5.14	Deferred Employee Compensation Expenses A/c. Dr. To, Employee Stock Options Outstanding A/c. (being the grant of 2,000 options at a discount of ₹ 90 each)		1,80,000	1,80,000
31.3.15	Employee Compensation Expense A/c. Dr. To, Deferred Employee Compensation Expense A/c. (being the amortization of the deferred compensation over two years on straight line basis)		90,000	90,000
31.3.16	Employee Compensation Expense A/c. Dr. To, Deferred Employee Compensation Expense A/c. (being the amortization of the deferred compensation over two years on straight line basis)		90,000	90,000

Illustration 53:

ABC Ltd. Granted 2,000 options on 1st June 2014 at ₹ 100 when the market price was ₹ 175. The vesting period was 3 years. The maximum exercise period was 1 year. All the 2,000 options were exercised by the employees on 31st December 2015. Pass necessary journal entries recording the above transactions.

Solution:

(i) Value of options = 2,000 x (₹ 175 - ₹ 100) = ₹ 1,50,000

(ii) Amount to be amortised = ₹ 1,50,000/3 = ₹ 50,000 each year In the books of ABC Ltd.

Journal

Date	Particulars	L.F.	₹	₹
01.06.09	Deferred Employee Compensation Expenses A/c. Dr. To, Employee Stock Options Outstanding A/c. (being the grant of 2,000 options at a discount of ₹ 80 each)		1,50,000	1,50,000
31.3.10	Employee Compensation Expense A/c. Dr. To, Deferred Employee Compensation Expense A/c. (being the amortization of the deferred compensation over three years on straight line basis)		50,000	50,000
31.3.11	Employee Compensation Expense A/c. Dr. To, Deferred Employee Compensation Expense A/c. (being the amortization of the deferred compensation over three years on straight line basis)		50,000	50,000
31.3.12	Employee Compensation Expense A/c. Dr. To, Deferred Employee Compensation Expense A/c. (being the amortization of the deferred compensation over three years on straight line basis)		50,000	50,000
31.12.12	Bank A/c. (2,000 x ₹ 100) Dr. Employee Stock Options Outstanding A/c Dr. To Equity Share Capital A/c. To Securities Premium A/c (being the exercise of 2,000 options)		2,00,000 1,50,000	20,000 3,30,000

Illustration 54:

ABCL grants 1,250 options on 1st May 2014 at ₹ 80 when the market price is ₹ 200 and the face value of ₹ 10. The vesting period is 3 years. The maximum exercise period is one year. 450 unvested options lapse on 1st June 2016, 800 options are exercised on 30th Sept. 2017. Pass necessary journal entries to record the above transactions and also show Deferred Employee Compensation Expense Account and Employee Stock Options Outstanding Account and state how these accounts will be shown in the Balance Sheet.

Solution:

Value of options = 1,250 x ₹ (200 – 80) = ₹ 1,50,000

Amount to be anortised = ₹ 1,50,000 /3 = ₹ 50,000 each year.

In the books of ABC Ltd.

Journal

Date	Particulars	L.F.	₹	₹
01.05.14	Deferred Employee Compensation Expenses A/c. Dr. To, Employee Stock Options Outstanding A/c. (being the grant of 1,250 options at a discount of ₹ 80 each)		1,50,000	1,50,000
31.3.15	Employee Compensation Expense A/c. Dr. To, Deferred Employee Compensation Expense A/c. (being the amortization of the deferred compensation over three years on straight line basis)		50,000	50,000

31.3.16	Employee Compensation Expense A/c. Dr. To, Deferred Employee Compensation Expense A/c. (being the amortization of the deferred compensation over two years on straight line basis)		50,000	50,000
01.06.16	Employee Stock Options Outstanding A/c. (Note 1) Dr. To, Deferred Employee Compensation Expense A/c.(Note 2) To, Employee Compensation Expense A/c. (Note 3) (being the reversal of compensation accounting on lapse of 450 options)		54,000	18,000 36,000
31.3.17	Employee Compensation Expense A/c Dr. To, Deferred Employee Compensation Expense A/c. (being the amortization of the balance deferred compensation)		32,000	32,000
30.09.17	Bank A/c. (800 x ₹ 80) Dr. Employee Stock Options Outstanding A/c Dr. To Equity Share Capital A/c. To Securities Premium A/c (being the exercise of 800 options)		64,000 96,000	8,000 1,52,000

Deferred Employee Compensation Expense Account

Dr. Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
01.05.14	To, Employee Stock Options Outstanding A/c	1,50,000	31.3.15	By,Employee Compensation Expense A/c By, Balance c/d	50,000 1,00,000
		1,50,000			1,50,000
01.04.15	To Balance b/d	1,00,000	31.3.16	By, Deferred Employee Compensation Expense A/c By, Balance c/d	50,000 50,000
		1,00,000			1,00,000
01.04.16	To Balance b/d	50,000	31.3.17	By, Employee Compensation Expense A/c By, Balance c/d	18,000 32,000
		50,000			50,000

Employee Stock Options Outstanding Account

Dr. Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
31.3.15	To, Balance c/d	1,50,000	01.05.14	By, Deferred Employee Compensation Expense A/c.	1,50,000
		1,50,000			1,50,000
31.3.16	To Balance c/d	1,50,000	01.04.15	By, Balance b/d	1,50,000
		1,50,000			1,50,000

31.3.17 30.9.17	To Deferred Employee Compensation Expense A/c. To, Employee Compensation Expense A/c. To, Equity Share Capital A/c To Securities Premium A/c	18,000 36,000 4,800 91,200	01.04.16	By, Balance b/d	1,50,000
		1,50,000			1,50,000

Disclosure in the Balance Sheet :

(i) Employee Stock Options Outstanding will appear in the Balance Sheet as part of networth or shareholders' equity.

(ii) Deferred employee compensation expense will appear as a negative item as part of networth or shareholders' equity.

Working notes:

(i) $\frac{\text{Total Value of Compensation}}{\text{Total Number of Options}} \times \text{Number of Options Not Exercised} = \frac{1,50,000}{1,250} \times 450 = ₹\ 54,000$

(ii) $\frac{\text{Not yet Amortised Value of Compensation}}{\text{Total Number of Options}} \times \text{Number of Options Not Exercised} = \frac{50,000}{1,250} \times 450 = ₹\ 18,000$

(iii) $\frac{\text{Amortised Value of Compensation}}{\text{Total Number of Options}} \times \text{Number of Options Not Exercised} = \frac{1,00,000}{1,250} \times 450 = ₹\ 36,000$

(iv) $\frac{\text{Total Value of Compensation}}{\text{Total Number of Options}} \times \text{Number of Options Not Exercised} = \frac{1,50,000}{1,250} \times 800 = ₹\ 96,000$

3.7 UNDERWRITING OF SHARES AND DEBENTURES

Introduction

Underwriting is an agreement, with or without conditions, to subscribe to the securities of a body corporate when existing shareholders of the corporate or the public do not subscribe to the securities offered to them.

When a company goes in for an Initial Public Offer (IPO), it may face certain uncertainty about whether its

Offer of shares or other securities will be subscribed in full or not. If the public issue does not get fully subscribed, the project for which the funds are being raised cannot be implemented. As per law, it is required that if the company is not able to collect 90% of the offer amount, then it needs to compulsorily return the money to those who have subscribed to the shares.

To avoid the risk of under-subscription companies may seek the help of a specialized group of risk-redeemers called Underwriters. The function of the Underwriters is to arrange subscription of floated shares.

If the whole or a certain portion of the shares or debentures of the company are not applied for by the public, the underwriters themselves apply or persuade others to apply for those shares or debentures. The underwriters, as risk-takers, are entitled to get commission at prescribed rates.

It can be easily comprehended that when the floated shares are likely to be under-subscribed, the underwriters come to the forefront. In other cases they remain in the background, acting as catalysts arranger of sale to the investing public.

Before entering into an agreement with the company, the underwriters assess the following: (a) worth of the public issue;

(b) Market response to the issue; and

(c) Their own ability to get the issue fully subscribed.

Depending upon the risk assessment of the issue, the underwriters decide on their amount of commission. Owing to under-subscription, if the issue devalues upon them, the underwriters pay up the required amount and deduct their commission from that.

From the *viewpoint of the issuer company,* the following are generally observed:

(a) While selecting underwriters and finalizing underwriting arrangements, lead merchant bankers shall ensure that the underwriters do not overexpose themselves so that it may become difficult to fulfill underwriting commitments.

(b) The overall exposure of underwriter(s) belonging to the same group or management in an issue shall be assessed carefully by the lead merchant banker.

(c) The lead merchant banker shall satisfy themselves about the ability of the underwriters o discharge their underwriting obligations.

(d) The lead merchant banker shall:

   (i) incorporate a statement in the offer document to the effect that in the opinion of the lead merchant banker, the underwriters' assets are adequate to meet their underwriting obligations;

   (ii) Obtain underwriters' written consent before including their names as underwriters in the final offer document.

(e) In respect of every underwritten issue, the lead merchant banker(s) shall undertake a minimum underwriting obligation of 5% of the total underwriting commitment or ₹ 25 lacs whichever is less.

(f) The outstanding underwriting commitments of a merchant banker shall not exceed 20 times its

   Net worth any point of time.

(g) In respect of an underwritten issue, the lead merchant banker shall ensure that the relevant details of underwriters are included in the offer document.

It should be noted that as per the latest SEBI Guidelines underwriting is not mandatory.

Under the SEBI rules, no person other than a share broker or merchant banker can act as underwrite unless he holds a certificate granted by SEBI.

Regarding underwriting, the following *disclosures* should be made in the Offer Document:

(a) Names and addresses of the underwriters and the amount underwritten by them.

(b) Declaration by board of directors of the issuer company that the underwriters have sufficient resources to discharge their respective obligations.

Underwriting Agreement

After the determination of the Issue Price and allocation of our Equity Shares but prior to filing of the Prospectus with ROC, our Company will entered into an Underwriting Agreement with the Underwriters for the Equity Shares proposed to be offered through this Issue. It is proposed that pursuant to the terms of the Underwriting Agreement, the BRLMs shall be responsible for bringing in the amount devolved in the event that the Syndicate Members (other than ESL) do not fulfill their underwriting obligations. Pursuant to the tem1s of the Underwriting Agreement, the obligations of the Underwriters are several and are subject to certain conditions precedent to closing, as specified therein.

The Underwriters have indicated their intention to underwrite the following number of Equity Shares:

(This portion has been intentionally left blank and will be filled in before filing of the Prospectus with RoC)

Name and Address of the Underwriter	**Indicative Number of Equity shares to be underwritten**	**Amount Underwritten (₹ in millions)**
<u>Running Lead Manager</u> Kotak Mahindra Capital Company Ltd. 229,Nariman point, Mumbai-400021, India	27,95,283	2306.1
Citi Group Global India Market Private Ltd 12th Fklhtawar, Nariman Point, Mumbai-400021, India.	27,95,382	2,306.2
Lehman Brothers Securities Private Ltd. Gee jay House, 11th Level, Plot F Shivsagar Estate Old Annie Besant Road, Worli Mumbai – 400018, India.	27,95,382	2,306.2

Sub-Underwriters

In order to spread the risk of under-subscription , the principal underwriters may enter into subsidiary agreements with sub-underwriters. Such agreements are made between the underwriters alone, with the company not being a party thereto. As per agreement, the company pays commission at a prescribed rate to the principal underwriters, who in turn, disburse commission to the sub-underwriters. Sometimes an additional commission is paid to the principal underwriters to encourage sub-underwriting. This is known as *over-riding commission.* The payment of an over-riding commission enables the company to deal with one or two underwriters instead of a number of them.

Underwriting Commission

It may be paid in cash or in fully paid-up shares or debentures or a combination of all these. It is paid on the issue price of the shares or debentures so underwritten. As per the provision of Section 40 of the Companies Act, 2013, commission is payable if the following conditions are satisfied:

(i) The payment of the commission is authorized by the articles;

(ii) The commission paid or agreed to be paid does not exceed in the case of *shares, five per cent* of the price at which the shares are issued or the amount or rate authorized by the articles, whichever is less, and in the case of *debentures, two and a half per cent* of the price at which the debentures are issued or the amount or rate authorized by the articles, whichever is less;

(iii) The amount or rate per cent of the commission paid or agreed to be paid is -

in the case of shares or debentures offered to the public for subscription, disclosed in the prospectus, and in the case of shares or debentures not offered to the public for subscription, disclosed in the statement in lieu of prospectus, or in a statement in the prescribed form signed in like manner as a statement in lieu of prospectus and filled in before the payment of the commission with the Registrar and, where a circular or notices not being a prospectus inviting subscription for the shares or debentures, is issued, also disclosed in that circular or notice:

(iv) The number of shares or debentures which persons have agreed for a commission to subscribe absolutely or conditionally is disclosed in the manner aforesaid; and

(v) A copy ‘If the contract for the payment of the commission is delivered to the Registrar at the time of delivery of the prospectus or the statement in lieu of prospectus for registration.

In this regard, the following points are to be noted:

(1) No underwriting commission is payable on the shares taken up by the promoters, employees, directors, business associates, etc.

(2) Commission is payable on the whole issue underwritten irrespective of the fact that whole of the issue may be taken over by the public.

However, as per Guidelines issued by the Stock Exchange division of the Department of Economic Affairs, Ministry of Finance vides their reference No. F-14/1/SE/85, dated 7th May, 1985, the following rates for payment of underwriting commission are in force.

	On amounts devolving on the underwriters (per cent)	**On amounts subscribed by the public (per cent)**
Equity Shares	2.5	2
Preference Shares / Convertible and Non-convertible Debentures		
(a) For amounts upto ₹ 5 lakhs	2.5	1.5
(b) For amounts in excess of ₹ 5 lakhs	2	1

(i) The rates of underwriting of commission mentioned above are maximum ceiling rates, within which any company will be free to negotiate the same with the underwriters.

(ii) Underwriting commission will not be payable on amounts taken up by the promoters group, employees, directors, their friends and business associates.

The company while fixing the underwriting commission should ensure that the commission is within the limits specified by the Central Government as stated in the above table.

Underwriting Agreement

There are two types of underwriting agreement: (a) conditional; and (b) firm.

Conditional underwriting: Under this type of agreement, the underwriter agrees to take up agreed

Proportion of shares, not taken up by the public. If the shares are fully subscribed by the public, the underwriter does not take up any share.

Firm underwriting: Under this type of agreement, the underwriter agrees to take up a specified number of shares irrespective of the number of shares subscribed for by the public. Unless it has otherwise agreed, the Underwriters' liability is determined without considering the number of shares taken up 'firm' by him.

Marked and Unmarked Applications

'Marked' applications are those applications which bear the stamp of an underwriter. If the issue is not fully subscribed, 'marked' applications shall be applied in reduction of underwriter's liability.

The 'unmarked' applications are those applications which bear no stamp of an underwriter. These applications are received by the company directly from the public. The *distinction between* marked and unmarked applications becomes immaterial when the whole issue is subscribed by only one underwriter. When there are more than one underwriter, the unmarked applications are divided amongst Underwriters in the ratio of their gross liability. When the issue is fully subscribed, the distinction between marked and unmarked applications becomes immaterial.

Full and Partial Underwriting

When the whole issue is underwritten by the underwriter(s) it is called full *underwriting*. When a part (say 75%) of the whole issue is underwritten by the underwriter(s) it is called *partial underwriting*. In this case the company is treated as having underwritten the balance of shares.

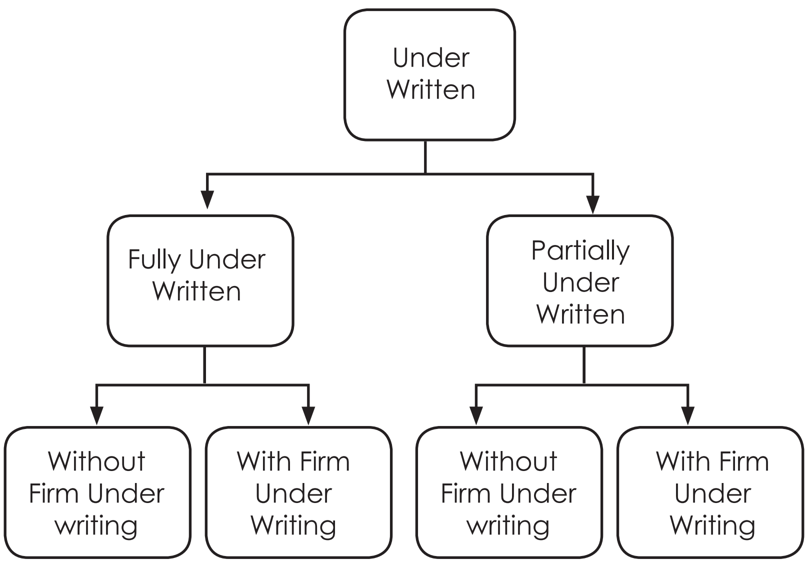
Accounting Entries

1. **For Commission/brokerage due:**

Commission/Brokerage A/c	Dr.
To Underwriter Account	Dr.
To Broker Account	

2. **For payment of Commission/brokerage**

Underwriter Account	Dr.
Broker Account	Dr.
To Bank Account	[Cheque]
To Share Capital Account	[Shares]
To Debentures Account	[Debentures]



Determination of Liability in respect of Underwriting Contract

The nature of underwriting contract determines the liability of the underwriter. The different types of underwriting contract with their subdivisions can be shown with the help of the following diagram:

1(a) When the Issue is Fully Underwritten [without Firm Underwriting]

If the entire issue has been underwritten by one underwriter, the determination of his liability is very simple. The total number of applications (both marked and unmarked) are deducted from the number of shares underwritten and the resultant figure is treated as a liability of the Underwriter. For example, X Ltd. issued l,00,000 equity shares of ₹ 10 each. The issue was fully underwritten by A. However, the company received applications for 80,000 shares which includes marked applications for 60,000 shares.

Here, A's liability will be 1,00,000- 60,000- 20,000 = 20,000 shares. A would get full credit for the unmarked 20,000 applications.

If the entire issue has been underwritten by *a number of underwriters* , certain difficulties may arise in respect of division of unmarked applications.

The unmarked applications can be divided between the underwriters in the following two ways.

Method 1

Under this method, all unmarked applications are divided between the underwriters in the ratio of *gross liability* of individual underwriter. For determining the liability of individual underwriter, the following steps are followed:

Step 1 Compute gross liability (if it has not been given) of individual underwriter on the basis of agreed ratio. For example, X Ltd. issued 1,00,000 Equity shares of ₹ 10 each. The issue was underwritten as:

A-30%; B -40% and C-30%. Here the gross liability will be: A-30% of 1,00,000 = 30,000 Shares; B-40% of 1,00,000 = 40,000 shares C-30% of 1,00,000 = 30,000 shares.

Step 2 Subtract marked applications from gross liability of respective underwriters.

Step 3 Determine the number of unmarked applications. (Unmarked application = Total applications received less marked applications). Divide unmarked applications between different underw1iters in the *ratio of gross liability* , as per our example, in the ratio of 3:4:3. If the resultant figures are all positive or zero, then stop here. Now these figures represents the net liability of each underwriter.

If some of the resultant figures are negative, then continue to Step 4**.**

Step 4 Add all negative figures and divide the resultant between the underwriters having positive figures in the ratio of gross liability y *inter se* (for details see *Illustration 3).*

Repeat *Step 4* unless all figures are non-negative. Now these figures represent the net liability of each underwriter.

Method 2

Under this method, all unmarked applications are divided between the underwriters in the ratio of *gross liability less marked applications.* For determining the liability of individual underwriter, following steps are followed:

Step 1 Compute gross liability in the usual manner (if it has not been given).

Step 2 Subtract marked applications from gross liability of respective underwriters. If some of the resultant figures are negative, then add all negative figures and divide their sum in the ratio of gross liability *inter se* (for details, See *Illustration 3* alternative solution).

Step 3 Determine the number of unmarked applications. Divide unmarked applications between different underwriters in the *ratio of gross liability less marked applications,* i.e., the resultant figures of *Step* 2. If the resultant figures of Step 3 are *all positive* or zero, then stop here. Now these figures represent the net liability of each underwriter.

If some of the resultant figures are negative, then continue to Step 4.

Step 4 Add all negative figures and divide their sum between the underwriters having positive figures in the same *ratio of Step 3.* Repeat Step 4 unless all figures are non-negative. Now these figures represents the net liability .

Illustration 55:

N Ltd. issued 80,000 Equity Shares which were underwritten as follows:

A	48,000 Equity Shares
B	20,000 Equity Shares
C	12,000 Eqiuty Shares

The above mentioned underwriters made applications for 'firm' underwritings as follows:

A	6,400 Equity Shares
B	8,000 Equity Shares
C	2,400 Equity Shares

The total applications excluding 'firm' underwriting, but including marked applications were for 40,000 Equity Shares.

The marked Applications were as under:

A	8,000 Equity Shares
B	10,000 Equity Shares
C	4,000 Equity Shares

(The underwriting contracts provide that underwriters be given credit for 'firm' applications and that credit for unmarked applications be given in proportion to the shares underwritten)

You are required to show the allocation of liability. Workings will be considered as a part of your answer.

Solution:

N Ltd.

Statement showing Liability of Underwriters

Particulars	A	B	C	Total
Gross Liability				
(No. of shares)	48,000	20,000	12,000	80,000
Unmarked Applications*				
(Ratio 48:20:12)	10,800	4,500	2,700	18,000
	37,200	15,500	9,300	62,000
Marked Applications	8,000	10,000	4,000	22,000
	29,200	5,500	5,300	40,000
Firm underwriting	6,400	8,000	2,400	16,800
Balance to be taken under	22,800	-2,500	2,900	23,200
the contract				
Credit for excess of				
B & Co. (ratio 48: 12)	2,000	2,500	500	
Net Liability	20,800		2,400	
Add: Firm Underwriting	6,400	8,000	2,400	16,800
Total Liability	27,200	8,000	4,800	40,000

Working Note:

* Total Applications	40,000	Shares
Marked Applications	22,000	Shares
Unmarked applications	18,000	Shares

Illustration 56:

A joint stock company resolved to issue 10 lakh equity shares of ₹ 10 each at a premium of ₹ 1 per share. One lakh of these shares were taken up by the directors of the company, their relatives, associates and friends, the entire amount being received forthwith. The remaining shares were offered to the public, the entire amount being asked for with applications.

The issue was underwritten by P, Q and R for a commission @2% of the issue price, 65% of the issue was underwritten by P, while Q's and R's shares were 25% and 10% respectively. Their firm underwriting was as follows:

P 30,000 shares, Q 20,000 shares and R 10,000 shares. The underwriters were to submit unmarked applications for shares underwritten firm with full application money along with members of the general public.

Marked applications were as follows:

P 1,19,500 shares, Q 57,500 shares and R 10,500 shares.

Unmarked applications totalled 7,00,000 shares.

Accounts with the underwriters were promptly settled.

You are required to:

(i) Prepare a statements calculating underwriters' liability for shares other than shares underwritten firm.

(ii) Pass journal entries for all the transactions including cash transactions.

Solution:

(i) Statement showing underwriters' liability for shares other than shares underwritten firm

Particulars	P	Q	R	Total
Gross liability	5,85,000	2,25,000	90,000	9,00,000
(9,00,000 shares in the ratio of 65: 25: 10)				
Less: Allocation of unmarked	1,19,500	57,500	10,500	1,87,500
applications (including firm	4,65,500	1,67,500	79,500	7,12,000
underwriting i.e. 7,00,000) in the				
ratio 65: 25: 10	4,55,000	1,75,000	70,000	7,00,000
	10,500	(7,500)	9,500	12,500
Surplus of Q allocated to P and				
R in the ratio 65: 10	(6,500)	7,500	(1,000)	–
	4,000	–	8,500	12,500
	₹	₹	₹	
Liability amount @ ₹ 11	44,000	–	93,500	
Underwriting commission payable				
(Gross liability × ₹ 11 × 2%)	1,28,700	49,500	19,800	
Net Amount payable	**84,700**	**49,500**		
Net Amount receivable			**73,700**	

(ii) **Journal Entries**

Particulars		Dr. (₹)	Cr. (₹)
Bank A/c	Dr.	11,00,000	
To Equity Shares Application A/c			11,00,000
(Being application money received on 1 lakh equity shares @ ₹ 11 per share)			
Bank A/c	Dr.	97,62,500	
To Equity Share Application A/c			97,62,500
(Application money received on 8,87,500 equity shares @ ₹ 11 per share from general public and underwriters for shares underwritten firm)			
Equity Share Application A/c	Dr.	1,08,62,500	
P' s A/c	Dr.	44,000	
R' s A/c	Dr.	93,500	
To Equity Share Capital A/c			1,00,00,000
To Securities Premium A/c			10,00,000
(Allotment of 10 lakh equity shares of ₹ 10 each at a premium of ₹ 1 per share)			
Underwriting commission A/c	Dr.	1,98,000	
To P's A/c			1,28,700
To Q's A/c			49,500
To R's A/c			19,800
(Amount of underwriting commission payable to P, Y and Z @2% on the amount of shares underwritten)			
Bank A/c	Dr.	73,700	
To R's A/c			73,700
(Amount received from Z in final settlement)			
P's A/c	Dr.	84,700	
Q's A/c	Dr.	49,500	
To Bank A/c			1,34,200
(Amount paid to X and Y in final settlement)			

Illustration 57:

Maruti Ltd. came out with an issue of 45,00,000 equity shares of ₹ 10 each at a premium of ₹ 2 per share. The promoters took 20% of the issue and the balance was offered to the public. The issue was equally underwritten by A; B and C

Each underwriter took firm underwriting of 1,00,000 shares each. Subscriptions for 31,00,000 equity shares were received with marked forms for the underwriters as given below:

A		7,25,000 shares
B		8,40,000 shares
C		13,10,000 shares
	Total	28,75,000 shares

The underwriters are eligible for a commission of 5% on face value of shares. The entire amount towards shares subscription has to be paid along with application. You are required to:

(a) Compute the underwriters liability (number of shares)

(b) Compute the amounts payable or due to underwriters; and

(c) Pass necessary journal entries in the books of Scorpio Ltd. relating to underwriting.

Solution:

(a) Computation of liabilities of underwriters (No. of shares):

Particulars	A	B	C
Gross liability	12,00,000	12,00,000	12,00,000
Less: Firm underwriting	1,00,000	1,00,000	1,00,000
	11,00,000	11,00,000	11,00,000
Less: Marked applications	7,25,000	8,40,000	13,10,000
	3,75,000	2,60,000	(2,10,000)
Less: Unmarked applications distributed to A and B in equal ratio	1,12,500	1,12,500	Nil
	2,62,500	1,47,500	(2,10,000)
Less: Surplus of C distributed to A and B in equal ratio	1,05,000	1,05,000	2,10,000
Net liability (excluding firm underwriting)	1,57,500	42,500	Nil
Add: Firm underwriting	1,00,000	1,00,000	1,00,000
Total liability (No. of shares)	2,57,500	1,42,500	1,00,000

(b) Computation of amounts payable by underwriters: (₹)

Particulars	A	B	C
Liability towards shares to be subscribed @12 per share	30,90,000	17,10,000	12,00,000
Less: Commission (5% on 12 lakhs shares @ 10 each)	6,00,000	6,00,000	6,00,000
Net amount to be paid by underwriters	24,90,000	11,10,000	6,00,000

(c) In the Books of Maruti Ltd.

Journal Entries

Particulars		Dr. ₹	Cr. ₹
Underwriting commission A/c	Dr.	1,80,000	
To A A/c			6,00,000
To B A/c			6,00,000
To C A/c			6,00,000
(Being underwriting commission on the shares underwritten)			
A A/c	Dr.	30,90,000	
B A/c	Dr.	17,10,000	
C A/c	Dr.	12,00,000	
To Equity share capital A/c			50,00,000
To Share premium A/c			10,00,000
(Being shares including firm underwritten shares allotted to underwriters)			
Bank A/c	Dr.	42,00,000	
To A A/c			24,90,000
To B A/c			11,10,000
To C A/c			6,00,000
(Being the amount received towards shares allotted to underwriters less underwriting commission due to them)			

Illustration 58:

G Ltd. came up with public issue of 30,00,000 Equity shares of ₹ 10 each at ₹ 15 per share. A, B and C took underwriting of the issue in 3: 2: 1 ratio.

Applications were received for 27,00,000 shares.

The marked applications were received as under:

A	8,00,000 shares
B	7,00,000 shares
C	6,00,000 shares

Commission payable to underwriters is at 5% on the face value of shares.

(i) Compute the liability of each underwriter as regards the number of shares to be taken up.

(ii) Pass journal entries in the books of Gemini Ltd. to record the transactions relating to underwriters.

Answer

(i) Computation of liability of underwriters in respect of shares

	(In shares)		
Particulars	**A**	**B**	**C**
Gross liability	15,00,000	10,00,000	5,00,000
Less: Unmarked applications	3,00,000	2,00,000	1,00,000
	12,00,000	8,00,000	4,00,000
Less: Marked applications	8,00,000	7,00,000	6,00,000
	4,00,000	1,00,000	(2,00,000)
Surplus of C distributed to A & B in 3:2 ratio	1,20,000	80,000	2,00,000
Net liability	2,80,000	20,000	Nil

(ii) Journal Entries in the books of Gemini Ltd.

Particulars		₹	₹
A's A/c	Dr.	42,00,000	
B's A/c	Dr.	3,00,000	
To Share Capital A/c			30,00,000
To Securities Premium A/c			15,00,000
(Being the shares to be taken up by the underwriters)			
Underwriting Commission A/c	Dr.	15,00,000	
To A's A/c			7,50,000
To B's A/c			5,00,000
To C's A/c			2,50,000
(Being the underwriting commission due to the underwriters)			
Bank A/c	Dr.	34,50,000	
To A's A/c			34,50,000
(Being the amount received from underwriter A for the shares taken up by him after adjustment of his commission)			
B's A/c	Dr.	2,00,000	
To Bank A/c			2,00,000
(Being the amount paid to underwriter B after adjustment of the shares taken by him against underwriting commission due to him)			
C's A/c	Dr.	2,50,000	
To Bank A/c			2,50,000
(Being the underwriting commission paid to C)			

Illustration 59:

H Ltd issued 20,000 Shares which are underwritten as follows: A - 12,000 Shares; B - 5,000 Shares and C - 3,000 Shares.

The Underwriters made applications for firm underwriting as under: A - 1,600 Shares; B - 600 Shares; and C - 2,000 Shares

The total subscriptions excluding Firm Underwriting but including marked applications were for 10,000 Shares. The marked applications were: A - 2,000 Shares; B- 4,000 Shares and C - 1,000 Shares.

You are required to show the allocation of liability of the underwriters.

Solution:

Statement of Underwriters Liability (Figures in No. of shares)

Particulars	**A**	**B**	**C**	**Total**
Gross Liability (given)	12,000	5,000	3,000	20,000
Less: Unmarked Applications In the ratio of Gross Liability	(1,800)	(750)	(450)	(3,000)
	10,200	4,250	2,550	17,000
Less: Marked Applications (given)	(2,000)	(4,000)	(1,000)	(7,000)
	8,200	250	1,550	10,000
Less: Firm underwriting (Given)	(1,600)	(600)	(2,000)	(4,200)
Net Liability Under the Contract	6,600	(350)	(450)	5,800
Adjustment: Surplus of B and C transferred to A	(800)	350	450	-
Balance to be underwriting	5,800	-	-	5,800
Add: Firm Underwriting	1,600	600	2,000	4,200
Total Liability	7,400	600	2,000	10,000

Note: Unmarked Applications = 3,000 i.e. Total Applications 10,000 – Marked Applications (2,000+4,000+1,000)= 7,000. These are distributed in the ratio of Gross Liability i.e.12:5:3

Illustration 60:

V Ltd. issued 80,000 Equity Shares which were underwritten as follows: A- 48,000 Equity Shares; B - 20,000 Equity Shares; and C - 12,000 Equity shares.

The above mentioned underwriters made application for Firm Underwriting as follows: A- 6,400 Equity Shares; B- 8,000 Equity Shares; and C - 2,400 Equity Shares.

The total applications excluding 'Firm' underwriting, but including Marked Applications were for 40,000 Equity Shares. The Marked Applications were under: A- 8,000 Equity Shares; B - 10,000 Equity Shares; and C - 4,000 Equity Shares.

The Underwriting Contracts provide that Underwriters be given credit for 'Firm' applications and that credit for unmarked applications be given in proportion to the Shares underwritten.

Compute the Underwriters' Liability

Solution:

Statement of Underwriters Liability (Figures in No. of shares)

Particulars	**A**	**B**	**C**	**Total**
Gross Liability (given)	48,000	20,000	12,000	80,000
Less: Unmarked Applications In the ratio of Gross Liability	(10,800)	(4,500)	(2,700)	(18,000)
	37,200	15,500	9,300	62,000
Less: Marked Applications (given)	(8,000)	(10,000)	(4,000)	(22,000)
	29,200	5,500	5,300	40,000

Particulars	A	B	C	Total
Less: Firm underwriting (Given)	(6,400)	(8,000)	(2,400)	(16,800)
Net Liability Under the Contract	22,800	(2,500)	2,900	23,200
Adjustment: Surplus of B transferred to A and C	(2,000)	2,500	(500)	-
Balance to be underwriting	20,800	-	2,400	23,200
Add: Firm Underwriting	6,400	8,000	2,400	16,800
Total Liability	27,200	8,000	4,800	40,000

Note: Unmarked Applications = 18,000 i.e. Total Applications 40,000 – Marked Applications (8,000+10,000+4,000)= 22,000. These are distributed in the ratio of Gross Liability i.e.48:20:12

Illustration 61:

B Limited issued to public 1,80,000 Equity Shares of ₹ 100 each at par. ₹ 50 per Share was payable along with Application and the balance on Allotment. The issue was underwritten equally by L, M and N for a commission of 3%. They agreed for a Firm Underwriting of 10,000 Shares each.

Applications for 1,40,000 Shares excluding Underwriters' Firm Underwriting were received as below:

Applications with marking of L's Seal	47,500
Applications with marking of M's Seal	42,500
Application with marking of N's Seal	38,000
Unmarked Applications	12,000

Compute the Underwriters' Liability and the amount payable / receivable.

Solution:

Statement of Underwriters Liability (Figures in No. of shares)

Particulars	L	M	N	Total
Gross Liability (given)	60,000	60,000	60,000	1,80,000
Less: Unmarked Applications in the ratio of Gross Liability	(4,000)	(4,000)	(4,000)	(12,000)
	56,000	56,000	56,000	1,68,000
Less: Marked Applications (given)	(47,500)	(42,500)	(38,000)	(1,28,000)
	8,500	13,500	18,000	40,000
Less: Firm underwriting (Given)	(10,000)	(10,000)	(10,000)	(30,000)
Net Liability Under the Contract	(1,500)	3,500	8,000	10,000
Adjustment: Surplus of L transferred to M and N	1,500	(750)	(750)	-
Balance to be underwriting	-	2,750	7,250	10,000
Add: Firm Underwriting	10,000	10,000	10,000	30,000
Total Liability (Shares to be subscribe)	**10,000**	**12,750**	**17,250**	**40,000**
Amount due to co. at ₹ 50 per Share (₹)	5,00,000	6,37,500	8,62,500	20,00,000
Less: Commission at 3% on Nominal Value of shares underwritten (60,000 x ₹100 x 3%) (₹)	(1,80,000)	(1,80,000)	(1,80,000)	(5,40,000)
Net amount Due from Underwriters (₹)	**3,20,000**	**4,57,500**	**6,82,500**	**14,60,000**

Note: Unmarked Applications = 12,000 i.e. Total Applications 1,80,000 – Marked Applications (47,500+42,500+38,000)= 1,28,000. These are distributed in the ratio of Gross Liability i.e.1:1:1

Illustrations 62:

A Ltd. with a Capital of ₹ 10 Lakhs divided into Equity Shares of ₹ 10 each places its entire issue on the market and the whole issue has been underwritten as follows

Name of Underwriter	S	P	G	M	N	SA
Number of Shares	30,000	35,000	10,000	15,000	2,000	8,000

All marked forms are to go in relief of the liabilities of the underwriter whose name they bear. The share underwritten "Firm" are also to be set off against the liabilities of the underwriters. The application received in Marked Forms is as follows:

Name of Underwriter	S	P	G	M	N	SA
Number of Shares	25,000	23,500	5,500	1,000	1,000	2,000

Applications for 20,000 Equity Shares are received on Unmarked Forms. In addition, there is a Firm Underwriting by the Underwriters as under

Name of Underwriter	S	P	G	M	N	SA
Number of Shares	500	1,500	7,000	3,000	1,000	4,000

Calculate the liability of the individual underwriters.

Solution:

Statement of Underwriters Liability (Figures in No. of shares)

Particulars	S	P	G	M	N	SA	Total
Ratio of Gross Liability	30%	35%	10%	15%	2%	8%	100%
Gross Liability (given)	30,000	35,000	10,000	15,000	2,000	8,000	1,00,000
Less: Unmarked Applications In the ratio of Gross Liability	6,000	7,000	2,000	3,000	400	1,600	20,000
	24,000	28,000	8,000	12,000	1,600	6,400	80,000
Less: Marked Applications	(25,000)	(23,500)	(5,500)	(1,000)	(1,000)	(2,000)	(58,000)
	(1,000)	4,500	2,500	11,000	600	4,400	22,000
Less: Firm underwriting	(500)	(1,500)	(7,000)	(3,000)	(1,000)	(4,000)	(17,000)
Net Liability Under the Contract	(1,500)	3,000	(4,500)	8,000	(400)	400	5,000
Adjustment: Surplus of S , G , and N to P,M and SA transferred to P,M and SA in Gross Liability Ratio at 35:15:8	1500	(3862)	4,500	(1,655)	400	(833)	-
Revised Net Liability	-	(862)	-	6,345	-	(483)	5,000
Adjust: Transfer of surplus of P and SA to M	-	862	-	(1,345)	-	483	-
Balance to be underwriting	-	-	-	5,000	-	-	5,000
Add: Firm Underwriting	500	1,500	7,000	3,000	1,000	4,000	17,000
Total Liability	500	1,500	7,000	8,000	1,000	4,000	22,000

Illustration 63:

L Limited came up with an issue of 20,00,000 Equity Shares of ₹ 10 each, at par. 5,00,000 equity shares were issued to the promoters and the balance offered to the public was underwritten by three underwriters P, G and K - equally.

Excluding Firm Underwriting of 50,000 Shares each, subscriptions totaled 12,97,000 Shares including Marked Forms, which were as under: P-4,25,000 Shares; G-4,50,000 Shares; and K -3,50,000 Shares.

Each of the underwriters had applied for the number of shares covered by Firm Underwriting. The amounts payable on application and allotment were ₹ 2.50 and ₹ 2 respectively. The agreed commission was 5%.

Pass Summary Journal Entries for (1) Allotment of Shares to the Underwriters; (2) Commission due to each of them d (3) Net Cash Paid and/or Received. (Unmarked application is to be credited to the underwriters equally.)

Solution:

1. Statement of Underwriters Liability (Figures in No. of shares)

Particulars	P	G	K	Total
Gross Liability (given)	5,00,000	5,00,000	5,00,000	15,00,000
Less: Unmarked Applications In the ratio of Gross Liability **(see note below)**	(24,000)	(24,000)	(24,000)	(72,000)
	4,76,000	4,76,000	4,76,000	14,28,000
Less: Marked Applications	(4,25,000)	(4,50,000)	(3,50,000)	(12,25,000)
	51,000	26,000	1,26,000	2,03,000
Less: Firm underwriting (Given)	(50,000)	(50,000)	(50,000)	(1,50,000)
Net Liability Under the Contract	1,000	(24,000)	76,000	53,000
Adjustment: Surplus of G transferred to P and K in Gross Liability Ratio (equally)	(12,000)	24,000	(12,000)	-
	(11,000)	-	64,000	53,000
Adjustment: Surplus of P transferred to K	11,000	-	(11,000)	-
Balance to be underwriting	-	-	53,000	53,000
Add: Firm Underwriting	50,000	50,000	50,000	1,50,000
Total Liability (Shares to be subscribe)	**50,000**	**50,000**	**1,03,000**	**2,03,000**
Amount due upto allotment at ₹ 4.50 per Share (₹)	2,25,000	2,25,000	4,63,500	9,13,500
Less: Amount paid for Firm underwriting for 50,000 shares at ₹ 2.50 per share (₹)	(1,25,000)	(1,25,000)	(1,25,000)	3,75,000
Balance Due fro Underwriters (₹)	1,00,000	1,00,000	3,38,500	5,38,500
Less: Commission at 5 % on Nominal Value of shares underwritten (₹)	(2,50,000)	(2,50,000)	(2,50,000)	(7,50,000)
Net amount Due from Underwriters (₹)	**(1,50,000)**	**(1,50,000)**	**88,500**	**(2,11,500)**

Note: Unmarked Applications = 72,000 i.e. Total Applications 12,97,000 – Marked Applications (4,25,000+4,50,000+3,50,000)= 12,25,000. These are distributed in the ratio of Gross Liability.

2. Journal entries in the books of the company (relating to underwriters only)

Sr. No	Particulars	Dr. (₹)	Cr (₹)
1	Bank A/c Dr.	3,75,000	
	To, Equity Share Application A/c		3,75,000
	(Being application money received on Firm Applications for ₹ 2.50 per share from P,G, and K)		
2	P A/c (point no. 1) Dr.	1,00,000	
	G A/c (point no. 1) Dr.	1,00,000	
	K A/c (point no. 1) Dr.	3,38,500	
	Equity Share Application A/c Dr.	3,75,000	
	To, Equity Share capital A/c (2,03,000 x ₹ 4.50)		9,13,500
	(Being allotment of shares to underwriters – 50,000 to P, 50,000 to G and 1,03,000 to K, application and allotment money credited to Equity Share capital A/c)		
3	Underwriting Commission A/c Dr.	7,50,000	
	To, P A/c		2,50,000
	To, G A/c		2,50,000
	To, K A/c		2,50,000
	(Being the underwriting Commission payable to P, G and K at 5% of the issue price of the shares underwritten)		
4	P A/c Dr.	1,50,000	
	G A/c Dr.	1,50,000	3,00,000
	To, Bank A/c		
	(being the amount paid to P and G in final settlement of underwriting commission due less amount receivable from them on shares allotted)		
5	Bank A/c Dr.	88,500	
	To, K A/c		88,500
	(being the amount received from K on shares allotted Less Underwriting Commission payable to him)		

Illustration 64:

P Limited planned to set up a unit for manufacture of bulk drugs. For the purpose of financing the, unit, the Board of Directors have issued 15,00,000 Equity Shares of ₹10 each. 30% of the issue was reserved for Promoters and the balance was offered to the public. A, B and C have come forward to underwrite the public issue in the ratio of 3:1:1 and also agreed for Firm Underwriting of 30,000, 20,000, 10,000 Shares, respectively. The Underwriting Commission was fixed at 4%. The amount payable on application was ₹ 2.50 per share. The details of subscriptions are:

Particulars	Marked Forms of A	Marked Forms of B	Marked Forms of C
No. of Shares	5,50,000	2,00,000	1,50,000

Unmarked Forms were received for 50,000 Shares. From the above, you are required to show the allocation of liability among underwriters with workings. Also, pass Journal Entries in the books of the Company for

1. Underwriters' net liability and the receipt or payment of cash to or from underwriters
2. Determining the liability towards the payment of commission to the Underwriters.

Solution:

Shares offered to public = 15,00,000 – 30% for promoters = 10,50,000 ; to be apportioned as 3:1:1.

1. Statement of Underwriters Liability (Figures in No. of shares)

Particulars	A	B	C	Total
Gross Liability (3:1:1)	6,30,000	2,10,000	2,10,000	1,80,000
Less: Unmarked Applications In the ratio of Gross Liability (3:1:1)	(30,000)	(10,000)	(10,000)	(50,000)
	6,00,000	2,00,000	2,00,000	10,00,000
Less: Marked Applications	(5,50,500)	(2,00,000)	(1,50,000)	(9,00,000)
	50,000	-	50,000	1,00,000
Less: Firm underwriting	(30,000)	(20,000)	(10,000)	(60,000)
Net Liability Under the Contract	20,000	(20,000)	40,000	40,000
Adjustment: Surplus of B transferred to A and C in 3:1	(15,000)	20,000	(5,000)	-
Balance to be underwriting	5,000	-	35,000	40,000
Add: Firm Underwriting	30,000	20,000	10,000	60,000
Total Liability (Shares to be subscribe)	**35,000**	**20,000**	**45,000**	**1,00,000**

2. Statement of amount receivable from/ payable to underwriters (₹)

Particulars	A	B	C	Total
a. Total Liability (incl. Firm underwriting) (Shares)	35,000	20,000	45,000	1,00,000
b. Amount due at 2.50 per share **(a x 2.50)**	87,500	50,000	1,12,500	2,50,000
c. Amount paid for firm Underwriting at 2.50 per share	(75,000)	(50,000)	(25,000)	(1,50,000)
d. Balance due from Underwriters **(b – c)**	12,500	Nil	87,500	1,00,000
e. Underwriting Commission payable by company	6,30,000 x 10x4% = 2,52,000	2,10,000 x 10 x 4% = 84,000	2,10,000 x 10 x 4% =84,000	4,20,000
f. Amt Due to/(payable by) co. (d – e)	(2,39,500)	(84,000)	3,500	

3. Journal entries in the books of the company (relating to underwriters only)

Sr. No	Particulars	Dr. (₹)	Cr (₹)
1	Bank A/c Dr. To, Equity Share Capital A/c (Being allotment of shares against amounts received towards subscription for Firm Underwriting at 30,000 ; 20,000 and 10,000 shares respectively from A, B, C at ₹ 2.50)	1,50,000	 1,50,000

Sr. No	Particulars	Dr. (₹)	Cr (₹)
2	A A/c (5,000 x 2.50) Dr. C A/c (35,000 x 2.50) Dr. To, Equity Share capital A/c (Being allotment of shares to underwriters – 50,000 to P, 50,000 to G and 1,03,000 to K, application and allotment money credited to Equity Share capital A/c)	12 ,500 87,500	 1,00,000
3	Underwriting Commission A/c Dr. To, A A/c To, B A/c To, C A/c (Being the underwriting Commission payable to A, B and c at 4% of the Nominal value of the shares underwritten)	4,20,000	 2,52,000 84,000 84,000
4	A A/c Dr. B A/c Dr. To, Bank A/c (being the amount paid to A and B in final settlement of underwriting commission due less amount receivable from them on shares allotted)	2,39,000 84,000	 3,23,500
5	Bank A/c Dr. To, C A/c (being the amount received from C on shares allotted Less Underwriting Commission payable to him)	3,500	 3,500

Study Note - 4

PRESENTATION OF FINANCIAL STATEMENTS (SCHEDULE III)

This Study Note includes

4.1 Part I – Form of Balance Sheet
4.2 Part II – Form of Statement of Profit and Loss
4.3 Managerial Remuneration

Introduction

Meaning and Objective of Financial Statement

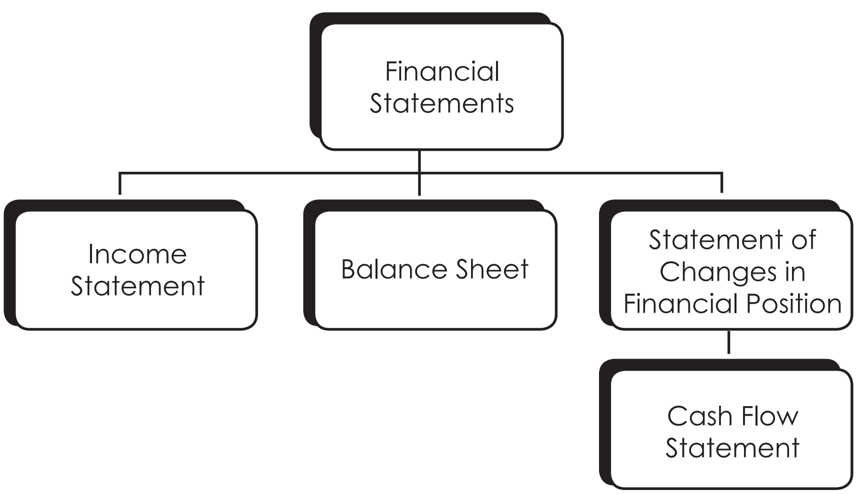
Financial statements are compilation of financial data, collected and classified in a systematic manner according to the accounting principles, to assess the financial position of an enterprise as regards to its profitability, operational efficiency, long and short – term solvency and growth potential.

Financial statements are basic and formal means through which management of an enterprise make public communication of financial information along with select quantitative details. They are structured financial representation of the financial position, performance and cash flows of an enterprise. Many users are rely on the general purpose financial statements as the major source of financial information and therefore, financial statements should be prepared and presented in accordance with their requirement. Of course, some of the users may have the power to obtain, information in addition to that contained in the financial statements. That does not undermine the dependence of the general users on the information contents of the financial statements.

Financial statements provide information about the financial position, performance and cash flows of an enterprise that is useful to wide range of users in making economic decisions. It means to show the results of the stewardship of management, or accountability of management, or the accountability of management for the resources entrusted to it.

Component of Finacial Statement

Financial statements comprise a number of statements prepared at the end of each financial year to assess the various financial activities and strength of an enterprise.



Financial Statements Components	Source /Type of Companies
Profit and Loss Account Schedule and Notes Forming Part thereto	Under section 129 of the companies Act, 2013 in accordance with the provisions of the Companies Act and the Indian GAAP, to be prepared by all the companies. As per section 133 all applicable accounting standards should be followed. Otherwise reasons of departure from accounting standards and financial effect should be disclosed. Compliance with accounting standards without any deviation is mandatory for the listed companies as per clause 50 of the Listing Agreement vide SEBI Circulars SMRP/Policy/Cir-44/01, Aug 31,2001
Cash Flow Statement	As per clause 32 of the Listing Agreement vide SEBI circular SMD-II/ Policy/cir-80/2000 February 4, 2000. Cash Flow Statement should be prepared in accordance with the requirements of AS- 3. To be prepared by listed companies.
Consolidated Financial Statements	Applicable to listed companies as per the SEBI circular SMRP/policy/ cir-44/01,Aug.31,2001 Companies Listed in a recognized stock exchange shall be mandatorily required to publish Consolidated Financial Statements in the annual report in addition to the individual financial Statements shall be mandatory. To be prepared in accordance with AS-21 and AS-23. Section 134 requires that board's Report shall include a Director's Responsibility Statement in which it is to be indicated that in the preparation of annual accounts, the applicable accounting standards are followed.

FRAME WORK

The conceptual Framework for Financial Reporting issued by the IASB has stated the following uses of the general purpose financial statements by the cross-section of users:

(a) to decide when to buy , hold or sell any equity investment,

(b) to assess the accountability of management,

(c) to assess the ability of the entity to pay and provide other benefits to its employees,

(d) to assess the security for amounts lent to the entity,

(e) to determine taxation policies,

(f) to determine distributable profits and dividends,

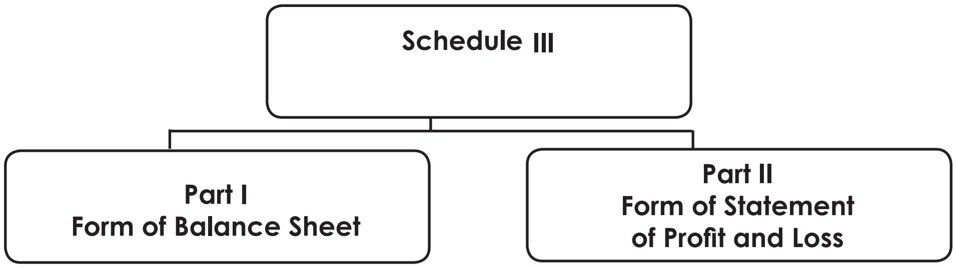
(g) to prepare and use national income statistics,

Important shortcoming of financial statements is that they are prepared to meet the common information needs of a wide range of users. They may fall short of specific information needs of the users.

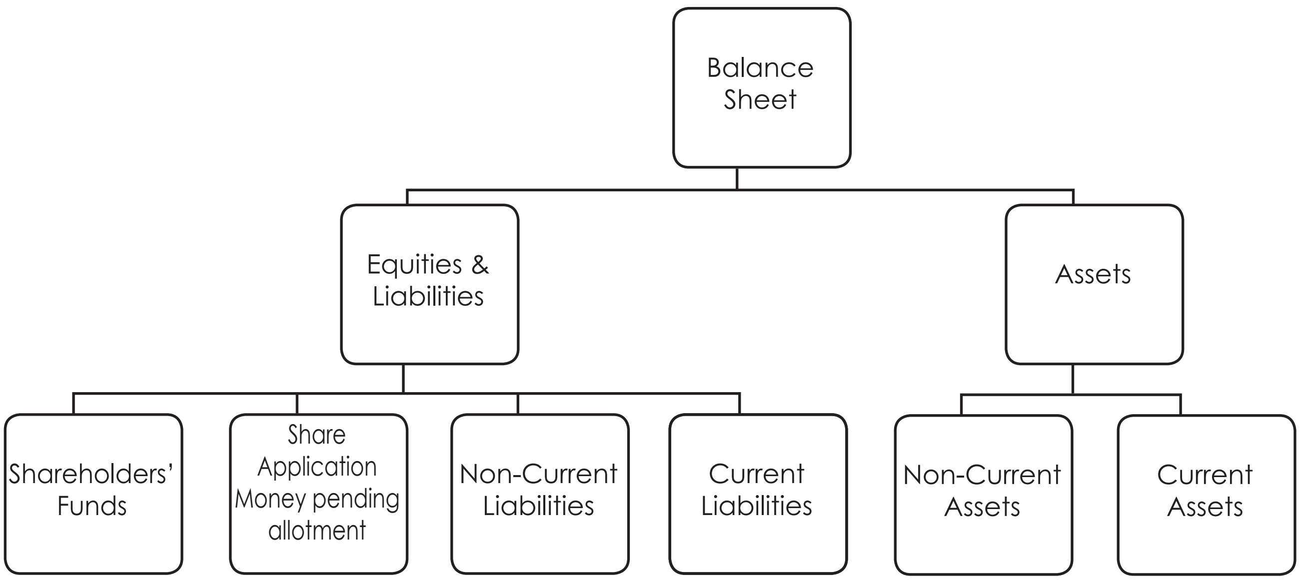
To meet the above – stated uses, financial statements provide information about an entity's assets, liabilities, equity, and income and expenses, including gains and losses, other changes in equity and cash flows. That information, along with other information in the notes, assists users of financial statements in predicting amount, timing and degree of certainty of the entity's future cash flows.

Applicability: As per Section 129 of the Company Act, 2013, the Schedule III is applicable from 01.04.2014.

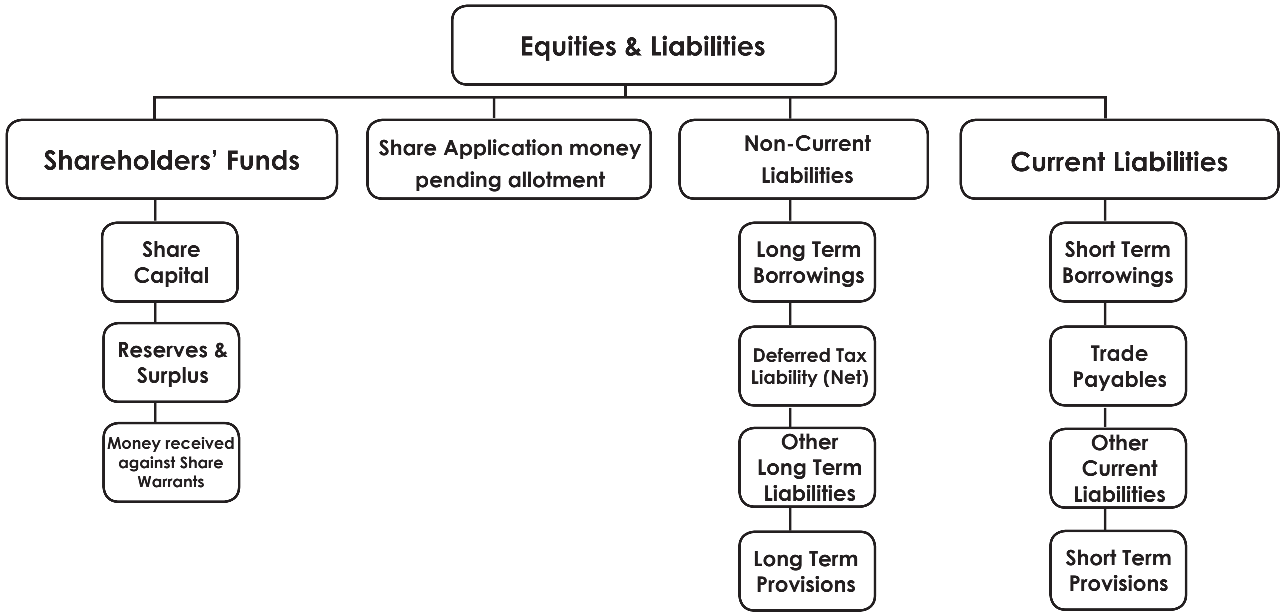
Date of enforcement of Schedule III:



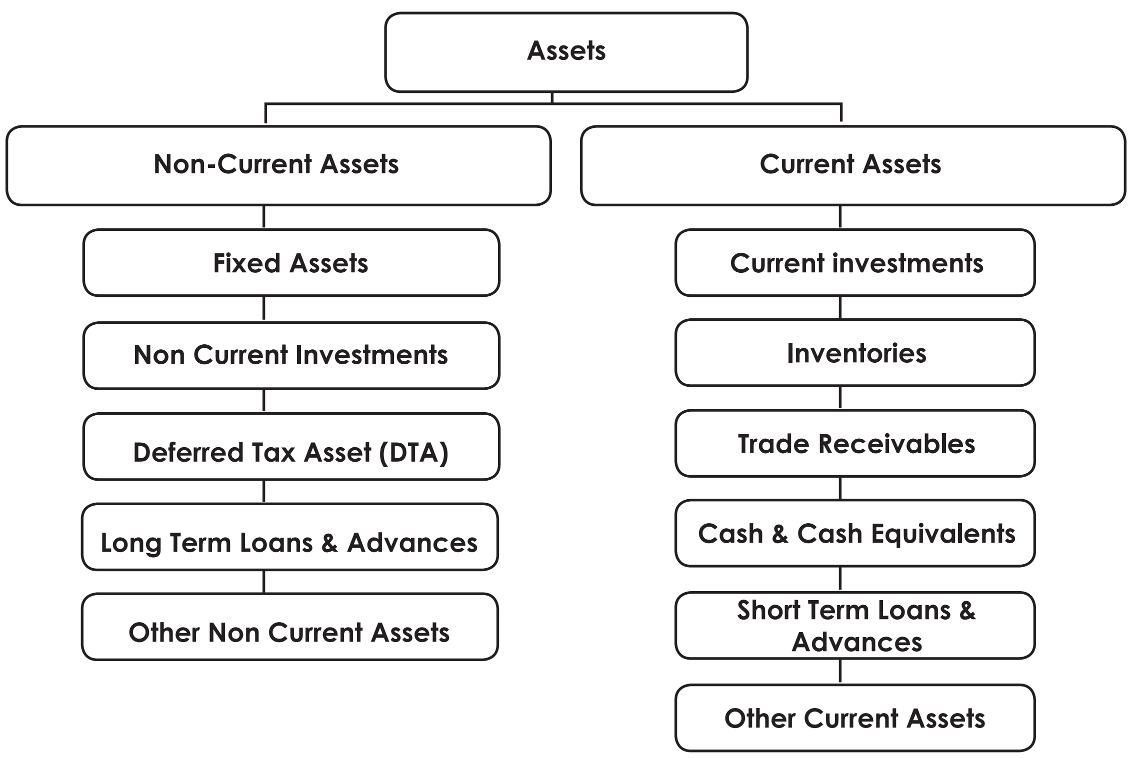
PART I – FORM OF BALANCE SHEET



Break-up of Equities & Liabilities



Break-up of Assets



4.1 PART I – FORM OF BALANCE SHEET

Name of the Company:………………………………………………..

Balance Sheet as at: ………………………………………………… **(₹ in……)**

	Particulars	Note	Figure as at the end of Current Reporting Period	Figures as at the end of the Previous Reporting Period
			₹	₹
I.	EQUITY AND LIABILITIES			
(1)	Shareholders' Funds			
	(a) Share Capital			
	(b) Reserves & Surplus			
	(c) Money Received against Share Warrants			
(2)	Share Application money pending allotment			
(3)	Non-Current Liabilities			
	(a) Long Term Borrowings			
	(b) DTL (Net)			
	(c) Other Long Term Liabilities			
	(d) Long Term Provisions			
(4)	Current Liabilities			
	(a) Short Term Borrowings			
	(b) Trade Payables			
	(c) Other Current Liabilities			
	(d) Short Term Provisions			
	Total			
II.	ASSETS			
(1)	Non-Current Assets			
	(a) Fixed Assets			
	(i) Tangible Assets			
	(ii) Intangible Assets			
	(iii) Capital WIP			
	(iv) Intangible Assets under Development			
	(b) Non-Current Investments			
	(c) DTA (Net)			
	(d) Long Term Loans & Advances			
	(e) Other Non-Current Assets			
(2)	Current Assets			
	(a) Current Investments			
	(b) Inventories			
	(c) Trade Receivables			
	(d) Cash & Cash Equivalents			
	(e) Short Term Loans & Advances			
	(f) Other Current Assets			
	Total			

For the purpose of this Schedule, the terms used herein shall be as per the applicable Accounting Standards	
Notes to Balance Sheet	A Company shall disclose the following in the Notes to Accounts- Details provided

Disclosure Requirement: Schedules Forming Part of Financial Statements/Annual Report

(A) FOR "EQUITY AND LIABILITIES" ITEMS

(1) SHAREHOLDERS' FUNDS

(a) SHARE CAPITAL

Sch. III Disclosure Requirement	**Points to be considered**
General	• Sch III deals only with presentation and disclosure requirements • Accounting classification into Debt and Equity components is governed by the applicable Accounting Standard • Preference Shares will have to be classified as "Share Capital" and also includes such Preference Shares of which redemption is overdue
For each Class of Share Capital (different classes of Preference Shares to be treated separately):	
(a) Authorized Capital	It is the maximum number and face/par value, of each class of shares that a corporate entity may issue in accordance with its instrument of incorporation.
(b) Number of Shares Issued, Subscribed and Fully Paid, and Subscribed but not Fully Paid	• Subscribed Share Capital" is "that portion of the Issued Share Capital which has actually been subscribed by the public and subsequently allotted to the shareholders by the entity. This also includes any Bonus shares issued to the Shareholders • "Paid-up Share Capital" is "that part of the Subscribed Share Capital for which consideration is cash or otherwise has been received. This also includes Bonus Shares allotted and shares issued otherwise than for cash against purchase consideration, by the corporate entity." • If Shares are not fully called, then disclose the called up value per share
(c) Face/Par Value per Share	• Face/Par Value, as per Capital Clause in Memorandum of Association should be disclosed
(d) Reconciliation of No. of Shares	• For the Amount of Share Capital; • For comparative previous period; • Separate statements for both Equity and Preference Shares, which should again be sub-classified and represented for each class of Shares
(e) Rights, Preferences and Restrictions attaching to shares including restrictions on the distribution of Dividends and the Repayment of Capital	• For Equity Share Capital, such rights / preferences / restrictions may be with voting rights, or with differential voting rights as to dividend, voting or otherwise as per Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001. • For Preference Shares, the rights include dividend and / or capital related rights. Further, Preference Shares can be cumulative, non-cumulative, redeemable, convertible, non-convertible, etc. • All such Rights, Preferences and Restrictions attached to each class of Shares, terms of redemption, etc. should be disclosed separately.
(f) Shares held in the Company held by its Holding Company or its ultimate Holding Company including Shares held by or by Subsidiaries or Associates of the Holding Company or the ultimate Holding Company in aggregate	• Disclose number of Shares held by the entire chain of Subsidiaries and Associates starting from the Holding Company and ending right up to the Ultimate Holding Company • All such disclosures should be made separately representing for each class of Shares, (for both Equity and Preference Shares)

(g)	List of Shareholders holding more than 5% shares as on the Balance Sheet Date	• Date for computing the 5% limit should be taken as the Balance Sheet date. So, if during the year, any Shareholder held more than 5% Equity Shares but does not hold as much at the Balance Sheet date, disclosure is not required. • Companies should disclose the Shareholding for each class of Shares, both within Equity and Preference Shares. So, such % should be computed separately for each class of Shares. • This information should also be given for comparative previous period.
(h)	Shares Reserved for issue under Options and Contracts/ commitments for the sale of Shares/ Disinvestment, including the Terms and Amounts	• Shares under Options generally arise under Promoters or Collaboration Agreements, Loan Agreements or Debenture Deeds (including Convertible Debentures), agreement to convert Preference Shares into Equity Shares, ESOPs or Contracts for supply of Capital Goods, etc. • Disclosure is required for the Number of Shares, Amounts and Other Terms for Shares so reserved. Such options are in respect of Unissued Portion of Share Capital
(i)	For the period of 5 years immediately preceding the date as at which the Balance Sheet is prepared- • Aggregate Number & Class of Shares allotted as Fully Paid and Up Pursuant to Contract(s) without payment being received in Cash • Aggregate No. and Class of Shares allotted as fully Paid up by way of Bonus Shares • Aggregate Number & Class of Shares bought back	Disclose only if such event has occurred during a period of 5 years immediately preceding the Current Year Balance Sheet date • The aggregate number of shares allotted or bought back • If the company is in operation for a period of less than 5 years, then disclosure should cover all such earlier financial years Not to disclose the following allotments: • The following allotments are considered as Shares allotted for payment being received in cash, and hence should not be disclosed under this Clause – (a) If the subscription amount is adjusted against a bonafide debt payable in money at once by the Company, (b) Conversion of Loan into Shares in the event of default in repayment
(j)	Terms of any Securities Convertible into Equity / Preference Shares issued along with the earliest date of conversion in descending order starting from the farthest such date	• In case of Compulsorily Convertible Securities, where conversion is done in fixed tranches, all the dates of conversion have to be considered. • In case of Convertible Debentures/Bonds, etc. for the purpose of simplification, reference may also be made to the terms disclosed under the note on Long-Term Borrowings where these are required to be classified in the Balance Sheet, rather than disclosing the same against under this Clause.
(k)	Calls Unpaid (showing aggregate value of Calls Unpaid by Directors and Officers)	• Unpaid Amount towards Shares subscribed by the Subscribers of Memorandum of Association should be considered as 'Subscribed and paid-Up Capital' in the Balance Sheet and the Debts due from the Subscribers should be appropriately disclosed as an Asset in the B/Sheet.
(l)	Forfeited Shares (amount originally paid up)	----

Example: Reporting Authorised, Issued, Subscribed, Called up and Paid up Capital including Forfeited Shares:

Authorised Capital: Equity Share 1,00,000 Shares @ ₹ 100 each = ₹ 1,00,00,000. Preference Share Capital: 15% Redeemable Preference Shares, 50,000 Shares @ ₹ 100 each = ₹ 50,00,000. 18%, Convertible Preference Shares, 30,000 shares @ ₹ 100 each = ₹ 30,00,000

Issued Capital: Equity Share 30,000 Shares @ ₹ 100 each, fully paid up = ₹ 30,00,000; 19,800 Equity Shares of ₹ 100 each, ₹ 80 called up and paid up = ₹ 15,84,000. Amount received on 200 shares forfeited for non-payment of allotment and first call of ₹ 30 and ₹ 40 each, final call was not made on those shares. Amount payable on application ₹ 10 per share. Preference Share Capital: 15% Redeemable Preference Shares, 10,000 Shares @ ₹ 100 each = ₹ 10,00,000. 18%, Convertible Preference Shares, 20,000 shares @ ₹ 100 each = ₹ 20,00,000

How will this shown in the Workings/Schedules, assuming first year of operation?

Solution:

Share Capital

A. Authorised Capital

Particulars	**Current Year**	**Previous Year**
(i) Equity Share 1,00,000 Shares @ ₹ 100 each	1,00,00,000	
(ii) 15%, 50,000 Redeemable Preference Shares @ ₹ 100 each	50,00,000	
(iii) 18%, 30,000 Convertible Preference Shares @ ₹ 100 each	30,00,000	
Total	1,80,00,000	

B. Issued Capital

Particulars	**Current Year**	**Previous Year**
(i) Equity Share 50,000 Shares @ ₹ 100 each	50,00,000	
(ii) 15%, 10,000 Redeemable Preference Shares @ ₹ 100 each	10,00,000	
(iii) 18%, 20,000 Convertible Preference Shares @ ₹ 100 each	20,00,000	
Total	80,00,000	

C. Subscribed, Called up and Paid up Capital

Particulars	**Current Year**	**Previous Year**
(i) 30,000 Equity Shares @ ₹ 100 each, fully paid up	30,00,000	
(ii) 19,800 Equity Shares @ ₹ 100 each, ₹ 80 called up and paid up	15,84,000	
(iii) 15%, 10,000 Redeemable Preference Shares @ ₹ 100 each	10,00,000	
(iv) 18%, 20,000 Convertible Preference Shares @ ₹ 100 each	20,00,000	
	75,84,000	
	75,84,000	
Add: Forfeited Shares (amount originally paid-up)	**2,000**	
Total for Balance Sheet	**75,86,000**	

D. Reconciliation of Number and Amount of Shares

(1) For Equity Shares

Particulars	Current Year		Previous Year	
	No. of Shares	Amount (₹)	No. of Shares	Amount (₹)
Opening Balance as on 01.04.2014	Nil	Nil	Nil	Nil
Add: Fresh Issue (including Bonus Shares, Right Shares, Split of Shares, Shares issued otherwise than for cash as a Purchase Consideration)	49,800	45,84,000	Nil	Nil
Sub Total	49,800	45,84,000	Nil	Nil
Less: Buy-back of Shares	Nil	Nil	Nil	Nil
Closing Balance as on 31.3.2015	49,800	45,84,000	Nil	Nil

(2) For Preference Shares

(a) For 15% Redeemable Preference Shares of ₹ 100 each

Particulars	Current Year		Previous Year	
	No. of Shares	Amount (₹)	No. of Shares	Amount (₹)
Opening Balance as on 01.04.2014	Nil	Nil	Nil	Nil
Add: Fresh Issue (including shares issued otherwise than for cash as a Purchase Consideration)	10,000	10,00,000	Nil	Nil
Sub Total	10,000	10,00,000	Nil	Nil
Less: Redemption of Shares	Nil	Nil	Nil	Nil
Closing Balance as on 31.3.2015	10,000	10,00,000	Nil	Nil

(b) For 18% Convertible Preference Shares of ₹ 100 each

Particulars	Current Year		Previous Year	
	No. of Shares	Amount (₹)	No. of Shares	Amount (₹)
Opening Balance as on 01.04.2014	Nil	Nil	Nil	Nil
Add: Fresh Issue	20,000	20,00,000	Nil	Nil
Sub Total	20,000	20,00,000	Nil	Nil
Less: Redemption/ Buy-back of Shares	Nil	Nil	Nil	Nil
Closing Balance as on 31.3.2015	20,000	20,00,000	Nil	Nil

(1) (b) RESERVES & SURPLUS

Sch. III Disclosure Requirement	Points
Reserves & Surplus shall be classified as – (a) Capital Reserves	• Capital Reserve is a Reserve of a Corporate Enterprise which is not available for distribution as Dividend. • Profit on Re-issue of Forfeited Shares is basically profit of a Capital Nature and, hence, it should be credited to Capital Reserve.
(b) Capital Redemption Reserve	Capital Redemption Reserve (CRR) is required to be created u/s 55 and 68 (for redemption of PSC and buyback of ESC), subject to conditions specified in the respective Sections.
(c) Securities Premium Reserve	Sch III uses the term "Securities Premium Reserve" but the Act uses the term "Securities Premium Account". Hence, the term used in the Act should be used.

(d) Debenture Redemption Reserve	Debenture redemption Reserve (DRR) is required to be created u/s 71, and maintained until such Debentures are redeemed. On redemption of the Debentures, the amounts no longer necessary to be retained in this Account should be transferred to the General Reserve.
(e) Revaluation Reserve	Revaluation Reserve is a Reserve created on the revaluation of Assets or Net Assets of an Enterprise represented by the surplus of the estimated Replacement Cost or estimated market values over the Book Values thereof.
(f) Share Options Outstanding Account	As per ICAI Guidance Note on ESOP, Share Options Outstanding should be shown as separate line item. Under Sch III, this line item should be shown separately under Reserves & Surplus.
(g) Other Reserves (specify the nature & purpose of each Reserve and the amount in respect thereof)	This includes any other Statutory Reserves, e.g. Tonnage Tax reserve to be created under the Income Tax Act, 1961.
(h) Surplus, i.e. balance in Statement of P&L disclosing allocations & appropriations such as Dividend, Bonus Shares and Transfer to/from Reserves etc. (Additions & Deductions since last Balance Sheet to be shown under each of specified heads)	• Appropriations to the Profit for the year (including carried forward balance) is to be presented under the main head 'Reserves and Surplus'. Under Sch III, the Statement of P&L will no longer reflect any appropriations, like Dividends transferred to Reserves, Bonus Shares, etc.

Notes:

1. **Fund:** A Reserve specifically represented by Earmarked Investments shall be termed as a 'Fund'.
2. **Profit and Loss Account (Dr.):** Debit balance Statement of P&L shall be shown as a Negative Figure under the head 'Surplus'. Similar, the balance of 'Reserves & Surplus', after adjusting Negative balance of Surplus, if any, shall be shown under the head 'Reserves & Surplus' even if the resulting figure is in the negative.

(1) (c) MONEY RECEIVED AGAINST SHARE WARRANTS

Sch. III Disclosure Requirement	**Points**
To be shown as a separate line item on the face of Balance Sheet	• In case of Listed Companies, Share warrants are issued to Promoters & others in terms of the Guidelines for Preferential Issues viz. SEBI (Issue of Capital and Disclosure Requirements), Guidelines, 2009. • Effectively, Share Warrants are amounts which would ultimately form part of the Shareholder's Funds. Since Shares are yet to be allotted against the same, these are not reflected as part of Share Capital, but as a separate line – item.

(2) SHARE APPLICATION MONEY PENDING ALLOTMENT

Sch. III Disclosure Requirement	Points
To be shown as a separate line item on the face of Balance Sheet	• Share Application Money not exceeding the Issued Capital and to the extent not refundable, is to be disclosed as a separate line item after "Share Holders Funds" and before "Non-Current Liabilities". • If the Company's Issued Capital is more than the Authorized Capital, and approval of increase in Authorized Capital is pending, the amount of Share Application Money received over and above the Authorized Capital should be shown under the head "Other Current Liabilities". • The amount shown as 'Share Application Money Pending Allotment' will not include Share Application Money to the extent refundable. For example, the amount in excess of Issued Capital, or where Minimum Subscription requirement is not met. Such amount will have to be shown separately under 'Other Current Liabilities'. • Calls Paid in Advance are to be shown under "Other Current Liabilities". The amount of interest which may accrue on such advance should also is to be reflected as a Liability.

(3) NON-CURRENT LIABILITIES

(3) (a) LONG TERM BORROWINGS

Sch. III Disclosure Requirement	Points
Long-Term Borrowings shall be classified as – (a) Bonds/Debentures,	-----
(b) Terms Loans – (i) from Banks, and (ii) from Other Parties,	Loans with repayment period beyond 36 months are usually known as "Term Loans". So, Cash Credit, Overdraft and Call Money Accounts/ Deposits are not covered by the expression "Term Loans".
(c) Deferred Payment Liabilities,	Deferred Payment Liabilities would include any Liability for which payment is to be made on deferred credit terms, e.g. Deferred Sales Tax Liability, Deferred Payment for Acquisition of fixed Assets, etc.
(d) Deposits,	Deposits classified under Borrowings would include Deposits accepted from Public and Inter – Corporate Deposits which are in the nature of Borrowings.
(e) Loans & Advances from Related Parties,	Loans and advances from related parties are required to be disclosed. Advances under this head should include those advances which are in the nature of loans.
(f) Long-Term Maturities of Finance Lease Obligations,	
(g) Other Loans & Advances (specify nature)	

Notes: **1. Security-wise Classification:** Borrowings shall further be sub-classified as Secured and Unsecured. Nature of Security shall be specified separately in each case.	• Nature of Security shall be specified separately in each case. A blanket disclosure of different securities covering all Loans classified under the same head such as "All Term Loans from Banks" will not suffice. • However, where one security is given for multiple Loans, the same may be clubbed together for disclosure purposes with adequate details of cross referencing. • Disclosure about the nature of security should also cover the type of asset given as security e.g. Inventories, Plant and Machinery, land and Building, etc. • When Promoters, other Shareholders or any third party have given any personal security for any borrowing, e.g. Shares or Other Assets held by them, disclosure should be made thereof, though such security does not result in the classification of such borrowing as secured.
2. Guarantees: where Loans have been guaranteed by Directors or Others, the aggregate amount of such Loans under each head shall be disclosed.	The word **"Others"** used in the phrase "Directors or Others" would mean any Person or Entity other than a Director, e.g. Related Parties, or any person associated with the Company in some manner.
3. Maturity Date-wise: Bonds / Debentures (along with Rate of Interest & particulars of Redemption or Conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest Redemption or Conversion Date, as the case may be.	• **Current** Maturities of all Long-Term Borrowings will be disclosed under "Other Current Liabilities" and not under Long-Term Borrowings and Short-Term Borrowings. • So, it is possible that the same Bonds/Debentures/ Term Loans may be bifurcated under both "Long-Term Borrowings" as well as under "Other Current Liabilities".
4. Installment Redemption: Where Bonds/Debentures are redeemable by Installments, the Date of Maturity for this purpose must be reckoned as the Date on which the First Installment becomes due.	------
5. Re-issue Powers: Particulars of any redeemed Bonds/ Debentures which the Company has power to reissue shall be disclosed.	------

6.	**Terms of Repayment:** Repayment of Term Loans and Other Loans shall be stated.	Other Loans should be interpreted to mean all categories listed under the heading 'Long-Term Borrowings' as per Sch VI (R). Disclosure of terms of repayment should be made preferably for each Loan unless the repayment terms of individual loans within a category are similar, in which case, they may be aggregated.
7.	**Default:** Period and amount of continuing default as on the Balance Sheet date in repayment of Loans and Interest, shall be specified separately in each case.	The term "Continuing Default" is used w.r.t. Long Term Borrowings, whereas the term "Default" is used w.r.t. Short Term Borrowings. • Under CARO, the Auditor shall report on the default made and the period of default. • As per Sch VI (R), the period and amount of continuing default as on the Balance Sheet date in repayment or Term Loans and Interest shall be specified separately in each case. • Disclosures relating to default should be made for all items listed under the category of Borrowings such as Bonds/ Debentures, Deposits, Deferred Payment Liabilities, Finance Lease Obligations, etc. and not only to items classified as "Loans" such as Term Loans, Loans & Advances etc. • Defaults other than in respect of repayment of Loan and Interest, e.g. non-compliance with Debt Covenants, etc. need not be disclosed. • Any default that had occurred during the year and was **subsequently made good** before the end of the year need not be disclosed.

(3) (b) DEFERRED TAX LIABILITIES **(Also Refer AS-22)**

Sch. III Disclosure Requirement	Points
To be shown as a separate line item on the face of Balance Sheet.	----

(3) (C) OTHER LONG TERM LIABILITIES

Sch. III Disclosure Requirement	Points
It shall be classified as – (a) Trade Payables	Sundry Creditors for Goods or Services, and Acceptances should be disclosed as part of Trade Payables. Disclosure Requirements under MSMED Act will also be required to be made in the annual Financial Statements
(b) Others	Amounts due under contractual obligations, e.g. payables in respect of statutory obligations like contribution to Provident Fund Purchase of Fixed Assets, Contractually Reimbursable Expenses, Interest Accrued on Trade Payables, etc. should be classified as "Others" and each such item should be disclosed nature-wise.

(3) (d) LONG TERM PROVISIONS

Sch. III Disclosure Requirement	Points
It shall be classified as – (a) Provision for Employee Benefits	This should be classified into short-term and long-term portions, and the latter amount should be included here.
(b) Others (Specifying nature)	This would include items like Provisions for Warranties, etc.

(4) CURRENT LIABILITIES

(4) (a) SHORT TERM BORROWINGS

Sch. III Disclosure Requirement	Points
1. Short-Term Borrowings shall be classified as – • Loans Repayable on demand– (i) from Banks, & (ii) Other Parties, • Loans and Advances from Related Parties, • Deposits, • Others Loans and Advances (specify nature) **2. Security-wise Classification:** Borrowings shall further be sub-classified as Secured and Unsecured. Nature of security shall be specified separately in each case. **3. Guarantees:** Where Loans have been guaranteed by Directors or others, the aggregate amount of such Loans under each head shall be disclosed. **4. Default:** Period & amount of default as on B/Sheet Date in repayment of Loans and Interest shall be separately in each case.	• Short-Term Borrowings will include all Loans within a period of 12 months from the date of the loan, Loans payable on demand, etc. but will not include Current Maturity of Long-Term Borrowings (Which should be treated only as "Other Current Liabilities"). • In case of Short-Term Borrowings, all defaults (not continuing defaults as in the case of Long Term Borrowings) existing as at the date of the Balance Sheet should be disclosed (item-wise) • A 3-Year Loan taken for a business with an 4-year Operating Cycle will be categorized only as Short Term Borrowings, and not as Long Term Borrowings.

(4) (b) TRADE PAYABLES

Sch. III Disclosure Requirement	Points
To be shown as a separate line item on the face of Balance Sheet.	• Refer to meaning of 'Trade Payable' given earlier. • **Liability for Capital Goods Purchases:** Amount due towards purchase disclosed under "Other Current Liabilities" with a suitable description. • **Liability under Contractual Obligations:** Liability towards Employees, Leases or other Contractual Liabilities should **not** be included under Trade Payables. Only "Commercial Dues" can be included under Trade Payables.

(4) (c) OTHER CURRENT LIABILITIES

Sch. III Disclosure Requirement	Points
It shall be classified as – (a) Current maturities of Long –Term Debt, (b) Current Maturities of Finance Lease Obligations, (c) Interest Accrued but not due on Borrowings, (d) Interest Accrued and due on Borrowings, (e) Income Received in Advance, (f) Unpaid Dividends, (g) Application Money received for allotment of Securities and due for Refund and Interest Accrued thereon (Refer Note below) (h) Unpaid Matured Deposits and Interest Accrued thereon, (i) Unpaid Matured Debentures and Interest Accrued thereon, (j) Other Payables (specify nature). **Note:** 1. Share Application Money includes Advances towards allotment of Share Capital. 2. Terms and Conditions including the Number of Shares proposed to be issued, the Amount of Premium, if any, and the period before which shares shall be allotted shall be disclosed. 3. It shall also be disclosed whether the Company has sufficient Authorized Capital to cover the Share Capital Amount resulting from Allotment of Shares out of such Share Application Money. 4. Further, the period for which the Share Application Money has been pending beyond the period for Allotment as mentioned in the document inviting application for shares along with the reason for such Share Application Money being pending shall be disclosed. 5. Share Application Money not exceeding the Issued Capital and to the extent not refundable shall be shown under the head 'Equity' and Share Application Money to the extent refundable, i.e. the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under '**Other Current Liabilities'.**	• The portion of Long Term Debts/ Lease Obligations, which is due for payments within 12 months of the reporting date is required to be classified under "Other Current Liabilities", while the balance amount should be classified under Long-Term Borrowings. • Trade Deposits and Security Deposits which are not in the nature of Borrowings should be classified separately under Other Non-Current / Current Liabilities. • **Other Payables** under this head may be in the nature of statutory dues such as Withholding Taxes, Service Tax, VAT, Excise Duty, etc. • **Current Year Classification as Current Liability and Previous Year Non-Current Liability:** Current/Non/Current Classification of Assets / Liabilities is determined a particular date, i.e. Balance Sheet date. So, if there is any change in the position at the end of the current year resulting in a different classification of Assets / Liabilities in the current year, it will **not** impact the classification made in the previous year.

(4) (d) SHORT TERM PROVISIONS

Schedule III Disclosure Requirement	Points
It shall be classified as – (a) Provision for Employee Benefits	This should be classified into short-term and long-term portions, and the former amount should be included here.
(b) Others (Specifying nature)	This includes Provision for Dividend, Provision for Taxation, Provision for Warranties, etc.

4 C. DISCLOSURE REQUIREMENTS FOR "ASSETS" ITEMS

(1) NON-CURRENT ASSETS

(1) (a) (i) TANGIBLE ASSETS (Also Refer AS – 6, 10)

Schedule III Disclosure Requirement	Points
1. Classification shall be given as –(a) Land, (b) Buildings, (c) Plant and Equipment, (d) Furniture & Fixtures, (e) Vehicles, (f) Office Equipment, (g) Others (Specify Nature).	AS-19 excludes Land Leases from its scope. **Leasehold Land** should be presented as a separate assets class under **Tangible Assets**. Also, Freehold Land should be presented as a separate asset class.
2. Assets under **Lease** shall be separately specified under each class of Asset.	• The term "under lease" should mean – (a) Assets given on Operating Lease in the case of Lessor, and (b) Assets held under Finance Lease in the case of Lessee. • Leasehold Improvements should continue to be shown as a separate asset class.
3. Revaluation: Where sums have been written off on a Reduction of Capital or Revaluation of Assets of where sums have been added on Revaluation of Assets, every Balance Sheet subsequent to date of such write-off, of addition shall show the Reduced or Increased figures as applicable and shall be way of a Note also show the amount of the Reduction or Increase as applicable together with the date thereof for the first 5 years subsequent to the dare of such Reduction or Increase.	• AS-10 requires disclosure of details such as Gross Book Value of Revalued Assets, Method adopted to compute revalued amounts, Nature of indices used, Year of appraisal, Involvement of External Valuer, etc. **as long as the concerned assets are held** by the Enterprise. [but only 5 years period is specified in Sch III] • AS-10 requirements will prevail. [**Note:**AS-26 does not permit revaluation of Intangible Assets.]

4. Reconciliation: A Reconciliation of the Gross and Net Carrying Amounts of each Class of Assets at the Beginning and End of the Reporting period showing Additions, Disposals, Acquisitions through Business Combinations and other Adjustments and the related Depreciation and Impairment Losses / Reversals shall be disclosed separately.	(a) Since reconciliation of Gross and Net Carrying Amounts of Fixed assets is required, the Depreciation / Amounts of fixed assets is required, the Depreciation / Amortization for each class of asset should be disclosed in terms of – • Opening Accumulated Depreciation, • Depreciation/Amortization for the year, • Deductions/Other Adjustments, and • Closing Accumulated Depreciation/ Amortization (b) Similar disclosures should also be made for Impairment, if any, as applicable. **(c) Business Combinations:** • Business Combination should be taken as an amalgamation or acquisition or any other mode of restructuring of a set of Assets and /or a group of Assets and Liabilities constituting a business. • Acquisitions through 'Business Combinations' should be disclosed separately for each class of assets. • Asset Disposals through Demergers, etc. any also be disclosed separately for each class of assets. **(d) Other Adjustments:** This includes – • Capitalization of FOREX Differences where such option has been exercised by the Company as per AS-11. • Adjustments on a/c of Exchange Fluctuations for Fixed Assets in case of Non-Integral Operations (AS-11). • Borrowing Costs capitalized as per AS-16.

(1) (a)(ii) INTANGIBLE ASSETS **(Also Refer AS – 26)**

Schedule III Disclosure Requirement	Points
Classification shall be given as – (a) Goodwill, (b) Brands / Trademarks, (c) Computer Software, (d) Mastheads and Publishing Titles, (e) Mining Rights, (f) Copyrights, and Patents and Other Intellectual Property Rights, Services and Operating Rights, (g) Recipes, Formulae, Models, Designs and Prototypes, (h) Licenses and Franchise, (i) Others (specify nature).	• Classification of Intangible Assets has been introduced under Sch VI (R). • Intangible Assets under development should also be disclosed separately, if AS-26 criteria are met.

Note: Points 3 and 4 of Tangible Assets is also applicable for Intangible Assets.

(1) (a)(iii) CAPITAL WORK IN PROGRESS

Schedule III Disclosure Requirement	Points
To be shown as a separate line item on the face of Balance Sheet	**Capital Advances** should be included under Long-Term Loans and Advances and hence, cannot be included under Capital WIP.

(1) (a)(iv) INTANGIBLE ASSETS UNDER DEVELOPMENT

Schedule III Disclosure Requirement	Points
To be shown as a separate line item on the face of Balance Sheet	Intangible Assets under development should be disclosed under this head provided they can be recognized based on the criteria laid down in AS-26.

(1) (b) NON CURRENT INVESTMENTS (Also Refer AS – 13)

Schedule III Disclosure Requirement	Points
Non-Current Investments shall be classified as Trade Investments and Other Investments, and further classified as Investments in – (a) Property, (b) Equity Instruments, (c) Preference Shares (d) Government / Trust Securities, (e) Debentures or Bonds, (f) Mutual Funds, (g) Partnership Firms, and (h) Other Non-Current Investments (specify nature).	• If a Debenture is to be redeemed partly within 12 months and balance after 12 months, the amount to be redeemed within 12 months should be disclosed as current, and balance as Non-Current. • **“Trade Investment”** is normally understood as an Investment made by a Company in Shares or Debentures of another Company, to promote the trade or business of the first Company.
Notes: 1. Under each classification, details shall be given of Names of Bodies Corporate (indicating separately whether such bodies are – (i) Subsidiaries, (ii) Associates, (iii) Joint Ventures, or (iv) Controlled Special Purpose Entities) in whom Investments have been made and the nature and extent of the Investment so made in each such Body Corporate (showing separately Investments which are partly-paid).	**(a) Controlled SPEs:** • Sch III requires separate disclosure of Investments in “Controlled Special Purpose Entities” in addition to Subsidiaries, Joint Venture, Associates, etc. • Since the expression “Controlled SPEs” is not defined in the Act/Sch. III/AS, **no disclosures** would be additionally required to be made under this caption. If and when such terminology is explained/ introduced in the applicable AS, the disclosure requirement would become applicable. **(b) Other Points:** “Nature and Extent” of Investment in each Body Corporate should be interpreted to mean the Number and Face Value of Share. Also, it is advisable to clearly disclose whether Investments are fully paid or partly paid. (item-wise)

2.	In regard to Investments in the capital of **Partnership Firms,** the Names of the Firms (with the names of all their Partners, Total Capital and the Shares of each Partner) shall be given.	**(a) LLP:** A LLP is a **Body Corporate,** and not a Partnership Firm as envisaged under the Partnership Act, 1932. Hence, disclosures pertaining to Investments, in Firms will **not** include LLPs. Investments in LLPs will be disclosed separately under "Other Investments". **(b) Change in Constitution:** In case of change in constitution of the Firm during the year, the names of the Other Partners should be disclosed based on the position existing as on the date of Company's B/s. **(c) Capital:** • The Total Capital of the Firm, to be disclosed, should be with reference to the Amount of Capital on the date of the Company's Balance Sheet. • If the Partnership Firm has separate accounts for Partner's Capital, Drawings or Current, Loans to or from Partners, etc. disclosure must be made with regard to the **Total of Capital Accounts** alone, since this is what constitutes the capital of the Partnership Firm. • Where, however, such Accounts have not been segregated, or where the Partnership Deed Provides that the Capital or each Partner is to be calculated by reference to the Net Amount at his credit after merging all the Accounts, the disclosure relating to the Partnership Capital must be made on the basis of the **total effect** of such accounts taken together. **(d) Share of each Partner:** Share of each Partner means share in the Profits of the Firm, rather than the share in the Capital. **(e) Different Reporting Dates:** If it is not practicable to draw up the Financial Statements of the Partnership upto such date and, are drawn upto different reporting dates, drawing analogy from AS-21 and AS-27, adjustments should be made for effects of significant transactions or other events that occur between those dates and the date of the Parent's Financial Statements. Also, the difference between reporting dates should not be more than 6 months. In such cases, the difference in reporting dates should be disclosed.

3. Investments carried at other than at Cost should be separately stated specifying the basis for valuation thereof	**Basis of Valuation:** Disclosure for basis of valuation of Non-Current Investments may be either of – (a) Cost, or (b) Cost less Provision for other than temporary diminution, or (c) Lower of Cost and Fair Value.
4. The following shall also be disclosed- (a) Aggregate amount of Quoted Investments and Market Value thereof, (b) Aggregate Amount of Unquoted Investments, (c) Aggregate Provision for Diminution in value of Investments.	it is recommended to disclose the amount of provision netted-off for each Long-Term Investment. However, the aggregate amount of provision made in respect of all Non-Current Investments should also be separately disclosed to comply with the specific disclosure requirement in Sch III.

(1) (c) DERERRED TAX ASSET (Also Refer AS – 22)

Schedule III Disclosure Requirement	Points
To be shown as a separate line item on the face of Balance Sheet.	-----

(1) (d) LONG TERM LOANS AND ADVANCES

Schedule III Disclosure Requirement	Points
1. General Classification: Long Term Loans and Advances shall be classified as – (a) Capital Advances, (b) Security Deposits, (c) Loans and Advances to Related Parties (giving details thereof), (d) Other Loans and Advances (specify nature)	Capital Advances: • It should be specifically included under Long-Term Loans and Advances and hence, cannot be included under Capital Work-In-Progress. • Capital Advances are advances given for procurement of Fixed Assets which are Non-Current Assets. They are not realized back in cash, nut over a period, get converted into Fixed Assets. Assets. Hence, they are always Long Term Advances, irrespective of when the Fixed Assets are expected to be recd. **Other Loans and Advances** should include all other items in the nature of advances recoverable in cash or kind, e.g. Prepaid Expenses, Advance Tax, CENVAT Credit Receivable, VAT Credit Receivable, Service Tax Credit Receivable, etc. which are not expected to be realized within the next 12 months or operating cycle whichever is longer, from the Balance Sheet date.
2. Security-wise Classification: The above shall be separately sub-classified as – (a) Secured, considered Good (b) Unsecured, considered Good (c) Doubtful.	---

3. **Bad / Doubtful:** Allowance for Bad and Doubtful Loans and Advances shall be disclosed under the relevant heads separately.	---
4. **Directors, etc.:** Loans and Advances due by Directors or Other Officers of the Company or any of them either severally or jointly with any other persons or amounts due by Firms or Private Companies respectively in which any Director is a Partner of a Director of a Member should be separately stated.	The term **"Details"** of Loans and Advances of Related Parties would mean disclosure requirements contained in AS-18.

(1) (e) OTHER NON CURRENT ASSETS

Schedule III Disclosure Requirement	Points
1. **Other Non-Current Assets** shall be classified as – (a) Long-term Trade Receivables (including Trade Receivables on Deferred Credit Terms) (b) Others (specify nature) **2.** **Security-wise Classification:** Long-Term Receivables shall be separately sub-classified as – (a) Secured, considered Good (b) Unsecured, Considered Good (c) Doubtful. **3.** **Bad / Doubtful:** Allowance for Bad and Doubtful Loans and Advances shall be disclosed under the relevant heads separately. **4.** **Directors, etc.:** Debts due by Directors or Other Officers of the Company or any of them either severally or jointly with any other person or Debts due by Firms or Private Companies respectively in which any Director is a Partner or a Director or a Member should be separately stated.	• A Receivable shall be classified as 'Trade Receivable' if it is in respect of the amount due on account of good sold or services rendered in the normal course of business. • Dues in respect of Insurance Claims, Sale of Fixed Assets, Contractually Reimbursable Expenses, Interest Accrued on Trade Receivables, etc. should be classified as **"Others"** and each such item should be disclosed nature-wise.

(2) CURRENT ASSETS

(2) (a) CURRENT INVESTMENTS **(Also Refer AS – 13)**

Schedule III Disclosure Requirement	Points
Current Investments shall be classified as – (a) Investments in Equity Instruments, (b) Investment in Preference Shares, (c) Investments in Government or Trust Securities, (d) Investments in Debentures or Bonds, (e) Investments in Mutual Funds, (f) Investments in Partnership Firms, (g) Other Investments (specify nature). **Notes:** 1. Under each classification, details shall be given of Names of Bodies Corporate [indicating separately whether such Bodies are – (i) Subsidiaries, (ii) Associates, (iii) Joint Ventures, or (iv) Controlled Special Purpose Entities] in whom Investments have been made and the nature and extent of the Investment so made in each such Body Corporate (Showing Separately Investments which are party-paid). In regard to Investments in the Capital of Partnership Firms, the names of the Firms (with the names of all their Partners, Total Capital and the Shares of each Partner) shall be given. 2. The following shall also be disclosed: (a) Basis of Valuation of individual Investments, (b) Aggregate Amount of Quoted Investments and Market Value thereof, (c) Aggregate Amount of Unquoted Investments, (d) Aggregate Provision made for Diminution in Value of Investments.	Principles given for Non-current Investments will apply here, to the extent relevant. However, Trade vs Non-Trade Classification, is not required for Current Investments.

(2) (b) INVENTORIES **(Also Refer AS-2)**

Schedule III Disclosure Requirement	Points
Inventories shall be classified as – (a) Raw materials, (b) Work In Progress, (c) Finished Goods, (d) Stock-in-Trade (in respect of goods acquired for Trading), (e) Stores and Spares, (f) Loose Tools, (g) Others (specify nature) **Note:** Goods-in-Transit shall be disclosed under the relevant sub-head of Inventories. Mode of Valuation shall be stated.	• Goods in Transit should be included under relevant heads with suitable disclosure. • The heading "Finished Goods" should comprise of all Finished Goods other than those acquired for trading purposes. Those acquired for trading purposes are to be shown under "Stock in Trade".

(2) (c) TRADE RECEIVABLES

Schedule III Disclosure Requirement	Points
1. Aggregate amount of Trade Receivables outstanding for a period exceeding 6 months from the date they are due for payment should be separately stated. **2. Security-wise Details:** Trade Receivables shall be separately sub-classified as – (a) Secured, considered Good (b) Unsecured, considered Good (c) Doubtful. **3. Bad /Doubtful:** Allowance for Bad and Doubtful Loans and Advances shall be disclosed under the relevant heads separately. **4. Directors, etc:** Debts due by Directors or Other Officers of the Company or any of them either severally or jointly with any other person or debts due by Firms or Private Companies respectively in which any Director is a Partner or a Director or a Member should be separately stated.	• Sch III requires separate disclosure of "Trade Receivables O/s for a period exceeding 6 months **from the date they become due for payment",** only for the current portion of Trade Receivables. • Where no due date is specifically agreed upon, normal credit period allows by the Company should be taken into consideration for computing the due date, which may vary depending upon the Nature of Goods or Services sold and the Type of Customers, etc. • Amounts due under contractual obligations, e.g. dues in respect of Insurance Claims, Sale of Fixed Assets, Contractually Reimbursable Expenses, Interest Accrued on Trade Receivables, etc, cannot be included within Trade Receivables, such Receivables should be classified as "Other Current Assets" and each such item should be disclosed nature –wise. • **Lean Period Activities:** Receivables arising out of sale of materials / rendering of services during a Company's lean period, should be included under "Trade Receivables", if such activity is in the normal course of business. If they are not part of "normal course of business", they are to be classified under **"Other Assets".**

(2) (d) CASH AND CASH EQUIVALENTS **(Also Refer AS – 3)**

Schedule III Disclosure Requirement	Points
Cash and Cash Equivalents shall be classified as – (a) Balances with Banks, (b) Cheques, Drafts on Hand, (c) Cash on Hand, (d) Other (Specify nature). Notes: • Earmarked Balances with Banks (e.g. for Unpaid Dividend) shall be separately stated. • Balances with Banks to the extent held as margin Money or Security against the Borrowings, Guarantees, Other Commitments shall be disclosed separately. • Repatriation restrictions, if any, in respect of Cash and Bank Balances shall be separately stated. • Bank Deposits with more than 12 months Maturity shall be disclosed separately.	• "Other Bank Balances" would comprise items like Balances with Banks to the extent of held as Margin Money or Security against Borrowings etc. and Bank Deposits with more than 3 months maturity. • Bank Deposits with more than 12 months maturity will also need to be separately disclosed under the above sub-head. • The Non-Current Portion of each of the above balances should be classified under the head "Other Non-Current Assets" with separate disclosure thereof.

(2) (e) SHORT TERM LOANS AND ADVANCES

Schedule III Disclosure Requirement	Points
1. General Classification: Short-Term Loans and Advances shall be classified as – (a) Loans and Advances to Related Parties (giving details thereof), (b) Others (specify nature). **2. Security-wise Classification:** The above shall also be sub-classified as- (a) Secured, considered Good, (b) Unsecured, considered Good, (c) Doubtful **3. Bad / Doubtful:** Allowance for Bad and Doubtful Loans and Advances shall be disclosed under the relevant heads separately. **4. Directors, etc.**: Loans & Advances due by Directors or Other Officers of the Company or any of them either severally or Jointly with any other person or amounts due by Firms or Private Companies respectively in which any Director is a Partner or a Director or a Member shall be separately stated.	Principles given for Long Term Loans and Advances will apply here, to the extent relevant.

(f) OTHER CURRENT ASSETS

Schedule III Disclosure Requirement	Points
• This is an all-inclusive heading, which incorporates Current Assets that do not fit into any other Asset Categories. • Nature of each item should be specified	• This is an **all-inclusive heading,** which incorporates Current Assets that do not fit into any other asset categories, e.g. Unbilled Revenue, Unamortized Premium on Forward Contracts, etc. • In case any amount classified under this category is doubtful, it is advisable that such doubtful amount as well as any provision made there against should be separately disclosed.

Special Point: UNAMORTISED PORTION OF SHARE ISSUE EXPENSES, etc.

1. Sch III does not contain any specifies disclosure requirement for the unamortized portion of expense items such as Share Issue Expenses, Ancillary Borrowing Costs and Discount or Premium relating to Borrowings.
2. As per AS-16, Ancillary Borrowing Costs and Discount or Premium relating to Borrowings could be amortized over the loan period. Further, share Issue Expenses, Discount on Shares, Ancillary Costs-Discount, Premium on Borrowing, etc. being special nature items, are excluded from the scope of AS-26 Intangible Assets.
3. Certain companies have taken a view that it is an acceptable practice to amortize these expenses over the period of benefit, i.e. normally 3 to 5 years.
4. **Conclusion:** Sch III does not deal with any accounting treatment of these items, and the same continues to be governed by the respective AS / best practices. So, a Company can disclose the Unamortized Portion of such expenses as "Unamortized Expenses", under the head "Other Current/ Non-Current Assets", depending on whether the amount will be amortized in the next 12 months or thereafter.

4.2 PART II-FORM OF STATEMENT OF PROFIT AND LOSS

Name of the Company :……………………………………………………

Profit and Loss Statement for the year ended:……………………………………….. (₹ in ……..)

	Particulars	Note No.	Figures for the Current Reporting Period	Figures for the Previous Reporting Period
I	Revenue from Operations		XXX	XXX
II	Other Income		XXX	XXX
III	**Total Revenue (I+II)**		**XXX**	**XXX**
IV	**Expenses:** Cost of Materials Consumed Purchases of Stock-In-Trade Changes in Inventories of Finished Goods / Work-in-progress and Stock-In-Trade Employee Benefits Expense Finance Costs Depreciation and Amortization Expense Other Expenses		 XXX XXX XXX	 XXX XXX XXX
	Total Expenses		**XXX**	**XXX**
V	Profit before Exceptional & Extraordinary Items and Tax (III – IV)		XXX	XXX
VI	Exceptional Items		XXX	XXX
VII	Profit before Extraordinary Items and IAX (V-VI)		XXX	XXX
VIII	Extraordinary Items		XXX	XXX
IX	Profit before Tax (VII-VIII)		XXX	XXX
X	Tax Expenses: (1) Current Tax (2) Deferred Tax		 XXX XXX	 XXX XXX
XI	Profit /(Loss) for the period from Continuing Operations (IX – X)		XXX	XXX
XII	Profit /(Loss) from Discontinuing Operations		XXX	XXX
XIII	Tax Expense of Discontinuing Operations		XXX	XXX
XIV	Profit /(Loss) from Discontinuing Operations (After Tax) (XII-XIII)		XXX	XXX
XV	Profit / (Loss) for the period (XI + XIV)		XXX	XXX
XVI	Earnings per Equity Share: (1) Basic (2) Diluted		XXX	XXX

General Instructions for preparation of Statement of P&L

<table>
<tr><th>Item</th><th colspan="2">Description</th></tr>
<tr><td>1. Sec.25 Companies</td><td colspan="2">The provisions of this Part shall apply to the Income and Expenditure Account referred to in Sec. 129 of the Act, in like manner as they apply to a Statement of Profit and Loss.</td></tr>
<tr><td>2. Revenue from Operations</td><td>For Company other than a Finance Company: Revenue from Operations shall disclose separately in the Notes, Revenue from –
(a) Sale of Products
(b) Sale of Services
(c) Other Operating Revenues
(d) Less: Excise Duty</td><td>For Finance Company: Revenue from Operations shall include Revenue from:
(a) Interest &
(b) Other Financial Services
Revenue under each of the above heads shall be disclosed separately by way of Notes to Accounts to the extent applicable.</td></tr>
<tr><td>3. Finance Costs</td><td colspan="2">Finance Costs shall be classified as –
(a) Interest Expenses,
(b) Other Borrowing Costs,
(c) Applicable Net Gain / Loss on Foreign Currency Transactions and Translation.</td></tr>
<tr><td>4. Other Income</td><td colspan="2">Other Income shall be classified as –
(a) Interest Income (in case of a Company other than a Finance Company),
(b) Dividend Income,
(c) Net Gain/Loss on Sale of Investments,
(d) Other Non-Operating Income (Net of Expenses directly attributable to such income).</td></tr>
<tr><td>5. Additional Information:</td><td colspan="2">A Company shall disclose by way of Notes, additional information regarding Aggregate Expenditure and Income on the following items referred below.</td></tr>
</table>

(i) Employee Benefits, Expense, Income Items, etc:

(a) **Employee Benefits Expense** [showing separately – (i) Salaries & Wages, (ii) Contribution to PF and Other Funds, (iii) Expense on ESOP and Employee Stock Purchase Plan (ESPP), (iv) Staff Welfare Expenses]

(b) Depreciation and Amortization Expenses,

(c) Any item of Income of Expenditure which exceeds 1% of Revenue from Operations or ₹ 1,00,000 whichever is **higher**,

(d) Interest Income,

(e) Interest Expense,

(f) Dividend Income,

(g) Net Gain / Loss on Sale of Investments,

(h) Adjustments to the Carrying Amount of Investments,

(i) Net Gain / Loss on Foreign Currency Transaction & Translation (other than considered as Finance Cost),

(j) **Payments to the Auditor** as – (a) Auditor, (b) For Taxation Matters, (c) For Company Law Matters, (d) For Management Services, (e) For other Services, (f) For Reimbursement of Expenses,

(k) Item of Exceptional and Extraordinary Nature,

(l) Prior Period Items.

(ii) Materials, Goods, Services, etc.

(a) In the case of **Manufacturing Companies –**

- Raw Materials under broad heads.
- Goods Purchased under broad heads.

(b) In the case of **Trading Companies**, Purchases in respect of goods Traded in by the Company under broad heads.

(c) In the case of **Companies rendering or supplying services**, Gross Income derived from Services Rendered or Supplied, under broad heads.

(d) In the case of a Company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if Purchases, Sales and Consumption of Raw Material and the Gross Income from Services rendered is shown under broad head.

(e) In the case of **Other Companies**, Gross Income derived under broad heads.

(iii) In the case of **all concerns having Works-in-Progress,** Works-in-Progress under broad heads**.**

(iv) Reserves – Creation & Utilisation:

(a) The aggregate, if materials, of any amounts set aside or proposed to be set aside, to Reserve, but not including Provisions made to meet any Specific Liability, Contingency or Commitment known to exist at the date as to which the Balance – Sheet is made up.

(b) The aggregate, if material, of any amounts withdrawn from such Reserves.

(v) Provision – Creation & Utilisation:

(a) The aggregate, if material, of the amounts set aside to Provisions made for meeting Specific Liabilities, Contingencies or Commitments.

(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(vi) Expenses, etc: Expenditure incurred on each of the following items, separately for each item:

(a) Consumption of Stores and Spare Parts,

(b) Power and Fuel,

(c) Rent,

(d) Repairs to Buildings,

(e) Repairs to Machinery,

(f) Repairs to Machinery,

(g) Insurance,

(h) Rates and Taxes, excluding, Taxes on Income,

(i) Miscellaneous Expenses.

(vii) Subsidiaries Information:

(a) Dividends from Subsidiary Companies.

(b) Provisions for Losses of Subsidiary Companies.

(viii) FOREX Information: The P&L A/c shall also contain by way of a Note the following Information, namely –

(a) Value of Imports Calculated on **CIF basis** by the Company during the Financial Year in respect of – (I) Raw Materials, (II) Components and Spare Parts, (III) Capital Goods,

(b) Expenditure in Foreign Currency during the Financial Year on account of Royalty, Know-How, Professional and Consultation Fees, Interest, and Other Matters,

(c) Total Value if all **Imported** Raw Materials, Spare Parts and Components consumed during the Financial Year and the Total Value of all **Indigenous** Raw Materials, Spare Parts and Components similarly consumed and the Percentage of each to the Total Consumption,

(d) Amount **remitted** during the year in Foreign Currencies on account of **Dividends** with a specific mention of the total number of Non-Resident Shareholders, the Total Number of Shares held by them on which the Dividends were due and the year to which the Dividends related.

(e) Earnings in Foreign Exchange classified under the following heads, namely-

- Export of Goods calculated on FOB Basis,
- Royalty, Know-How, Professional & Consultation Fees,
- Interest and Dividend,
- Other Income, indicating the nature thereof.

Note: Broad heads shall be decided taking into account the concept of **Materiality** and **Presentation of True and Fair view** of Financial Statements**.**

Illustration 1:

The following information has been extracted from the books of account of Hero Ltd. as at 31st March, 2015:

	Dr. (₹ '000)	Cr. (₹ '000)
Administration Expenses	480	
Cash at Bank and on Hand	228	
Cash Received on Sale of Fittings		10
Long Term Loan		70
Investments	200	
Depreciation on Fixtures, Fittings, Tools and Equipment (1st April, 2014)		260
Distribution Costs	102	
Factory Closure Costs	60	
Fixtures, Fittings, Tools and Equipment at Cost	680	
Profit & Loss Account (at 1st April, 2014)		80
Purchase of Equipment	120	
Purchases of Goods for Resale	1710	
Sales (net of Excise Duty)		3,000
Share Capital (1,00,000 shares of ₹ 10 each fully paid)		1,000
Stock (at 1st April, 2014)	140	
Trade Creditors		80
Trade Debtors	780	
	4,500	4,500

Additional Information:

(1) The stock at 31st March, 2015 (valued at the lower of cost or net realizable value) was estimated to be worth ₹ 2,00,000.

(2) Fixtures, fittings, tools and equipment all related to administration. Depreciation is charged at a rate of 20% per annum on cost. A full year's depreciation is charged in the year of acquisition, but no depreciation is charged in the year of disposal.

(3) During the year to 31st March, 2015, the Company purchased equipment of ₹ 1,20,000. It also sold some fittings (which had originally cost ₹ 60,000) for ₹ 10,000 and for which depreciation of ₹ 30,000 had been set aside.

(4) The average Income tax for the Company is 50%. Factory closure cost is to be presumed as an allowable expenditure for Income tax purpose.

(5) The company proposes to pay a dividend of 20% per Equity Share.

Prepare Hero Ltd.'s Profit and Loss Account for the year to 31st March, 2015 and balance Sheet as at that date in accordance with the Companies Act, 2013 in the Vertical Form along with the Notes on Accounts containing only the significant accounting policies.

Solution:

Name of the Company: Hero Ltd.

Balance Sheet as at: 31st March, 2015 (₹ in '000)

Ref No.	Particulars		Note No.	As at 31st March, 2015	As at 31st March, 2014
	I	**EQUITY AND LIABILITIES**			
	1	**Shareholder's Fund**			
		(a) Share capital	1	1,000	
		(b) Reserves and surplus	2	150	
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**			
		(a) Long-term borrowings	3	70	
	4	**Current Liabilities**			
		(a) Other current liabilities	4	80	
		(b) Short-term provisions	5	470	
		Total (1+2+3+4)		1,770	
	II	**ASSETS**			
	1	Non-current assets			
		(a) Fixed assets			
		(i) Tangible assets	6	362	
		(b) Non-current investments	7	200	
	2	**Current assets**			
		(a) Inventories	8	200	
		(b) Trade receivables	9	780	
		(c) Cash and cash equivalents	10	228	
		Total (1+2)		1,770	

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Name of the Company : Hero Ltd.

Profit and Loss Statement for the year ended: 31st March, 2015 (₹ in ……..)

		Note No.		As at 31st March, 2015	As at 31st March, 2014
I	REVENUE FROM OPERATION	11		3,000	
	Less: Excise duty				
				3,000	
II	OTHER INCOME				
III	TOTAL REVENUE(I+II)			3000	
IV	EXPENSES:				
	(a) Cost of material consumed				
	(b) Purchase of products for sale		1,710		
	(c) changes in inventories of finished goods, work-in-progress and products for sale (140-200)		(60)		
	(d) Employees cost/ benefits expenses				
	(e) Finance cost				
	(f) Depreciation and amortization expenses		148		
	(g) Product development expenses/Engineering expenses				
	(h) Other expenses	12	602		
	(i) Expenditure transfer to capital and other account				
	TOTAL EXPENSES			2,400	
V	PROFIT BEFORE EXCEPTIONAL AND EXTRAORDINARY ITEMS AND TAX (III-IV)			600	
VI	EXCEPTIONAL ITEMS				
VII	PROFIT BEFORE EXTRAORDINARY ITEMS AND TAX (V-VI)			600	
VIII	EXTRAORDINARY ITEMS			60	
IX	PROFIT BEFORE TAX FRON CONTINUING OPERATIONS (VII-VIII)			540	
X	Tax expenses:				
	(1) Current Tax			270	
	(2) deferred tax				
XI	PROFIT AFTER TAX FOR THE YEAR FROM CONTINUING OPERATION(IX-X)			270	
XII	Profit (loss) from discontinuing operations				
XIII	Tax expenses from discontinuing operations				
XIV	Profit(loss) from discontinuing operations (after tax)(XII-XIII)				
XV	PROFIT (LOSS) FOR THE PERIOD (XI+XIV)			270	
	Balance brought forward from previous year				
	Profit available for appropriation			80	
				350	
	Appropriation:				
	Proposed dividend		200		
	Transfer to General Reserve		30	230	
	Balance carried forward			120	
XVI	Earning per equity share:				
	(1) Basic				
	(2) Diluted				

(₹ In '000)

Note 1. Share Capital	As at 31st March, 2015	As at 31st March, 2014
Authorized, Issued, Subscribed and paid-up Share capital:		
1,00,000 Equity share of ₹ 10 each	1,000	
Total	1,000	

RECONCILIATION OF SHARE CAPITAL

FOR EQUITY SHARE	As at 31st March, 2015		As at 31st March, 2014	
	Nos.	Amount (₹)	Nos.	Amount (₹)
Opening Balance as on 01.04.11 (Figure in '000)	100	1,000		
Add: Fresh Issue (Including Bonus shares, right shares, split shares, share issued other than cash)				
	100	1,000		
Less: Buy Back of share				
Total	100	1,000		

Note 2. Reserve & Surplus	As at 31st March, 2015	As at 31st March, 2014
General Reserve	30	
Profit and loss A/c	120	
Total	150	

Note 3. Long term borrowings	As at 31st March, 2015	As at 31st March, 2014
Long term loan	70	
Total	70	

Note 4. Trade Payables	As at 31st March, 2015	As at 31st March, 2014
Sundry Creditors	80	
Total	80	

Note 5. Short- term provisions	As at 31st March, 2015	As at 31st March, 2014
Proposed dividend (20% on ₹ 10,00,000)	200	
Provision for Taxation	270	
Total	470	

Note 6. Tangible Assets		As at 31st March, 2015	As at 31st March, 2014
Fixtures, Fittings, Tools and equipment at cost- Opening	680		
Add: Additions	120		
Less: Sale/ disposed	(30)		
Less: Depreciation (260+148)	(408)	362	
Total		362	

Note 7. Non Current Investments	As at 31st March, 2015	As at 31st March, 2014
Investments	200	
Total	200	

Note 8. Inventories	As at 31st March, 2015	As at 31st March, 2014
Stock	200	
Total	200	

Note 9.Trade Receivables	As at 31st March, 2015	As at 31st March, 2014
Trade Debtors (more than six months considered good) –	780	
Total	780	

Note 10. Cash and cash equivalents	As at 31st March, 2015	As at 31st March, 2014
Cash at Bank and on hand	228	
Total	228	

Note 11. Revenue from operation	As at 31st March, 2015	As at 31st March, 2014
Sales (net of Excise Duty)	3,000	
Total	3,000	

Note 12. Other Expenses	As at 31st March, 2015	As at 31st March, 2014
Administrative Expenses	480	
Distribution Expenses	102	
Loss on sale of Fixed Assets	20	
Total	602	

Notes:

(1) The rate of interest on long term loan is not given in the question. Reasonable assumption may be made regarding the rate of interest and accordingly it may be accounted for.

(2) As per Companies (Transfer of Profits to Reserve) Rules, the amount to be transferred to the reserves shall not be less than 7.5% of the current profits since proposed dividend exceeds 15% but does not exceed 20% of the paid up capital. In this answer, it has been assumed that ₹. 30,000 have been transferred to General Reserve. The students may transfer any amount based on a suitable percentage not less than 7.5%.

(3) In the absence of details regarding factory closure costs, there costs are treated as extraordinary items in the above solution assuming that the factory is permanently closed. However, the factory may close for a short span of time on account of strikes, lockouts etc. and such type of factory closure costs should be treated as loss from ordinary activities. In that case also, a separate disclosure regarding the factory closure costs will be required as per para 12 of AS 5 (Revised) 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.'

NOTES ON ACCOUNTS FOR THE YEAR ENDED 31ST MARCH, 2015

Significant Accounting Policies:

(a) Basis for preparation of financial statements: The financial statements have been prepared under the historical cost convention, in accordance with the generally accepted accounting principles and the provisions of the companies Act, 2013 as adopted consistently by the company.

(b) Depreciation: Depreciation on fixed assets is provided using the straight-line method, based on the period of five yea₹ Depreciation on additions is provided for the full year but no depreciation is provided on assets sold in the year of their disposal.

(c) Investments: Investments are valued at lower of cost or net realizable value.

(d) Inventories: Inventories are valued at the lower of historical cost or the net realizable value.

Working Notes:

	Particulars		(₹ in '000)
(1)	**Tangible Asset**		
	Furniture and Fixtures		
	Gross Block		
	As on 1.4.2014	680	
	Add: Additions during the year	120	
		800	
	Less: Deductions during the year	60	
	As on 31.3.2015		740
	Depreciation		
	As on 1.4.2014	260	
	For the year (20% on 740)	148	
		408	
	Less: Deduction during the year	30	
	As on 31.3.2015		378
	Net block as on 31.3.2015		362
(2)	Provision for taxation		
	Profit as per profit and loss account		540
	Add back: Loss on sale of asset (short term capital loss)	20	
	Depreciation	148	
			168
			708
	Less: Depreciation under Income-tax Act		168
			540
	Provision for tax @ 50%		270

It has been assumed that depreciation calculated under Income-tax Act amounts to (₹ 1,68,000)

Illustration 2:

The following balances are extracted from the books of Supreme Ltd., a real estate company, on 31st March, 2015:

		(₹ '000)
	Dr.	**Cr.**
Sales		13,800
Purchases of materials	6,090	
Share capital fully paid		500
Land purchased in the year as stock	365	
Leasehold premises	210	
Creditors		2,315
Debtors	3,675	
Directors' salaries	195	

Wages	555	
Work in progress on 01.04.2014	1,050	
Sub-contractors' cost	4,470	
Equipment, Fixtures and Fittings at cost on 01.04.2014	1,320	
Stock on 01.04.2014	295	
Profit and Loss Account, Credit Balance on 01.04.2014		640
Secured Loan		560
Bank Overdraft		525
Interest on Loan and Overdraft	110	
Depreciation on Equipment on 01.04.2014		820
Administration Expenses	735	
Office Salaries	90	
	19,160	19,160

You also obtain the following information:

(a) On 31st March, 2015, stock on hand including the land acquired during the year, is valued at ₹ 7,10,000. Work in progress at that date is valued at ₹ 7,00,000.

(b) On 1st October, 2014 the company moved to new premises. The premises are on a 12 years lease and the lease premium paid amounted to ₹ 2,10,000. The company used sub-contract labour of ₹ 2,00,000 and materials at cost of ₹ 1,90,000 in the refurishment 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 ₹ 1,75,000 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) Supreme Ltd. sued Shallow Ltd. for supplying defective materials which has been written off as valueless. The Directors are confident that Shallow Ltd. will agree for a settlement of ₹ 2,50,000.

(f) The directors propose a dividend of 25%.

(g) ₹ 1,00,000 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, 2015 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.

Solution:

Name of the Company: Supreme Ltd.

Balance Sheet as at: 31st March, 2015 (₹ in '000)

Ref No.	Particulars		Note No.	As at 31st March, 2015	As at 31st March, 2014
	I	**EQUITY AND LIABILITIES**			
	1	**Shareholder's Fund**			
		(a) Share capital	1	500	
		(b) Reserves and surplus	2	945	
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**			
		(a) Long-term borrowings	3	560	
	4	**Current Liabilities**			
		(a) Short-term borrowings	4	525	
		(b) Trade payables	5	2,315	
		(c) Other current liabilities	6	100	
		(d) Short-term provisions	7	895	
		Total (1+2+3+4)		5840	
	II	**ASSETS**			
	1	Non-current assets			
		(a) Fixed assets			
		(i) Tangible assets	7	1,000	
	2	**Current assets**			
		(a) Inventories	8	1,410	
		(b) Trade receivables	9	3,430	
		Total (1+2)		5840	

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Name of the Company : Supreme Ltd.

Profit and Loss Statement for the year ended: 31st March, 2015 (₹ in ....)

Ref. No.	Particualrs	Note No.		As at 31st March, 2015	As at 31st March, 2014
I	REVENUE FROM OPERATION	11		13,800	
	Less: Excise duty				
				13,800	
II	OTHER INCOME				
III	TOTAL REVENUE(I+II)			13,800	
IV	EXPENSES:				
	(a) Cost of material consumed	12		11,025	
	(b) Purchase of products for sale				
	(c) changes in inventories of finished goods, work-in-progress and products for sale				
	(d) Employees cost/ benefits expenses	13		405	
	(e) Finance cost			110	
	(f) Depreciation and amortization expenses			100	
	(g) Other expenses	14		1,080	
	TOTAL EXPENSES			12,720	
V	PROFIT BEFORE EXCEPTIONAL AND EXTRAORDINARY ITEMS AND TAX (III-IV)			1,080	
VI	EXCEPTIONAL ITEMS				
VII	PROFIT BEFORE EXTRAORDINARY ITEMS AND TAX (V-VI)			1,080	
VIII	EXTRAORDINARY ITEMS				
IX	PROFIT BEFORE TAX FRON CONTINUING OPERATIONS (VII-VIII)			1,080	
X	Tax expenses:				
	(1) Current Tax			650	
	(2) deferred tax				
XI	PROFIT AFTER TAX FOR THE YEAR FROM CONTINUING OPERATION(IX-X)			430	
XII	Profit (loss) from discontinuing operations				
XIII	Tax expenses from discontinuing operations				
XIV	Profit(loss) from discontinuing operations (after tax)(XII-XIII)				
XV	PROFIT (LOSS) FOR THE PERIOD (XI+XIV)			430	
	Balance brought forward from previous year			640	
	Profit available for appropriation			1,070	
	Appropriation:				
	Proposed dividend		125		
	Transfer to General Reserve		45	170	
	Balance carried forward			900	
XVI	Earning per equity share:				
	(1) Basic				
	(2) Diluted				

(₹ In '000)

Note 1. Share Capital	As at 31st March, 2015	As at 31st March, 2014
Authorized, Issued, Subscribed and paid-up Share capital:		
50,000 Equity share of ₹ 10 each	500	
Total	500	

RECONCILIATION OF SHARE CAPITAL

FOR EQUITY SHARE	As at 31st March, 2015		As at 31st March, 2014	
	Nos.	Amount (₹)	Nos.	Amount (₹)
Opening Balance as on 01.04.14 (Figure in '000)	50	500		
Add: Fresh Issue (Including Bonus shares, right shares, split shares, share issued other than cash)				
	50	500		
Less: Buy Back of share				
Total	50	500		

Note 2. Reserve & Surplus	As at 31st March, 2015	As at 31st March, 2014
General Reserve	45	
Profit and loss A/c	900	
Total	945	

Note 3. Long term borrowings	As at 31st March, 2015	As at 31st March, 2014
Secured Loan	560	
Total	560	

Note 4. Short-term borrowings	As at 31st March, 2015	As at 31st March, 2014
Bank Overdraft	525	
Total	525	

Note 5. Trade Payables	As at 31st March, 2015	As at 31st March, 2014
Sundry Creditors	2,315	
Total	2,315	

Note 6. Other Current Liabilities	As at 31st March, 2015	As at 31st March, 2014
Audit fees	100	
Total	100	

Note 7. Short- term provisions	As at 31st March, 2015	As at 31st March, 2014
Proposed dividend	125	
Provision for Taxation	650	
Provision for bonus	120	
Total	895	

Note 8. Tangible Assets		**As at 31st March, 2015**	**As at 31st March, 2014**
Equipment, Fixtures & Fittings at cost- Opening	1,320		
Less: Depriciation	895	425	
Leasehold premises (210+200+190)	600		
Less: Witten off	25	575	
Total		1,000	

Note 9. Inventories	**As at 31st March, 2015**	**As at 31st March, 2014**
Stock – Finished stock	710	
Work in progress	700	
Total	1410	

Note 10.Trade Receivables	**As at 31st March, 2015**	**As at 31st March, 2014**
Trade Debtors (more than six months)	3,675	
Less: Provision for doubtful debts	245	
Total	3,430	

Note 11. Revenue from operation	**As at 31st March, 2015**	**As at 31st March, 2014**
Sales (net of Excise Duty)	13,800	
Total	13,800	

Note 12. Cost of materials Consumed		**As at 31st March, 2015**	**As at 31st March, 2014**
Manufacturing expenses- Opening Stock (FG)	295		
Opening WIP	1,050	1,345	
Purchase of materials (6,090-190)		5,900	
Purchase of land as stock		365	
Wages		555	
Sub-contract Cost (4,470-200)		4,270	
Less: Closing Stock- Finished goods	710		
Work in progress	700	(1,410)	
Total		11,025	

Note 13. Employees benefit expenses	**As at 31st March, 2015**	**As at 31st March, 2014**
Salary- office staff (90+195)	285	
Bonus	120	
Total	405	

Note 14. Other Expenses	**As at 31st March, 2015**	**As at 31st March, 2014**
Administrative Expenses	735	
Provision for doubtful debts	245	
Auditors remuneration	100	
Total	1,080	

NOTES ON ACCOUNTS FOR THE YEAR ENDED 31ST MARCH, 2015

Significant Accounting Policies:

(a) Basis for preparation of financial statements: The financial statements have been prepared under the historical cost convention, in accordance with the generally accepted accounting principles and the provisions of the companies Act, 2013 as adopted consistently by the company.

(b) Fixed Assets: Fixed assets are shown at cost less depreciation. Cost comprises the purchase prise and other attributable expenses.

(c) Depreciation: Depreciation on fixed assets is provided using the written down method. Lease-hold premises/improvements are being amortised over the lease period.

(d) Inventories: Inventories are valued at the lower of historical cost or the net realizable value.

1. Other Matters:

(a) The cost of leasehold premises includes the cost of refurbishment to the extent of ₹ 3,90,000 (Materials ₹ 1,90,000 + Labour ₹ 2,00,000).

(b) Shallow Ltd. has been sued for supplying defective materials. Settlement of ₹ 2,50,000 is hopeful however it has not been recognized in the accounts as it represents contingent gain.

(1a)	Administration Expenses		735
	Directors' Salaries		195
	Provision for Doubtful Debts [175 + 2% of (3675 – 175)]		245
	Audit Fees		100
	Other expenses		1,275
b)	Employee Benefits:		
	Office salaries		90
			120
	Bonus		210
(2)	Bonus Calculation		
	Sales		13,800
	Less: Manufacturing Expenses	11,025	
	Other Exp. (excluding bonus)	1,365	
	Depreciation	100	
	Interest	110	
			12,600
	Pre-tax Profit		1,200
	Bonus (10%)		120
(3)	Fixed Asset:		
	Tangible Asset		
	(a) Gross block		
	Furniture and Fixture		1,320
	Leasehold Premises (210 + 200 + 190)		600
			1,920

	(b) Depreciation		
	Furniture and fixture(1.4.2014) 820	820	
	For the year [15% on (1,320– 820)]	75	
	Cost of Leasehold Premises written off		895
	[(210 + 200 + 190) X 1/12 X 1/2]		25
			920
(4)	Provision for Taxation		
	Profit as per Profit and Loss Account		1,080
	Add back: Provision for doubtful debts	245	
	Cost of Leasehold premises written off	25	
	Depreciation on equipment, fixtures and fittings	75	345
			1,425
	Less: Depreciation under Income-tax Act		125
			1,300
	Provision for Tax (@ 50%)		650
	(It has been assumed that depreciation calculated under Income-tax Act amounts to ₹ 1,25,000)		

Illustration 3:

On 1st November, 2014 Squash Ltd. was incorporated with an authorized capital of ₹ 200 crores. It issued to its promoters equity capital of ₹ 10 crores which was paid for in full. On that day it purchased the running business of Jam Ltd. for ₹ 40 crores and allotted at par equity capital of ₹ 40 crores in discharge of the consideration. The net assets taken over from Jam Ltd. were valued as follows: Fixed Assets ₹ 30 crores, Inventory ₹ 2 crores, Customers' dues ₹ 14 crores and Creditors ₹ 6 crores. Squash Ltd. carried on business and the following information is furnished to you:

(a) Summary of cash/bank transactions (for year ended 31st October, 2015).

		(₹ in Crores)
Equity capital raised:		
Promoters (as shown above)	10	
Others	50	60
Collections from customers		800
Sale proceeds of fixed assets (cost ₹ 18 crores)		4
		864
Payments to suppliers	400	
Payments to employees	140	
Payment for expenses	100	640
Investments in Upkar Ltd.		20
Payments to suppliers of fixed assets:		
Instalment due	120	
Interest	10	130
Tax payment		54
Dividend		10
Closing cash/bank balance		10
		864

(b)

On 31st October, 2015 Squash Ltd.'s assets and liabilities were:		(₹ in Crores)
Inventory at cost		3
Customers' dues		80
Prepaid expenses		2
Advances to suppliers		8
Amounts due to suppliers of goods		52
Amounts due to suppliers of fixed assets		150
Outstanding expenses		6

(c) Depreciation for the year under:

(i) Companies Act, 2013 ₹ 36 crores

(ii) Income tax Act, 1961 ₹ 40 crores

(d) Provide for tax at 38.5% of "total income". There are no disallowed expenses for the purpose of income taxation. Provision for tax is to be rounded off.

For Squash Ltd. prepare:

(i) Revenue statement for the year ended 31st October, 2015 and

(ii) Balance Sheet as on 31st October, 2015 from the above information.

Solution:

Name of the Company: Squash Ltd

Balance Sheet as at: 31st October, 2015 **(₹ in Crores)**

Ref No.		Particulars	Note No.	As at 31st March, 2015	As at 31st March, 2014
	I	**EQUITY AND LIABILITIES**			
		Shareholder's Fund			
		(a) Share capital	1	100	
		(b) Reserves and surplus	2	77.4	
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**		NIL	
	4	**Current Liabilities**			
		(a) Trade payables	3	52	
		(b) Other current liabilities	4	156	
		(c) Short-term provisions	5	52	
		Total (1+2+3+4)		437.40	
	II	**ASSETS**			
	1	Non-current assets			
		(a) Fixed assets			
		(i) Tangible assets	6	260.4	
		(b) Non-current investments	7	20	
		(c) Long-term loans and advances	8	54	
	2	**Current assets**			
		(a) inventories	9	3	
		(b) trade receivables	10	80	
		(c) Cash and cash equivalents	11	10	
		(d) Short-term loans and advances	12	10	
		Total (1+2)		437.40	

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Name of the Company : Squash Ltd

Profit and Loss Statement for the year ended: 31st October, 2015 **(₹ in Crores))**

Ref No.	Particulars	Note No.	As at 31st March, 2015	As at 31st March, 2014
I	REVENUE FROM OPERATION	13	866	
	Less: Excise duty			
			866	
II	OTHER INCOME			
III	TOTAL REVENUE(I+II)		866	
IV	EXPENSES:			
	(a) Cost of material consumed	14	437	
	(b) Purchase of products for sale			
	(c) changes in inventories of finished goods, work-in-progress and products for sale			
	(d) Employees cost/ benefits expenses		140	
	(e) Finance cost		10	
	(f) Depreciation and amortization expenses		36	
	(g) Other expenses	15	104	
	TOTAL EXPENSES		727	
V	PROFIT BEFORE EXCEPTIONAL AND EXTRAORDINARY ITEMS AND TAX (III-IV)		139	
VI	EXCEPTIONAL ITEMS			
VII	PROFIT BEFORE EXTRAORDINARY ITEMS AND TAX (V-VI)		139	
VIII	EXTRAORDINARY ITEMS		0.4	
IX	PROFIT BEFORE TAX FRON CONTINUING OPERATIONS (VII-VIII)		139.40	
X	Tax expenses:			
	(1) Current Tax		52	
	(2) deferred tax			
XI	PROFIT AFTER TAX FOR THE YEAR FROM CONTINUING OPERATION(IX-X)		87.4	
XII	Profit (loss) from discontinuing operations			
XIII	Tax expenses from discontinuing operations			
XIV	Profit(loss) from discontinuing operations (after tax)(XII-XIII)			
XV	PROFIT (LOSS) FOR THE PERIOD (XI+XIV)		87.4	
	Balance brought forward from previous year			
	Profit available for appropriation		87.4	
	Appropriation:			
	Proposed dividend		10	
	Balance carried forward		77.40	
XVI	Earning per equity share:			
	(1) Basic			
	(2) Diluted			

(₹ in Crores)

Note 1. Share Capital	As at 31st March, 2015	As at 31st March, 2014
Authorized Equity share capital of ₹ 10 each	200	
Issued, Subscribed and paid-up Share capital: 10 Crores Equity share of ₹ 10 each (of which 4 crores equity share have been issued for a consideration other than cash, on take-over of business of Jam Ltd.	100	
Total	100	

RECONCILIATION OF SHARE CAPITAL

FOR EQUITY SHARE	As at 31st March, 2015		As at 31st March, 2014	
	Nos.	Amount (₹)	Nos.	Amount (₹)
Opening Balance as on 01.04.11 (Figure in crores)	10	100		
Add: Fresh Issue (Including Bonus shares, right shares, split shares, share issued other than cash)				
	10	100		
Less: Buy Back of share				
Total	10	100		

Note 2. Reserve & Surplus	As at 31st March, 2015	As at 31st March, 2014
Profit and loss A/c	77.40	
Total	77.40	

Note 3. Trade Payables	As at 31st March, 2015	As at 31st March, 2014
Sundry Creditors	52	
Total	52	

Note 4. Other Current Liabilities	As at 31st March, 2015	As at 31st March, 2014
Amount due to supplier of fixed assets	150	
Outstanding expenses	6	
Total	156	

Note 5. Short- term provisions	As at 31st March, 2015	As at 31st March, 2014
Provision for Taxation	52	
Total	52	

Note 6. Tangible Assets		As at 31st March, 2015	As at 31st March, 2014
Fixed Assets taken over from Jam Ltd	30		
Add: Purchase (120+150)	270	300	
Less: Sale proceeds	3.60		
Less: Depreciation	36	39.60	
Total		260.40	

Note 7. Non-current Investments	**As at 31st March, 2015**	**As at 31st March, 2014**
Investments in Upkar Ltd	20	
Total	20	

Note 8. Long term loans and advances	**As at 31st March, 2015**	**As at 31st March, 2014**
Advance Tax	54	
Total	54	

Note 9. Inventories	**As at 31st March, 2015**	**As at 31st March, 2014**
Inventories at cost	3	
Total	3	

Note 10. Trade receivables	**As at 31st March, 2015**	**As at 31st March, 2014**
Customer's Due	80	
Total	80	

Note 11.Cash and cash equivalents	**As at 31st March, 2015**	**As at 31st March, 2014**
Cash/bank balance	10	
Total	10	

Note 12. Short-term loans and advances	**As at 31st March, 2015**	**As at 31st March, 2014**
Advance to suppliers	8	
Prepaid expenses	2	
Total	10	

Note 13. Revenue from operation	**As at 31st March, 2015**	**As at 31st March, 2014**
Sales (net of Excise Duty)	866	
Total	866	

Note 14. Cost of materials Consumed	**As at 31st March, 2015**	**As at 31st March, 2014**
Stock taken over	2	
Purchase	438	
	440	
Less: Closing Stock	3	
Total	437	

Note 15. Other Expenses	**As at 31st March, 2015**	**As at 31st March, 2014**
Payment for expenses	100	
Add: Outstanding expenses	6	
Less: Prepaid expenses	(2)	
Total	104	

Working Notes:

(₹. in crores)

(1) Net assets of Jam Ltd. taken over:

Fixed Assets	30
Inventory	2
Customers' dues	14
	46
Less: Creditors	6
	40

Purchase consideration: 4 crores equity shares of ₹ 10 each.

(2) **Customers' Account**

Dr. **Cr.**

Particulars	**₹**	**Particulars**	**₹**
To Business Purchase A/c	14	By Bank A/c	800
To Sales A/c (Balancing figure)	866	By Balance c/d	80
	880		880

Suppliers' (Goods) Account

Particulars	**₹**	**Particulars**	**₹**
To Bank A/c (400 – 8)	392	By Business Purchase A/c	6
To Balance c/d	52	By Purchases A/c (Balancing figure)	438
	444		444

Suppliers' (Fixed Assets) A/c, Fixed Assets A/c, Expensess A/c, and calculation of tax provision should be included in the working notes.

4.3 MANAGERIAL REMUNERATION

Managers mean the directors of the company including notified managers, whole time director, part time director and managers. There are two types of companies — (a) Companies making adequate profits (b) Companies not making adequate profit or loss in business.

Maximum remuneration payable (sec.197): Overall Maximum Remuneration to Directors and Manager = 11% of Net Profits. The Remuneration to Directors shall not be deducted from Gross Profit. The ceiling limits are as under:

Overall Maximum Remuneration to Directors and Manager = 11% of Net Profits
Notes: This can be increased only with —
Company's resolution in a General Meeting, and (b) approval of Central Govt.

Maximum Limit of Managerial Remuneration on the basis of Net Profit:-

Situation – I If company having only one Whole time Director, M.D. or Managers	5% of Net Profit.
Situation – II If company having more than one whole time Director ,or M.D., or Managers	10% of Net Profit.
Situation – III If company having only one part time director or M.D. or Managers	3% of Net Profit.
Situation – IV Situation I+ Situation III	6% of Net Profit.
Situation – V Situation II + Situation III	11% of Net Profit.

Remuneration Payable by Companies having no Profit or Inadequate Profit without Central Government Approval:

Where in any financial year during the currency of tenure of a managerial person, a company has no profits or its profits are inadequate, it may, without Central Government approval, pay remuneration to the managerial person not exceeding the higher of the limits under (A) and (B) given below:—

(A):

(1)	(2)
Where the effective capital is	Limit of yearly remuneration payable shall not exceed (Rupees)
(i) Negative or less than 5 crores	30 lakhs
(ii) 5 crores and above but less than 100 crores	42 lakhs
(iii) 100 crores and above but less than 250 crores	60 lakhs
(iv) 250 crores and above	60 lakhs plus 0.01% of the effective capital in excess of ₹ 250 crores:

Provided that the above limits shall be doubled if the resolution passed by the shareholders is a special resolution.

Explanation.—It is hereby clarified that for a period less than one year, the limits shall be pro-rated.

(B) In the case of a managerial person who was not a security holder holding securities of the company of nominal value of rupees five lakh or more or an employee or a director of the company or not related to any director or promoter at any time during the two years prior to his appointment as a managerial person, — 2.5% of the current relevant profit.

Provided that if the resolution passed by the shareholders is a special resolution, this limit shall be doubled.

Provided further that the limits specified under this section shall apply, if—

(i) payment of remuneration is approved by a resolution passed by the Board and, in the case of a company covered under sub-section (1) of section 178 also by the Nomination and Remuneration Committee;

(ii) the company has not made any default in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of thirty days in the preceding financial year before the date of appointment of such managerial person;

(iii) a special resolution has been passed at the general meeting of the company for payment of remuneration for a period not exceeding three years;

Remuneration Payable by Companies having no Profit or Inadequate Profit without Central Government Approval in Certain Special Circumstances:

In the following circumstances a company may, without the Central Government approval, pay remuneration to a managerial person in excess of the amounts provided in Section II above:—

(a) where the remuneration in excess of the limits specified in Section I or II is paid by any other company and that other company is either a foreign company or has got the approval of its shareholders in general meeting to make such payment, and treats this amount as managerial remuneration for the purpose of section 197 and the total managerial remuneration payable by such other company to its managerial persons including such amount or amounts is within permissible limits under section 197.

(b) where the company—

(i) is a newly incorporated company, for a period of seven years from the date of its incorporation, or

(ii) is a sick company, for whom a scheme of revival or rehabilitation has been ordered by the Board for Industrial and Financial Reconstruction or National Company Law Tribunal, for a period of five years from the date of sanction of scheme of revival, it may pay remuneration up to two times the amount permissible under Section II.

(c) where remuneration of a managerial person exceeds the limits in Section II but the remuneration has been fixed by the Board for Industrial and Financial Reconstruction or the National Company Law Tribunal.

Provided that the limits under this Section shall be applicable subject to meeting all the conditions specified under Section II and the following additional conditions:—

(i) except as provided in para (a) of this Section, the managerial person is not receiving remuneration from any other company;

(ii) the auditor or Company Secretary of the company or where the company has not appointed a Secretary, a Secretary in whole-time practice, certifies that all secured creditors and term lenders have stated in writing that they have no objection for the appointment of the managerial person as well as the quantum of remuneration and such certificate is filed along with the return as prescribed under sub-section (4) of section 196.

(iii) the auditor or Company Secretary or where the company has not appointed a secretary, a secretary in whole-time practice certifies that there is no default on payments to any creditors, and all dues to deposit holders are being settled on time.

(d) a company in a Special Economic Zone as notified by Department of Commerce from time to time which has not raised any money by public issue of shares or debentures in India, and has not made any default in India in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of thirty days in any financial year, may pay remuneration up to ₹ 2,40,00,000 per annum.

Perquisites shall not be included in Managerial Remuneration.

Statement Showing Calculation of Net Profit

Net profit as per financial books	XXX
Provision (All)	XXX
Appropriation (All)	XXX
Actual Depreciation	XXX
Depreciation as per companies act	(XXX)
Voluntary Compensation	XXX
Voluntary Donation	XXX
Profit on sale of investment	(XXX)
Loss on sale of investment	XXX
Interest/ Dividend/ Rental income	(XXX)
Profit on sale of fixed assets (If profit is higher than the provisional depreciation)	(XXX)
Capital Expenditure (Research and development)	XXX
TOTAL	XXXX
***Management salary**	XXX
***Management Commission**	XXX
NET PROFIT	XXXX

*Director Fees should not be included as a part of managerial remuneration and it should be allowed under the calculation of net profit as per specified section.

Statement Showing Calculation of Effective Capital

Share Capital	XXX
Reserve and Surplus	XXX
Long Term Loan	XXX
Investment	(XXX)
Misc Expenditure	(XXX)
Effective Capital	XXXX

Illustration 4.

The following is the Statement of Profit and Loss Account of ABC Ltd., for the year ended 31st march, 2015:

Dr. **Cr.**

Particulars	**Amount (₹)**	**Particulars**		**Amount (₹)**
To Administrative, Selling and distribution expenses	8,22,542	By Balance b/d		5,72,350
To Donation to Charitable Funds	25,500	By Balance form Trading A/c		40,25,365
To Directors Fees	66,750	By Subsidies received from Govt.		2,32,560
To Interest on debentures	31,240	By Interest on Investments		15,643
To Compensation for breach of contracts	42,530	By Transfer fees		722
To Managerial remuneration	2,85,350	By Profit on sale of machinery:		25,000
To Depreciation on fixed assets	5,22,543	Amount realized	55,000	48,71,640
To Provision for taxation	11,42,500	Written down value	30,000	
To General reserve	5,00,000			
To Investment Revaluation Reserves	12,500			
To Net Profit	14,20,185			
	48,71,640			

Additional Information:

(i) Original cost of the machinery sold was ₹40,000.

(ii) Depreciation on fixed assets as per Schedule II of the Companies Act,2013 was ₹5,75,345.

You are required to comment on the managerial remuneration in the following situations:

(a) There is only one whole time director;

(b) There are two whole time director;

(c) There are two whole time directors, a part time director, and a manager.

Solution:

Calculation of Profits U/S 198

Particulars	Amount (₹)
Net Profit (bal c/d)	14,20,185
(+) Managers remuneration	2,85,350
(+) Depreciation charged	5,22,543
(+) Provision for taxation	11,42,500
(+) General Reserve	5,00,000
(+) Investment Revaluation Reserve	12,500
(-) Opening Profit	5,72,350
(-) Profit on machinery — Capital Profit (₹55,000-₹40,000)	15,000
(-) Depreciation as per Schedule II	5,75,345
Book Profit	27,20,383

(a) 5% of ₹27,20,383 = ₹1,36,019

(b) 10% of ₹27,20,383 = ₹2,72,038

(c) 11% of ₹27,20,383 = ₹2,99,242

Illustration 5.

From the following particulars, calculate Commission to the managing Director:

Profit as per Profit and Loss A/c is ₹1,45,09,000, after deducting the depreciation of ₹1,24,24,000, Salary and remuneration to the managing director of ₹72,000 and director fees of ₹4,000. The depreciation as per U/S 198 of the Companies Act, 2013 is of ₹1,04,24,000.

Solution:

Computation of Commission to the Managing Director

Particulars	₹ 000's	₹ 000's
Profit as per Profit and Loss A/c		14,509
Add: Depreciation charged in the Profit and Loss A/c	12,424	
Salary and remuneration to the managing director	72	
director fees	4	12,500
		27,009
Less: Depreciation u/s 198 of the Companies Act		(10,424)
Profit u/s 198 for the purpose of Managerial Remuneration		16,585
Maximum remuneration (5%)		829
Less: Salaries and remuneration paid (director's fees is excluded here)		(72)
Maximum commission payable to Managing Director		757
Commission to be provided for at 1% of Net Profits (1% of ₹16,585)		166

Illustration 6.

Ananda Pvt Ltd. has furnished that the net profit before tax and managing director's remuneration is ₹5,85,60,000, after adjusting the Depreciation as per books of ₹71,00,000 (Depreciation as per schedule II is ₹ 80,00,000), provision for doubtful debts of ₹80,000. The managing director's remuneration is at 5% of Net Profit as per law subject to maximum of ₹2,40,000 p.a. Compute the Managing Director's remuneration.

Solution:

Computation of Managing Director's Remuneration

Particulars	₹ 000's
Net profit before tax and managing director's remuneration	58,560
Add: Depreciation as per books	7,100
Provision for doubtful debts	80
	65,740
Less: Depreciation as per schedule II to Companies Act,2013	(8,000)
Net profit for the purpose of Managerial remuneration	57,740
Maximum managerial remuneration at 5% of net profit	2,887
Restricted to actual payment under the agreement	240

Illustration 7.

From the following particulars of Ajanta Ltd, you are required to calculate the managerial remuneration in the following situation:

(i) There is only one whole time director;

(ii) There are two whole time directors;

(iii) There are two whole time directors, a part time director and a manager;

Particulars	Amount (₹)
Net profit before provision for income tax and managerial remuneration, but after depreciation and provision for repairs	8,70,410
Depreciation provided in the books	3,10,000
Provision for repairs of office premises during the year	25,000
Depreciation allowable under schedule II	2,60,000
Actual expenditure incurred on repairs during the year	15,000

Solution:

Section 197 of the Companies Act,2013 prescribe the maximum percentage of profit that can be paid as managerial remuneration. For this purpose, profit is to be calculated in the manner a specified in section 198.

Calculation of net profit U/S 198 of the Companies Act,2013

Particulars	Amount (₹)	Amount (₹)
Net profit before provision for income tax and managerial remuneration, but after depreciation and for provision for repairs		8,70,410
Add back: Depreciation provided in the books	3,10,000	
Provision for repairs of office premises	25,000	3,35,000
		12,05,410
Less: Depreciation allowable under schedule II	2,60,000	
Actual expenditure incurred on repairs	15,000	2,75,000
Profit u/s 198		9,30,410

Calculation of Managerial Remuneration

(i) There is only one whole time director:

Managerial Remuneration = 5% of ₹9,30,410 = ₹46,520.50

(ii) There are two whole time directors:

Managerial Remuneration = 10% of ₹9,30,410 = ₹93,041

(iii) There are two whole time directors, a part time director and a manager:

Managerial Remuneration = 11% of ₹9,30,410 = ₹1,02,345.10

Illustration 8

The following is the Profit and Loss Account of the Lakhotia Paper Ltd. for the year ending 31st March:

Particulars	**Amount (₹)**	**Particulars**		**Amount (₹)**
To, Admn, Selling & Finance Expenses	5,75,000	By, Balance b/d		4,53,000
To, National Defence Fund	29,000	By, Balance from Trading Account		38,60,400
To, Directors Fees	55,000	By, Interest on Investment		10,000
To, Interest on Debentures	20,750	By, Transfer Fee		1,050
To, Managing Director's Remuneration	3,80,000	By, Profit on Sale of Plant		
To, Depreciation of Fixed Assets	4,64,700	Amount realized	40,000	
To, Provision for Taxation	11,45,000	Less: Book Value	(31,000)	
To, General Reserve	5,49,000			9,000
To, Debenture Sinking Fund	14,000			
To, Investment Revaluation Reserve	9,000			
To, Net Profit	10,92,000			
	43,33,450			43,33,450

As an Auditor you are required to comment on the managerial remuneration.

Solution:

1. Computation of Net Profit under Section 198

Particulars	**Amount (₹)**	**Amount (₹)**
Balance from Trading Account		38,60,400
Add: Interest on Investment		10,000
Transfer Fee received		1,050
Profit on Sale of Plant		9,000
Total		38,80,450
Less: Admn, Selling & Finance Expenses	5,75,000	
Contribution to National Defence Fund	29,000	
Directors Fees	55,000	
Interest on Debentures	20,750	
Depreciation of Fixed Assets	4,64,700	11,44,450
		27,36,000

2. Maximum Remuneration Payable to the Managing Director u/s 197

   = 5% of Net Profit u/s 198=5% ₹ 27,36,000=₹ 1,36,800

   However, Managing Director's Remuneration as per the above P & L Account is ₹ 3,80,000

3. Maximum Remuneration Payable under Schedule V- Inadequate Profit:

   By virtue of Section 197, where the Company has no profits or its profits is inadequate, it may pay Remuneration to any Managerial Person, within the limits specified in Schedule V. The ceiling limits are based on the Effective Capital of the Company. In the above case, the Effective Capital of the Company is not known. However, presuming the basic limit of Effective Capital of "Less than ₹1 Crore", the maximum permissible remuneration is ₹ 2,50,000 per month or ₹ 30,00,000 per annum.

Study Note - 5

CASH FLOW STATEMENT (AS-3)

This Study Note includes

5.1 Statement of Cash Flows
5.2 Meaning of Cash and Cash Equivalent
5.3 Types of Cash Flow

Introduction

Cash flow statement is additional information to user of financial statement. This statement exhibits the flow of incoming and outgoing cash and cash. It assesses the ability of the enterprise to generate cash and utilize cash. Cash Flow Statement is one of the tools for assessing the liquidity and solvency of the enterprise.

5.1 STATEMENT OF CASH FLOWS

"The information provided in a statement of cash flows, if used with related disclosures and information in the other financial statements, should help investors, creditors, and others to (a) assess the enterprise's ability to generate positive future net cash flows; (b) assess the enterprise's ability to meet its obligations, its ability to pay dividends, and its needs for external financing; (c) assess the reasons for differences between net income and associated cash receipts and payments; and (d) assess the effects on an enterprise's financial position of both its cash and non-cash investing and financing transactions during the period." - SFAS 95 Statement of Cash Flows, Financial Accounting Standards Board, US

5.1.1 Why Cash Flow Statement is Prepared?

Cash Flow Statement is considered to be a summarized statement showing sources of Cash Inflows and application of cash outflows of an enterprise during a particular period of time. It is prepared on the basis of the published data as disclosed by the Financial Statement of two different financial periods. It is an essential tool for managerial decision-making. Cash Flow reports the management Net Cash Flow (i.e. cash inflow less cash outflow or vice versa) from each activity of the enterprise as well as of the overall business of the enterprise. The management of the enterprise gets a picture of movement of cash resources from the Cash Flow Statement and can assess the stronger and weaker area of movement of cash for different activities of the business for drawing up the future planning.

5.1.2 Importance of Cash flows

Cash flows are crucial to business decisions. Cash is invested in the business and the rationality of such investment is evaluated taking into account the future cash flows it is expected to generate. Economic value of an asset is derived on the basis of its ability to generate future cash flows. Economic value of an asset is given by the present value of future cash flows expected to be derived from the asset.

Profit is an accounting concept. Profit is derived on accrual assumption. Profit and cash flows from operational activities are not the same. Dividend decision is taken on the basis of profit, although it is to be paid in cash. Similarly, debt servicing capacity of a company is determined on the basis of cash flows from operations before interest. Ploughing back of profit is a much talked about source of financing modernisation, expansion and diversification. Unless retained profit is supported by cash, ploughing back is not possible. Thus cash flows analysis is an important basis for making several management decisions.

Preparation of Group Cash Flow Statement

The actual cash paid for the subsidiary is shown under the heading 'Acquisitions and Disposals'. It is possible that the purchase consideration will include other forms of payments such as the issue of shares or loan stock and there is no cash flow effect in these cases.

In exchange for the purchase consideration, the group acquires the individual net assets of the subsidiary and goodwill is recognized on acquisition.

The net assets in the closing consolidated Balance Sheet will include those of the newly acquired subsidiary. The preparation of the group cash flow statement must recognize that the movement from opening to closing positions is increased in party by the net assets of the new subsidiary and the amounts relating to that subsidiary are therefore excluded from the cash flow statement.

For example, additions to fixed assets are represented by purchases during the year plus fixed assets of the acquired subsidiary. This is broken down as follows:

Opening + cash purchases + fixed assets of – disposals- depreciation=closing

NBV for additions acquired subsidiary NBV

Only cash purchase for additions are included in the cash flow statement under 'inventive activities'.

5.2 MEANING OF CASH AND CASH EQUIVALENT

A cash flow statement explains the reasons for change in the cash and cash equivalent between two financial statement dates. Before we introduce the technique of cash flow analysis, let us learn the meaning of the term 'cash and cash equivalent'.

Cash means cash in hand and balance of foreign currency. Cash equivalent implies bank balance and other risk-free short term investments, and advances which are readily encashable. Cash equivalent means short term highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value. An investment of short maturity, say three months or less from the date of acquisition is generally considered as cash equivalent. Equity investments are not considered as cash equivalent because of high market risk. Investments in call money market, money market mutual funds, repo transactions, badla transactions, etc., are usually classified as cash equivalents.

5.3 TYPES OF CASH FLOW

Cash Flow Statement explains cash movements under three different heads, namely

- Cash flow from operating activities;
- Cash flow from investing activities;
- Cash flow from financing activities.

Sum of these three types of cash flow reflects net increase or decrease of cash and cash equivalents.

Operating activities are the principal revenue - producing activities of the enterprise and other activities that are not investing and financing. Operating activities include all transactions that are not defined as investing or financing. Operating activities generally involve producing and delivering goods and providing services.

Investment activities are the acquisition and disposal of long term assets and other investments not included in cash equivalents.

Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

5.3.1 Elements of operating cash flow

Given below are elements of operating cash flow:

Description of elements of operating cash flow
• Cash receipts from sale of goods and rendering services.
• Cash receipts from royalty, fees, commissions and other revenue.
• Cash payments to suppliers for goods and services.
• Cash payments to and on behalf of employees.
• Cash receipts and cash payments by an insurance enterprise for premiums and claims, annuities and other policy benefits.
• Cash payments and refunds of income taxes unless these are specifically identified as cash flow from financing or investment.
• Cash receipts and payments relating to contracts held for dealing or trading purposes.
• Cash flow arising from dealing in securities when an enterprise holds securities for such purpose.
• Cash advances and loans made by financial institutions including all contracts held for trading purposes which may range from sale licence, export-import quota, any other operating contract. This may not necessarily be a contract relating to derivative instruments.

5.3.2 Elements of cash flow from investment activities

Given below are eight elements of investment cash flow:

Elements of cash flow from investment activities:	
1.	Cash payments for acquisition of fixed assets including intangibles.
2.	Cash receipts from disposal of fixed assets.
3.	Cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint venture.
	This does not include an item covered in cash equivalents and items held for dealing or trading purposes.
4.	Cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint venture.
	This does not include an item covered in cash equivalents and items held for dealing or trading purposes.
5.	Cash advances and loans made to third parties.
	This does not include loans and advances made by financial institutions as these fall under operating cash flow.
6.	Cash receipts from repayments of advances and loans made to third parties. This does not include loans and advances made by financial institutions as these fall under operating cash flow.

7.	Cash payments for future, forward, option and swap contracts.
	This does not include contracts held for dealing or trading purposes or contracts which are classified as financing activities.
8.	Cash receipts from future, forward, option and swap contracts.
	This does not include contracts held for dealing or trading purposes or contracts which are classified as financing activities.

5.3.4 Classification of derivative transactions –

Derivative Transactions which are for Heading		Speculative contracts
•	Of Operating transactions like oil future, currency forward relating to sale or purchase of goods or services, commodity futures or options that relates to raw materials and finished goods: Should be classified as operating cash flow.	• Of dealers - Operating activities. • Of others - Investment activities.
•	Of investment transactions like stock index futures to protect value investment in shares, T- bill futures or options to protect value of in vestment debt instruments Should be classified as investment cash flow.	
•	Of financing activities like swaps against foreign currency loans and floating rate interest: Should be classified as financing cash flow.	

5.3.5 Elements of cash flow from financing activities

Given below are five elements illustrated cash flow from financing activities:

Elements of cash flow from financing activities	
1.	Cash proceeds from issuing shares or other equity instruments.
2.	Cash payments to owners to acquire or redeem the enterprise's shares.
3.	Cash proceeds from issuing debentures, loans, notes, bonds, mortgages, and other short term and long term borrowings.
4.	Cash repayments of amounts borrowed.
5.	Cash payments by a lease for the reduction of the outstanding liability relating to a finance lease.

5.3.6 Cash Flow from Operating Activities

Operating cash flows can be derived either in pursuance of a direct method or indirect method. Under direct approach major classes of cash receipts and payments are disclosed. Whereas under indirect approach net profit or loss adjusted to derive operating cash flow. Although direct method is not appropriate, the SEBI requires computation of cash flow from operating activities using indirect method.

Direct Method:

PROFORMA OF CASH FLOW STATEMENT AS PER AS-3

Proforma of Cash Flow Statement under Direct Method

Cash Flow Statement of______________________ for the period ended______________

		₹	₹	₹
	A. **Cash Flows from Operating Activities:**			
	Cash receipts from Customers		--	
Less:	Cash paid to Suppliers and Employees		--	
	Cash Generated from Operation		--	
Less:	Income Tax Paid		--	
	Cash Flows from Operation before Extraordinary Items		--	
Add:	Proceeds from any Disaster Settlement		--	
	Net Cash Flow from Operating Activities			--
	B. **Cash Flows from Investing Activities:**			
	Proceeds from Sale Fixed assets including Investments		--	
Less:	Purchase from Sale Fixed assets including Investments		--	
			--	
Add:	Interest Received		--	
	Dividends Received		--	
	Net Cash Flow from Investing Activities			--
	C. **Cash Flows from Financing Activities:**			
	Proceeds from issuance of share capital		--	
	Proceeds from Long-term Borrowings		--	
			--	
Less:	Repayment of Long-term Borrowings			
	including Redemption of Preference Shares		--	
			--	
Less:	Interest Paid			
	Dividend Paid		--	
	Net Cash Flow from Financing Activity	--		--
	Net Increase in Cash and cash Equivalents	--		--
Add:	**Cash and Cash Equivalents at**			
	the beginning of the period			--
	Cash and Cash Equivalents at			
	the end of the period			--

Notes:

(1) Figures of cash sales may be directly available from cash book. Then Cash collection can be derived taking Credit sales + Opening balance of debtors - closing balance of debtors.

(2) Similarly figures of cash purchases can also be obtained from cash books.

(3) Interest and dividend are investment cash inflow and, therefore, to be excluded.

(4) Interest expense is financing cash outflow.

(5) Tax provision is not cash expense, advance tax paid should be treated as tax cash outflow.

Indirect Method:

Proforma of Cash Flow Statement under Indirect Method
Cash Flow Statement of______________________ for the period ended______________

Particulars		₹	₹	₹
A.	**Cash Flows from Operating Activities:**			
	Net Profit for the Period before Taxation & Extraordinary Items		--	
Add:	Adjustment for Non-current and Non-operating Items charged to Profit & Loss A/c			
	Depreciation	--		
	Interest paid	--		
	Foreign Exchange Loss	--		
	Loss on Sale of Fixed Assets & Investments	--	--	
			--	
Less:	Adjustment for Non-current and Non-operating Items Charged to Profit & Loss A/c			
	Interest Earned	--		
	Dividend Earned	--		
	Profit on Sale of Fixed Assets & Investments	--	--	
	Operating Profit before Working Capital Changes		--	
Add:	Increase in Current Liabilities	--		
	Decrease in Current Assets	--	--	
			--	
Less:	Increase in Operating Current Assets	--		
	Decrease in Operating Current Liabilities	--	--	
	Cash Generated from Operation		--	
Less:	Income Tax Paid		--	
Add:	Proceeds from any Disaster Settlement		--	
	Net Cash Flow from Operating Activities			--
B.	**Cash Flows from Investing Activities:**			
	Proceeds from Sale Fixed assets including Investments		--	
Less:	Purchase from Sale Fixed assets including Investments		--	
			--	
Add:	Interest Received		--	
	Dividends Received		--	
	Net Cash Flow from Investing Activities			--
C.	**Cash Flows from Financing Activities:**			
	Proceeds from issuance of Share Capital		--	
	Proceeds from Long-term Borrowings		--	
			--	
Less:	Repayment of Long-term Borrowings including Redemption of Preference Shares		--	
Less:	Interest Paid	--		
	Dividend Paid	--		
	Net Cash Flow from Financing Activity			--
	Net Increase in Cash and cash Equivalents			--
Add:	**Cash and Cash Equivalents at the beginning of the period**			--
	Cash and Cash Equivalents at the end of the period			--

Illustration 1.

Given below is Profit and Loss Account of ABC Ltd. and relevant Balance Sheet information :

Profit and Loss Statement for the year ended 31st March, 2015 **(₹ in lakhs)**

	Particulars	Note No.	As at 31st March,2015	As at 31st March,2014
I	REVENUE FROM OPERATION		4,150	
II	OTHER INCOME		100	
III	**TOTAL REVENUE(I+II)**		4,250	
IV	EXPENSES:			
	(a) Cost of material consumed			
	(b) Purchase of products for sale		2,400	
	(C) changes in inventories of finished goods, work-in-progress and products for sale		(20)	
	(d) Employees cost/ benefits expenses		800	
	(e) Finance cost		60	
	(f) Depreciation and amortization expenses		100	
	(g) Product development expenses/Engineering expenses			
	(h) Other expenses		200	
	(i) Expenditure transfer to capital and other account			
	TOTAL EXPENSES		3,540	
V	PROFIT BEFORE EXCEPTIONAL AND EXTRAORDINARY ITEMS AND TAX (III-IV)		710	
VI	EXCEPTIONAL ITEMS		-	
VII	PROFIT BEFORE EXTRAORDINARY ITEMS AND TAX (V-VI)		710	
VIII	EXTRAORDINARY ITEMS		-	
IX	PROFIT BEFORE TAX FROM CONTINUING OPERATIONS (VII-VIII)		710	
X	Tax expenses:			
	(1) Current Tax		200	
	(2) deferred tax		-	
XI	PROFIT AFTER TAX FOR THE YEAR FROM CONTINUING OPERATION(IX-X)		510	
XII	Profit (loss) from discontinuing operations			
XIII	Tax expenses from discontinuing operations			
XIV	Profit(loss) from discontinuing operations (after tax) (XII-XIII)			
XV	PROFIT (LOSS) FOR THE PERIOD (XI+XIV)			
	Balance brought forward from previous year		50	
	Profit available for appropriation		560	
	Appropriation:			
	Proposed dividend		300	
	Transfer to General Reserve		200	
	Distribution Tax		30	
	Total		530	
	Balance carried forward		30	
XVI	Earning per equity share:			
	(1) Basic			
	(2) Diluted			

Notes on Accounts **(₹ in lakhs)**

1. Revenue from operation	**As at 31st March,2015**	**As at 31st March,2014**
Sales (net of Excise Duty)	4,150	
Total	4,150	

2. Other Income	**As at 31st March,2015**	**As at 31st March,2014**
Interest and Dividend	100	
Total	100	

3. Employees Cost/ Benefits Expenses	**As at 31st March,2015**	**As at 31st March,2014**
Wages and Salaries	800	
Total	800	

4. Finance Expenses	**As at 31st March,2015**	**As at 31st March,2014**
Interest	60	
Total	60	

Relevant Balance Sheet information	**31-03-2015 ₹ in lakhs**	**31-03-2014 ₹ in lakhs**
Debtors	400	250
Inventories	200	180
Creditors	250	230
Outstanding wages	50	40
Outstanding expenses	20	10
Advance tax	195	180
Tax provision	200	180
Assessed tax liability		180

Let us now study the technique of direct method of calculating operating cash flow:

Computation of cash flow from Operating Activities
Direct Method

Cash Receipts (a)	**₹ in lakhs**
Cash sales & Collection from debtors	
Sales+Opening Debtors - Closing Debtors (4,150+250-400)	4000
Cash Payments (b)	
Cash purchases & Payment to creditors	
Purchases+ Opening Creditors - Closing creditors (2,400+230-250)	2380
Wages & salaries paid (800+40-50)	790
Cash Expenses (200+10-20)	190
Taxes paid - Advance tax	195
	3555
Cash Flow from Operating Activities (a-b)	445

(₹ in lakhs)

Indirect Method	
Profit before tax	710
Add : Non-cash items : Depreciation	100
Add : Interest : Financing cash outflow	60
Less : Interest and Dividend : Investment	100
Cash inflow	770
Less : Tax paid	195
Working Capital Adjustments	575
Debtors (250 - 400)	(150)
Inventories (180 - 200)	(20)
Creditors (250 - 230)	20
Outstanding wages (50 - 40)	10
Outstanding expenses (20 -10)	10
Cash Flow from Operating Activities	**445**

Illustration 2.

Name of the Company: MZ Ltd.

Profit and Loss Statement for the year ended 31st March, 2015

(₹ in lakhs)

	Particulars	Note No.	As at 31st March,2015	As at 31st March,2014
I	REVENUE FROM OPERATION		10,000	
II	OTHER INCOME		1,200	
III	**TOTAL REVENUE (I+II)**		11,200	
IV	EXPENSES:			
	(a) Cost of material consumed		5,500	
	(b) Purchase of products for sale			
	(C) changes in inventories of finished goods, work-in-progress and products for sale		(1,000)	
	(d) Employees cost/ benefits expenses		2,500	
	(e) Finance cost		800	
	(f) Depreciation and amortization expenses		500	
	(g) Product development expenses/Engineering expenses		-	
	(h) Other expenses		2,000	
	(i) Expenditure transfer to capital and other account			
	TOTAL EXPENSES		10,300	
V	PROFIT BEFORE EXCEPTIONAL AND EXTRAORDINARY ITEMS AND TAX (III-IV)		900	
VI	EXCEPTIONAL ITEMS		-	
VII	PROFIT BEFORE EXTRAORDINARY ITEMS AND TAX (V-VI)		900	
VIII	EXTRAORDINARY ITEMS		-	
IX	PROFIT BEFORE TAX FROM CONTINUING OPERATIONS (VII-VIII)		900	
X	Tax expenses:			
	(1) Current Tax		100	
	(2) deferred tax		-	

(₹ in lakhs)

	Particulars	Note No.	As at 31st March,2015	As at 31st March,2014
XI	PROFIT AFTER TAX FOR THE YEAR FROM CONTINUING OPERATION(IX-X)		800	
XII	Profit (loss) from discontinuing operations		-	
XIII	Tax expenses from discontinuing operations		-	
XIV	Profit(loss) from discontinuing operations (after tax) (XII-XIII)		-	
XV	PROFIT (LOSS) FOR THE PERIOD (XI+XIV)			
	Balance brought forward from previous year		100	
	Profit available for appropriation		900	
	Appropriation:			
	Proposed dividend		600	
	Transfer to General Reserve		250	
	Distribution Tax		-	
	Total		850	
	Balance carried forward		50	
XVI	Earning per equity share:			
	(1) Basic			
	(2) Diluted			

Name of the Company: MZ Ltd.

Balance Sheet as at 31st March, 2015 (₹ in lakhs)

Ref No.		Particulars	Note No.	31.03.14	31.03.15
I		**EQUITY AND LIABILITIES**			
	1	**Shareholders' fund**			
		(a) Share capital		3,000	4,000
		(b) Reserves and surplus-		850	1050
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**			
		(a) Long-term borrowings		4,000	6,000
	4	**Current Liabilities**			
		(a) Trade payables		4,650	4,200
		(b) Short-term provisions		750	850
		Total		**13,250**	**16,100**

II		ASSETS			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets		5,000	6,500
		(b) Non-current investments		1,000	1,500
		(c) Long-term loans and advances		150	100
	2	**Current assets**			
		(a) Inventories		5,000	5,500
		(b) Trade receivables		1,500	2,000
		(c) Cash and cash equivalents		600	500
		Total		**13,250**	**16,100**

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Notes on Accounts **(₹ in lakhs)**

1. Revenue from operation	**As at 31st March,2015**	**As at 31st March,2014**
Sales (net of Excise Duty)	10,000	
Total	10,000	

2. Other Income	**As at 31st March,2015**	**As at 31st March,2014**
Income from Investments	1,200	
Total	1,200	

3. Raw Material Consumed	**As at 31st March,2015**	**As at 31st March,2014**
Opening Stock Of Raw Material	2,000	
Add: Purchase of Raw Material	5,000	
	7,000	
Less: Closing Stock of Raw Material	1,500	
Total	5,500	

4. Changes in stock of Finished Goods	**As at 31st March,2015**	**As at 31st March,2014**
Closing stock	4,000	
Less: Opening Stock	3,000	
Total	1,000	

5. Employees Benefits	**As at 31st March,2015**	**As at 31st March,2014**
Salaries and Contribution to Retirement Benefit Schemes	2,500	
Total	2,500	

6. Reserve and Surplus	**31.03.14**	**31.03.15**
General Reserve	750	1,000
Profit & Loss A/c	100	50
Total	850	1050

7. Long Term Borrowings	**31.03.14**	**31.03.15**
Secured Loan	4,000	6,000
Total	4,000	6,000

8. Tangible Assets	**31.03.14**	**31.03.15**
Gross Block	6,000	8,000
Less: Accumulated Depreciation	1,000	1,500
	5,000	6,500

9. Long Term Loans and Advances	**31.03.14**	**31.03.15**
Advance tax	150	100
	150	100

10. Short Term Provisions	**31.03.14**	**31.03.15**
Tax Provision	150	100
Other Provisions	150	150
Propose dividends	450	600
	750	850

Consider the above Profit and Loss account and Balance Sheet and derive Cash flows from operating activities using direct and indirect method.

Solution:

Computation of cash flows from operating activities by direct method:

	₹ in lakh	**₹ in lakh**
Cash inflows (a)		
Sales	10,000	
Add : Opening S/Debtors	1,500	
	11,500	
Less : Closing S/Debtors	2,000	9,500
Cash outflows (b)		
Creditors :		
Opening balance	4,650	
Add : Purchases	5,000	
Less : Closing balance	4,200	5,450
Salaries and Contributions to retirement Benefit Schemes		2,500
Other Expenses		2,000
		9,950
Cash flow from operating activities (a-b)		(450)
Less : Advance tax paid		(100)
Cash flow from after tax operating activities		(550)

- Figures within bracket indicate cash outflows.

Notes :

- Cash inflows from sale of goods and services are given by cash sales plus collection from debtors.
- Cash outflows on account of purchase of materials are given by cash purchases plus payment to creditors.

- It may be noted that income from investments is classified as cash flows from investment activities and interest payment on long term loans is classified as cash flows for financing activities. Dividend payment also falls under the category of cash flows for financing activities.

Computation of Operating Cash Flow using Indirect Method

		₹ in lakh
Increase in General Reserve		250
Decrease in P & L A/c		(50)
Tax provision		100
Proposed Dividend		600
Interest		800
Depreciation		500
		2,200
Less : Income from Investments		1,200
		1,000
Working Capital Adjustments :		
Inventories	(500)	
Sundry Debtors	(500)	
Sundry Creditors	(450)	(1,450)
Cash from operating activities		(450)
Less : Advance tax paid		(100)
Cash flow from after tax operating activities		(550)

Working Capital Adjustments : Increase in current asets like inventories, debtors, prepayments blocks the cash flows, whereas decrease in current assets releases cash. Although there was profit before interest and depreciation amounting to ₹ 1,000 lakh, such profit was not represented by cash since it was blocked in inventories and debtors.

Similarly, any increase in current liabilities means withholding cash payments. In other words, increase in current liabilities means increase in cash flows from opening activities. On the other hand, decrease in current liabilities means additional cash outflows which further reduces cash flows from operating acitivies.

After the working capital adjustments, it appears that there was net cash outflows from operating activities.

However, under both the direct and indirect methods cash flows from operating activities can be derived at a same level.

Reconciliation : In case indirect method is followed, it is better to have a reconciliation of cash flows and PAT

		₹ in lakh
Cash flows from operating activities		(450)
Add : Working Capital adjustments		1450
		1000
Less : Depreciation		(500)
Less : Interest		(800)
		(300)
Add : Income from investments		1200
PBT		900
Less : Tax Provision		100
PAT		800

Illustration 2 (a) Taking the data given in Illustration 2, and using the following additional information derive cash flow from investment activities :

Take 10% of the investments given in the Balance Sheets as risk-free and readily encashable and remaining of the investments as long term investments.

Cash flow from Investment Activities

Particulars			**₹ in lakh**
Purchase of fixed assets			
Increase in gross block			(2,000)
Purchase of long term investments			
	31-3-2014	31-3-2015	
	1,000	1,500	
Less : Cash equivalents	100	150	
	900	1,350	(450)
			(2,450)
Income from Investments			1,200
			(1,250)

Thus there was net cash outflows for investing activities.

Illustration 2 (b) : Take the information given in Illustration 2. & 2.(a) and derive cash flow from financing activities :

Cash flows from financing activities	(₹ in lakh)
Issure of shares	1,000
Loans	2,000
Interest	(800)
Dividend	(450)
	1,750

Thus there was net cash inflows from financing activities.

Illustration 2 (c): Use the data given in Illustration 2 & 2.(a) and find out change in cash and cash equivalents:

₹ in lakh

Particulars	**31-03-2014**	**31-03-2015**	**Increase/ (Decrease)**
Cash and bank Balances	600	500	(100)
Risk-free and readily encashable Investments	100	150	50
	700	650	(50)

There was a decrease in Cash and Cash equivalents by ₹ 50 lakh.

Illustration 2 (d) : Now using data given in Illustration 2-2.(c), prepare a cash flow statements :

Cash Flow Statement	**₹ in lakh**
Cash flows from operating activities	(550)
Cash flows from investment activities	(1250)
Cash flows from financing activities	1750
Decrease in cash and cash equivalents :	(50)

Cash flows statement is largely used fro management decisions. However, there is global trend in favour of inclusion of cash flows statement as a part of corporate financial statements. In India, the SEBI has already issued a notification requiring the listed companies to include a cash flow statement in the annual report. The Institute of Chartered Accountants of India has also issued Accounting Standard 3 (AS-3) Cash Flow Statement. It has now become part of the financial statements of the listed companies.

Illustration 3. Given below are summarised Balance Sheets of Harsh Chemicals Ltd. as at 31-03-14 and 31-03-15. The company issued one bonus share for every 4 shares held. The company also acquired machinery amounting to ₹ 30,00,000 from Levenz of France on deferred credit basis. You are required to prepare the cash flow statement.

(₹ in thousand)

Ref No.	**Particulars**		**Note No.**	**As at 31.03.15**	**As at 31.03.14**
I		**EQUITY AND LIABILITIES**			
	1	**Shareholders' fund**			
		(a) Share capital		8,500	4,000
		(b) Reserves and surplus-		9,700	9,350
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**			
		(a) Long-term borrowings		13,150	12,400
	4	**Current Liabilities**			
		(a) Trade payables		1,050	1,600
		(b) Other current liabilities		880	120
		(c) Short-term provisions		5,000	3,000
		Total		**38,280**	**30,470**
II		**ASSETS**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets		18,950	13,800
		(ii) Capital work-in-progress		8,200	6,000
		(b) Non-current investments		1,650	2,320
		(c) Long-term loans and advances		1,600	1,400
	2	**Current assets**			
		(a) Inventories		4,000	3,200
		(b) Trade receivables		1,090	2,200
		(c) Cash and cash equivalents		540	750
		(d) Short-term loans and advances		1,700	200
		(e) Other current assets		550	600
		Total		**38,280**	**30,470**

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Notes on Accounts **(₹ in thousand)**

1. Reserve and Surplus	**31.03.15**	**31.03.14**
General Reserve	7,000	7,600
Profit & Loss A/c	1,200	1,000
Share Premium Accounts	1,500	750
Total	9,700	9,350

2. Long Term Borrowings	**31.03.15**	**31.03.14**
Secured loans	4,800	5,400
Unsecured loans	5,350	4,000
Deferred Credits	3,000	3,000
Total	13,150	12,400

3.Tangible Assets	**31.03.15**	**31.03.14**
Gross Block	22,400	17,000
Less: Accumulated Depreciation	3,450	3,200
Total	18,950	13,800

4.Long Term Loans Advances	**31.03.15**	**31.03.14**
Advance Taxes	1,600	1,400
Total	1,600	1,400

5. Other Current Liabilities	**31.03.15**	**31.03.14**
Outstanding expenses	880	120
Total	880	120

6. Short Term Provision	**31.03.15**	**31.03.14**
Proposed Dividend	3,400	1,600
Tax Provision	1,600	1,400
Total	5,000	3,000

6. Other Current Expenditure	**31.03.15**	**31.03.14**
Misc Expenditure	550	600
Total	550	600

Other Information:

(1) Fixed assets costing ₹ 4,00,000, accumulated depreciation ₹ 3,00,000 were sold for ₹ 1,50,000.

(2) Actual tax liability for 2013-14 was ₹ 14,00,000.

(3) Loans represent long term loans given to group companies.

(4) Interest on loan funds for 2014-15 was ₹ 18,41,000 and interest and dividend income were ₹ 4,02,000.

(5) Investments costing ₹ 20,00,000 were sold for ₹ 25,00,000.

Solution:

(₹ in thousand)

Cash flow from operating activities		
Change in general reserve	-600	
Change in profit and loss account	200	
Proposed dividend	3,400	
Provision for tax	1,600	
Profit before tax		4,600
Add : Depreciation	550	
Add : Misc. Expenses	50	
Add/(Less) Loss (profit) on sale of fixed assets	-50	
Add/(Less) Loss (profit) on sale of Investments	-500	50
Funds flow from operations		4,650
Add : Interest paid		1,841
Less : Interest and Dividend Received		-402
Add/Less Working Capital Adjustment		6,089
Inventories	-800	
Debtors	1,110	
Creditors	-550	
Outstanding expenses	760	520
Cash Flow from Operating Activities (Before tax)		6,609
Less : Advance tax for 2014-15		1,600
Cash flow from Operating Activities (After Tax)		5,009
Cash flow Financing Activities		
Issue of shares		
Face value	4,500	
Premium	750	5250
Repayment of Secured Loans	-600	
Raising of Unsecured Loans	1,350	
Net loan		750
Interest payment		-1,841
Dividend payment for 2013-14		-1,600
Cash flow from Financing Activities		2,559
Cash flow from Investment Activities		
Purchase of Fixed Assets	-5,800	
Sale of Fixed Assets	150	
Capital WIP	-2,200	
Fixed Assets (Net)		-7,850
Purchase of Investments	-1,330	
Sale Proceeds of Investments	2,500	
Investments (Net)		1,170
Loans		-1,500
Interest & Dividend Income		402
Cash flow from Investment Activities		-7,778
Cash Flow Statement		
Cash flow from Operating Activities (After Tax)		5,009
Cash flow from Financing Activities		2,559
Cash flow from Investment Activities		-7,778
Increase/decrease in Cash & Bank Balance		-210
Add: OP. Cash & Bank Balance		750
Closing Cash & Bank Balance		540

Illustration 4.

The following is the income statement XYZ Company for the year 2014-15:

			(₹)
Sales			1,62,700
Add: Equity In ABC Company's earning			6,000
			1,68,700
Expenses		(₹)	
Cost of goods sold		89,300	
Salaries		34,400	
Depreciation		7,450	
Insurance		500	
Research and development		1,250	
Patent amortisation		900	
Interest		10,650	
Bad debts		2,050	
Income tax :			
Current	6,600		
Deferred	1,550	8,150	
Total expenses			1,54,650
Net income			14,050

Additional informations are :

(i) 70% of gross revenue from sales were on credit.

(ii) Merchandise purchases amounting to ₹ 92,000 were on credit.

(iii) Salaries payable totaled ₹ 1,600 at the end of the year.

(iv) Amortisation of premium on bonds payable was ₹ 1,350.

(v) No dividends were received from the other company.

(vi) XYZ Company declared cash dividend of ₹ 4,000.

(vii) Changes in Current Assets and Current Liabilities were as follows:

	Increase (Decrease) ₹
Cash	500
Marketable securities	1,600
Accounts receivable	(7,150)
Allowance for bad debt	(1,900)
Inventory	2,700
Prepaid insurance	700
Accounts payable (for merchandise)	5,650
Salaries payable	(2,050)
Dividends payable	(3,000)

Prepare a statement showing the amount of cash flow from operations.

Solution:

Statement showing cash flow from Operations

	₹	₹
Cash flow from operations		
Cash sales (30% 1,62,700)	48,810	
Collection from debtors	1,20,890	
Total cash from operations		1,69,700
Uses of cash from operations		
Payment to suppliers	86,350	
Salaries expense	36,450	
Payment for insurance	1,200	
Research and development	1,250	
Interest payment	12,000	
Income tax payment	6,600	
Total operating cash payment		1,43,850
Net cash flow from operations		25,850

Notes:

		₹
(1)	Collection from debtors	
	Credit sales (70%× 1,62,700)	1,13,890
	Less : Bad debts (2,050 less 1,900)	150
		1,13,740
	Add : decrease in accounts receivables	7,150
	Collection from debtors on credit sales	1,20,890

(2) Dividends earned ₹ 6,000 on equity of ABC Company has not been considered as it has not been received in cash.

		₹
(3)	Payment to suppliers	
	Cost of goods sold	89,300
	Add: Increase in inventory	2,700
	Purchases	92,000
	Less: increase in accounts payable	5,650
	Payment to suppliers	86,350
(4)	Calculation of salaries payment	
	Salary expense	34,400
	Add : decrease in salary payable	2,050
	Payment of salaries	36,450
(5)	Insurance payments	
	Insurance	500
	Add : increase in prepaid insurance	700
	Payment for insurance	1,200
(6)	Interest payment	
	Interest expenses	10,650
	Add : Amortisation of bond premium	1,350
	Interest payments	12,000

		₹
(7)	Income tax payments	
	Income tax expense	8,150
	Less: Deferred tax	1,550
		6,600
	Changes in current tax payable	Nil
	Income tax payments	6,600

Illustration 5.

From the information contained in Income Statement and Balance Sheet of 'A' Ltd., prepare Cash Flow Statement:

Income Statement for the year ended March 31, 2015

		₹
Net Sales	(A)	2,52,00,000
Less:		
Cash Cost of Sales		1,98,00,000
Depreciation		6,00,000
Salaries and Wages		24,00,000
Operating Expenses		8,00,000
Provision for Taxation		8,80,000
	(B)	2,44,80,000
Net Operating Profit (A – B)		7,20,000
Non-recurring Income – Profits on sale of equipment		1,20,000
		8,40,000
Retained earnings and profits brought forward		15,18,000
		23,58,000
Dividends declared and paid during the year		7,20,000
Profit and Loss Account balance as on March 31, 2015		16,38,000

Name of the Company: A Ltd.
Balance Sheet as at : 31.03.15

					(₹ in Cores)
Ref No.	**Particulars**		**Note No.**	**As at 31.03.15**	**As at 31.03.14**
I		**EQUITY AND LIABILITIES**			
	1	**Shareholders' fund**			
		(a) Share capital		44,40,000	36,00,000
		(b) Reserves and surplus-		16,38,000	15,18,000
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**		NIL	
	4	**Current Liabilities**			
		(a) Trade payables		23,40,000	24,00,000
		(b) Other current liabilities		4,80,000	2,40,000
		(c) Short-term provisions		1,32,000	1,20,000
		Total		**90,30,000**	**78,78,000**
II		**ASSETS**			
	1	**Non-current assets**			
		(a) Fixed assets			

(₹ in Cores)					
Ref No.	Particulars		Note No.	As at 31.03.15	As at 31.03.14
		(i) Tangible assets		54,00,000	28,80,000
	2	**Current assets**			
		(a) Inventories		9,60,000	26,40,000
		(b) Trade receivables		18,60,000	16,80,000
		(c) Cash and cash equivalents		7,20,000	6,00,000
		(d) Short-term loans and advances		90,000	78,000
		Total		**90,30,000**	**78,78,000**

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Note on Accounts

1. Tangible Assets	**31.03.15**		**31.03.14**	
Land		9,60,000		4,80,000
Building and Equipments	57,60,000		36,00,000	
Less: Depreciation	13,20,000	44,40,000	12,00,000	24,00,000
Total		54,00,000		28,80,000

2.Short Term Provisions	**31.03.15**	**31.03.14**
Income Tax Payable	1,32,000	1,20,000
Total	1,32,000	1,20,000

3. Other Current Liabilities	**31.03.15**	**31.03.14**
Outstanding Expenses	4,80,000	2,40,000
Total	4,80,000	2,40,000

4. Short Term Loans and Advances	**31.03.15**	**31.03.14**
Advances	90,000	78,000
Total	90,000	78,000

The original cost of equipment sold during the year 2014-15 was ₹ 7,20,000.

Solution:

Cash Flow Statement of Company A Ltd. for the year ending March 31, 2015

Cash flows from Operating Activities

	₹
Net Profits before Tax and Extra-ordinary Item	16,00,000
Add: Depreciation	6,00,000
Operating Profits before Working Capital Changes	22,00,000
Increase in Debtors	(1,80,000)
Decrease in Stock	16,80,000
Increase in Advances	(12,000)
Decrease in Sundry Creditors	(60,000)
Increase in Outstanding Expenses	2,40,000
Cash Generated from Operations	38,68,000
Income tax Paid	8,68,000
Net Cash from Operations	30,00,000

Cash flows from Investment Activities

	₹
Purchase of Land	(4,80,000)
Purchase of Buildings and Equipment	(28,80,000)
Sale of Equipment	3,60,000
Net Cash used in Investment Activities	(30,00,000)

Cash flows from Financing Activities

	₹
Issue of Share Capital	8,40,000
Dividends Paid	(7,20,000)
Net Cash from Financing Activities	1,20,000
Net increase in Cash and Cash Equivalents	1,20,000
Cash and Cash Equivalents at the beginning	6,00,000
Cash and Cash Equivalents at the end	7,20,000

Buildings and Equipment Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d	36,00,000	By Sale of Asset	7,20,000
To Cash/Bank (purchase) (Balancing figure)	28,80,000	By Balance c/d	57,60,000
	64,80,000		64,80,000

Accumulated Depreciation on Buildings and Equipment Account

Dr. **Cr.**

	₹		₹
To Sale of Asset		By Balance b/d	12,00,000
(Accumulated depreciation)	4,80,000	By Profit and Loss (Provisional)	6,00,000
To Balance c/d	13,20,000		
	18,00,000		18,00,000

Sale of Asset Account

	₹
Original Cost	7,20,000
Less: Accumulated Depreciation	4,80,000
Net Cost	2,40,000
Profit on Sale of Asset	1,20,000
Sale Proceeds from Asset Sales	3,60,000

Illustration 6:

X Ltd. has the following balances as on 1st April, 2014

	₹
Fixed Assets	11,40,000
Less; Depreciation	3,99,000
	7,41,000
Stocks and Debtors	4,75,000
Bank Balance	66,500
Creditors	1,14,000
Bills payable	76,000
Capital (Shares of ₹ 100 each)	5,70,000

The Company made the following estimates for financial year 2014-15:

(i) The company will pay a free of tax dividend of 10% the rate of tax being 25%.

(ii) The company will acquire fixed assets costing ₹1,90,000 after selling one machine for ₹ 38,000 costing ₹ 95,000 and on which depreciation provided amounted to ₹ 66,500.

(iii) Stocks and Debtors, Creditors and Bills payables at the end of financial year are expected to be ₹ 5,60,500, ₹ 1,48,200 and ₹ 98,800 respectively.

(iv) The profit would be ₹ 1,04,500 after depreciation of ₹ 1,14,000.

Prepare the projected cash flow statement and ascertain the bank balance of X Ltd. at the end of Financial year 2014-15.

Solution:

Working:

(i)	Cash Flow from operations	₹
	Profit for the year	1,04,500
	Add: Depreciation (non cash item)	1,14,000
		2,18,500
	Less: Profit on sale of machine	9,500
		2,09,000
	Add increase in:	
	Creditors (₹ 1,48,200 – ₹ 1,14,000) = ₹ 34,200	
	Bills payable (₹ 98,800 – ₹ 76,000) = ₹ 22,800	57,000
		2,66,000
	Less : Increase in stocks & debtors (₹ 5,60,500 – ₹ 4,75,000)	85,500
	Cash from operations	1,80,500
(ii)	Payment of Dividend	
	10% on capital ₹ 5,70,000 = ₹ 57,000	
	Gross up Amount	
	Total Dividend	₹ 76,000
	Tax 25%	₹ 19,000
	Payment of Dividend	₹ 57,000

Note: Income Tax on Company's Profit Ignored

Projected Cash Flow Statement
for the Year ending on 31st March, 2015

		₹	₹
Bank Balance as on 1st April, 2014			66,500
Add:	Inflow of Cash		
	Sale of Machine	38,000	
	Cash From operation	1,80,500	2,18,500
Less:	Outflow of Cash		2,85,000
	Purchase of Fixed Assets	1,90,000	
	Payment of Dividend	57,000	
	Tax Paid	19,000	2,66,000
Bank Balance on 31st March, 2015			19,000

Illustration 7. Astor Limited had the following condensed Trial Balance as at 31-03-2014:

Dr. **Cr.**

Particulars	**Amount** ₹	**Particulars**	**Amount** ₹
Cash	7,500	Current Liabilities	15,000
Account Receivable	30,000	Long-Term Notes Payable	25,500
Investments	20,000	Bonds Payable	25,000
Plant Assets	67,500	Capital Stock	75,000
Land	40,000	Retained Earnings	24,500
	1,65,000		1,65,000

During 2014-2015, the following transactions took place :

(i) A tract of land was purchased for ₹ 7,750 cash.

(ii) Bonds payable in the amount of ₹ 6,000 were retired for cash at face value.

(iii) An additional ₹ 20,000 equity shares were issued at par for cash.

(iv) Dividends totalling ₹ 9,375 were paid.

(v) Net income for 2014-2015 was ₹ 28,450 after allowing for depreciation of ₹ 9,500.

(vi) Land was purchased through the issuance of ₹ 22,500 in bonds.

(vii) Usha Ltd. sold a part of its investments portfolio for ₹ 12,875 cash. The transaction resulted in a gain of ₹ 1,375 for the firm.

(viii) Current liabilities increased to ₹ 18,000 at 31-3-2015.

(ix) Accounts receivable at 31-3-2015 total ₹ 38,000.

Prepare a statement of cash flows for 2014-2015 with the indirect method as per AS-3 (Revised).

Solution :

Cash Flow Statement for the year ended 31-03-2015

Cash Flows from Operating Activities		
Net Profit	28,450	
Add : Depreciation	9,500	
Less : Gain on Sale of Investment	(1,375)	
Operating Profit before Working Capital changes	36,575	
Add : Increase in current liabilities	3,000	
Less : Increase in accounts receivable	(8,000)	
Net Cash from operating activities		31,575
Cash Flows from Investing activities		
Sale of Investment	12,875	
Purchase of Land (For cash only)	(7,750)	
Net Cash from investing activities		5,125
Cash Flows from Financing Activities		
Issue of shares	20,000	
Redemption of Bonds	(6,000)	
Dividend Paid	(9,375)	
Net Cash from financing activities		4,625
Net Increase in cash and cash equivalents during the period		41,325
Add : Cash and cash equivalents in the beginning of the period		7,500
Cash and cash equivalents at the end of the period		48,825

Note : Significant Non-cash Transactions : Purchase of land by issue of bonds ₹ 22,500.

Illustration 8. From the following information, prepare cash flow statement by using indirect method as per AS-3.

Name of the Company :

Balance Sheet as at 30th June,2015 :

Ref No.	Particulars		Note No.	As at 30 th June, 2015	As at 31st June, 2015
				(₹)	(₹)
I		**EQUITY AND LIABILITIES**			
	1	**Shareholders' fund**			
		(a) Share capital		50,00,000	50,00,000
		(b) Reserves and surplus-		36,90,000	26,50,000
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**		NIL	
	4	**Current Liabilities**			
		(a) Short-term borrowings		12,00,000	1,50,000
		(b) Trade payables		8,20,000	8,80,000
		(c)Other current liabilities		4,70,000	3,30,000
		(d) Short-term provisions		3,00,000	1,50,000
		Total		**1,14,80,000**	**91,60,000**
II		**ASSETS**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets		38,40,000	21,20,000
	2	**Current assets**			
		(a)Current investments		15,00,000	11,80,000
		(b) Inventories		19,20,000	20,10,000
		(c) Trade receivables		26,40,000	22,40,000
		(d) Cash and cash equivalents		18,20,000	15,20,000
		(e) Other current assets		1,20,000	90,000
		Total		**1,14,80,000**	**91,60,000**

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Notes on Accounts (₹)

1. Short Term Borrowings	**30.06.2014**	**30.06.2015**
Debentures	-	9,00,000
Bank Loan	1,50,000	3,00,000
Total	1,50,000	12,00,000

2. Other Current Liabilities	30.06.2014	30.06.2015
Liabilities for Expenses	3,30,000	2,70,000
Creditors for plant and Machinery Purchased		2,00,000
Total	3,30,000	4,70,000

3.Plant and Machinery	30.06.2014	30.06.2015
Plant and Machinery	27,30,000	42,70,000
Less: Depreciation	6,10,000	7,90,000
Total	21,20,000	38,40,000

4.Debtors	30.06.2014	30.06.2015
Debtors	23,90,000	28,30,000
Less: Provision	1,50,000	1,90,000
Total	22,40,000	26,40,000

5. Current Investment	30.06.2014	30.06.2015
Marketable Securities	11,80,000	15,00,000
Total	11,80,000	15,00,000

6. Other Current Assets	30.06.2014	30.06.2015
Prepaid Expenses	90,000	1,20,000
Total	90,000	1,20,000

Additional Information:

(1) Net Income for the year ended 30.06.2015, after charging depreciation ₹ 1,80,000 is ₹ 22,40,000.

(2) Debtors of ₹ 2,30,000 were determined to be worthless and were written off against the provisions for doubtful debts account.

(3) The Board of Directors declared dividend of ₹ 12,00,000.

Note : Marketable securities are treated as cash equivalents.

Solution:

Cash Flow Statement for the year ended 30-06-2015

Cash Flows from Operating Activities		
Net Income		22,40,000
Add: Depreciation		1,80,000
		24,20,000
Add: Decrease in Inventories		90,000
Increase in Provision for Doubtful Debts*		40,000
		25,50,000

Less: Increase in Current Assets:		
Debtors*		(4,40,000)
Prepaid Expenses		(30,000)
Decrease in Current Liabilities:		
Creditors		(60,000)
Expenses Outstanding		(60,000)
Net Cash from Operating Activities (a)		19,60,000
Cash Flows from Investing Activities		
Payment for Purchase of Plant & Machinery (15,40,000–2,00,000)	(13,40,000)	
Cash outflow from Investing Activities (b)		(13,40,000)
Cash Flows from Financing Activities		
Bank Loan Raised	1,50,000	
Issue of Debentures	9,00,000	
Payment of Dividend	(10,50,000)	
Cash flows from Financing Activities (c)		—
Net Increase in cash and Cash equivalents during the year (a+b+c)		6,20,000
Add : Opeaning balance of cash and cash equivalents		27,00,000
Cash balance as on 30-6-2015		33,20,000

* Alternatively, provision for doubtful debts created (₹ 40,000) + ₹ 2,30,000 (Bad Debts) may be added. In that case, increase in debtors (including bad debts written off) ₹ 6,70,000 (₹ 4,40,000 + ₹ 2,30,000) is subtracted. However, net effect will remain same. It is only a matter of presentation. Adjustment for interest on bank loan is ignored as rate of interest is not given.

Illustration 9. From the following balance sheets of X Ltd. and additional information, prepare statement of changes in financial position (working capital basis) :

Name of the Company : X Ltd.
Balance Sheet as at :

(₹ In '000)

Ref No.		Particulars	Note No.	Current Reporting Period	Previous Reporting Period
I		**EQUITY AND LIABILITIES**			
	1	**Shareholders' fund**			
		(a) Share capital		3,50,000	2,50,000
		(b) Reserves and surplus-		1,65,000	1,30,000
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**		NIL	
	4	**Current Liabilities**			
		(a)Other current liabilities		1,20,000	90,000
		(b) Short-term provisions		95,000	70,000
		Total		**7,30,000**	**5,40,000**

(₹ In '000)

Ref No.	Particulars		Note No.	Current Reporting Period	Previous Reporting Period
II		**ASSETS**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets		3,95,000	2,90,000
		(ii) Intangible assets		50,000	60,000
	2	**Current assets**			
		(a) Cash and cash equivalents		55,000	20,000
		(b) Other current assets		2,30,000	1,70,000
		Total		**7,30,000**	**5,40,000**

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Notes on Accounts (₹ In '000)

1. Short Term Provisions	**Current Reporting Period**	**Previous Reporting Period**
Proposed Dividend	35,000	20,000
Provision for Tax	60,000	50,000
Total	95,000	70,000

2.Fixed Assets	**Current Reporting Period**	**Previous Reporting Period**
Fixed Assets	3,95,000	2,90,000
Total	3,95,000	2,90,000

4.Goodwill	**Current Reporting Period**	**Previous Reporting Period**
Goodwill	50,000	60,000
Total	50,000	60,000

Additional Information:

(i) Depreciation on fixed assets provided during the year ₹ 30,000; Net profit during the year ₹ 80,000; Income-tax paid ₹ 50,000; Final dividend paid ₹ 20,000; Interim dividend was also paid.

(ii) Fixed asset costing ₹ 60,000 (accumulated depreciation ₹ 35,000) sold for ₹ 30,000.

(iii) Fixed asset costing ₹ 50,000 was purchased by issue of Share Capital.

Solution :

Cash Flow Statement for the year ended ....

Cash Flows from Operating Activities		
Net profit for the year	80,000	
Adjustment for:		
Provision for taxation (closing)	60,000	
Depreciation	30,000	
Goodwill written off	10,000	
Profit on sale of fixed assets	(5,000)	
Operating profit before working capital changes	1,75,000	
Add : Increase in current liabilities	30,000	
Less : Increase in current assets (excluding cash and cash equivalent [(2,85,000–55,000)] – [1,90,000–20,000]	(60,000)	
Cash provided by operations	1,45,000	
Less : Tax paid	50,000	
Net cash flow provided by operating activities		95,000
Cash Flows from Investing Activities		
Sale of Fixed Assets	30,000	
Purchase of Fixed Asset	(1,10,000)	
Net cash used in investing activities		(80,000)
Cash Flows from Fianancing Activities		
Issue of shares for cash	50,000	
Payment of Final Dividend	(20,000)	
Payment of Interim Dividend	(10,000)	
Net cash flow from financing activities		20,000
Net increase in cash during the year		35,000
Add opening balance of cash and cash equivalents		20,000
Closing balance of cash and cash equivalents		55,000

Note: Significant non-cash trasnsactions: Fixed assets worth ₹ 50,000 purchased by issue of shares.

Working Notes:

Dr. **Fixed Assets Account** **Cr.**

To Balance b/d	2,90,000	By Bank A/c (Sale)	30,000
To Share capital A/c	50,000	By Depreciation A/c	30,000
To Profit & Loss A/c (Profit on sale)	5,000	By Balance c/d	3,95,000
To Bank A/c (balance figure) - Purchase	1,10,000		
	4,55,000		4,55,000

Calculation of Funds from Operating Activities

	₹
Net Profit for the year	80,000
Add : Depreciation on Fixed Assets	30,000
Provision for Taxation (Closing balance)	60,000
Goodwill written off (60,000 – 50,000)	10,000
Less : Profit on sale of Fixed Assets	1,80,000
Funds from Operating Activities before Tax	5,000
	1,75,000

Dr. Reserves Account Cr.

To Proposed Dividend	35,000	By Balance b/d	1,30,000
To Interim Dividend (balancing fig.)	10,000	By Net Profit	80,000
To Balance c/d	1,65,000		
	2,10,000		2,10,000

Illustration 10. The balance sheet of Hari Ltd. for 2014 and 2015 are given below:

Name of the Company : Hari Ltd.

Balance Sheet as at :

Ref No.		Particulars	Note No.	31.12.2015	31.12.2014
				(₹)	**(₹)**
I		**EQUITY AND LIABILITIES**			
	1	**Shareholders' fund**			
		(a) Share capital		8,00,000	6,00,000
		(b) Reserves and surplus-		5,70,000	4,60,000
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**		NIL	
	4	**Current Liabilities**			
		(a) Short-term borrowings		2,80,000	4,00,000
		(b)Other current liabilities		2,68,000	2,40,000
		(c) Short-term provisions		2,42,000	2,40,000
		Total		**21,60,000**	**19,40,000**
II		**ASSETS**			
	1	Non-current assets			
		(a) Fixed assets			
		(i) Tangible assets		13,20,000	11,40,000
	2	**Current assets**			
		(a) Other current assets		6,80,000	6,00,000
		Total		**21,60,000**	**19,40,000**

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Notes on Accounts (₹)

1. Reserve and Surplus	**31.12.2015**	**31.12.2014**
Capital Reserve	20,000	
General Reserve	4,00,000	3,40,000
Profit and Loss	1,50,000	1,20,000
Total	5,70,000	4,60,000

2. Short Term Borrowings	31.12.2015	31.12.2014
Debentures	2,80,000	4,00,000
Total	2,80,000	4,00,000

3.Other current Liabilities	31.12.2015	31.12.2014
Current liabilities	2,60,000	2,40,000
Unpaid Dividends	8,000	
Total	2,68,000	2,40,000

4.Short Term Provision	31.12.2015	31.12.2014
Proposed Dividend	72,000	60,000
Provision for Tax	1,70,000	1,80,000
Total	2,42,000	2,40,000

5. Fixed Assets	31.12.2015	31.12.2014
Fixed Assets	19,00,000	16,00,000
Less: Depreciation	5,80,000	4,60,000
Total	13,20,000	11,40,000

6. Other Current Assets	31.12.2015	31.12.2014
Current Assets	6,60,000	5,60,000
Prepaid Expenses	20,000	40,000
Total	6,80,000	6,00,000

Additional Information:

During the year 2015, the Company:

1. Sold one machine for ₹ 50,000, the cost of which was ₹ 1,00,000 and the depreciation provided on it was ₹ 40,000;
2. Provided ₹ 1,80,000 as depreciation;
3. Sold some investment at a profit of ₹ 20,000, which was credited to Capital Reserve;
4. Redeemed 30% of the Debentures @ 105;
5. Decided to value stock at cost, whereas previously the practice was to value stock at cost less 10%. The stock according to books on 31-12-2014 was ₹ 1,08,000. The stock on 31-12-2015 was correctly valued at ₹ 1,50,000; and
6. Decided to write of fixed assets costing ₹ 28,000 on which depreciation amounting to ₹ 20,000 has been provided.

Prepare cash flow statement using indirect method. Assume that investments are long-term investments and current assets in the beginning of and at the end of the year do not include cash and bank balance.

Solution:

Cash Flow Statement for the year ended ....

Cash Flow from Operating Activities		
Cash flow before working capital chages	5,44,000	
Add: Increase in current Liabilities	20,000	
	5,64,000	
Less: Increase in Current Assets (6,60,000–5,72,000)	(88,000)	
Cash generated by operations	4,76,000	
Less: Tax paid	(1,80,000)	
		2,96,000
Net Cash flow provided by operating activities		
Cash flow from Investing Activities		
Purchase of Fixed Asset	(4,28,000)	
Sale of Fixed Asset	50,000	
Sale of Investment	60,000	
Net Cash flow used in investing activites		(3,18,000)
Cash Flow from Financing Activities		
Issue of share capital	2,00,000	
Redemption of Debentures	(1,26,000)	
Dividend Paid	(52,000)	
Net Cash flow provided by financing activities		22,000
Net increase (decrease) in cash and Cash Equivalents during the year		—
Add : Balance in the beginning		—
Balance of Cash and Cash equivalents at the end of the year		—

Working Notes:

Calculation of Funds from Operation before tax

Increase in Profit and Loss A/c [1,50,000 – (1,20,000 + 12,000)]	18,000
Add: Transfer to general reserve	60,000
Prepaid Expenses written off	20,000
Depreciation	1,80,000
Loss on sale of machine	10,000
Decrease in fixed assets (28,000 – 20,000)	8,000
Premium on redemption of debentures	6,000
Proposed dividend	72,000
Provision for tax	1,70,000
Funds from operating activities before tax	5,44,000

Dr. Fixed Assets Account Cr.

To Balance b/d	16,00,000	By Asset Disposal A/c	1,00,000
To Bank A/c (balancing fig.)	4,28,000	By Asset Disposal A/c	28,000
		By Balance c/d	19,00,000
	20,28,000		10,28,000

Sale of Investment = Decrease in balance + Gain on sale

= (2,00,000 – 1,60,000) + 20,000 = ₹ 60,000

Loss on Sale of fixe Assets = Cost – Accumulated Depreciation – Sale Price

= 1,00,000 – 40,000 – 50,000 = ₹ 10,000

3. Unpaid dividend is taken as non-current item and dividend paid is shown on the application side. Alternatively, unpaid dividend may be taken as current liability and dividend declared (paid plus unpaid) is shown as application of funds.
4. Revaluation of stock will increase opening stock by ₹ 12,000 and also the opening balance of profit and loss account by ₹ 12,000. The opening balance of profit and loss account after revaluation of stock will be ₹ 1,32,000 (1,20,000 + 12,000).
5. Working capital at the end = 6,60,000 – 2,60,000 = 4,00,000

   Working capital in the beginning = (5,60,000 + 12,000) – 2,40,000 = 3,32,000

   68,000

Illustration 11. Examine the following schedule prepared by K Ltd.:

Schedule of funds provided by operations for the year ended 31st July, 2015

(₹ '000)

Sales		32,760	
Add: Decrease in bills receivable		1,000	
Less: Increase in accounts receivable		(626)	
Inflow from operating revenues			33,134
Cost of goods sold	18,588		
Less: Decrease in inventories	(212)		
Add: Decrease in trades payable	81	18,457	
Wages and Salaries	5,284		
Less: Increase in wages payable	(12)		
Administrative Expenses	3,066		
Add: Increase in repaid expenses	11	3,077	
Property taxes		428	
Interest expenses	532		
Add: Amortisation of premium on bonds payable	20	552	
Outflow from operating expenses			27,786
Net inflow from operations			5,384
Rent Income	207		
Add: Increase in unearned rent	3		210
			5,558
Income-tax	1,330		
Less: Increase in deferred tax	50		1,280
Funds from operations			4,278

Required:

(i) What is the definition of funds shown in the schedule?
(ii) What amount was reported as gross margin in the income statement?
(iii) How much case was collected from the customers?
(iv) How much cash was paid for the purchases made?
(v) As a result of change in inventories, did the working capital increase or decrease and by what amount?
(vi) How much rent was actually earned during the year?
(vii) What was the amount of tax expenses reportd on the income statement?
(viii) Which method of calculating funds from operation is used?
(ix) Can you reconcile the profit after tax with the funds provided by the operations?

Solution:

(i) 'Funds' shown in the schedule refer to the cash and cash equivalents as defined in AS-3 (Revised) on 'Cash Flow Statement'.

(ii)

Gross Margin In The Income Statement **(₹ '000)**

Sales	32,760
Cost of goods sold	18,588
	14,172

(iii)	Cash collected from the customers	33,134
(iv)	Cash paid for purchases made	18,457
(v)	Change in inventories would reduce the working capital by	212
(vi)	Rental income earned during the year	207
(vii)	Tax expenses reported in the income statement	1330

(viii) Direct method of calculating cash flow from operating activities is used.

Reconciliation of Profit after Tax with Cash Funds

Profit after tax	3,719
Decrease in bills receivable	1,000
Increase in accounts receivable	(626)
Decrease in inventories	212
Decrease in trades payable	(81)
Increase in wages payable	12
Increase in prepaid expenses	(11)
Increase in unearned rent	3
Increase in deferred tax	50
Funds (i.e. cash and cash equivalents) from operations as shown in the schedule	4,278

Working Notes :

(i)

Calculation of Profit after Tax **(₹ '000)**

Sales		32,760
Less: Cost of goods sold		18,588
Gross margin		14,172
Add: Rental income		207
		14,379
Less: Wages and salaries	5,284	
Administrative expenses	3,066	
Property taxes	428	
Interest expenses	532	
Amortisation of premium on bonds payable	20	
		9,330
Profit before tax		5,049
Less: Income-tax		1,330
Profit after tax		3,719

(ii) Amortisation of premium payable on bonds is not an operating transaction. It should be taken as part of financing activities. Further, it is assumed that premium amortised was paid during the year and, therefore, it is a cash item affecting flow of cash.

Illustration 12. From the following information prepare cash flow statement:

Name of the Company :

Balance Sheet as at 31-12-2014 and 31-12-2015

(₹ in thousands)

Ref No.	Particulars		Note No.	31.12.2015	31.12.2014
I		**EQUITY AND LIABILITIES**			
	1	**Shareholders' fund**			
		(a) Share capital		1,500	1,250
		(b) Reserves and surplus		3,410	1,380
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**		NIL	
		(a) Long-term borrowings		1,110	1,040
	4	**Current Liabilities**			
		(a) Trade payables		150	1,890
		(b)Other current liabilities		230	100
		(c) Short-term provisions		400	1,000
		Total		**6,800**	**6,660**
II		**ASSETS**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets		730	850
		(b) Non-current investments		2,500	2,500
	2	**Current assets**			
		(a)Current investments		670	135
		(b) Inventories		900	1,950
		(c) Trade receivables		1,700	1,200
		(d) Cash and cash equivalents		200	25
		Total		**6,800**	**6,660**

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Notes on Accounts

(₹ in thousands)

1. Other Current Liabilities	**31.12.2015**	**31.12.2014**
Interest Payable	230	100
Total	230	100

2.Short Term Provision	**31.12.2015**	**31.12.2014**
Income Tax Payable	400	1,000
Total	400	1,000

(₹ in thousands)

3. Fixed Assets	31.12.2015	31.12.2014
Fixed Assets at cost	2,180	1,910
Less: Accumulated Depreciation	1,450	1,060
Total	730	850

4. Other Current Assets	31.12.2015	31.12.2014
Interest Receivable	100	-
Total	100	-

Statement of Profit and Loss for the year ended 31-12-2015 (₹ in thousands)

Sales	30,650
Cost of sales	(26,000)
Gross profit	4,650
Depreciation	(450)
Administration and selling expenses	(910)
Interest expenses	(400)
Interest income	300
Dividend income	200
Foreign exchange loss	(40)
Net profit before taxation and extraordinary item	3,350
Extraordinary item - Insurance proceeds from earthquake disaster settlement	180
Net profit afte extraordinary item	3,530
Income-tax	(300)
Net profit	3,230

Additional information (₹ in thousands) :

(a) An amount of ₹ 250 was raised from the issue of share capital an a further ₹ 250 was raised from long-term borrowings.

(b) Interest expense was ₹ 400 of which ₹ 170 was paid during the period. ₹ 100 relating to interest expenses of the prior period was also paid during the period.

(c) Dividends paid were ₹ 1,200.

(d) Tax deducted at source on dividends received (included in the tax expenses of ₹ 300 for the year) amounted to ₹ 40

(e) During the period, the enterprise acquired fixed assets for ₹ 350. The payment was made in cash.

(f) Plant with original cost of ₹ 80 and accumulated depreciation of ₹ 60 was sold for ₹ 20.

(g) Foreign exchange loss of ₹ 40 represents reduction in the carrying amount of a short-term investment in foreign currency designated bonds arising out of a change in exchange rate between the date of acquisition of the investments and the balance sheet date.

(h) Sundry debtors and sundry creditors include amounts relating to credit sales and credit purchases only.

Solution :

Cash Flow Statement (Direct Method) **(₹ in thousand)**

Cash Flows from Operating Activities:		
Cash receipts from customers	30,150	
Cash paid to suppliers and employees	(27,600)	
Cash generated from operations	2,550	
Income taxes paid	(860)	
Cash flow before extraordinary item :	1,690	
Proceeds from earthquake disaster settlement	180	
Net cash from operating activities (a)		1,870
Cash Flows from Investing Activities:		
Purchase of fixed assets	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividend received	160	
		30
Net cash from investing activities (b)		
Cash Flows from Financing Activities:		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowing	250	
Repaymants of long-term borrowings	(180)	
Interest paid	(270)	
Dividend paid	(1,200)	
Net cash used in financing activites (c)		(1,150)
Net increase in cash and cash equivalents		750
Add: Cash and cash equivalents at beginning of period		160
Cash an cash equivalents at end of period		910

Cash Flow Statement (Indirect Method)

Cash flows from Operating Activities		
Net profit before taxation, and extraordinary item	3,350	
Adjustments for:		
Depreciation	450	
Foreign exchange loss	40	
Interest income	(300)	
Dividend income	(200)	
Interest expenses	400	
Operating profit before working capital changes	3,740	
Increase in sundry debtors	(500)	
Decrease in inventories	1,050	
Decrease in sundry creditors	(1,740)	
Cash generated from operations	2,550	
Income taxes paid	(860)	
Cash flow before extraordinary item :	1,690	
Proceeds from earthquake disaster settlement	180	

Net cash from operating activities		1,870
Cash Flows from Investing Activities		
Purchase of fixed assets	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividend received	160	
Net cash from investing activities		30
Cash Flows from Financing Activities:		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Repayment of long-term borrowings	(180)	
Interet paid	(270)	
Dividends paid	(1,200)	
Net cash used in financing acitivities		(1,150)
Net increase in cash and cash equivalents		750
Cash and cash equivalents at beginning of period		160
Cash and cash equivalents at end of period		910

Working Notes :

1. **Cash and Cash Equivalents**

   Cash and cash equivalents consist of cash on hand and balance with banks, and investments in money-market instruments. Cash and cash equivalents included in the cash flow statement comprise the following balance sheet amounts :

Particulars	**2015**	**2014**
Cash on hand and balances with banks	200	25
Short-term investments	670	135
Cash and cash equivalents	870	160
Effect of exchange rate changes	40	
Cash and cash equivalents as restated	910	160

   Cash an cash equivalents at the end of the period include deposits with banks of 100 held by a branch which are not freely remissible to the company because of currency exchange restrictions. The company has undrawn borrowing facilities of 2,000 of which 700 may be used only for future expansion.

2. **Total tax paid during the year** (including tax deducted at source on dividends received) amounted to 900.

3. **Cash receipts from customers**

Sales	30,650
Add : Sundry debtors at the beginning of the year	1,200
	31,850
Less : Sundry debtors at the end of the year	1,700
	30,150

4. Cash paid to suppliers and employees

Cost of sales			26,000
Administrative & selling expenses			910
			26,910
Add :	Sundry creditors at the beginning of the year	1,890	
	Inventories at the end of the year	900	2,790
			29,700
Less :	Sundry creditors at the end of the year	150	
	Inventories at the beginning of the year	1,950	2,100
			27,600

5. Income taxes paid (including tax deducted at source from dividends received)

Income tax expenses for the year (includin tax) deducted at source from dividends received)	300
Add : Income tax liability at the beginning of the year	1,000
	1,300
Less : Income tax liability at the end of the year	400
	900

Out of 900, tax deducted at source on dividends received (amounting to 40) is included in cash flows from investing activities and the balance of 860 is included in cash flows from operating activities.

6. Repayment of long-term borrowing

Long-term debt at the beginning of the year	1,040
Add : Long-term borrowings made during the year	250
	1,290
Less : Long-term borrowings at the end of the year	1,110
	180

7. Interest Paid

Interest expenses for the year	400
Add : Interest payable at the beginning of the year	100
	500
Less : Interest payable at the end of the year	230
	270

Study Note - 6

SEGMENTAL REPORTING

This Study Note includes

6.1 Need for Segmental Reporting
6.2 International Scenario
6.3 The Indian Scenario
6.4 Segmental Reporting Problems & Difficulties
6.5 Specific Issues Relating to Management Accounts
6.6 Segmental Disclosure – A practical example

Introduction

Segmental reporting or segment reporting or line of business reporting or product line reporting is a dimension of corporate financial reporting due to diversification of industry activities into different products, geographical networks and market segments, etc.

The major purpose of segment information is to assist financial statement users in analysing and understanding the enterprise's financial statements by permitting better assessment of the enterprise's past performance and future prospects.

A company wide income statement provides only a summary of overall operations; as such, it typically does not contain enough detail to allow the manager to detect opportunities and problems that may exist in the organization. To operate effectively, managers need more information at their disposal than is available in a single company wide income statement.

6.1 NEED FOR SEGMENTAL REPORTING

In recent times it has become evident that many companies have grown much larger and more diversified. The size and relative importance of diversified companies has in turn, presented many problems for the users of accounts. Shareholders are interested in the future cash flows they may obtain from investing in a company and the risk or uncertainty of these cash flows. They are therefore interested in the performance of a company as a whole rather than the performance of any specific part of the company. However, this does not mean that only consolidated information is of value to them. Both the size and uncertainty of future cash flows are likely to be affected by many factors. Different industries have different profit potentials, degrees and types of risk, and growth opportunities. Different rates of return on investment and different capital needs are also likely to occur across the various segments of a business. Because of this diversification of operations , there has been a demand for companies also to report key disaggregated information, especially turnover and profits. Such disaggregated or segmented data is typically provided for both geographical areas and lines of business.

Segmented information is likely to aid shareholders by allowing them to combine company specific information with external information and so allow a more accurate assessment of both the risk and potential for future growth.

In addition, an idea of the success of past operations can be gained by the company with others, i.e. whether or not a company has done better than other similar companies. However, for most diversified companies, such external yardsticks are not available. In principle, the provision of disaggregated data may allow shareholders to compare the success of individual segments with those of other companies. However, given the very large degree of latitude, that companies have in deciding upon what constitutes a reportable segment, such an advantage of comparability may be more apparent than real. This is especially the case when comparing profit measures, as not only is there discretion in the choice of segments but also discretion in the methods used for common cost allocations and transfer pricing.

Other users often have a direct relationship not with the company as a whole, but with a part of the company. Disaggregated data regarding the performance of that segment of the company would then be relevant. This would apply to employees, creditors and host governments. All of those groups are likely to be interested, therefore, not only in a company as a whole but also in that sector of a company that most affects themselves. They will often require information that is even more disaggregated than that currently provided, e.g. employees will also want information at the plant level, host governments at the individual country level and creditors at the level of the individual subsidiary or legal entity. However, segmentally disaggregated information will go at least some way towards meeting these information needs.

This is especially important for those groups who often lack the power to demand specific information that is of relevance to them in particular.

It is now strongly felt that enterprises whose securities are publicly traded and other economically significant entities should disclose, as a supplement to the traditional financial statements, certain significant information for the industry segments and geographical segments. Past data are used for projecting the future. Investors -both existing and potential, lenders, employees and many others want to know the future prospects of the reporting entity, which is traditionally projected on the basis of available, aggregated financial information. However the corporate analysts would generally agree that their efforts to predict future earnings of a diversified company is seriously handicapped owing to company's non disclosure of financial information by important segments.

It is highly absurd to project earnings of a company which come from paper, chemicals, glass, food products and steel without understanding the relative contribution of different segments. The price earnings ratio (P/E) is an important fundamental indicator which the investors mostly watch. However, price earnings multiples are affected by risk and prospect for future growth in earnings. These factors vary among different industries and markets and also changes with time. Thus in the absence of segmental information the analysts hobble around blindly. A segmental reporting system can effectively subserve the information needs of user groups adequately.

The need for disclosure of the operations of the major segments of diversified firms and firms with geographical or customer segmented markets arose because the differing rates of growth, profitability and degrees of risk of various segments cannot be evaluated and analysed effectively from aggregated data. Disaggregation of financial data is necessary to permit the prediction of future return and risk for well informed decision making for capital investments The consolidated reports of diversified companies could not meet the needs of investors, creditors or antitrust authorities. Consolidated data provided becomes inadequate. By analysing segment information one may discover that the major portion of the company's earnings are in high risk area, or that the growth of certain segments has virtually stopped. So users can come to know the performance of each material segment and its importance relative to the company as a whole. Thus, the extended disclosure of segment information is necessary for proper evaluation of management ability in a highly decentralised company, its competitive position and its internal stability.

Arguments Against Segmental Reporting

The arguments against segmental reporting can be enumerated as below

(i) It is generally felt that segmental revenues and expenses are not distinguishable objectively in many cases. Revenues of a weak product line may be derived only because of the existence of a strong product line. Also many joint costs are only separable arbitrarily.

(ii) Much of segmental results depend on the inter-departmental transfer pricing which are not always logically established.

(iii) Various segments of an enterprise may use common resources which makes it difficult to arrive at a segment wise performance ratio.

(iv) Since the users are in no position to know the proper base for cost allocation the segment results would be less than meaningful.

(v) The last argument consists of the competitive implications of the firm. Some academics content that company secret will be disclosed while others referred to the competitive hardship suffered by some firms if segmented data is required. Suppose that Company X, a small company, has a segment identical to one in Company Y, a huge conglomerate. Company X would have to disclose the segment while Company Y would not because the segment is not considered material to Y's operations.

However, considering the problems of joint allocation, often it is suggested to follow a contribution margin approach for reporting segmental results. By this only identifiable costs are deducted from segment revenues and gross segment margins may only be indicated. But for all practical purposes, this becomes a useless exercise when proportion of identifiable cost is insignificant.

6.2 INTERNATIONAL SCENARIO

In 1967 the Accounting Principles Board issued a statement urging companies to disclose segment information voluntarily. In 1969 the Securities Exchange Commission (SEC) required line of business reporting in registration statements of new stock issues and in 1970 expanded its requirement to annual reports filed on Form 10-K. In 1974 the SEC took these requirements further to include annual reports to share holders.

The Organisation for Economic Co-operation and Development (OECD) issued a guideline for disclosure of segmental information in 1976, inter-alia requiring the following disclosures.

a) The geographical areas where operations are carried out and the principal activities carried on therein by the parent company and the main affiliates.

b) The operating results and sales by geographical area and the sales in major lines of business for there enterprise as a whole.

c) Significant new capital investments by geographical areas and as far as practicable by major lines of business for the enterprise as a whole.

d) The policies followed in respect of inter group pricing.

In 1976 The Financial Accounting Standards Board (FASB) issued SFAS 14, requiring that financial statements prepared in conformity with GAAP contain information about

a) the company's operations in different industries

b) the enterprise's foreign operations and export sales, and

c) its major customers.

The information presented in this "disaggregation" of the company's consolidated financial data must be prepared using the same accounting principles. There is one major difference between consolidated information and business segment information' intercompany transactions are eliminated, but segment information includes intercompany transactions.

SFAS 14 requires a reconciliation of segment information with the amounts in the consolidated financial statements to account for this difference and generally requires that segment information be presented for the most recent three year period.

In 1996, the Canadian Institute of Chartered Accountants and the FASB issued similar Exposure Drafts pertaining to the reporting of disaggregated information about business enterprises. The FASB's Exposure Draft would supersede SFAS14 and would change the way that public enterprises report disaggregated information in their financial statements. Rather than taking an "industry segment approach," the Exposure

Draft takes the position that financial information should be reported on the basis that is used internally for evaluating segment performance and deciding how to allocate resources to segments. Thus it would require that enterprises report financial and descriptive information about their "operating segments."

Operating segments are defined as revenue producing components of the enterprise about which separate financial information is produced internally and that are subject to evaluation by the chief operating decision maker in deciding how to allocate resources. The proposed Statement would require that public business enterprise reports segment profit or loss, certain specific revenue and expense items, segment assets and segment liabilities. It would require reconciliations of total segment revenues, total segment profit or loss, total segment assets, and total segment liabilities to corresponding amounts in the enterprise's general purpose financial statements.

It would require that all public business enterprises report information about the revenues derived from the product or services (or groups of similar products and services) of each operating segment and about certain countries in which the operating segments earn revenues and hold assets, regardless of whether that information is used in making operating decisions. However, enterprises would not be required to report information that is not used internally if reporting it is impracticable.

The proposed Statement also would require that a public business enterprise report descriptive information about the way that the operating segments were determined, the products or services provided by the operating segments, differences between the measurements used in providing segment information and those used in the enterprise's financial statements, and changes in the measurement of segment information from period to period.

IFRS

International Financial Reporting Standard 8- Operating Segments (IFRS - 8) was issued in November 2006 in place of IAS 14.

IFRS 8 sets out requirements for disclosure of information about an entity's operating segments and also about the entity's products and services, the geographical areas in which it operates and its major customers.

Main Features:

Entities are required to report financial and descriptive information about its reportable segments. Reportable segments are operating segments or aggregations of operating segments that meet specified criteria. Operating segments are components of an entity about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Generally, financial information is required to be reported on the same basis as used internally for evaluating operating segment performance.

The following items are expected to be reported:

A measure of:

Operating segment profit/loss,

Segment assets/liabilities

Particular income/expense items, if these are provided to the chief operating decision maker.

Reporting also requires the reconciliation of these measures to corresponding measures in the entity's financial statements.

The IFRS requires an entity to report information about the revenues derived from its products or services(or groups of similar products or services), about the countries in which it earns revenues and holds assets, and about major customers, regardless of whether the management uses this information for decision making or not. However, if the benefit of compiling this information does not justify the cost of doing it, the IFRS does not require the information to be reported if the management does not use it for decision making.

The IFRS requires descriptive information about the way the operating segments were determined, the products and services provided by the segments, differences between measurements used in segment reporting and the entity's financial statements, and changes in measurement of segment amounts from period to period.

Applicability:

An entity shall apply this IFRS 8 for annual periods beginning on or after January 1st, 2009. Earlier application is permitted, but shall be appropriately disclosed by the entity.

Identification of segments:

An entity uses information for decision making. An entity's decision maker is the best judge regarding its division into segments for operation, sales, products, services, etc. Entities have specific characteristics and vary widely on the number of products, services, departments, importance of each product in relation to the total business volume, etc.

The decision maker is the best judge in each entity to decide what into what detailed fragments and segments infonnation is to be presented for ideal understanding and decision making. He needs this information to steer the entity to profitability, which is precisely the use an outsider reading the statements is aiming at. Hence, the IFRS allows information to be compiled according to the needs of the internal reporting requirement for business decisions. Apart from this, for the sake of uniformity, broad guidelines are given across varying enterprises in different industries to determine what a segment should comprise of, broadly on the basis of value, volume, location, importance, etc. The amount reported for each operating segment is only the measure adapted by the chief operating decision maker together with an explanation of how these measurements are made for each reportable segment.

Disclosure:

The IFRS requires an entity to disclose the following information:

a) Factors used to identify the entity's operating segments, including the basis of organisation (for example, whether management organises the entity around differences in products and services, geographical areas, regulatory environments, or a combination of factors and whether segments have been aggregated), and

b) Types of products and services from which each reportable segment derives its revenues.

The IFRS requires an entity to disclose specified items about each reportable segment, if the specified amounts are included in the measure of segment profit or loss and are reviewed by or otherwise regularly provided to the chief operating decision maker.

The IFRS requires an entity to report interest revenue separately from interest expense for each reportable segment unless a majority of the segment's revenue are from interest and the chief operating decision maker relies primarily on net interest revenue to assess the performance of the segment and to make decisions on resources to be allocated to the segment.

The IFRS requires an entity, including an entity with a single reportable segment, to disclose information for the entity as a whole about its products and services, geographical areas, and major customers. This requirement applies, regardless of the entity's organisation, if the information is not included as part of the disclosures about segments.

The IFRS 8- Operating Segments

Core Principle:

1. An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

Scope:

2. This IFRS shall apply to:

   a) The separate or individual financial statements of an entity;

      - Whose debt or equity instruments are traded in a public market(a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets),or
      - That files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market: and

   The consolidated financial statements of a group with a parent satisfying (i) or (ii) above.

3. If an entity that is not required to apply this IFRS chooses to disclose information about segments that does not comply with this IFRS, it shall not describe the information as segment information.

4. If a financial report contains both the consolidated financial statements of a parent that is within the scope of this IFRS as well as the parent's separate financial statements, segment information is required only in the consolidated financial statements.

   Operating Segments

   An operating segment is a component of an entity:

   a) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity).

   b) Whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance and,

   c) For which discrete financial information is available.

   An operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues.

5. Not every part of an entity is necessarily an operating segment or part of an operating segment. For example, a corporate headquarters or some functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the operating segments. For the purposes of this 1FRS, an entity's post-employment benefit plans are not operating segments.

6. The term 'chief operating decision maker' identifies a function and not necessarily a manager with a specific title. The Junction is to allocate resources and to assess the performance of the operating systems of an entity and could therefore refer to more than a single individual.

7. An entity may make use of reports in more than one way of presentation. Also, every segment need not have a manager, and every segment manager need not have a single segment under him. In such cases, information may be suitably classified and aggregated for efficient use by the chief decision maker. He will, in these cases, take one of the presentations as operating segment reports for the purpose of this IFRS.

8. Aggregation Criteria:

9. Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating systems would be expected if their economic characteristics were similar. Therefore, segments could be aggregated if they are similar in respect of:

   i) The nature of products and services

   ii) The nature of production processes

iii) The type or class of customer for their products and services

iv) The methods used to distribute their products or provide their services and

10. If applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

11. Quantitative thresholds:

    An entity shall report separately information about an operating segment that meets any of the following quantitative thresholds:

    a) Its reported revenue, including internal transfers and external sales is 10 % or more of the combined revenue, internal and external, of all operating segments.

    b) The absolute amount of its reported profit or loss is 10 % or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not report a loss and (ii) the combined reported loss of all operating systems that reported a loss.

    c) Its assets are 10% or more of the combined assets of all operating segments.

    Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.

12. An entity may combine segments not individually meeting the aforesaid quantitative criteria only if they have similar economic characteristics,

13. Even if the quantitative threshold is not met, additional segments may be identified and reported if the existing number of segments does not constitute at least 75 % of the total external revenue of the entity.

14. Information about other business activities and operating segments that are not reportable shall be combined and disclosed in an "all other segments" category separately from other reconciling items in the reconciliations required in para 28.The sources of revenue included in this category shall be described.

15. A segment identified as reportable in the immediately preceding period shall continue to be reportable if the management considers it as significant, even though it now fails to meet the criteria to qualify as a reportable segment.

16. Contrarily, if a segment is identified as reportable in the current period due to its meeting the requisite criteria, the segment data for the immediately preceding period shall be restated along the same comparable lines, except if the additional cost exceeds the benefits of this exercise in the eyes of the management.

17. Segmental information on too many segments may result in too much detail. The entity should consider whether a practical limit has been reached if the number of reportable segments exceeds ten.

18. An entity shall report separately information about each operating segment that:

    - Segments have been identified in accordance with the foregoing paragraphs and
    - Segments exceed the quantitative thresholds described above.

19. Disclosure:

    An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

    To give effect to this principle, an entity shall disclose the following for each period for which an income statement is presented:

a) General information on the factors used to form reportable segments, for example, whether geographic area, types of products or services, regulatory environment or a combination of factors and also the type of products or services from which reportable segment derives its revenues.

b) Information about reported segment profit or loss, including specified revenues and expenses included in reported segment profit or loss, segment assets and liabilities and the basis of measurement.

c) Reconciliation of the above measures to corresponding entity amounts.

Information about profit or loss, assets and liabilities:

The following information shall be reported on each reportable segment if such information is reviewed by or regularly provided to the chief operating decision maker of the entity:

a) Revenues from external customers

b) Revenues from transactions with other operating segments of the same entity

c) Interest revenue

d) Interest expense

e) Depreciation and amortisation

f) Material items of income and expenditure disclosed in accordance with IAS -1

g) The entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method

h) Income tax expense or income

i) Material non cash items other than depreciation and amortisation

An entity shall report interest revenue separately from interest expense for each reportable segment unless amajority of the segment's revenues are frominterest and the chief operating decision maker relies primarily on net revenue to assess the performance of the segment and make decisions about resources to be allocated to the segment. In that situation, an entity may report that segment's revenue net of its interest expense and disclose that it has done so.

An entity shall disclose the following about each reportable segment if the specifies amounts are included in the measure of segment assets reviewed by the chief operating decision maker or are otherwise regularly provided to the chief operating decision maker, even if not included in the measure of segment assets:

a) The amount of investments in associates and joint ventures accounted for by the equity method, and

b) The amounts of addition to non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets and rights arising under insurance contracts.

The amount of each segment item reported shall be the measure provided to the chief operating decision maker for allocating resources to the segment. If the decision maker uses more than one measure, then the one which is more consistent with the measurement principles of the entity in its financial statements shall be used for the segment report.

At a minimum, an entity shall disclose the following:

a) The basis of accounting for any transactions between reportable segments

b) The nature of differences between the measurement of the reportable segments' assets and liabilities and those of the entity. Those differences could include accounting policies and policies for allocation of jointly used assets or liabilities that are necessary for an understanding of the reported segment information.

c) The nature of changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of thole changes on the measure of segment profit or loss.

d) The nature and effect of any asymmetrical allocations to reportable segments. For example, an entity may allocate depreciation expense to a segment without allocating the related depreciable asset to the segment.

Reconciliation:

An entity shall provide reconciliation of the amounts of a reportable segment to the entity's total, in respect of revenues, profit or loss, assets, liabilities and every material item of information included in the reportable segment's report and all such reconciliation items identified separately and described.

Restatement of previously reported information:

If an entity changes the internal organisational structure so as to effect a change in constitution of reportable segments, the segment information shall be restated to provide the corresponding information for the earlier periods unless the costs of restating do not justify provision of such information and this fact of not restating shall be disclosed by the entity in the year of restructuring.

Entity-wide disclosures:

The following paragraphs on information about products and services, geographical areas and major customers shall apply to all entities subject to this IFRS including those having a single reportable segment. Some entities' business activities are not organised on the basis of differences in related products and services or differences in geographical areas of operations. Such an entity's reportable segments may report revenues from a broad range of essentially different products and services, or more than one of its reportable segments may provide essentially the same products and services. A similar situation may exist for assets. Information required by the following paragraphs shall be provided only if it is not provided as part of the reportable segment information required by this IFRS.

Information about products and services

An entity shall report the revenues from external customers for each product and service, or each group of similar products and services, unless the information necessary is not available and the cost to develop it would be excessive, in which case, that fact shall be disclosed. The amount of revenues reported shall be based on the financial information used to provide the entity's financial statements.

Information about geographical areas

a) An entity shall report the following geographical information, unless the necessary information is not available and the cost to develop it will be excessive:

b) Revenues from external customers (i) attributed to the entity's country of domicile and (ii) attributed to all foreign countries in total from which the entity derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues shall be disclosed separately. An entity shall disclose the basis for attributing revenues from external customers to individual countries.

c) Non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets, and rights arising under insurance contracts under (i) and (ii) above.

The amounts reported shall be based on the financial information that is used to produce the entity's financial statements. Subtotals of geographical information about groups of countries may be provided at the option of the entity.

Information about major customers

An entity shall provide information about the extent of its reliance on its major customers. If revenues from transactions with a single external customer amount to ten per cent or more of an entity's total revenues, the entity shall disclose the fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The entity need not disclose the identity of a major customer or the amount of revenues each segment reports from that customer. For the purposes of this IFRS, a group of entities known to a reporting entity to be under common control shall be considered a single customer, and a government (national, state, provincial, territorial, local or foreign) and entities known to the reporting entity to be under the control of that government shall be considered a single customer.

Transition and effective date

An entity shall apply this IFRS in its annual financial statements for periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies this IFRS earlier to this date, it shall disclose that fact.

6.3 THE INDIAN SCENARIO

In India, disclosures of disaggregated information are required as per Schedule III to the Companies Act, 2013. A manufacturing company is required to disclose value and quantities of opening and closing stock of goods produced by each class of goods. Also it has to disclose quantitative information about licensed and installed capacities and actual production by each class of goods.

Although these disclosure requirements give certain vital information to the users of accounts, they fall short of segmental reports. It is difficult to link raw materials consumption to sales by each class of goods. Moreover, information about direct production costs are missing. Hence it can be said that disclosure of segmental financial information has not become popular in India and the disaggregated quantitative and value disclosures that are presently required as per the Companies Act, 2013 are not par with the international requirements.

6.3.1 DEFINITIONS

A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments. Factors that should be considered in determining whether products or services are related include:

(a) the nature of the products or services;

(b) the nature of the production processes;

(c) the type or class of customers for the products or services;

(d) the methods used to distribute the products or provide the services; and

(e) if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

A geographical segment is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying

geographical segments include:

(a) similarity of economic and political conditions;

(b) relationships between operations in different geographical areas;

(c) proximity of operations;

(d) special risks associated with operations in a particular area;

(e) exchange control regulations; and

(f) the underlying currency risks.

A reportable segment is a business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by this Statement. Enterprise revenue is revenue from sales to external customers as

reported in the statement of profit and loss.

Segment revenue is the aggregate of

(i) the portion of enterprise revenue that is directly attributable to a segment,

(ii) the relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, and

(iii) revenue from transactions with other segments of the enterprise.

Segment revenue does not include:

(a) extraordinary items as defined in AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies;

(b) interest or dividend income, including interest earned on advances or loans to other segments unless the operations of the segment are primarily of a financial nature; and

(c) gains on sales of investments or on extinguishment of debt unless the operations of the segment are primarily of a financial nature.

Segment expense is the aggregate of

(i) the expense resulting from the operating activities of a segment that is directly attributable to the segment, and

(ii) the relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment, including expense relating to transactions with other segments of the enterprise.

Segment expense does not include:

(a) extraordinary items as defined in AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies;

(b) interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature;

(c) losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature;

(d) income tax expense; and

(e) general administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis.

Segment result is segment revenue less segment expense.

Segment assets are those operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. If the segment result of a segment includes interest or dividend income, its segment assets include the related receivables, loans, investments, or other interest or dividend generating assets.

Segment assets do not include income tax assets.

Segment assets are determined after deducting related allowances/ provisions that are reported as direct offsets in the balance sheet of the enterprise.

Segment liabilities are those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities.

Segment liabilities do not include income tax liabilities.

Segment accounting policies are the accounting policies adopted for preparing and presenting the financial statements of the enterprise as well as those accounting policies that relate specifically to segment reporting.

Reportable Segments

A business segment or geographical segment should be identified as a reportable segment if:

(a) its revenue from sales to external customers and from transactions with other segments is 10 per cent or more of the total revenue, external and internal, of all segments; or

(b) its segment result, whether profit or loss, is 10 per cent or more of -

    (i) the combined result of all segments in profit, or

    (ii) the combined result of all segments in loss,

    whichever is greater in absolute amount; or

(c) its segment assets are 10 per cent or more of the total assets of all segments.

A business segment or a geographical segment which is not a reportable segment, may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item.

If total external revenue attributable to reportable segments constitutes less than 75 per cent of the total enterprise revenue, additional segments should be identified as reportable segments, even if they do not meet the 10 per cent, until at least 75 per cent of total enterprise revenue is included in reportable segments.

6.3.2 Disclosure Requirements

An enterprise should disclose the following for each reportable segment:

(a) segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;

(b) segment result;

(c) total carrying amount of segment assets;

(d) total amount of segment liabilities;

(e) total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);

(f) total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and

(g) total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets, that were included in segment expense and, therefore, deducted in measuring segment result.

6.3.3 Accounting and Auditing Issues

Segment information includes an entities operation in different industries, its foreign operations and export sales, and its major customers in annual financial statements that are intended to present financial position, results of operations and cash flows in conformity with generally accepted accounting principles. Disclosure of segment information requires the disaggregation of 'certain significant elements of an entities financial statements, such as revenue, operating profit or loss, identifiable assets, depreciation and capital expenditures. The preface to the statements of Accounting Standards issued by ICAI states that -

While discharging their attest function, 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 financial statements may be aware of such deviation.

Further, AAS - 2 of ICAI on Objective and Scope of Audit of financial statement indicates as follows -

Objective of an Audit :

The objective of an audit of financial statements, prepared within a frame work of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements.

The auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. In the context of reporting segment wise information the auditor performing an audit of financial statements in accordance with the generally accepted auditing standards considers the segmental information as other informative disclosures in relation to the financial statements taken as a whole. Hence, it can be said that the auditors objective is to find out whether -

1. The information provided by the segments are in conformity with the generally accepted accounting principles, and
2. The disclosures of the segment are in conformity with the disclosure provided by the enterprise as a whole.

In the context of the above the following issues emerge -

A. Inapplicability of segment wise information and refusal of segment wise information.

Under the Indian context it is not mandatory for any company to give the breakup of the information segment wise except that what is stated under Schedule III. Hence, unless or otherwise disclosure requirements are made mandatory the above issue is not strictly relevant. However if it is made mandatory it is necessary for the auditor to make out a qualification.

If the auditor is unable to reach a conclusion based on his knowledge of the entitys business or if the entity declines to provide such information which the auditor considers necessary for reaching a conclusion the auditor should indicate the same i.e. the limitation of his audit and qualify his opinion on the financial statements taken as a whole.

B. Materiality and consistency.

The concept of materiality is applied by the auditor while determining the nature, timing and extent of auditing procedures to be applied. Materiality of segmental information is analysed by relating the value of the information to the financial statement taken as a whole. However, there may be a contradiction as regards the materiality of a segment since, it may not depend entirely on the size. Further, it may be that the segment may carry a different product line. In that context it may be necessary for the auditor to give a separate report on the segment and in such a situation the materiality should be confined to the segments only.

As per AS-1, going concern, consistency and accrual are the generally accepted fundamental accounting assumptions. Hence, consistency is an important measure for preparing the segment wise information. As regards segment information inconsistencies may occur due to -

1. Change in the basis of accounting for sales or transfers between segments.
2. Change in the method of allocating operating expenses.
3. Change in the method of determining the profitability.

In all the above circumstances it may be necessary for the auditor to qualify if the nature and effect of such a change is not properly disclosed in the financial statements.

C. Plans and procedures to be adopted by auditor in evaluating the segments.

Plans :

1. Internal control system and the degree of integration.
2. Nature, size and number of the segments.
3. The accepted accounting principles for each segment if such segments are not homogeneous. Procedures

1. Find out as to how the segmental information is determined.
2. Analyse the basis of accounting with special reference to sales and transfers.
3. Application of analytical procedures for comparing the segments.
4. Analyse the methods of allocating operating expenses.
5. Analyse the consistency of the information provided.

D. Mis-statement or omission of an information at the segment level

In forming his opinion on the financial statements the auditor follows such procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and the operating results of the enterprise. The auditor recognizes that because of the test nature and other inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatement may remain undiscovered.

While in many situation the discovery of a material misstatement by the management may often arise during the conduct of the audit, such discovery is not the main object of audit nor is the auditor's programme of work specifically designed for such discovery.

If the audit reveals a misstatement in the segment information that is material in relation to the financial statements taken as a while and that misstatement is not corrected, the auditor should modify his opinion on the financial statements because of a departure from generally accepted accounting principles.

If the entity declines to include in the financial statements part or all of the segment information that the auditor believes, based on his knowledge of the entity's business, is required to be disclosed, the auditor should modify his opinion on the financial statements because of the inadequate disclosure and should describe the type of information omitted. The auditor is not required to provide the omitted information in his report. The following is an example of an auditor's report qualified because of an omission of segment information.

E. The relevance of AAS - 10 and AAS - 12

In a situation where a segment happens to be a branch or a subsidiary or a division all the procedures laid down in the above two AASs will be fully applicable.

6.4 SEGMENTAL REPORTING PROBLEMS & DIFFICULTIES

Depreciation accounting

Depreciation is a controllable expense. This conclusion is based on the view that the nature and the amount of capital equipment and other fixed assets employed by a division are matters over which it has a large degree of control, if not in the immediate sense at least in the longer view. Underlying this statement is (he supposition that when a decision is taken to acquire or to scrap divisional fixed assets the decision will be appropriately reflected on the debit side of the future divisional income statements through the depreciation charge for such assets. If the depreciation charges are inappropriately calculated for reasons unconnected with the circumstances of the division itself - and corporate tax requirements are the most likely cause of such inappropriate calculations - the status of depreciation as a controllable expense has to be seriously questioned.

The appropriate charge for depreciation must depend on what the role of depreciation is presumed to be. An operating asset bought under competitive conditions will have cost the purchaser a sum roughly equal to the discounted present value of the future stream of benefits expected to accrue to the purchaser from the asset. In money terms this is equivalent to the discounted present value of the assets expected contribution to net profit.

As the asset renders services over the years the assets expectation of life diminishes, and the present 'value of remaining services therefore falls. Ideally depreciation reflects this periodic fall of present value.

If the time pattern of the depreciation charges for a particular asset is to match the time pattern of its net earnings it follows that a firm with a varied collection of fixed assets should have a depreciation policy employing many different depreciation methods, each of which is appropriate to a different type of asset.

Each division should be allowed to chose its own depreciation method, subject only to the requirement that it must satisfy the corporate financial executives. The policy chosen must be appropriate to the needs of the division in the sense that it does, as accurately as possible, reflect the facts of divisional asset life expectancies. There is no reason why all division should follow a uniform policy if there needs are not uniform.

In selecting its depreciation methods, each division should classify assets into as many group as may be necessary to make each group reasonably homogeneous. In the light of the expected pattern of net results to be generated by the assets in each group the method and rate of depreciation should be chosen for each asset group.

Division should be required to account only for fixed assets under the control. Corporate assets should be held by a corporate division, and should not be allocated to divisions for the purpose of computing Capital Employed by the division or for any other purposes.

Division should be given considerable autonomy in the matter of asset disposals. They should however be required to offer surplus assets to the other divisions at the price they propose to accept from outside purchasers prior to selling the asset outside. If corporate head quarters thinks an asset up for disposal is work more than the division is ready to accept for it the asset should be transferred to the corporate division at the price acceptable to the disposable division, pending final sale or other disposition.

Direct Costing: The Allocation of Income Tax to divisions:

Divisions as such do not pay income tax since tax is levied on the legal entity. Nevertheless a majority of divisionalised companies do allocate back to each of their divisions a part of the company's tax assessment proportional to the share of the company's taxable profit deemed to have been earned by each division. This raises certain questions :

a) Is the tax allocation a controllable expense of the division?

b) Should negative tax allocation be made to divisions making losses?

c) How, if at all, should taxes be allocated to divisions, where the company chooses not to allocate central company overheads and therefore does not report divisional net profit?

Tax allocated to a division typically have two sets of determinants. One is the controllable contribution which the division make to the company's profitability, whether the divisional profit statements ever show that figure are not.

The other is made up of all those other items which account for the difference between this" Actual controllable divisional profit " and the divisions share of the company's taxable profit. These items include any difference between the divisions true depreciation and the depreciation actually charged on its assets for tax purposes.

If divisional tax allocation is the resultant of two sets of forces, one controllable and other non-controllable, at the divisional level, the net result must be declared to be non-controllable; and if the tax allocation is non controllable, the division's after tax profit must also be non controllable.

This means that after tax profit is not an appropriate figure to use in evaluating the performance of the division's management. It does not mean however that the allocation of Income tax to divisions serves no purpose whatever following the distinction between the appraisal of the performance of a division's management and the appraisal of performance of its business, though a divisional tax allocation may not be useful for the first purpose it would seem to be essential-to the second so long as it represents at least approximately the increment in the company's tax liability which results from the division's operations.

This is likely to be particularly important where the company's various divisions are not at all uniformly placed tax wise. To use before tax profits as a basis for decisions about investment policy, say would be sure to lead to unsound decisions.

Turning now to the treatment divisions making losses the question was raised whether they should receive negative tax allocation. Many companies do give tax relief to loss making divisions on the ground that the company's tax liability is reduced by reason of a division's loss. The rule of divisional profit independence would seem to veto negative tax allocation to loss making divisions except to the extent that a separate company making losses could recover taxes it had previously paid.

6.5 SPECIFIC ISSUES RELATING TO MANAGEMENT ACCOUNTS

Transfer Pricing & Interdivisional Relationship

If a divisionalized company could arrange its affairs so that its divisions had no dealings of any kind with each other it would have removed one of the principal complexities of divisional profit measurement. It would also however, have lost a valuable feature of decentralisation, namely, the capacity to enjoy the fruits of division of labour and of specialisation while simultaneously benefiting from integration to a greater or lesser degree. The fact that a divisionalized company is more than the sum of its parts is evidenced through the intricate pattern of interdivisional relationships, which can establish itself within a large divisionalized company.

Whenever transactions between divisions make up 'more than a negligible proportion of the total transactions, it is obvious that the division's relative profitability can be very much affected by the formulae used for pricing interdivisional business. The more important these interdivisional transactions become, the more dependent is the whole system of profit measurement on the system of transfer pricing. Unfortunately, as the performance of one division becomes increasingly bound up with the affairs of other divisions, it also becomes more doubtful whether separate profit responsibility, the hallmark of a full-fledged division continues to be feasible.An essential condition , if a division's separate profit responsibility is to become a reality, is that the division must be substantially independent of other divisions, both in respect of its production facilities and marketing organization.

The apparent advantages of decentralisation through delegated profit responsibility has caused some companies to adopt a semblance of this system where it was not appropriate, and a set of more or less arbitrarily chosen transfer prices has been one of the investments which has made the system appear to work.

Since transfer prices are an essential part of the profit measurement system, they must, as accurately as possible, help management to evaluate the performance of the profit centres viewed as separate entities. They must also motivate them to set in, a manner which is conducive to the success of the company as a whole. There is, unfortunately, a real possibility of conflict here, for a set of transfer prices suitable for evaluating performance may lead divisions to act contrary to the corporate interest. Contrariwies, a set of transfer prices providing the right motivation may leave certain divisions, currently contributing materially to corporate success, with losses, showing on their divisional income statement.

The motivating aspect of transfer prices is of primary importance. It is cleared that a system which makes it possible for a division to add to its own profit while reducing that of the corporation as a whole, is not to be tolerated.

A badly chosen set of transfer prices may, however do just that. e.g.: A division supplying another with an intermediate product may be in the position of a monopolist supplier. By taking advantage of its own position it could hold the division it suppliers up to ransom.

The parent corporation could perhaps afford to take a detached view of the situation if the amount which the transferor division could add to its own profit merely offset the dimination in the profit of the transferee division. But it is more than possible that the transferee division will lose more than the transferor division can gain.

It is common to find one supplier division supplying intermediate product to two or more other divisions which incorporate the intermediate in final products for sale to outside customers. Each of the divisions using the intermediate can estimate the net incremental revenue to be obtained by adding to its consumption and processing of the intermediate for sale as a final product. These net incremental revenues can be aggregated for all the consuming divisions. Before the right course for the supplying division and the several consuming divisions can be determined, this aggregate net incremental revenue, the incremental cost of the supplying division, and the competitive price at which the intermediate can be bought and sold on the market must all be looked together. The theoretically correct course is to set the transfer price equal to the competitive market price.

The divisions, which consume the intermediate product, will each require that quantity of it, which equates its market price with the net incremental revenue, derived from processing the marginal unit taken. The supplier division will wish to produce at that level which equates its incremental cost with a market price of the intermediate.

If this level exceeds the aggregate demand of the consumer divisions, the supplier division must sell its surplus out put on the outside market; if, on the other hand, the aggregate demand of the consumer division exceeds the amount which the supplier division wishes to produce at the market price, then the consumer divisions should make up their supply from external sources at that price.

In highly theoretical conditions, the total profit of the company would unaffected if the supplier division did no business with the other divisions, but sold the whole of its out put on the, market, leaving the consumer divisions to buy all their requirements out side. In real life, however such behaviour would not be likely to leave the company's profit unchanged. The supplier division would incur selling expenses in making outside sales which it does not incur on inter divisional sates. It will also incur collection expenses and bad debts.

It would probably cost the consuming division no more, on the other hand to buy from another company than to buy from another division of their own company.

If the supplier division really does change the full market price therefore the other divisions will not be driven by self interest to take their supplies from it; and if they do not the corporation will be poorer to the extent of the selling expenses incurred by the supplier division in disposing of its output to outsiders. In recognition of this fact, many companies modified the "Market price" rule for pricing interdivisional transfers.

They deduct from the market price a margin estimated to cover either the whole, or a part, of the selling and collection expenses and bad debts which the transferor division saves on internal transfers as compared with outside sales.

Where the transferred product is also sold outside, a deduction from the competitive price is made for selling expenses not incurred, to encourage divisions to buy internally. As cash discounts are not given on payment of inter divisional invoices, these discounts are allowed for in the transfer prices.

In arriving at the maximum transfer price where transferred products are not also sold outside, no deduction from the competitive price is made for selling expenses not incurred by the transferor division. If this maximum price were charged, therefore there would be no incentive for the purchasing division to buy internally rather than externally. This may involve the company in loss though there is an "escape clause" in that the transferor division-may charge less than the maximum allowed use of the "escape clause" would substitute a negotiated price for the market price.

If a good competitive market for the intermediate product is lacking, or if for any other reason there is not a well-defined market for it, independent of the quantity bought or sold by the divisions of the company themselves, then another basis of transfer pricing has to be found.

The transfer price conducive to optimal decision making in that it will lead the divisions to maximize the corporation's profits, is the marginal or incremental cost of the transferor division for that output at which this marginal cost equals the transferee division's net marginal revenue from using the transferred products. Even when there is an outside competitive price which can be used, the marginal cost rule still holds. The transferor division should produce up to the point where its marginal cost equals the competitive price, so that by setting the transfer price equal to the competitive price we are also setting it equal to the transferor division's marginal cost for its marginal unit of output.

Transfer prices should be set equal to the marginal cost of supply, not just any output, but at one particular equilibrium output. What this rule means is that assuming a company's object is to maximize profit the production policy best for it if it were organized as a single profit centre is also best if it is organised divisionally.

If the firm were organised with a single manager in charge of both the production of the intermediate and of its conversion into the final product, the most profitable course would be to push production to the point where the marginal cost of output equaled the marginal revenue to be obtained from it.From the company's point of view, this policy does not cease to be right just because the responsibility for production divided between two or more profit centres.

Strong reinforcement for the marginal cost rule is to be found whenever a choice has to be made between buying an intermediate needed by a division or having it made by another division and transferred- Within a decision, "make or buy" decisions, if made rationally call for a comparison of the cost of buying outside with the incremental cost of producing the article inside. The nature of the decision, from the company's point of view, is not changed simply because the intermediate would have to cross divisional lines if made internally. The use of incremental cost as the basis of transfer pricing will enable the make or buy decision to be made list as it would be in a non-divisionalised firm. If there is a competitive market outside for the intermediate in which the divisions are really free to buy and sell there is no problem.

In the absence of such a market some common bases of transfer pricing - full standard cost, or full standard cost plus a return on investment could cause a division to buy an intermediate outside because the price was below the transfer price, even though the incremental cost of production internally in another division would have been below the outside price. Obviously in such a situation, outside purchase would add more to the company's outlays than production within the company would have done.

Segmental Performance – Measurement & Evaluation

The proper measures of performance of a segment are related to the degree of de-centralization present and are a function of the level of the organization as a whole. Segments may take various forms such as department or cost centre, plant or operating unit, branch or a division or a subsidiary and company. Measures of performance can be either quantitative or qualitative. While qualitative measures may be with reference to attributes such as quality, efficiency, safety, customer satisfaction, morale etc. quantitative measures are confined to financial measures. Such measures often lead to assessment of the profitability of the enterprise as well as the return on investment. In other words they are measurements concerning revenue and capital.

One of the most crucial factors that goes with the measurement of performance is the concept of controllability. From the view point of accounting and finance it is essential that the concept of controllability exists what ever be the nature of the segment. In this chapter the two most commonly used performance measures namely -i) Return on Investments (ROI) (ii) Residual Income (RI) are discussed.

ROI is calculated by dividing operating income by average (depreciated) or beginning investment. Accounting numbers are traditionally used to measure income and investment, so ROI is encumbered with many of the problems that plague the determination of accounting income.

Residual income (RI) is operating income minus an implicit interest cost on the investment. The calculation of RI has the same accounting problems as that of ROI. ROI can be an appropriate device to measure the performance of division managers provided the limitations of the technique are clearly understood. However ROI probably should not be employed as the only means of evaluating performance. The separate components of ROI must be properly defined and valued for ROI to be a useful measure. The investment should include only these assets under the control of the division manager and the division manager should exercise control over all revenue and expenses of the division.

Investment base is defined as assets employed less division liabilities which implies that corporate assets are not allocated to divisions. In addition, division managers evidently exercise control over the investment base because they are responsible for the acquisition of division assets. Division managers apparently are responsible for all revenue and costs within the division because each division's sales are separate.

A properly defined ROI may cause sub-optimum behavior if it is used as the sole criterion of divisional performance. Emphasis on divisional ROI may result in the rejection of an investment project which has forecasted returns in excess of the firms cost of capital if the projects return is less than the divisions present ROI; acceptance of such a project would reduce the divisions actual ROI even though the company profits would be benefited.

The sub optimum behavior which can result from ROI can be overcome by evaluating divisions on the basis of their residual income.

When residual income is adopted for evaluating purposes emphasis is placed on marginal profit above the cost of capital rather than on the rate itself. Several other performance measures might be used in conjunction with ROI to identify components which contribute to divisional performance.

Additional measures may include profit margin, profit growth, sales growth, market penetration, product development and management personnel development. All of these would be compared with prior years' results and current budgets and projections to aid the evaluation of divisional performance. While the net result of these items may be reflected in the ROI calculations, a closer examination of these items provides additional insight and a more comprehensive picture of performance.

Performance Measure in multi national context

Segment performance evaluation in multinational firms presents special problems. Cultural differences across countries make the behavioral implication of performance evaluation systems unique to specific divisions in each country. Tariff and trade restrictions make evaluation of sales and profit performance more complicated. Changing relationships among foreign currencies and different tax laws introduce complexities into the measurement of the income and investment base. Differential and changing tax laws create tax incentives that vary across countries.

These problems have not been solved completely by many international firms that are struggling with performance evaluation criteria for their multinational operations. The problems of evaluating the performance of foreign subsidiaries are - Analysis of results - Should it be local currency or foreign currency?

1. Management explanation of variances - in local currency or foreign currency?
2. What should be the time frame for comparative data - Plan or forecast?

6.6 SEGMENTAL DISCLOSURE – A PRACTICAL EXAMPLE

The following is the disclosure made by Infosys Technologies pursuant to Accounting Standard 17 – Segment Reporting

The Infosys Group's operations predominantly relate to providing end-to-end business solutions, that leverage technology thereby enabling clients to enhance business performance, delivered to customers globally operating in various industry segments. Accordingly, revenues represented along industry classes comprise the primary basis of segmental information set out in these financial statements. Secondary segmental reporting is performed based on the geographical location of customers.

The accounting principles consistently used in the preparation of the financial statements are also consistently applied to record income and expenditure in individual segments. These are as set out in the note on significant accounting policies.

Industry segments at the Company are primarily financial services comprising customers providing banking, finance and insurance services; manufacturing companies; companies in the telecommunications and the retail industries; and others such as utilities, transportation and logistics companies.

Income and direct expenses in relation to segments is categorized based on items that are individually identifiable to that segment, while the remainder of the costs are categorized in relation to the associated turnover of the segment. Certain expenses such as depreciation, which form a significant component of total expenses, are not specifically allocable to specific segments as the underlying services are used interchangeably. The Company believes that it is not practical to provide segment disclosures relating to those costs and expenses, and accordingly these expenses are separately disclosed as "unallocated" and directly charged against total income.

Fixed assets used in the Company's business or liabilities contracted have not been identified to any of the reportable segments, as the fixed assets and services are used interchangeably between segments. Accordingly, no disclosure relating to total segment assets and liabilities are made.

Customer relationships are driven based on the location of the respective client. North America comprises the United States of America, Canada and Mexico; Europe includes continental Europe (both the east and the west), Ireland and the United Kingdom; and the rest of the world comprises all other places except those mentioned above and India.

Geographical revenues are segregated based on the location of the customer who is invoiced or in relation to which the revenue is otherwise recognize.

Industry Segments

Year ended March 31, 2015 and 2014: *in ₹ crore*

Particual	Financial service	Manufacturing	Telecom	Retail	Others	Total
Revenues	5,706	2,291	3,215	1,945	2,491	15,648
	4,951	1,805	2,409	1,386	2,598	13,149
Identifiable operating expenses	2,426	1,028	1,401	836	1,085	6,776
	2,139	767	1,096	588	1,111	5,621
Allocated expenses	2,426	572	804	485	624	3,909
	1,224	454	605	384	652	3,303
Segemental operating income	1,856	691	1,010	624	782	4,963
	1,568	584	788	450	835	4,225
Unallocable expenses						546
						469
Operating income						4,417
						3,756
Other income (expense), net						683
						373
Net profit before taxes and exceptional items						100
						4,129
Income taxes						630
						352
Net profit after taxes and before exceprional items						4,470
						3,777
Income on sale of investments (net on taxes						-
						6
Net profit after taxes and exceptional itmes						4,470
						3,783

Geographical Segments

in ₹ crore

Year ended March 31, 2015 and 2014:

Particual	North America	Europe	India	Rest of the World	Total
Revenues	9,873	4,207	219	1,349	15,648
	8,395	3,393	214	1,147	13149
Identifiable operating expenses	4,308	1,668	46	754	6,776
	3,636	1,314	53	618	5,621
Allocated expenses	2,466	1,050	56	337	3,909
	2,110	853	53	276	3,303
Segemental operating income	3,099	1,489	117	258	4,963
	2,649	1,226	108	242	4,225
Unallocable expenses					546
					469
Operating income					4,417
					3,756
Other income (expense), net					683
					373
Net profit before taxes and exceptional items					5100
					4,129
Income taxes					630
					352
Net profit after taxes and before exceprional items					4,470
					3,777
Income on sale of investments (net on taxes					-
					6
Net profit after taxes and exceptional itmes					4,470
					3,783

Accounting policy leading to a change in segment identification

Illustration - 1

A Manufacturer of traditional electrical and engineering goods such as switchgears, motors, etc. each constituting a separate division has entered into new areas such as telecom, software, etc. Due to significant change in its activity profile, it has changed its internal reporting structure to combine the traditional products such as switchgears, switchboard and motors into one division. According to management the earlier form of segmental reporting is no longer relevant and they plan to switch to reporting the traditional products under one segment. The following questions are relevant:

Can this be done? If no, will we have to reconstruct segment information based on the earlier position? If yes, would it constitute a change in segment accounting policy? In that case what are the disclosures required?

Solution:

Whether the three traditional divisions of the company can be combined into one segment for financial reporting, after they have been merged for internal reporting purposes? To answer this question several factors have to be considered. These are:

Are the risks and returns to switchgear, switchboard and motors significantly different from each other? Or can they be for all practical purposes combined into one basket of traditional engineering/electrical goods? Factors that should be considered in determining whether products and services are related include:

- the nature of the products or services:
- the nature of the production processes:
- the type or class of customer for the products or services: and
- the methods used to distribute the products or provide the services

A single business segment does not include products and services with significantly different risks and returns. While there may be dissimilarities with respect to one or several of the above factors, the products and services included in a single business segment are expected to be similar with respect to a majority of the factors.

The predominant sources of risks affect how most enterprises are organized and managed. Therefore, the organizational structure of an enterprise and its internal financial reporting system is normally the basis for identifying its segments. If in the given situation, it can be demonstrated that the traditional products faced the same risks and return situation (i.e., they are not significantly different) and that the internal reporting has actually changed, then it should be possible to combine the three divisions for segment reporting purposes.

Based on the analysis above, the following position would emerge:

a) Telecom and software development activities cannot be combined with the traditional product-line (switch gear etc) and made into one segment.

b) Subject to fulfillment of definition criteria laid down in AS 17, traditional product lines can be combined into one segment.

c) Changes in identification of segments would not constitute a change in accounting policy because there is no change in the policy parse, the policy for the current year continues to be to determine segments based on the internal reporting structure and the guidelines set out in AS 17.

Illustration - 2

From the following information of a company having two primary segments, prepare a statement classifying the same under appropriate heads.

		(₹ in lakh)
Segment Revenue	A	27,050
Segment Revenue	B	3,280
Inter Segment Revenue	A	50
Segment Profit	A	4,640
	B	
Segment Profit	Loss	197
Dividend Income		285
Interest Expense		35
Tax Provision		1,675
Capital Expenditure	A	1,300
Capital Expenditure	B	16
Non Cash Expenses (excluding epreciation)		
Segment	A	114
Segment	B	16
Liabilities	A	3,430
Liabilities	B	770
Other Liabilities		2,200
Assets	A	19,450
Assets	B	2,700
Other Assets		6,550
Depreciation	A	110
Depreciation	B	15

Solution:

	Particulars	Segment A	Segment B	Others	Eliminations	Total
I	Revenue:					
	a) External Revenue	27,050	3,280			30,330
	b) Inter segment Revenue	50			-50	
Total		27,100	3,280		-50	30,330
II	Result:	4,640	-197			4,443
	a) Income from Investment					285
	b) Interest Expenses					-35
	c) Tax provision					-1,675
	d) Net profit					3,018
III	Assets:					
	a) Segment assets (directly attributable & allocated)	19,450	2,700			22,150
	b) Unallocated assets					6,550

IV	Liabilities			
	a) Segment assets (directly attributable & allocated)	3,440	770	4,200
	b) Unallocated liabilities			2,200
V	Others:			
	a) Depreciation	110	15	125
	b) Non cash expenses	114	16	130
	c) Capital Expenditure	1,300	16	1,316

Illustration – 3

Information relating to five segments of V Ltd. is as under: (₹ in lakhs)

Segments	A	B	C	D	E	Total
Segment Revenue	100	300	200	100	300	1,000
Segment Result	40	(60)	90	10	(30)	50
Segment Assets	45	55	140	20	40	300

As a cost accountant of this company management wishes to know from you which company need to be reported.

Solution: (₹ in lakh)

Particulars	A	B	C	D	E	Total
1. Segment Revenue	100	300	200	100	300	1,000
2. % of Segment Revenue	10%	30%	20%	10%	30%	
3. Segment Result: Profit	40		90	10		140
Loss		(60)			(30)	(90)
4. % of segment Result, absolute amount of profit/ whichever is higher, i.e. as a % of 140	28.57%	42.88%	64.29%	7.14%	21.43%	
5. Segment Assets	45	55	140	20	40	300
6. % of Segment Assets	15%	18.33%	46.67%	6.66%	13.33%	
Reportable Segment	Yes	Yes	Yes	Yes	Yes	
Criteria satisfied	Revenue, Result & Assets	Revenue, Result & Assets	Revenue, Result & Assets	Revenue	Revenue, Result & Assets	

Illustration – 4

ABC ENTERPRISES LIMITED (FROM CFS)

Segment accounting

Based on guiding principles given in Accounting Standard on "Segment Reporting" – AS 17, single financial report contains both Standalone financial statement and Consolidation financial statement of the company. Hence, the required segment information has been appended in the Consolidated Financial Statements (CFS).

Notes to Accounts

Segment reporting

i) Primary Segment

Segments have been identified in line with Accounting Standard 17 – "Segment Reporting", taking into account the organisation structure as well as different risk and returns of these segments.

ii) Secondary Segment

Two Secondary Segments have been identified based on the geographical locations of customers; within India and outside India.

Illustration – 5

BXZ CROPSCIENCE LIMITED

Segment Reporting

The company has only one reportable business segment "Agri Care" as primary segment. The company has identified the

Secondary Segment as geographical segment based on the location of customers.

(₹ in '000s)

Secondary Segmental Reporting	2014-15	2013-14
1. Segment Revenue		
(a) Segment – Local	1,94,55,109	1,59,93,904
(b) Segment – Exports	30,08,972	21,57,763
Total	2,24,64,081	1,81,51,667
2. Segmental Assets (excluding Deferred Tax Assets)		
(a) In India	1,50,20,767	1,02,65,477
(b) Outside India	5,19,954	3,63,530
Total	1,55,40,721	1,06,29,007
3. Capital Expenditure during the year in India	7,39,850	8,16,062

Illustration – 6

HAPPY INDIA LIMITED (FROM CFS)

Segment Reporting

The company is engaged in three segments – "Construction and Engineering, Oil exploration and Realty Development" including businesses acquired on account of new acquisitions. The revenue from oil exploration and reality development are less than threshold limit of 10% and hence no disclosure of separate segment reporting is made in terms of Accounting Standard (AS-17). The Group although operates on a worldwide basis across the globe, they operate in two principal geographical areas of the world in India and the other countries. The following table presents the break-up of the revenues and assets regarding the geographical.

Particulars	Amount (₹ In Crores)			Percentage (%)	
	Domestic	Overseas	Total	Domestic	Overseas
Segment Revenue	5,995.50 (4,758.21)	2,848.14 (2,309.42)	8,843.64 (7,067.63)	67.79 (67.32)	32.21 (32.68)
Segment Asset	9,910.32 (7,577.92)	3,442.63 (4,034.24)	13,352.95 (11,612.16)	74.22 (65.26)	25.78 (34.74)
Capital Expenditure	4,455.23 (3,359.07)	1,010.16 (1,264.47)	5,465.39 (4,623.54)	81.52 (72.65)	18.48 (27.35)
(Previous period figures in brackets)					

Illustration – 7

DEEPAK LIMITED

Disclosures as required by the Accounting Standard 17 on "Segment Reporting" are given below:

Business Segments

(Refer to Note 1 below)

Amount in ₹

Particulars	31st March 2016				31st March 2015			
	Pharma-ceuticals	Animal Health	Services	Total	Pharma-ceuticals	Animal Health	Services	Total
Segment revenue								
External sales and								
services								
Total Segment revenue	1,01,790.76	15,920.01	7,392.42	1,25,103.19	66,611.17	10,620.86	2,741.53	79,973.56
Segment results	1,01,790.76	15,920.01	7,392.42	1,25,103.19	66,611.17	10,620.86	2,741.53	79,973.56
Unallocated corporate	28,630.71	3,193.79	791.48	32,615.98	16,968.93	2,069.08	735.44	19,773.45
(expenses)/income								
(net)								
Operating profit								
Interest expense and				(5,279.77)				(2,672.35)
bank charges				27,336.21				17,101.10
Interest income								
Income tax				(278.75)				(234.30)
Exceptional Items –net				7,707.06				5225.98
Net profit				(11,827.89)				(7,312.68)
Other information	(228.06)	(74.50)		(302.56)	(1,091.77)			(1,091.77)
Segment assets				22,634.07				13,688.33
Unallocated corporate								
Assets	26,148.81	6,154.18	4,421.72	36,724.71	20,690.19	3,550.89	838.39	25,079.47
Total assets								
Segment liabilities								
Unallocated corporate				1,01,621.59				95,257.43
Liabilities				1,38,346.30				1,20,336.90
Total liabilities	15,160.05	1,569.30	548.06	17,277.41	10,879.22	1,040.13	296.20	12,215.55
Capital expenditure								
Depreciation /								
Amortization				4,724.18				8,688.09
				22,001.59				20,903.64
	430.37	1.21	56.65	488.23	450.78	5.50	4.00	460.28
	949.75	6.81	14.10	970.66	759.92	11.54	43.79	815.25

Geographical Segments

(Refer to Note 2 below)

Particulars	31st March 2016			31st March 2015		
	India	Other Countries	Total	India	Other Countries	Total
Segment Revenue external sales & services	121292.16	3811.03	125103.19	77414.75	2558.81	79973.56
Carrying amount of segment assets	137838.01	508.29	138346.30	119550.87	786.03	120336.90
Capital expenditure	699.60	---	699.60	1871.48	---	1871.48

Notes

1. **Business Segments:** The business operations of the company comprise Pharmaceuticals Animal Health and Services. The business segments have been identified and reported taking into account, the nature of products and services, and differing risks and returns and the internal financial reporting systems. The Pharmaceuticals business comprises of manufacturing of bulk drugs and formulations, trading of formulations and also includes rendering of marketing services. The Animal Health business has presence primarily in the large animal health and poultry market segments and also includes rendering of marketing services. Services – Clinical Development Operations primarily include conducting clinical trials, new product development and undertaking comprehensive data management for new drug development.

2. **Geographical Segments:** For the purpose of geographical segments the consolidated sales are divided into two segments – India and other countries.

3. The accounting policies of the segment are the same as those described in the summary of significant accounting policies are referred to in Schedule 18 to the Financial statements.

Study Note - 7

BUSINESS COMBINATIONS AND CORPORATE RESTRUCTURING

This Study Note includes

7.1 Merger
7.2 Acquisitions
7.3 Accounting for Mergers And Acquisitions
7.4 External Reconstruction
7.5 Profit Prior to Incorporation

Introduction

In today's global business environment, companies may have to grow to survive, and one of the best ways to grow is by merging with another company or acquiring other companies. A merger occurs when one firm assumes all the assets and all the liabilities of another. The acquiring firm retains its identity, while the acquired firm ceases to exist.

A majority vote of shareholders is generally required to approve a merger. A merger is just one type of acquisition. One company can acquire another in several other ways, including purchasing some or all of the company's assets or buying up its outstanding shares of stock.

In general, mergers and other types of acquisitions are performed in the hopes of realizing an economic gain. For such a transaction to be justified, the two firms involved must be worth more together than they were apart. Some of the potential advantages of mergers and acquisitions include achieving economies of scale, combining complementary resources, garnering tax advantages, and eliminating inefficiencies. Other reasons for considering growth through acquisitions include obtaining proprietary rights to products or services, increasing market power by purchasing competitors, shoring up weaknesses in key business areas, penetrating new geographic regions, or providing managers with new opportunities for career growth and advancement. Since mergers and acquisitions are so complex, however, it can be very difficult to evaluate the transaction, define the associated costs and benefits, and handle the resulting tax and legal issues.

7.1 MERGER

Merger or amalgamation contemplates joining two or more companies to form a new company, an altogether a new entity or absorbing of one or more companies by an existing company. The term ˜merger" and "amalgamation" are used synonymously.

$\boxed{\text{Co. A}}$ + $\boxed{\text{Co. B}}$ – $\boxed{\text{New Co. C}}$

Figure 1

Co. A and Co. B = Transferor/Amalgamating Company

New Co. C = Transferee/Amalgamated Company

$\boxed{\text{Co. A}}$ + $\boxed{\text{Co. B}}$ + $\boxed{\text{Co.C}}$ – $\boxed{\text{Existing Co.As}}$

Figure 2

Co. B and Co. C = Transferor/Amalgamating Company

Co. A = Transferee/Amalgamated Company

In other words, merger involves consolidation of business of Company A and Company B into a new Company C on a going concern basis as shown in Figure 1 above or transfer of business of Company B and Company C to Company A on a going concern basis as shown in Figure 2 above. The transaction involves arrangement with the shareholders.

The consideration for transfer of business may be discharged either through issue of shares (equity or preference) or other instruments of the transferee company or by cash.

Varieties of Mergers

From the perspective of business structures, there are a whole host of different mergers. Here are a few types, distinguished by the relationship between the two companies that are merging:

- Horizontal merger Two companies that are in direct competition in the same product lines and markets.
- Vertical merger A customer and company or a supplier and company. Think of a cone supplier to an ice cream maker.
- Market-extension merger: Two companies that sell the same products in different markets.
- Product-extension merger: Two companies selling different but related products in the same market.
- Conglomeration: Two companies that have no common business areas.

  From the perspective of how the merge is financed, there are two types of mergers: purchase mergers and consolidation merger Each has certain implications for the companies involved and for investors:

  - o Purchase Mergers - As the name suggests, this kind of merger occurs when one company purchases another one. The purchase is made by cash or through the issue of some kind of debt instrument, and the sale is taxable.

    Acquiring companies often prefer this type of merger because it can provide them with a tax benefit. Acquired assets can be ''written-up'' to the actual purchase price, and the difference between book value and purchase price of the assets can depreciate annually, reducing taxes payable by the acquiring company (we discuss this further in part four of this tutorial).

  - o Consolidation Mergers - With this merger, a brand new company is formed and both companies are bought and combined under the new entity. The tax terms are the same as those of a purchase merger.

7.2 ACQUISITIONS

As you can see, an acquisition may be only slightly different from a merger. In fact, it may be different in name only. Like mergers, acquisitions are actions through which companies seek economies of scale, efficiencies, and enhanced market visibility. Unlike all mergers, all acquisitions involve one firm purchasing another – there is no exchanging of stock or consolidating as a new company. Acquisitions are often congenial, with all parties feeling satisfied with the deal. Other times, acquisitions are more hostile.

In an acquisition, as in some of the merger deals we discussed above, a company can buy another company with cash, with stock, or a combination of the two. Another possibility, which is common in smaller deals, is for one company to acquire all the assets of another company. Company X buys all of Company Y's assets for cash, which means that Company Y will have only cash (and debt, if they had debt before). Of course, Company Y becomes merely a shell and will eventually liquidate or enter another area of business.

Another type of acquisition is a reverse merger, a deal that enables a private company to get publicly-listed in a relatively short time period. A reverse merger occurs when a private company that has strong prospects and is eager to raise financing buys a publicly-listed shell company, usually one with no business and limited assets. The private company reverse merges into the public company, and together they become an entirely new public corporation with tradable shares.

Regardless of their category or structure, all mergers and acquisitions have one common goal: they are all meant to create synergy that makes the value of the combined companies greater than the sum of the two parts. The success of a merger or acquisition depends on how well this synergy is achieved.

Types of Acquisitions

In general, acquisitions can be horizontal, vertical, or conglomerate. A horizontal acquisition takes place between two firms in the same line of business. For example, one tool and die company might purchase another. In contrast, a vertical merger entails expanding forward or backward in the chain of distribution, toward the source of raw materials or toward the ultimate consumer. For example, an auto parts manufacturer might purchase a retail auto parts store. A conglomerate is formed through the combination of unrelated businesses.

Another type of combination of two companies is a consolidation. In a consolidation, an entirely new firm is created, and the two previous entities cease to exist. Consolidated financial statements are prepared under the assumption that two or more corporate entities are in actuality only one. The consolidated statements are prepared by combining the account balances of the individual firms after certain adjusting and eliminating entries are made.

Another way to acquire a firm is to buy the voting stock. This can be done by agreement of management or by tender offer. In a tender offer, the acquiring firm makes the offer to buy stock directly to the shareholders, thereby bypassing management. In contrast to a merger, a stock acquisition requires no stockholder voting. Shareholders wishing to keep their stock can simply do so. Also, a minority of shareholders may hold out in a tender offer.

A bidding firm can also buy another simply by purchasing all its assets. This involves a costly legal transfer of title and must be approved by the shareholders of the selling firm. A takeover is the transfer of control from one group to another. Normally, the acquiring firm (the bidder) makes an offer for the target firm. In a proxy contest, a group of dissident shareholders will seek to obtain enough votes to gain control of the board of directors

Distinction Between Mergers and Acquisitions

Although they are often uttered in the same breath and used as though they were synonymous, the terms ''merger'' and "acquisition" mean slightly different things.

When a company takes over another one and clearly becomes the new owner, the purchase is called an acquisition. From a legal point of view, the target company ceases to exist and the buyer "swallows" the business, and stock of the buyer continues to be traded.

In the pure sense of the term, a merger happens when two firms, often about the same size, agree to go forward as a new single company rather than remain separately owned and operated. This kind of action is more precisely referred to as a "merger of equals." Both companies' stocks are surrendered, and new company stock is issued in its place. For example, both Daimler-Benz and Chrysler ceased to exist when the two firms merged, and a new company, DaimlerChrysler, was created.

In practice, however, actual mergers of equals don't happen very often. Often, one company will buy another and, as part of the deal's terms, simply allow the acquired firm to proclaim that the action is a merger of equals, even if it's technically an acquisition. Being bought out often carries negative connotations. By using the term "merger," dealmakers and top managers try to make the takeover more palatable.

A purchase deal will also be called a merger when both CEOs agree that joining together in business is in the best interests of both their companies. But when the deal is unfriendly–that is, when the target company does not want to be purchased–it is always regarded as an acquisition.

So, whether a purchase is considered a merger or an acquisition really depends on whether the purchase is friendly or hostile and how it is announced. In other words, the real difference lies in how the purchase is communicated to and received by the target company's board of directors, employees and shareholders

Synergy is the magic force that allows for enhanced cost efficiencies of the new business. Synergy takes the form of revenue enhancement and cost savings. By merging, the companies hope to benefit from the following:

- Staff reductions – As every employee knows, mergers tend to mean job losses. Consider all the money saved from reducing the number of staff members from accounting, marketing and other departments. Job cuts will also include the former CEO, who typically leaves with a compensation package.
- Economies of scale yes, size matters. Whether it's purchasing stationery or a new corporate IT system, a bigger company placing the orders can save more on costs. Mergers also translate into improved purchasing power to buy equipment or office supplies – when placing larger orders, companies have a greater ability to negotiate price with their supplier
- Acquiring new technology – To stay competitive, companies need to stay on top of technological developments and their business applications. By buying a smaller company with unique technologies, a large company can keep or develop a competitive edge.
- Improved market reach and industry visibility – Companies buy companies to reach new markets and grow revenues and earnings. A merge may expand two companies' marketing and distribution, giving them new sales opportunities. A merger can also improve a company's standing in the investment community: bigger firms often have an easier time raising capital than smaller ones.

That said, achieving synergy is easier said than done – it is not automatically realized once two companies merge. Sure, there ought to be economies of scale when two businesses are combined, but sometimes it works in reverse. In many cases, one and one add up to less than two.

Sadly, synergy opportunities may exist only in the minds of the corporate leaders and the dealmakers. Where there is no value to be created, the CEO and investment bankers – who have much to gain from a successful M&A deal – will try to build up the image of enhanced value. The market, however, eventually sees through this and penalizes the company by assigning it a discounted share price. We talk more about why M&A may fail in a later section of this tutorial.

Conclusion & Resources

One size does not fit all. Many companies find that the best route forward is expanding ownership boundaries through mergers and acquisitions. For others, separating the public ownership of a subsidiary or business segment offers more advantages. At least in theory, mergers create synergies and economies of scale, expanding operations and cutting costs. Investors can take comfort in the idea that a merger will deliver enhanced market power.

By contrast, de-merged companies often enjoy improved operating performance thanks to redesigned management incentives. Additional capital can fund growth organically or through acquisition. Meanwhile, investors benefit from the improved information flow from de-merged companies.

M&A comes in all shapes and sizes, and investors need to consider the complex issues involved in M&A. The most beneficial form of equity structure involves a complete analysis of the costs and benefits associated with the deals.

7.3 ACCOUNTING FOR MERGERS AND ACQUISITIONS

The two principal accounting methods used in mergers and acquisitions are the pooling of interests method and the purchase method. The main difference between them is the value that the combined firm's balance sheet places on the assets of the acquired firm, as well as the depreciation allowances and charges against income following the merger.

The pooling of interests method assumes that the transaction is simply an exchange of equity securities. Therefore, the capital stock account of the target firm is eliminated, and the acquirer issues new stock to replace it. The two firms' assets and liabilities are combined at their historical book values as of the acquisition date. The end result of a pooling of interests transaction is that the total assets of the combined firm are equal to the sum of the assets of the individual firms. No goodwill is generated, and there are no charges against earnings. A tax-free acquisition would normally be reported as a pooling of interests.

Under the purchase method, assets and liabilities are shown on the merged firm's books at their market (not book) values as of the acquisition date. This method is based on the idea that the resulting values should reflect the market values established during the bargaining process. The total liabilities of the combined firm equal the sum of the two firms' individual liabilities. The equity of the acquiring firm is increased by the amount of the purchase price.

Accounting for the excess of cost over the aggregate of the fair market values of the identifiable net assets acquired applies only in purchase accounting. The excess is called goodwill, an asset which is charged against income and amortized over a period that cannot exceed 40 years. Although the amortization "expense" is deducted from reported income, it cannot be deducted for tax purposes.

Purchase accounting usually results in increased depreciation charges because the book value of most assets is usually less than fair value because of inflation. For tax purposes, however, depreciation does not increase because the tax basis of the assets remains the same. Since depreciation under pooling accounting is based on the old book values of the assets, accounting income is usually higher under the pooling method. The accounting treatment has no cash flow consequences. Thus, value should be unaffected by accounting procedure. However, some firms may dislike the purchase method because of the goodwill created. The reason for this is that goodwill is amortized over a period of year

Accounting Standard (AS-14) as prescribed by the Institute of Chartered Accountants of India deals with accounting for amalgamation and treatment for resulting goodwill or reserves. AS-14 classifies amalgamation into two types, viz.:

Amalgamation in nature of merger; and

Amalgamation in nature of purchase.

Amalgamation in nature of merger is an amalgamation, which satisfies all the following conditions:

i. All the assets and liabilities of the transferor company become the assets and liabilities of the transferee company;

ii. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than transferee company and its nominees) become equity shareholders of the transferee company after amalgamation;

iii. The consideration is to be discharged by way of issue of equity shares in the transferee company to the shareholders of the transferor company on the amalgamation;

iv. The business of the transferor company is to be carried on by the transferee company;

v. No adjustments are intended to be made to the book values of the assets and liabilities of the transferor company.

If any one or more of the aforesaid conditions are not satisfied then the amalgamation is in nature of purchase.

Amalgamation in the nature of merger is to be accounted as per the Pooling of Interest Method and in case of amalgamation in the nature of purchase accounting needs to be done as per the Purchase Method.

Methods of Accounting:

Pooling of Interest Method (In the nature of merger)

i. The assets, liabilities and reserves of the transferor company are to be recorded at their existing carrying amounts and in the same form as it was appearing in the books of the transferor company.

ii. The identity of the reserves of the transferor company is to be kept intact in the balance sheet of the transferee company.

iii. Difference between the amounts of share capital issued plus any other additional consideration paid by the transferee company and the amount of the share capital of the transferor company should be adjusted in Reserves.

Purchase Method:

i. The assets and the liabilities of the transferor company are to be recorded at their existing carrying amounts or, alternatively, the consideration should be allocated to individual assets and liabilities on the basis of fair values at the date of amalgamation while preparing the financial statements of the transferee company.

ii. The identity of the reserves of the transferor company other than the statutory reserves is not preserved. The identity of the statutory reserves is preserved in the same form and is recorded in the books of the transferee company by a corresponding debit to the amalgamation adjustment a/c.

iii. Excess or shortfall of consideration over the value of net assets acquired should be credited/ debited as capital reserve/goodwill, as the case may be.

iv. It is appropriate to amortize goodwill over a period of not exceeding 5 years unless a longer period is justified.

The accounting treatment as specified in AS-14 needs to be followed for accounting of reserves. In case the scheme of amalgamation sanctioned prescribes a separate treatment to be given to the reserves of the transferor company on amalgamation, it can be followed.

However the Institute of Chartered Accountants of India has issued a general clarification wherein the following disclosure is to be made in case the accounting treatment for reserves is different from that specified in AS-14:

i. Description of the accounting treatment given to reserves;

ii. Deviation in the Accounting Treatment and the reasons for following a treatment different from that prescribed in the AS-14;

iii. The financial effect, if any, arising due to such deviation is to be disclosed.

iv. Other Disclosure Requirements

  a. General

    - Names and general nature of business of the amalgamating companies
    - Effective date of amalgamation for accounting purposes
    - Method of accounting used to reflect the amalgamation and Exchange Ratio
    - Particulars of the scheme sanctioned by the Court

  b. If Pooling of Interest Method is used

    - Description and number of shares issued, together with the percentage of each company's equity shares exchanged.
    - The amount of any difference between the consideration and the value of net identifiable assets acquired and the treatment thereof.

  c. If Purchase Method is used

    - Consideration for the amalgamation and description of consideration paid/payable
    - The amount of difference between the consideration and the value of net identifiable assets acquired and the treatment thereof including the period of amortization of any goodwill arising on amalgamation

ENTRIES IN BOOKS OF VENDOR COMPANY

1. Transfer to Realisation A/c.

Particulars		Debit ₹	Credit ₹
a. Assets taken over by purchasing Company at Book values.			
Realisation A/c	Dr.	XXX	
To Liquidator of A Ltd. A/c			XXX
b. Liabilities taken over by Purchasing Company at Balance Sheet value.			
Liabilities A/c	Dr.	XXX	
To Realisation A/c			XXX

2. Purchase Consideration

Purchase consideration represents consideration paid by transferee company to shareholders (equity and preference) in any form viz., cash, shares, debentures etc.

Particulars		Debit ₹	Credit ₹
a. Due Entry for consideration			
Transfer company A/c	Dr.	XXX	
To Realisation A/c			XXX
b. Receipt of Considertion			
Shares/Securities of transferee company A/c	Dr.	XXX	
Bank A/c	Dr.	XXX	
To Transferee company A/c			XXX

3. Sale of Assets not taken over (Assuming Profits)

Particulars		Debit ₹	Credit ₹
Bank A/c (Sale proceeds)	Dr.	XXX	
To Assets A/c (Book value)			XXX
To Realisation A/c (Profits)			XXX

4. Settlement of liabilities not taken over (Assuming at a discount)

Particulars		Debit ₹	Credit ₹
Liabilities A/c (book value)	Dr.	XXX	
To Bank A/c		XXX	
To Realisation A/c (discount)			XXX

5. Realisation expenses

Particulars		Debit ₹	Credit ₹
a. Incurred by transferor company			
Realisation A/c	Dr.	XXX	
To Bank A/c			XXX
b. Incurred by transferee company no Entry			

Particulars		Debit ₹	Credit ₹
c. Incurred by transferor company reimbursed by transferee company			
i. On incurring the expenses			
Transferee company A/c	Dr.	XXX	
To Bank			XXX
ii. On reimbursement			
Bank A/c	Dr.	XXX	
To Transferee company A/c			XXX

6. Amount due to the euqity Share holders

Particulars		Debit ₹	Credit ₹
a. Transfer of share capital and reserves to shareholders account			
Equity Share Capital A/c	Dr.	XXX	
Reserves A/c	Dr.	XXX	
To Shareholders A/c			XXX

7. Settlement to Share holders by transfer of consideration received:

Particulars		Debit ₹	Credit ₹
Shareholders A/c	Dr.	XXX	
To Shares/Securities of transferee company A/c			XXX
To Bank A/c			XXX

ENTRIES IN BOOKS OF TRANSFEREE COMPANY

a) Three basic entries

For purchase consideration due	
Business Purchase a/c	Dr.
To Liquidator of Vendor Company	
For assets and liabilities taken over	
Sundry Assets A/c	Dr.
Goodwill A/c	Dr. (Bal. fig.)
To Sundry Liabilities	
To Business Purchase A/c	
To Capital Reserve A/c (Bal. fig.)	
For discharge of purchase consideration	
Liquidator of Vendor Company A/c	Dr.
To Equity Share Capital A/c	
To Securities Premium A/c	
To Debentures A/c	
To Preference Share Capital A/c	
To Cash A/c	

b) **For liquidation expenses paid by purchasing company**

Goodwill/Capital Reserve A/c	Dr.
To Cash A/c	

c) **For cancellation of mutual owings**

Creditor/Bills payable A/c	Dr.
To Debtors/Bills receivable A/c	

d) **For adjustment of unrealised profit**

Goodwill/Capital reserve A/c	Dr.
To Stock A/c	

e) **For carry forward of statutory reserves**

Amalgamation Adjustment A/c	Dr.
To Statutory Reserve A/c	

f) **If both capital reserve and goodwill appears in books**

Capital Reserve A/c	Dr.
To Goodwill A/c	

How To Value An Acquisition

Valuing an acquisition is similar to valuing any investment. The analyst estimates the incremental cash flows, determines an appropriate risk-adjusted discount rate, and then computes the net present value (NPV). If firm A is acquiring firm B, for example, then the acquisition makes economic sense if the value of the combined firm is greater than the value of firm A plus the value of firm B. Synergy is said to exist when the cash flow of the combined firm is greater than the sum of the cash flows for the two firms as separate companies. The gain from the merger is the present value of this difference in cash flows.

Sources of Gains From Acquisitions

The gains from an acquisition may result from one or more of the following five categories: (1) revenue enhancement, (2) cost reductions, (3) lower taxes, (4) changing capital requirements, or (5) a lower cost of capital. Increased revenues may come from marketing gains, strategic benefits, and market power. Marketing gains arise from more effective advertising, economies of distribution, and a better mix of products. Strategic benefits represent opportunities to enter new lines of business. Finally, a merger may reduce competition, thereby increasing market power. Such mergers, of course, may run afoul of antitrust legislation.

A larger firm may be able to operate more efficiently than two smaller firms, thereby reducing costs. Horizontal mergers may generate economies of scale. This means that the average production cost will fall as production volume increases. A vertical merger may allow a firm to decrease costs by more closely coordinating production and distribution. Finally, economies may be achieved when firms have complementary resources — for example, when one firm has excess production capacity and another has insufficient capacity.

Tax gains in mergers may arise because of unused tax losses, unused debt capacity, surplus funds, and the write-up of depreciable assets. The tax losses of target corporations can be used to offset the acquiring corporation's future income. These tax losses can be used to offset income for a maximum of 15 years or until the tax loss is exhausted. Only tax losses for the previous three years can be used to offset future income.

Tax loss carry-forwards can motivate mergers and acquisitions. A company that has earned profits may find value in the tax losses of a target corporation that can be used to offset the income it plans to earn. A merger may not, however, be structured solely for tax purposes. In addition, the acquirer must continue to operate the pre-acquisition business of the company in a net loss position. The tax benefits may be less than their "face value," not only because of the time value of money, but also because the tax loss carry-forwards might expire without being fully utilized.

Tax advantages can also arise in an acquisition when a target firm carries assets on its books with basis, for tax purposes, below their market value. These assets could be more valuable, for tax purposes, if they were owned by another corporation that could increase their tax basis following the acquisition. The acquirer would then depreciate the assets based on the higher market values, in turn, gaining additional depreciation benefits.

Interest payments on debt are a tax-deductible expense, whereas dividend payments from equity ownership are not. The existence of a tax advantage for debt is an incentive to have greater use of debt, as opposed to equity, as the means of financing merger and acquisition transactions. Also, a firm that borrows much less than it could may be an acquisition target because of its unused debt capacity. While the use of financial leverage produces tax benefits, debt also increases the likelihood of financial distress in the event that the acquiring firm cannot meet its interest payments on the acquisition debt.

Finally, a firm with surplus funds may wish to acquire another firm. The reason is that distributing the money as a dividend or using it to repurchase shares will increase income taxes for shareholders With an acquisition, no income taxes are paid by shareholders.

Acquiring firms may be able to more efficiently utilize working capital and fixed assets in the target firm, thereby reducing capital requirements and enhancing profitability. This is particularly true if the target firm has redundant assets that may be divested.

The cost of debt can often be reduced when two firms merge. The combined firm will generally have reduced variability in its cash flows. Therefore, there may be circumstances under which one or the other of the firms would have defaulted on its debt, but the combined firm will not. This makes the debt safer, and the cost of borrowing may decline as a result. This is termed the coinsurance effect.

Diversification is often cited as a benefit in mergers. Diversification by itself, however, does not create any value because stockholders can accomplish the same thing as the merger by buying stock in both firms.

Valuation Procedures

The procedure for valuing an acquisition candidate depends on the source of the estimated gains. Different sources of synergy have different risks. Tax gains can be estimated fairly accurately and should be discounted at the cost of debt. Cost reductions through operating efficiencies can also be determined with some confidence. Such savings should be discounted at a normal weighted average cost of capital. Gains from strategic benefits are difficult to estimate and are often highly uncertain. A discount rate greater than the overall cost of capital would thus be appropriate.

The net present value (NPV) of the acquisition is equal to the gains less the cost of the acquisition. The cost depends on whether cash or stock is used as payment. The cost of an acquisition when cash is used is just the amount paid. The cost of the merger when common stock is used as the consideration (the payment) is equal to the percentage of the new firm that is owned by the previous shareholders in the acquired firm multiplied by the value of the new firm. In a cash merger the benefits go entirely to the acquiring firm, whereas in a stock-for-stock exchange the benefits are shared by the acquiring and acquired firms.

Whether to use cash or stock depends on three considerations. First, if the acquiring firm's management believes that its stock is overvalued, then a stock acquisition may be cheaper. Second, a cash acquisition is usually taxable, which may result in a higher price. Third, the use of stock means that the acquired firm will share in any gains from merger; if the merger has a negative NPV, however, then the acquired firm will share in the loss.

In valuing acquisitions, the following factors should be kept in mind. First, market values must not be ignored. Thus, there is no need to estimate the value of a publicly traded firm as a separate entity. Second, only those cash flows that are incremental are relevant to the analysis. Third, the discount rate used should reflect the risk associated with the incremental cash flows. Therefore, the acquiring firm should not use its own cost of capital to value the cash flows of another firm. Finally, acquisition may involve significant investment banking fees and costs.

Mergers and acquisitions and corporate restructuring – or M&A for short – are a big part of the corporate finance world. Everyday, Wall Street investment bankers arrange M&A transactions that bring together separate companies to make larger ones. When they are not creating big companies from smaller ones, corporate finance deals do the reverse and break up companies through spinoffs, carve-outs, or tracking stocks.

Not surprisingly, these types of actions often make the news. Deals can be worth hundreds of millions or even billions of dollars, and they can dictate the fortunes of the companies involved for years to come. For CEOs, leading M&A can represent the pinnacle of their careers.

7.4 EXTERNAL RECONSTRUCTION

Reconstruction means reorganization of a company's financial structure. In reconstruction of a company, usually the assets and liabilities of the company are revalued, the losses suffered by the company are written off by a deduction of the paid-up value of shares and/or varying of the rights attached to different classes of shares and compounding with the creditors It may be done without liquidating the company and forming a new company in which case the process is called internal reconstruction. However, there may be external reconstruction in which case the undertaking being carried on by the company is transferred to a newly started company consisting substantially of the same shareholders with a view to the business of the transferee company being continued by the transferee company. An attempt is made that the newly started company has a sound financial structure and a good set of assets and liabilities recorded in the books of the transferee company at their fair values.

From the point of view of an accountant, external reconstruction is similar to amalgamation in the nature of purchase; the books of the transferee company are closed and in the books of the transferee company, the purchase of the business is recorded. But otherwise external reconstruction and amalgamation differs as follows:

(i) In external reconstruction, only one company is involved whereas in amalgamation, there are at least two existing companies which amalgamate.

(ii) In external reconstruction, a new company is certainly formed whereas in amalgamation a new company may be formed or in the alternative one of the existing companies may take over the other amalgamating company or companies and no new company may be formed.

(iii) The objective of the external reconstruction is to reorganize the financial structure of the company, on the other hand, the objective of the amalgamation is to cut competition and reap the economies of larger scale.

Scheme of Internal

The need for reconstruction arises when a company has accumulated losses or when a company finds itself overcapitalized which means either that the value placed on assets is too much as compared to their earning capacity or that the profits as a whole are insufficient to pay a proper dividend. Apart from clarity, wide acceptance and justice, the reconstruction scheme must take into account the following:-

The fundamental basis of any proposals is the earning power of the company. Even the interest to debenture holders cannot be paid unless the company's activities are profitable. A very careful estimate should, therefore, be made of the profits expected by the company in the future. Unless the profits are sufficient to meet all the expenses including adequate depreciation, interest to debenture holders and other creditors, preference dividend, and a reasonable return to the equity shareholder, it would be useless to process with any reconstruction scheme because, otherwise, the need for reconstruction will soon arise again.

Assuming that adequate profits can be expected, the reconstruction scheme should not adversely affect the rights of preference shareholders (not to speak of creditors and debenture holders) unless it is absolutely necessary. Suppose, the profits are such that after paying dividends to preference shareholders little remains for equity shareholders: the preference shareholder may be persuaded to accept a sacrifice either by reduction of capital or by reduction in the rate of dividend or both because the alternative to such acceptance of sacrifice may be the liquidation of the company (in which case, due to forced sale, the asset may not realize much and the preference shareholder may not be able to get back what they have invested). If the company is in very bad position, even the debenture holders may be prevailed upon to accept a reduction of their claims. But, so far as is possible, contractual and legal rights and priorities should be maintained.

The equity shareholder will naturally have to bear the brunt of the losses and sacrifice. This is not as bade as it sounds because (a) the equity shareholders realize from the very beginning that if losses occur they have to bear them before anybody else can be called upon to do so, and (b) they must have already known that the value of their holding is small due to absence of dividend. The market price of share is related to dividend and not to the face or nominal value of the share. It really does not matter, therefore, whether the nominal value of an equity share is ₹ 1 or ₹ 100 or ₹ 1,000 as long as it is not 0. (This does matter in case of preference shareholders and debenture holders whose earnings depend on the nominal value). In fact, a reconstruction scheme may be beneficial to the equity shareholders by enabling the payment of a dividend on such shares. On this ground, it would be unjust to ask the preference shareholders to accept a sacrifice when the equity shareholders improve their position.

There is, however, one important right which the equity shareholders enjoy. This is control over the affairs of the company. The equity shareholders will not easily give up this rite, and hence the reconstruction scheme should keep this in mind. The equity shareholder may not agree to the conversion of preference share or debenture into equity share even if the holders of preference shares or debenture are willing to accept lower security for their holdings. The equity share holders may agree to this only if there is a threat of the company being wound up (in which case they will lose almost all). It should also be noted that without the consent of the parties their liability cannot be increased. For instances, fully paid shares cannot be converted into partly paid shares without the consent of the shareholders

The requirements of the working capital must not be overlooked. Cash may require to pay certain dissenting creditor or even to pay arrears of preference dividend. Generally, therefore, a company under reconstruction will have to raise funds to enable it to pay off such dissenters and to carry on its work smoothly. Which of the various parties are willing to subscribe more shares will have to be seen. The equity shareholders will like to consolidate their position by buying more shares. Sometimes, outsiders are willing to subscribe to the shares but they will generally prefer to do so if they are given a controlling share.

Steps:

(1) First of all the total amounts to be written off should be ascertained. This would mean totaling up the debit balance of the Profit and Loss account, all fictitious assets like goodwill, preliminary expenses, discount on shares or debentures, any fall in value of assets, any increase in liabilities and arrears of dividends on cumulative preference shares. If the value of any share can be legitimately increased the amount of loss would then be reduced accordingly. The other way to get at the same figure would be to add up the present value as a going concern, of all the assets and deduct there from the amount of liabilities and also the arrears of dividend on cumulative preference shares. What is left is "net assets". The share capital compared with net assets will show how much amount is to be written off.

(2) The question now arises has to who is to bear the loss. If the net assets are more than the preference share capital, it is obvious the whole of the loss will have to be borne by the equity shareholders The nominal value of the equity shares should be reduced by a sufficient margin to cover the loss. If the net assets are not sufficient to cover the preference share capital (or if the net assets are just sufficient), the preference share holder will have to accept a sacrifice, although their sacrifice will be

smaller than that of the equity share holders (Equity share holders should not be completely wiped off). If the future earning power of the company permits, the dividend rate should be increased so that, in terms of rupees, the dividend remains unchanged. Thus if 10.5% preference share of ₹ 100 are converted into preference share of ₹ 75 each, rate of dividend should be raised to 14%, if possible. In both cases, then the dividend will be ₹ 10.5 per share.

(3) Payment of arrears of dividend (question arises only in case of cumulative preference shares) in cash immediately may present difficulties. In such a case a good method is to issue deposit certificates. This is preferable to issuing shares because (a) it will not upset the voting power and (b) the certificate can be redeemed as soon as opportunity arises. The rate of interest need not be heavy, but of course, it will depend on the future earning capacity of the company.

(4) Debenture holders and other creditors are affected by the reconstruction scheme only if the total assets in the company are insufficient to cover even the liabilities (although they are concerned is necessary to any scheme that may be formulated). In such an eventuality, the creditors (including debenture holders) will have to accept sacrifice unless they think that by sending the company into liquidation we will be able to realize substantial portion of their claims. The share holders, both preference and equity will have to accept a heavy reduction in the value of share but they cannot be expected to agree to complete wiping of the shares, in which case they will have no interest in keeping the company going. Generally, the sacrifice to be borne by the creditors will be as follows:

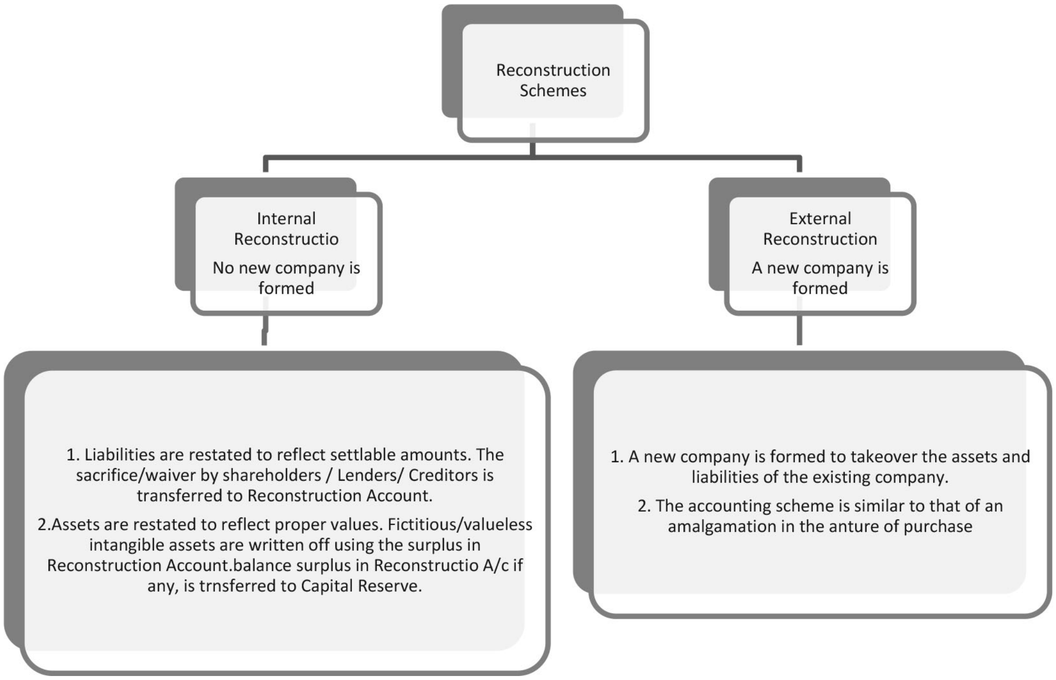
Preferential creditors Nil

(According to law)

Depending upon the value of the security Heaviest.

In short, the whole scheme should broadly depend upon the expected earning power and upon the position as it likely to obtain if the company is sent to liquidation.

Reconstruction Schemes



Journal Entries for Internal Reconstruction Schemes

No.	Transaction	Journal Entry
1.	Increase in value of productive assets	(Relevant) Assets A/c Dr. To, Reconstruction A/c
2.	Disposal of unproductive assets	Bank/Cash A/c(amount realized) Dr. Reconstruction A/c(if sold in loss) Dr. To, (Relevant) Assets A/c(book value of assets sold) To, Reconstruction A/c(if sold in profit)
3.	Waiver of recorded liabilities (No entry for waiver of unrecorded liab.)	(Relevant) Liability A/c Dr. To, Reconstruction A/c
4.	Settlement of liabilities at an amount lower/higher than recorded value	(Relevant) Liability A/c Dr. Reconstruction A/c(if settled at higher amount) Dr. To, Bank/Cash A/c(amount paid) To, Reconstruction A/c(if settled in discount)
5.	Reduction in paid up value of capital	Equity Share Capital A/c(old paid up value) Dr. To, Equity Share Capital A/c(new paid up value) To, Reconstruction A/c(difference/surplus)
6.	Surrender of fully paid shares	Equity Share Capital A/c Dr. To, Shares Surrendered A/c
7.	Reissue of surrendered shares A. If re-issued for cash consideration, the entire amount received from fresh allottees is as surplus and hence transferred to Reconstruction A/c B. If reissued for discharge of an existing liability, the amount of liability will be cancelled and transferred to Reconstruction A/c	A. for Cash Consideration (i) Equity Share Capital A/c Dr. To, Shares Surrendered A/c (ii) Bank/Cash A/c Dr. To, Reconstruction A/c B. Discharge of Existing Liability (i) Equity Share Capital A/c Dr. To, Shares Surrendered A/c (ii) (Relevant) Liability A/c Dr. To, Reconstruction A/c
8.	Balance in Shares Surrendered A/c not reissued	Shares Surrendered A/c Dr. To, Reconstruction A/c
9.	Utilisation of Reconstruction Surplus for writing off losses/intangible assets/overstated assets and recognisition of previously unrecorded liability	Reconstruction A/c Dr. To, P & L A/c (debit balance written off) To, Misc. Exp.to the extent not w/off(individualy) To, Goodwill/ Other Intangible Assets having no value To, Other Assets (which are overstated) To, Liability A/c (previously not recorded)
10	Balance Surplus in Reconstruction A/c	Reconstruction A/c Dr. To, Capital Reserve A/c

Note:

- Reconstruction A/c can also be called as “ Reorganisation Account” or “ Capital Reduction Account”.
- While preparing the B/Sheet of the reconstructed company, the words “and Reduced” should be added to the name of the company, if the Court/ NCLAT directs so. Also, the amount written off against Fixed Assets under the scheme of reconstruction,should be shown for a period of five years.

Internal vs. External Reconstruction: Having decided who is to bear how much sacrifice of loss and having settled the broad details of the scheme, and important question remains to be decided. Will the reconstruction be internal or external? Internal reconstruction means that the scheme will be carried out by liquidating the existing company and incorporating immediately another company (with the name only slightly changed such as A B Ltd. , to take over the business of the outgoing company. There are advantages in both, but generally internal reconstruction is preferred. The advantages in its favour are:-

(a) Creditors, specially bank overdraft and debenture holders, may continue whereas they may not if the company is formally liquidated which will involve payment of claims to outsiders, If they do not continue, the company may suffer from want of financial assistance. This is, however, only academic since no reconstruction scheme, even internal, will be really formulated without the consent of the bank, debenture holders Etc.

(b) The company will be able to set off its past losses against future profits for income-tax purposes. This will materially reduce the income-tax liability depending on the losses suffered during the preceding eight years Losses can be carried forward for eight years provided the business is carried on. The business will technically end when the company is liquidated. Hence, in case of external reconstruction, losses cannot be carried forward for income tax purposes.

The arguments in favour of external reconstruction are as under:-

(a) External reconstruction may be the only way to bring about speedy reconstruction because sometimes a few people hold up the scheme by delaying tactics by means of legal objections.

(b) It may help in raising more finance by issuing to the existing shareholders partly paid shares in the new company. It should be remembered that in internal reconstruction fully paid up shares unless every shareholder gives his assent in writing. This may prove cumbersome. However, if shareholders are willing to accept partly paid shares in the new company, there is not much reason why they should refuse to buy new shares under a scheme of internal reconstruction.

Legal position as regards external reconstruction:

Sec 319 of the Companies Act permits the liquidator of a company to transfer the whole or any part of the company's business or property to another company and receive from the transferee company for distribution among the share holders of the company under liquidation. The liquidator must obtain the sanction of the company by a special resolution. Any sale of arrangement in pursuance of this section is binding on the members of the transferor company.

But a shareholder who has not voted for the special resolution may, within seven days of the resolution, serve a notice on the liquidator expressing his dissent and requiring the liquidator either, (a) to abstain from carrying the resolution into effect, or (b) to purchase his interest at a price to be determined by agreement or by arbitration.

Computation and Discharge of Purchase Consideration

Illustration 1:

The Oil Shell Ltd. was incorporated on 1st April 2014 for the purpose of acquiring P Ltd., Q. Ltd., and R Ltd.

The Balance sheet of these companies as on 31st March 2015 are as follows:

(₹)

Particulars	P Ltd.	Q Ltd.	R Ltd.
Assets:			
Tangible Fixed assets - at cost less depreciation	50,00,000	40,00,000	30,00,000
Goodwill	—	6,00,000	—
Other assets	20,00,000	28,00,000	8,50,000
Total	70,00,000	74,00,000	38,50,000

(₹)

Particulars	P Ltd.	Q Ltd.	R Ltd.
Liabilities:			
Issued Equity Share Capital (shares of ₹ 10 each)	40,00,000	50,00,000	25,00,000
Profit and Loss A/c	15,00,000	11,00,000	6,00,000
10% Debentures	7,00,000	—	4,00,000
Sundry Creditors	8,00,000	13,00,000	3,50,000
Total	70,00,000	74,00,000	38,50,000
Average annual profits before debentures interest (April 2014 to March 2015 inclusive)	9,00,000	12,00,000	5,00,000
Professional valuation of tangible assets on 31st March 2015	62,00,000	48,00,000	36,00,000

1. The directors in their negotiations agreed that: (i) the recorded goodwill of Q Ltd. is valueless; (ii) the "Other assets" of P Ltd. are worth ₹ 3,00,000; (iii) the valuation of 31st March 2015 in respect of tangible Fixed assets should be accepted. (iv) these adjustments are to be made by the individual companyt before the completion of the acquitition.
2. The acquisition agreement provided for the issue of 12% unsecured Debentures to the value of the net assets of companies P Ltd., Q Ltd. and R Ltd. and for the issuance of ₹ 100 nominal value equity shares for the capitalized average profit of each acquired company in excess of net assets contributed. The capitalisation rate is established at 10%.

You are required to:

i. Compute Purchase consideration.

ii. Dicscharge of Purchase consideration.

Solution:

Computation of Purchase Consideration

WN # 1: Consideration in the form of 12% Debentures

Particulars	P Ltd.		Q Ltd.		R Ltd.	
	₹	₹	₹	₹	₹	₹
a. Asset						
i. Tangilbe Fixed assets (as valuation)	62,00,000		48,00,000		36,00,000	
ii. Other Assets (as per directors negotiation)	3,00,000	65,00,000	28,00,000	76,00,000	8,50,000	44,50,000
b. Liabilities						
i. Sundry Creditors	8,00,000		13,00,000		3,50,000	
ii. 10% Debentures	7,00,000	(15,00,000)	—	(13,00,000)	4,00,000	(7,50,000)
c. NET ASSETS (a-b)		50,00,000		63,00,000		37,00,000
d. 12% Debentures to be issued.		50,00,000		63,00,000		37,00,000

WN # 2: Consideration in the form of Equity Shares

Particulars	P Ltd. ₹	Q Ltd. ₹	R Ltd. ₹
a. Average annual profit before debenture interest (given)	9,00,000	12,00,000	5,00,000
b. Debenture interest (on 10% Debentures)	70,000	—	40,000
c. Profit after debentures interest (a-b)	8,30,000	12,00,000	4,60,000

Particulars	P Ltd. ₹	Q Ltd. ₹	R Ltd. ₹
d. Capitalisation rate	10%	10%	10%
e. Capitalised average profit (c/d)	83,00,000	1,20,00,000	46,00,000
f. Net Assets takeover (WN # 1(c))	50,00,000	63,00,000	37,00,000
g. Excess of capitalised average profit over net assets take over (e-f)	33,00,000	57,00,000	9,00,000

WN # 3: Summary of Purchase Consideration

Particulars	P Ltd. ₹	Q Ltd. ₹	R Ltd. ₹
a. 12% Debentures of Oil Shell Ltd. each @ ₹ 100 [WN # 1(d)]	50,00,000	63,00,000	37,00,000
b. Equity shares of ₹ 100 each of Oil Shell Ltd. [WN # 2(g)]	33,00,000	57,00,000	9,00,000
c. Total Consideration	83,00,000	1,20,00,000	46,00,000

Illustration 2:

Zee Ltd. agreed to absorb Gulf Ltd. on 31st March, 2015, whose Balance sheet stood as follows:

Liabilities	₹	Assets	₹
Share capital		Fixed assets	70,00,000
80,000 shares of ₹ 100 each fully paid	80,00,000	Investments	—
Reserves and surplus		Current assets, Loans and	
General Reserve	10,00,000	Advances	
Secured Loan	—	Stock in trade	10,00,000
Unsecured Loan	—	Sundry Debtors	20,00,000
Current Liabilities and Provisions			
Sundry creditors	10,00,000		
	1,00,00,000		1,00,00,000

Note: Assumed that secured and unsecured loan is of less that 12 months, hence to be treated as short term borrowings (ignoring interest)

The consideration was agreed to be paid as follows:

a. A payment in cash of ₹ 50 per share in Gulf Ltd. and

b. The issue of shares of ₹ 100 each in Zee Ltd., on the basis of 2 Equity Shars (valued at ₹ 150) and one 10% cumulative preference share (valued at ₹ 100) for every five shares held in Gulf Ltd.

It was agreed that Zee Ltd. will pay in cash for fractional shares equivalent at agreed value of shares in Gulf Ltd. i.e. ₹ 650 for five shares of ₹ 500 paid.

The whole of the Share capital consists of shareholdings in exact multiple of five except the following holding.

Bharati	116	
Sonu	76	
Hitesh	72	
Jagat	28	
Other individuals	8	(eight members holding one share each)
	300	

Prepare a statement showing the purchase consideration receivable by above shareholders in shares and cash.

Solution:

WN # 1: Statement of consideration paid for fraction shares

	Particulars	Bharti	Sonu	Hitesh	Jagat	Others	Total
a.	Holding of shares	116	76	72	28	8	300
b.	Non-exchangeable shares (Payable in Cash)	1	1	2	3	8	15
c.	Exchangeable Shares [(a) - (b)]	115	75	70	25	—	285
d.	Above shares						
	i. in Equity shares (2:5)	46	30	28	10	—	114
	ii. in Preference shares (1:5)	23	15	14	5	—	57

WN # 2: Number of shares to be issued

a. Exchangeable shares:

= Total shares – Non Exchangeable shares

= 80,000 – 15 = 79,985

b. Equity shares to be issued:

$= \frac{79{,}985}{5} \times 2 = 31{,}994$ Shares (i.e. 2 shares for every 5 shares)

c. Preference shares to be issued

$= \frac{79{,}985}{5} \times 1 = 15{,}997$ Shares (i.e. 1 shares for every 5 shares)

WN # 3: Cash to be paid

	Particulars	₹
a.	79,985 shares @ ₹ 50 each	39,99,250
b.	Consideration for non-exchangeable $[15\times100]\times\frac{650}{500}$ (i.e. ₹ 650 for five shares of ₹ 500 paid)	1,950
c.	Total	40,01,200

Statement of Purchase Consideration:

	Particulars		₹
a.	In Shares:		
	i. 31,994 Equity shares @ ₹ 150 each	47,99,100	
	ii. 15,997 Preference shares @ ₹ 100 each	15,99,700	63,98,800
b.	In Cash (WN # 3)		40,01,200
c.	Total (a+b)		1,04,00,000

Illustration 3:

The summarized Balance Sheets of P Ltd. and R Ltd. for the year ended 31.3.2015 are as under:

	P Ltd. ₹	R Ltd. ₹		P Ltd. ₹	R Ltd. ₹
Equity Share capital (in shares of ₹ 100 each)	24,00,000	12,00,000	Fixed Assets	55,00,000	27,00,000
8% Preference Share capital (in share of ₹ 100 each)	8,00,000	—	Current Assets	25,00,000	23,00,000

10% Preference Share capital (in shares of ₹ 100 each)	—	4,00,000			
Reserves	30,00,000	24,00,000			
Current liabilities	18,00,000	10,00,000			
	80,00,000	**50,00,000**		**80,00,000**	**50,00,000**

1. The following information is provided:

		P Ltd. ₹	R Ltd. ₹
a)	Profit before tax	10,64,000	4,80,000
b)	Taxation	4,00,000	2,00,000
c)	Preference dividend	64,000	40,000
d)	Equity dividend	2,88,000	1,92,000

2. The Equity shares of both the companies are quoted in the market. Both the companies are carrying on similar manufacturing operations.
3. P. Ltd. proposes to absorb R Ltd. as on 31.3.2015. The terms of absorption are as under:
   a. Preference shareholders of R Ltd. will receive 8% preference shares of P. Ltd. sufficient to increase the income of preference shareholders of R Ltd. by 10%
   b. The equity shareholders of R Ltd. will receive equity shares of P Ltd. on the following basis:
      i. The equity shares of R Ltd. will be valued by applying to the earnings per share of R Ltd. 75% of price earnings ratio of P Ltd. based on the results of 2014-2015 of both the companies.
      ii. The market price of equity shares of P Ltd. is ₹ 400 per share.
      iii. The number of shares to be issued to the equity shareholders of R Ltd. will be based on the above market value.
      iv. In addition to equity shares, 8% preference share of P Ltd. will be issued to the equity shareholders of R Ltd. to make up for the loss in income arising from the above exchange of shares based on the dividends for the year 2014-2015.
4. For the next two years, no increase in the rate of equity dividend is expected.

   You are required to:
   i) Calculate purchase consideration.
   ii) Give the Balance Sheet as on 31.3.2015 after absorption.

Note: Journal entires are not required.

Solution:

I. Purchase Consideration

A. Preference Shareholders

8% preference shares of P Ltd. sufficient to increase income by 10%.

Particulars	₹
Current income from Preference shares of R Ltd. (₹ 4,00,000 × 10%)	40,000
Add: 10% increase there of	4,000
Income from Preference Shares of P Ltd.	44,000
Value of 8% Preference Shares of R Ltd. to be issued [44,000×100/8]	5,50,000

B. Equity Shareholders

i. Consideration by way of Equity shares

Valuation of shares of P Ltd.
(12,000 shares × ₹ 240 [WN # 3]

₹ 28,80,000

Share Capital
[7,200 shares* × ₹ 100]
₹ 7,20,000

Share Premium
[7,200 shares* × ₹ 300]
₹ 21,60,000

* No. of shares to be issued = ₹ 28,80,000 ÷ ₹ 400

= 7,200 Shares

ii. Consideration by way of Preference Shares

	Particulars	₹
i.	Current equity dividend from R Ltd.	1,92,000
ii.	Expected Equity dividend from P Ltd. $\left(\frac{₹\ 2,88,000}{₹\ 24,00,000} \times ₹\ 7,20,000\right)$	86,400
iii.	Loss in income	1,05,600
iv.	Value of 8% Preference Shares to be issued (1,05,600 ÷ 8%)	13,20,000

C. Total Purchase Consideration

[5,50,000 + 28,80,000 + 13,20,000] ₹ 47,50,000

WN # 1: Computation of EPS

₹

Particulars	P Ltd.	R Ltd
Profit before tax (PBT)	10,64,000	4,80,000
Less: Tax (given)	(4,00,000)	(2,00,000)
Profit after tax (PAT)	6,64,000	2,80,000
Less: Preference dividend	(64,000)	(40,000)
Profit available to equity shareholders	6,00,000	2,40,000
Earnings per share (Profit for Equity Shareholders ÷ No of Shares)	25	20

WN # 2: P/E ratio of R Ltd.

$$\text{P/E ratio} = \frac{\text{Market Price}}{\text{EPS}} = \frac{400}{25} = ₹\ 16$$

75% of P/E ratio = (16×0.75) = ₹ 12

WN # 3: Value per share of P Ltd.

= EPS × P/E ratio

= ₹ 20 × ₹ 12

= ₹ 240

WN # 4: Adjustment with Reserves

Total Purchase Consideration paid to R Ltd.	47,50,000
Less: Share Capital of R Ltd.	16,00,000
(Equity + Preference) (₹ 12,00,000 + ₹ 4,00,000)	
To be adjusted with Reserves	31,50,000

... Reserves = 30,00,000 + 24,00,000 – 31,50,000 = 22,50,000

Name of the Company: P Ltd.

Balance Sheet as at 31st March, 2015

Ref No.	Particulars		Note No.	As at 31st March, 2015	As at 31st March, 2014
				₹	₹
	I.	**Equity and Liabilities**			
	1	**Shareholders' funds**			
		(a) Share capital	1	57,90,000	
		(b) Reserves and surplus	2	44,10,000	
		(c) Money received against share warrants		NIL	
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**		NIL	
	4	**Current Liabilities**			
		(a) Other current liabilities	3	28,00,000	
		Total (1+2+3+4)		1,30,00,000	
	II.	**Assets**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets	4	82,00,000	
	2	**Current assets**			
		(a) Other current assets	5	48,00,000	
		Total (1+2)		1,30,00,000	

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

(₹)

Note 1. Share Capital	As at 31st March, 2015	As at 31st March, 2014
Equity Share Capital (share of ₹100 each)(24,000 + 7,200 Eq. Shares)	31,20,000	
8% Preference Share capital (in share of ₹100 each) (8,000+5,500+13,200=26,700 shares)	26,70,000	
Total	57,90,000	

RECONCILIATION OF SHARE CAPITAL

FOR EQUITY SHARE:	As at 31st March, 2015		As at 31st March, 2014	
	Nos	Amount (₹)	Nos	Amount (₹)
Opening Balance as on 01.04.14	24,000	24,00,000	–	–
Add: Fresh Issue (Incld Bonus shares , Right shares, split shares, shares issued other than cash)	7,200	7,20,000	–	–
	31,200	31,20,000	–	–
Less: Buy Back of shares	–	–	–	–
	31,200	31,20,000	–	–

FOR 8% PREFERENCE SHARE:-	As at 31st March, 2015		As at 31st March, 2014	
	Nos	Amount (₹)	Nos	Amount (₹)
Opening Balance as on 01.04.14	8,000	8,00,000	–	–
Add: Fresh Issue (Incld Bonus shares , Right shares, split shares, shares issued other than cash)	18,700	18,70,000	–	–
	26,700	26,70,000	–	–
Less: Buy Back of shares	–	–	–	–
	26,700	26,70,000	–	–

Note 2. Reserves and Surplus	As at 31st March, 2015	As at 31st March, 2014
Reserves	22,50,000	
Securities Premium	21,60,000	
Total	44,10,000	

(₹ in '000)

Note 3. Other Current Liabilities	As at 31st March, 2015	As at 31st March,2014
Current Liabilities (18,00,000+10,00,000)	28,00,000	
Total	28,00,000	

Note 4. Tangible Assets	As at 31st March, 2015	As at 31st March, 2014
Fixed Assets	55,00,000	
Add: R Ltd.	27,00,000	
Total	82,00,000	

(It is assumed that all fixed assets are tangible fixed assets)

Note 5. Other Current assets	As at 31st March, 2015	As at 31st March, 2014
Current Liabilities (25,00,000+23,00,000)	48,00,000	
Total	48,00,000	

II Basics of Amalgamation and Absorption

Illustration 4:

A Ltd. and B Ltd. amalgamated on and from 1st April 2015. A new Company C Ltd. was formed to take over the businesses of the existing companies.

Balance Sheet as on 31.03.2015

₹ in '000

Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
Equity Shares of ₹ 100 each	60,000	70,000	Sundry Fixed Assets	85,000	75,000
General reserve	15,000	20,000	Investments	10,500	5,500
Profit and Loss A/c	10,000	5,000	Stock	12,500	27,500
Investment allowance			Debtors	18,000	40,000
Reserve	5,000	1,000	Cash and Bank	4,500	4,000
Export profit reserve	500	1,000			
12% Debentures	30,000	40,000			
Sundry creditors	10,000	15,000			
	1,30,500	1,52,000		1,30,500	1,52,000

C Ltd. issued requisite number of equity shares to discharge the claims of the equity shareholders of the transferor companies; The total shares issued as consideration is to be aggregate of paid up capital of A Ltd. and B Ltd.

Compute the Purchase Consideration and mode of discharge thereof and draft the Balance Sheet of C Ltd. after amalgamation on the following assumptions.

a. Amalgamation in the nature of MERGER
b. Amalgamation in the nature of PURCHASE

Solution:

i. Amalgamation in the nature of MERGER
   - ♦ Nature of Amalgamation → MERGER
   - ♦ Method of Accounting → POOLING OF INTEREST METHOD

ii. Computation of Purchase Consideration

(₹ in '000)

	Particulars	A Ltd.		B Ltd.	
A.	**Assets**				
i.	Sundry Fixed assets	85,000		75,000	
ii.	Investments	10,500		5,500	
iii.	Stock	12,500		27,500	
iv.	Debtors	18,000		40,000	
v.	Cash and Bank	4,500		4,000	
			1,30,500		1,52,000
B.	**Liabilities**				
i.	12% Debentures	30,000		40,000	
ii.	Sundry creditors	10,000		15,000	
			(40,000)		(55,000)
C.	**NET ASSETS taken over [A-B]**		90,500		97,000

Journal Entries in the Books of C Ltd. (in the case of Amalgamation in the nature of Merger)

Purchase consideration for amalgamation in the nature of merger.

Total consideration payable = Aggregate of paid-up capital of A Ltd. and B Ltd.

= ₹ 60,000 + ₹ 70,000

= ₹ 1,30,000

Total net assets taken over = ₹ 90,050 + ₹ 97,000

= ₹ 1,87,500

The total consideration payable to A Ltd. and B Ltd. is apportioned based on the net assets of the companies.

A Ltd. : ₹ 1,30,000 x $\frac{90,500}{1,87,500}$ = ₹ 62,750

B Ltd. : ₹ 1,30,000 x $\frac{97,000}{1,87,500}$ = ₹ 67,250

(₹ in '000)

Particulars		Debit	Credit
I. Take over A Ltd:			
a. For Business Purchase			
Business Purchase A/c	Dr.	62,750	
To Liquidator of A Ltd. A/c			62,750
b. For Assets and Liabilities taken over:			
i. Purchase consideration paid - 62,750			
ii. Less: Paid up Share capital - 60,000			
iii. Excess consideration paid - 2,750			
As per AS-14 consideration will be adjusted against for reserves of A Ltd.			
The General reserves of A Ltd. to be incorporated = ₹ 15,000 - ₹ 2,750 = ₹ 12,250			
c. Sundry Fixed Assets A/c	Dr.	85,000	
Investments A/c	Dr.	10,500	
Stock A/c	Dr.	12,500	

Particulars		Debit	Credit
Debtors A/c	Dr.	18,000	
Cash and Bank A/c	Dr.	4,500	
To General Reserve A/c			12,250
To Profit and Loss A/c			10,000
To Investment Allowance Reserve A/c			5,000
To Export Profit Reserve A/c			500
To 12% Debentures A/c			30,000
To Sundry creditors A/c			10,000
To Business Purchase A/c			62,750
d. For Discharge of Purchase Consideration:			
Liquidator of A Ltd. A/c	Dr.	62,750	
To Equity Share capital A/c			62,750
II. Take over of B Ltd:			
a. For Business Purchase			
Business Purchase A/c	Dr.	67,250	
To Liquidator of B Ltd. A/c			67,250
b. For Assets and Liabilities Taken over:			
i. Purchase Consideration Paid : 67,250			
ii. Paid up Share capital : 70,000			
iii. Short fall to Purchase Consideration : 2,750			
The above short payment is to be credited to "Capital reserve A/c" as per ICAI - Expert Advisory Committee Opinion on AS-14			
c. Sundry Fixed Assets A/c	Dr.	75,000	
Investments A/c	Dr.	5,500	
Stock A/c	Dr.	27,500	
Debtors A/c	Dr.	40,000	
Cash and Bank A/c	Dr.	4,000	
To General Reserve A/c			20,000
To Profit and Loss A/c			5,000
To Investment Allowance Reserve A/c			1,000
To Export Profit Reserve A/c			1,000
To 12% Debentures A/c			40,000
To Sundry Creditors A/c			15,000
To Business Purchase A/c			67,250
To Capital Reserve A/c*			2,750
d. For Discharge purchase consideration:			
Liquidator of B Ltd. A/c	Dr.	67,250	
To Equity Share capital A/c			67,250

Name of the Company: C Ltd.
Balance Sheet as at 01.04.2015

Ref No.	**Particulars**		**Note No.**	**As at 1st April, 2015**	**As at 31st March, 2015**
				₹ in '000	₹ in '000
	I.	**Equity and Liabilities**			
	1	**Shareholders' funds**			
		(a) Share capital	1	1,30,000	
		(b) Reserves and surplus	2	57,500	
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**			
		(a) Long-term borrowings	3	70,000	
	4	**Current Liabilities**			
		(a) Trade payables	4	25,000	
		Total (1+2+3+4)		2,82,500	
	II.	**Assets**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets	5	1,60,000	
		(b) Non-current investments	6	16,000	
	2	**Current assets**			
		(a) Inventories	7	40,000	
		(b) Trade receivables	8	58,000	
		(c) Cash and cash equivalents	9	8,500	
		Total (1+2)		2,82,500	

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

₹ in '000

Note 1. Share Capital	**As at 1st April, 2015**	**As at 31st March, 2015**
Equity Share Capital (share of ₹100 each)(60,000+70,000)	1,30,000	
Total	1,30,000	

RECONCILATION OF SHARE CAPITAL				
FOR EQUITY SHARE:-	**As at 1st April, 2015**		**As at 31st March, 2015**	
	Nos	**Amount (₹)**	**Nos**	**Amount (₹)**
Opening Balance as on 01.04.15	-----	-----		
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash)	13,000	1,30,000		
	13000	13000		
Less: Buy Back of shares	-	-		
	13000	13000		

₹ in '000

Note 2. Reserves and Surplus	**As at 1st April, 2015**	**As at 31st March, 2015**
Capital Reserves	2,750	
Gerneral Reserves (12,250+20,000)	32,250	
Profit and Loss A/C (10,000+5,000)	15,000	
Investment Allowance Reserve (5,000+1,000)	6,000	
Export Profit Reserve (500+1,000)	1,500	
Total	57,500	

Note 3. Long-term borrowings	**As at 1st April, 2015**	**As at 31st March, 2015**
12% Debentures(30,000+40,000)	70,000	
Total	70,000	

Note 4. Trade payables	**As at 1st April, 2015**	**As at 31st March, 2015**
Sundry Creditors (10,000+15,000)	25,000	
Total	25,000	

₹ in '000

Note 5. Tangible Assets	**As at 1st April, 2015**	**As at 31st March, 2015**
Sundry Fixed assets (85,000+75,000)	1,60,000	
Total	1,60,000	

Note 6. Non current Investments	**As at 1st April, 2015**	**As at 31st March, 2015**
Investments (10,500+5,500)	16,000	
Total	16,000	

Note 7. Inventories	**As at 1st April, 2015**	**As at 31st March, 2015**
Stock (12,500+27,500)	40,000	
Total	40,000	

Note 8. Trade Receivables	**As at 1st April, 2015**	**As at 31st March, 2015**
Debtors (18,000+40,000)	58,000	
Total	58,000	

Note 9. Cash and Cash equivalents	**As at 1st April, 2015**	**As at 31st March, 2015**
Cash and Bank	8,500	
Total	8,500	

Journal Entries in the Books of C Ltd. (in the case of Amalgamation in the nature of Purchase)

In the case of Amalgamation in the nature of purchase consideration will be paid on the bais of "Net Assets" and hence the purchase consideration is for A - ₹ 90,500 and for B - ₹ 97,500.

Particulars		Debit ₹ in '000	Credit ₹ in '000
I. Take over of A Ltd:			
a. For Business Purchase:			
Business Purchase A/c	Dr.	90,500	
To Liquidator of A Ltd. A/c			90,500
b. For Assets and Liabilities taken over:			
Sundry Fixed Assets A/c	Dr.	85,000	
Investments A/c	Dr.	10,500	
Stock A/c	Dr.	12,500	
Debtors A/c	Dr.	18,000	
Cash and Bank A/c	Dr.	4,500	
To Business Purchase A/c			90,500
To 12% Debentures A/c			30,000
To Sundry Creditors A/c			10,000
c. For Discharge of Purchase Consideration:			
Liquidator of A Ltd. A/c	Dr.	90,500	
To Equity Share capital A/c			90,500
II. Take over of B Ltd:			
a. For Business Purchase			
Business Purchase A/c	Dr.	97,000	
To Liquidator of B Ltd. A/c			97,000
b. For Assets and Liabilities taken over:			
Sundry Fixed Assets A/c	Dr.	75,000	
Investments A/c	Dr.	5,500	
Stock A/c	Dr.	27,500	
Debtors A/c	Dr.	40,000	
Cash and Bank A/c	Dr.	4,000	
To Business Purchase A/c			97,000
To 12% Debentures A/c			40,000
To Sundry creditors A/c			15,000
c. Discharge of Purchase Consideration:			
Liquidator of A Ltd. A/c	Dr.	97,000	
To Equity Share capital A/c			97,000

Note: Assumed that new debetures were issued in exchange of the old debentures.

Amalgamation Adjustment A/c Dr. 7,500

To Statutory Reserve A/c 7,500

Note : The "Amalgamation Adjustment A/c" should be disclosed as a part of "Miscellaneous Expenditure" to the extent not written off or other similar category in the Balance Sheet of the TRANSFEREE Company.

Name of the Company: C Ltd.

Balance Sheet as at 01.04.2015

Ref No.	Particulars		Note No.	As at 1st April, 2015	As at 31st March, 2015
				₹ in '000	₹ in '000
	I.	**Equity and Liabilities**			
	1	**Shareholders' funds**			
		(a) Share capital	1	1,87,500	
		(b) Reserves and surplus	2	7,500	
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**			
		(a) Long-term borrowings	3	70,000	
	4	**Current Liabilities**			
		(a) Trade payables	4	25,000	
		Total (1+2+3+4)		2,90,000	
	II.	**Assets**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets	5	1,60,000	
		(b) Non-current investments	6	16,000	
		(c) Other non-current assets	7	7,500	
	2	**Current assets**			
		(a) Inventories	8	40,000	
		(b) Trade receivables	9	58,000	
		(c) Cash and cash equivalents	10	8,500	
		Total (1+2)		2,90,000	

(₹ '000)

Note 1. Share Capital	**As at 1st April, 2015**	**As at 31st March, 2014**
Equity Share Capital (share of ₹100 each)(90,500+97,000)	1,87,500	
Total	1,87,500	

RECONCILATION OF SHARE CAPITAL				
FOR EQUITY SHARE:-	**As at 1st April, 2015**		**As at 31st March, 2014**	
	Nos	**Amount (₹)**	**Nos**	**Amount (₹)**
Opening Balance as on 01.04.15	—	—	NIL	NIL
Add: Fresh Issue (Incld Bonus shares , Right shares, split shares, shares issued other than cash)	18,750	187,500	NIL	NIL
	18750	1,87,500	NIL	NIL
Less: Buy Back of shares	—	—	—	—
	18750	1,87,500	NIL	NIL

Note 2. Reserves and Surplus	As at 1st April, 2015	As at 31st March, 2015
Investment Allowance Reserve (5,000+1,000) Export Profit Reserve (500+1,000)	6,000 1,500	
Total	7,500	

Note 3. Long-term borrowings	As at 1st April, 2015	As at 31st March, 2015
12% Debentures(30,000+40,000)	70,000	
Total	70,000	

Note 4. Trade payables	As at 1st April, 2015	As at 31st March, 2015
Sundry Creditors (10,000+15,000)	25,000	
Total	25,000	

Note 5. Tangible Assets	As at 1st April, 2015	As at 31st March, 2015
Sundry Fixed assets (85,000+75,000)	1,60,000	
Total	1,60,000	

(₹ '000)

Note 6. Non current Investments	As at 1st April, 2015	As at 31st March, 2015
Investments (10,500+5,500)	16,000	
Total	16,000	

Note 7. Other noncurrent assets	As at 1st April, 2015	As at 31st March, 2015
Amalgamation adjustment A/c	7,500	
Total	7,500	

Note 8. Inventories	As at 1st April, 2015	As at 31st March, 2015
Stock (12,500+27,500)	40,000	
Total	40,000	

Note 9. Trade Receivables	As at 1st April, 2015	As at 31st March, 2015
Debtors (18,000+40,000)	58,000	
Total	58,000	

Note 10. Cash and Cash equivalents	As at 1st April, 2015	As at 31st March, 2015
Cash and Bank	8,500	
Total	8,500	

Illustration 5:

A Ltd. and B Ltd. were amalgamation on and from 1st April, 2015. A new company X Ltd. was formed to take over the business of the existing companies. The Balance sheet of A Ltd and B Ltd as on 31st March, 2015 are given below:

(₹ in lakhs)

Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
Share capital:			Fixed assets:		
Equity Shares of	850	725	Land and Building	460	275
₹ 100 each			Plant and Machinery	325	210
10% Preference Share of			Investments	75	50
₹ 100 each	320	175	Current Asset and		
Reserves and surplus:			Loans and Advances:		
Revaluation Reserve	125	80	Stock	325	269
General reserve	240	160	Sundry Debtors	305	270
Investment Allowance	50	30	Bills receivable	25	—
Reserve			Cash and Bank	385	251
Profit and Loss Account	75	52			
Secured Loans:					
13% Debentures (₹100 each)	50	28			
Unsecured Loan:					
Public Deposits	25	—			
Current liabilities and Provision:					
Sundry creditors	145	75			
Bills Payable	20	—			
	1,900	**1,325**		**1,900**	**1,325**

Other Information:

i. 13% debentures of A Ltd and B Ltd are discharged by X Ltd. by issuing such number of its 15% debentures of ₹ 100 each so as to maintain the same amount to interest.

ii. Preference shareholders of the two companies are issued equivalent number of 15% preference shares of X Ltd. at a price of ₹ 125 per share (face value ₹ 100)

iii. X Ltd. will issue 4 equity shares for each equity share of A Ltd. and 3 equity shares for each equity share of B Ltd. The shares are to be issued @ ₹ 35 each, having a face value of ₹ 10 per share.

iv. Investment allowance reserve is to be maintained for two more years.

Prepare the Balance sheet of X Ltd. as on 1st April, 2015 after the amalgamation.

Note: Unsecured Loans in assumed to be of less than 12 months hence treated on short term borrowings ignoring interest.

Solution:

Method 1: Amalgamation in the Nature of Merger

WN # 1: ***Calculation of Purchase Consideration*** **(figures in lakh)**

		Particulars	A Ltd.	B Ltd.
a.	Equity Shares:			
	i.	No. of Shares outstanding	8.50	7.25
	ii.	Exchange Ratio	4:1	3:1
	iii.	No. of Shares to be issued	34	21.75
	iv.	Issue price per share (₹)	35	35

	v.	Purchase Consideration	1190	761.25
		• Share capital	340	217.50
		• Securities Premium	850	543.75
b.	Preference Shares :			
	i.	No. of Shares outstanding	3.2	1.75
	ii.	Exchange Ratio	1:1	1:1
	iii.	No. of Shares to be issued	3.2	1.75
	iv.	Issue price per share (₹)	125	125
	v.	Purchase Consideration	400	218.75
		• Share capital	320	175.00
		• Securities Premium	80	43.75
c.	Total Considertion {a(iv) + b(iv)}		1590	980.00
			₹ 2,570 Lakhs	

WN # 2: ***Computation of Debenture to be issued***

	Particulars	A Ltd.	B Ltd.
a.	Value of 13% Debentures takes over	50,00,000	28,00,000
b.	13% Interest on above value	6,50,000	3,64,000
c.	15% Debentures to be issued to keep same interest amount	43,33,333.33	24,26,666.66
		$\left[6,50,000 \times \frac{100}{15}\right]$	$\left[3,64,000 \times \frac{100}{15}\right]$
d.	Total amont of debenture issued		₹ 67,60,000

Note : Normally fractions of Debentures is settled in Cash.

Name of the Company: X Ltd.

Balance Sheet as at 01.04.2015

Ref No.	Particulars		Note No.	As at 1st April, 2015 (₹ in lakh)
	I.	**Equity and Liabilities**		
	1	**Shareholders' funds**		
		(a) Share capital	1	1,052.50
		(b) Reserves and surplus	2	1,839.9
	2	**Share application money pending allotment**		NIL
	3	**Non-current liabilities**		
		(a) Long-term borrowings	3	67.6
	4	**Current Liabilities**		
		(a) Short-term borrowings	4	25
		(b) Trade payables	5	220
		(c) Other current liabilities	6	20
		Total (1+2+3+4)		3225.00

Ref No.		Particulars	Note No.	As at 1st April, 2015 (₹ in lakh)
	II.	**Assets**		
	1	**Non-current assets**		
		(a) Fixed assets		
		(i) Tangible assets	7	1,270
		(b) Non-current investments	8	125
	2	**Current assets**		
		(a) Inventories	9	594
		(b) Trade receivables	10	575
		(c) Cash and cash equivalents	11	636
		(d) Other current assets	12	25
		Total (1+2)		3,225

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

(₹ in lakh)

Note 1. Share Capital	**As at 1st April, 2015**
Equity Share share of ₹100 each (340+217.5)[out of the above all the shares were issued for consideration other than cash]	557.5
15% Preference Share of ₹100 each (320+175) [out of the above all the shares were issued for consideration other than cash]	495
Total	1,052.5

RECONCILATION OF SHARE CAPITAL

FOR EQUITY SHARE:-	**As at 1st April, 2015**	
	Nos	**Amount (₹)**
Opening Balance as on 01.04.15		
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash) (34+21.75)	55.75	557.50
	55.75	557.50
Less: Buy Back of shares	-	-
	55.75	557.50

RECONCILATION OF SHARE CAPITAL

FOR 15% PREFERENCE SHARE:-	**As at 1st April, 2015**	
	Nos	**Amount (₹)**
Opening Balance as on 01.04.15		
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash)(3.2+1.75)	4.95	495.00
	4.95	495.00
Less: Buy Back of shares	-	-
	4.95	495.00

(₹ in lakhs)

Note 2. Reserves and Surplus	As at 1st April, 2015
Securities Premium (850+543.75+80+43.75)	1,517.50
Profit and Loss A/c (WN # 3)	37.40
Revaluation Reserve	205.00
Investment Allowance Reserve	80.00
Total	1,839.90

Note 3. Long-term borrowings	As at 1st April, 2015
15% Debentures(₹100 each)(WN#2)	67.60
Total	67.60

Note 4. Short-term borrowings	As at 1st April, 2015
Unsecured Loan:	
Public Deposits	25.00
Total	25.00

Note 5. Trade payables	As at 1st April, 2015
Sundry Creditors	220.00
Total	220.00

Note 6. Other Current Liabilities	As at 1st April, 2015
Bills Payable	20.00
Total	20.00

Note 7. Tangible Assets	As at 1st April, 2015
Land and Biuldings(460+275)	735
Plant and Machinery(325+210)	535
Total	1270

Note 8. Non current Investments	As at 1st April, 2015
Investment (75+50)	125
Total	125

Note 9. Inventories	As at 1st April, 2015
Stock (325+269)	594
Total	594

Note 10. Trade Receivables	As at 1st April, 2015
Sundry Debtors(305+270)	575
Total	575

Note 11. Cash and Cash Equivalents	As at 1st April, 2015
Cash and Bank (385+215)	636
Total	636

Note 12. Other Current assets	As at 1st April, 2015
Bills Receivable	25
Total	25

WN # 3: Calculation of reserves to be incorporated in Balance Sheet. (₹ in lakhs)

	Particulars		
a.	Aggregated Purchase Consideration		2,570
b.	Aggregate paid-up capial		
	i. Equity Share capital	1,575	
	ii. Preference Share capital	495	2,070
c.	Excess		500
d.	The above excess to be adjusted against:		
	i. General reserves	400	
	ii. P & L Account	100	500
e.	Balance of Reserves available		
	i. Profit and Loss A/c	27	
	ii. Investment allowance reserve	80	
	iii. Revaluation reserve	205	312
f.	Settlement to debenture holders		
	i. Debenure of transferee companies	78.00	
	ii. Less: Amount of X Ltd.'s debenture issued	(67.60)	
	iii. Profit to be credited to Profit and Loss A/c		10.40
g.	Balance of reserves to be incorporated		
	i. P and L Account		37.40
	ii. Investment allowance reserve		80.00
	iii. Revaluation reserve		205.00

Method 2: Amalgamation in Nature of Purchase

Name of the Company: X Ltd.

Balance Sheet as at 1.04.2015 (after amalgamation)

Ref No.		Particulars	Note No.	As at 1st April, 2015
				₹
	I.	**Equity and Liabilities**		
	1	**Shareholders' funds**		
		(a) Share capital	1	1,052.50
		(b) Reserves and surplus	2	1,919.90
	2	**Share application money pending allotment**		NIL
	3	**Non-current liabilities**		
		(a) Long-term borrowings	3	67.6
	4	**Current Liabilities**		
		(a) Short-term borrowings	4	25
		(b) Trade payables	5	220
		(c) Other current liabilities	6	20
		Total (1+2+3+4)		3,305.00

Ref No.	Particulars		Note No.	As at 1st April, 2015
				₹
	II.	**Assets**		
	1	**Non-current assets**		
		(a) Fixed assets		
		(i) Tangible assets	7	1,270
		(b) Non-current investments	8	125
		(c) Other non-current assets	9	80
	2	**Current assets**		
		(a) Inventories	10	594
		(b) Trade receivables	11	575
		(c) Cash and cash equivalents	12	636
		(d) Other current assets	13	25
		Total (1+2)		3,305.00

(₹ in lakhs)

Note 1. Share Capital Authorised Issued and subscribed Capital	**As at 1st April, 2015**
Equity Share share of ₹100 each (340+217.5) [out of the above all the shares were issued for consideration other than cash]	557.5
15% Preference Share of ₹100 each (320+175) [out of the above all the shares were issued for consideration other than cash]	495
Total	1,052.5

RECONCILATION OF SHARE CAPITAL

FOR EQUITY SHARE:-	**As at 1st April, 2015**	
	Nos	Amount (₹)
Opening Balance as on 01.04.15	-----	-----
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash) (34+21.75)	55.75	557.50
	55.75	557.50
Less: Buy Back of shares	-	-
	55.75	557.50

FOR 15% PREFERENCE SHARE:-	**As at 1st April, 2015**	
	Nos	Amount (₹)
Opening Balance as on 01.04.15		
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash) (3.2+1.75)	4.95	495.00
	4.95	495.00
Less: Buy Back of shares	-	-
	4.95	495.00

(₹ in lakhs)

Note 2. Reserve & Surplus	**As at 1st April, 2015**
Secirotiеs Premium (WN#1)	1517.50
Capital Reserve (312 + 10.40)	322.40
Investment allowance	80.00
Total	1919.90

Note 3. Long-term borrowings	As at 1st April, 2015
15% Debentures(₹100 each)(WN#2)	67.60
Total	67.60

Note 4. Short-term borrowings	As at 1st April, 2015
Unsecured Loan: Public Deposits	 25.00
Total	25.00

Note 5. Trade payables	As at 1st April, 2015
Sundry Creditors	220.00
Total	220.00

Note 6. Other Current Liabilities	As at 1st April, 2015
Bills Payable	20.00
Total	20.00

Note 7. Tangible Assets	As at 1st April, 2015
Land and Biuldings (460+275) Plant and Machinery (325+210)	735 535
Total	1270

Note 8. Non current Investments	As at 1st April, 2015
Investment (75+50)	125
Total	125

Note 9. Other non current Assets	As at 1st April, 2015
Amalgamation Adjustment A/c	80
Total	80

Note 10. Inventories	As at 1st April, 2015
Stock (325+269)	594
Total	594

Note 11. Trade Receivables	As at 1st April, 2015
Sundry Debtors (305+270)	575
Total	575

12. Cash and Cash Equivalents	As at 1st April, 2015
Cash and Bank(385+215)	636
Total	636

13. Other Current assets	As at 1st April, 2015
Bills Receivable	25
Total	25

Illustration 6:

A Limited and B Limited were amalgamated on and from 1st April, 2015. A new company D Limited was formed to takeover the business of the existing companies. The Balance Sheet of A Limited and B Limited and as on 31st March, 2015 are given below:

(₹ in lakhs)

Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
Share capital:			**Fixed assets**	1,200	1,000
Equity Shares of ₹ 100 each	1,000	800	Current assets,		
			Loans and Advances	880	565
15% Preference Share	400	300			
Capital of ₹ 100 each					
Reserve and Surplus:					
Revaluation Reserve	100	80			
General Reserve	200	150			
P & L Account	80	60			
Secured Loan:					
12% Debentures of					
₹ 100 each	96	80			
Current Liabilities					
and Provisions	204	95			
	2,080	**1,565**		**2,080**	**1,565**

Other Information:

1. 12% Debenture holders of A Ltd. and B Ltd. are discharged by D Limited by issuing adequate number of 16% Debentures of ₹ 100 each to ensure that they continue to receive the same amount of interest.
2. Preference shareholders of A Ltd. and B Ltd. have received same number of 15% Preference share of ₹ 100 each of D Limited.
3. D Ltd. has issued 1.5 equity shares for each equity share of A Ltd. and 1 equity share each equity share of B Ltd. The face value of shares issued by D Ltd. is ₹ 100 each.

Required:

Prepare the Balance sheet of D Ltd. as on 1st April, 2015 after the amalgamation has been carried out using pooling of interest method.

Solution:

WN # 1: ***Calculation of purchase consideration:***

	Purchase consideration	A Ltd.	B Ltd.
i.	No. of equity shares	10,00,000	8,00,000
	Exchange Ratio	1:1.5	1:1
	No. of equity shares to be issued	15,00,000	8,00,000
	Equity Shares capital	₹ 1,500 Lakhs	₹ 800 Lakhs
ii.	No. of preference shares	4,00,000	3,00,000
	Exchange Ratio	1:1	1:1
	No. of preference share to be issued	4,00,000	3,00,000
	Preference Share Capital	₹ 400 Lakhs	₹ 300 Lakhs

Journal Entries in the books of D Ltd.

- Nature of Amalgamation - Merger
- Method of Accounting - Pooling of Interest

	Particulars			A Ltd. Debit ₹	A Ltd. Credit ₹	B Ltd. Debit ₹	B Ltd. Credit ₹
a.	For Business Purchase						
	Business Purchase A/c		Dr.	1,900		1,100	
	To Liquidator of Selling Co. A/c				1,900		1,100
b.	Incorporation of Assets and Liabilities taken over:						
	Fixed Assets A/c		Dr.	1,200		1,000	
	Current Assets A/c		Dr.	880		565	
	Profit and Loss A/c		Dr.	220			
	To Current Liabilities A/c				204		95
	To 12% Debentures A/c				96		80
	To Revaluation Reserve A/c				100		80
	To General Reserve A/c	WN # 2			—		150
	To Pofit and Loss A/c				—		60
	To Business Purchase A/c				1,900		1,100
c.	Discharge of Purchase Consideration						
	Liquidator of Selling Co. A/c		Dr.	1,900		1,100	
	To Equity Share Capital A/c				1,500		800
	To Preference Share Capital A/c				400		300
d.	Discharge of Debentures:						
	12% Debentures A/c		Dr.	96		80	
	To 16% Debentures A/c				72		60
	To Profit & Loss A/c (WN # 3)				24		20

WN # 2: ***Reserves to be incorporated on the Amalgamation:***

(₹ in Lakhs)

	Particulars		A Ltd.	B Ltd.
(i)	Purchase consideration payable		1,900	1,100
(ii)	Total paid up Share capital			
	(a) Equity Share capital	1,000		
	(b) Preference Share capital	400	1,400	1,100
(iii)	Excess purchase consideration		500	Nil
(iv)	Adjustment against reserves of transferor company:			
	(a) General reserve		(200)	
	(b) Profit & Loss A/c Balance		(80)	
	(c) Profit & Loss A/c debit balance		(220)	
(v)	Reserves of transferor company to be incorporated			
	(a) Revaluation Reserve		100	80
	(b) General Reserve		—	150
	(c) Profit & Loss A/c		—	60

WN # 3: Settlement of Debentures:

(in ₹ Lakhs)

	Particulars	A Ltd.	B Ltd.
(i)	Value of 12% Debentures	96	80
(ii)	Interest Payable	11.52	9.6
(iii)	16% Debentures to be issued	72	60
	$A = \frac{11.52}{16} \times 100$, $B = \frac{9.6}{16} \times 100$		
(iv)	Amount to be credited to Profit & Loss A/c (i)-(iii)	24	20

Name of the Company: D Ltd.				
Balance Sheet as at 01.04.2015				
Ref No.	**Particulars**		**Note No.**	**As at 1st April, 2015 (₹ in lakh)**
	I.	**Equity and Liabilities**		
	1	**Shareholders' funds**		
		(a) Share capital	1	3,000
		(b) Reserves and surplus	2	214
	2	**Share application money pending allotment**		NIL
	3	**Non-current liabilities**		
		(a) Long-term borrowings	3	132
	4	**Current Liabilities**		
		(a) Other current liabilities	4	299
		Total (1+2+3+4)		**3,645**
	II.	**Assets**		
	1	**Non-current assets**		
		(a) Fixed assets		
		(i) Tangible assets	5	2,200
	2	**Current assets**		
		(a) Short-term loans and advances	6	1,445
		Total (1+2)		**3,645**

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

(₹ In Lakhs)

Note 1. Share Capital	As at 1st April, 2015
Equity Share share of ₹100 each	2,300
15% Preference Share of ₹100 each	700
Total	3,000

RECONCILATION OF SHARE CAPITAL

FOR EQUITY SHARE:-	As at 1st April, 2015	
	Nos	(₹ in lakh)
Opening Balance as on 01.04.15		
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash)	23	2,300
	23	2,300
Less: Buy Back of shares		-
	23	2,300

RECONCILATION OF SHARE CAPITAL

FOR PREFERENCE SHARE:-	As at 1st April, 2015	
	Nos	(₹ in lakh)
Opening Balance as on 01.04.15		
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash)	7	700
	7	700
Less: Buy Back of shares		-
	7	700

(₹ in Lakhs)

Note 2. Reserves and Surplus	As at 1st April, 2015
General Reserve	150
Profit and Loss A/c [60+24+20−220]	(116)
Revaluation Reserve	180
Total	214

Note 3. Long-term borrowings	As at 1st April, 2015
16% Debentures(₹100 each)(72+60)	132
Total	132

Note 4. Other Current Liabilities	As at 1st April, 2015
Current Liabilities and Provisions (204+95)	299
Total	299

Note 5. Tangible Assets	As at 1st April, 2015
Fixed assets (1,200+1,000)	2,200
Total	2,200

Note 6. Other Current Assets	As at 1st April, 2015
Current assets, Loans and Advances (880+565)	1,445
Total	1,445

Illustration 7:

Given below Balance Sheets of M Ltd. and N Ltd. as on 31st March, 2015.

Balance Sheets

(₹ in 000's)

Liability	M Ltd. ₹	N Ltd. ₹
Share Capital	1,00,000	1,20,000
General Reserve	50,000	40,000
Export Profit Reserve	20,000	30,000
(Statutory Reserve as per Income Tax Law)		
14% Debentures	50,000	50,000
Sundry Creditors	20,000	10,000
Provisions	20,000	20,000
Proposed Dividend	25,000	30,000
	2,85,000	**3,00,000**

Assets	M Ltd. ₹	N Ltd. ₹
Fixed Assets	1,65,000	1,80,000
Investments	50,000	—
Stock	50,000	50,000
Debtors	15,000	65,000
Cash and Bank Balances	5,000	5,000
	2,85,000	**3,00,000**

Shares of M Ltd. and N Ltd. are ₹ 100 each. M Ltd. held 15% shares of N Ltd. Z Ltd. has been formed for the purpose of amalgamation which took over M Ltd. and N Ltd. and in exchange, shares of Z Ltd. were issued. Expenses for amalgamation were ₹ 100 thousand. You are required to prepare post amalgamation balance sheet of Z Ltd. Show also the purchase consideration and exchange ratio. Calculate the number of shares to be issued to the shareholders of the amalgamated company without increasing the issued capital.

Solution:

(I) Calculation of Purchase Consideration

(₹ in '000's)

	Particulars	M Ltd. ₹	N Ltd. ₹
a.	Sundry Assets	2,85,000	3,00,000
b.	Outside Liabilities:		
	i. Debentures	50,000	50,000
	ii. Creditors	20,000	10,000
	iii. Provisions	20,000	20,000
	iv. Proposed Dividend	25,000	30,000
		1,15,000	1,10,000
c.	Net Assets (a-b)	1,70,000	1,90,000
d.	Consideration restricted to ₹ 2,20,000 in the ratio 17:19 as the problem required not to increase the Share capital.	1,03,900	1,16,100

(II) In the books of Z Ltd.

Section A: Amalgamation of M Ltd and N Ltd.

- Nature of Amalgamation - Merger
- Method of Amalgamation - Pooling of Interest

(₹ in '000)

Particulars		M Ltd. Debit	M Ltd. Credit	N Ltd. Debit	N Ltd. Credit
1. For Business Purchase:					
Business Purchase A/c	Dr.	1,03,900		1,16,100	
To Liquidator of M Ltd.			1,03,900		1,16,100
2. For Assets and Liabilities (Working Note) Taken over:					
a. Purchase consideration		1,03,900		1,16,100	
b. Less: Paid up capital		(1,00,000)		(1,20,000)	
c. Excess consideration paid (Short fall)		3,900		(3,900)	
d. Above excess to be adjusted against General Reserve of M Ltd.					
e. Balance reserve to be taken from M Ltd. to incorporate in Z Ltd.					
• General Reserve (50,000-3900), (40,000+3,900)			46,100		43,900
• Export Profit Reserve			20,000		30,000
Fixed Assets A/c	Dr.	1,65,000		1,80,000	
Investments A/c	Dr.	50,000		—	
Stock A/c	Dr.	50,000		50,000	
Debtors A/c	Dr.	15,000		65,000	
Cash and Bank Balances A/c	Dr.	5,000		5,000	

Particulars	M Ltd.		N Ltd.	
	Debit	Credit	Debit	Credit
To Debenture holders A/c		50,000		50,000
To Creditors A/c		20,000		10,000
To Provisions A/c		20,000		20,000
To Proposed Dividend A/c		25,000		30,000
To General Reserve A/c		46,100		43,900
To Export Profit Reserve A/c		20,000		30,000
To Business Purchase A/c		1,03,900		1,16,100
3. For Discharge of Purchase Consideration:				
Liquidator of M Ltd. A/c Dr.	1,03,900		1,16,100	
To Equity Share Capital A/c		1,03,900		1,16,100

(B): Other transactions

(₹ in '000)

Particulars	Debit	Credit
1. Issue of debentures to debenture holders of M Ltd. and N Ltd.		
Debenture holders of M Ltd. Dr.	50,000	
Debenture holders of N Ltd. Dr.	50,000	
To 14% Debentures A/c		1,00,000
2. Expenses of amalgamation		
Profit and Loss A/c Dr.	100	
To Bank A/c		100

Name of the Company: Z Ltd.				
Balance Sheet as at 31.03.2015 (After absorption)				
Ref No.	**Particulars**		**Note No.**	**After absorption**
				₹
	I.	**Equity and Liabilities**		
	1	**Shareholders' funds**		
		(a) Share capital	1	2,20,000
		(b) Reserves and surplus	2	139,900
	2	**Share application money pending allotment**		NIL
	3	**Non-current liabilities**		
		(a) Long-term borrowings	3	1,00,000
	4	**Current Liabilities**		
		(a) Trade payables	4	30,000
		(b) Short-term provisions	5	95,000
		Total (1+2+3+4)		5,84,900

Ref No.	Particulars		Note No.	After absorption
				₹
	II.	**Assets**		
	1	**Non-current assets**		
		(a) Fixed assets		
		(i) Tangible assets	6	3,45,000
		(b) Non-current investments		50,000
	2	**Current assets**		
		(a) Inventories	7	1,00,000
		(b) Trade receivables	8	80,000
		(c) Cash and cash equivalents	9	9,900
		Total (1+2)		**5,84,900**

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Note 1. Share Capital	**After absorption**
Authorized, Issued and Subscribed (of the above,all shares are issued for consideration other than cash toM Ltd. And N Ltd. Pursuant to Amalgamation approved by Honorable Court)	2,20,000
Total	2,20,000

RECONCILATION OF SHARE CAPITAL

FOR EQUITY SHARE:-	**After absorption**	
	Nos	Amount (₹)
Opening Balance as on 01.04.14		
Add: Fresh Issue (Incld Bonus shares , Right shares, split shares, shares issued other than cash)		2,20,000
		2,20,000
Less: Buy Back of shares	–	–
		2,20,000

Note 2. Reserves and Surplus	**After absorption**
Gerneral Reserves (43,900+46,100)	90,000
Profit and Loss A/c	(100)
Export Profit reserve (20,000+30,000)	50,000
Total	1,39,900
Note 3. Long-term borrowings	**After absorption**
14% Debentures	100,000
Total	100,000

Note 4. Trade Payables	**After absorption**
Creditors	30,000
Total	30,000

Note 5. Short term Provisions	After absorption
Provision	40,000
Proposed Dividend	55,000
Total	95,000

Note 6. Tangible Assets	After absorption
Fixed Assets (1,65,000 +1,80,000)	3,45,000
Total	3,45,000

Note 7. Inventories	After absorption
Stock (50,000+50,000)	1,00,000
Total	1,00,000

Note 8. Trade Receivables	After absorption
Debtors(15,000+65,000)	80,000
Total	80,000

9. Cash and Cash Equivalents		After absorption
Cash at Bank	10,000	
Less: Preliminary Expenses	(100)	9,900
Total		9,900

Illustration 8:

D Ltd. and F Ltd. were amalgamated on and from 1st April, 2015. A new Company P Ltd. was formed to takeover the business of the existing companies. The Balance Sheets of D Ltd. and F Ltd. as on 31st March, 2015 are given below:

Liabilities	D Ltd. ₹	F Ltd. ₹	Assets	D Ltd. ₹	F Ltd. ₹
Share capital			**Fixed assets:**		
Equity Shar of ₹ 10 each	85,000	72,500	Land and Building	79,500	43,300
9% Preference	32,000	17,500	Investments	7,500	5,000
Shares of ₹ 10 each			**Current assets:**		
Reserve and Surplus:			Stock	32,500	26,900
Revaluation Reserve	12,500	8,000	Debtors	30,500	27,000
General Reserve	24,000	16,000	Bills Receivable	2,500	—
Export Profit Reserve	7,500	3,000	Cash and Bank	30,000	25,100
Secured Loan:					
13% Debentures of	5,000	2,800			
₹ 100 each					
Current liabilities					
and Provisions					
Bills Payable	2,000	–			
Sundry creditors	14,500	7,500			
	1,82,500	**1,27,300**		**1,82,500**	**1,27,300**

Other informations:

1. 13% Debenture holders of D Ltd. and F Ltd. are discharged by P Ltd. by issuing such number of its 15% Debentures of ₹ 100 each so as to maintain the same amount of interest.
2. Preference Shareholders of the two companies are issued equivalent number of 12% Preference Shares of P Ltd. at a price of ₹ 12.50 per share (face value ₹10).
3. P Ltd. will issue 2 equity shares for each equity share of D Ltd. and 2 equity shares for each equity share of F Ltd. at ₹ 15 per share having a face value ₹ 10.
4. Export Profit Reserve is to be maintained for two more years.

Prepare Journal Entries and prepare the Balance Sheet of P Ltd. after the amalgamation is carried out using under Merger Method.

Solution:

WN # 1: ***Calculation of Purchase Consideration***

Particulars	**D Ltd.** ₹	**F Ltd.** ₹
a. In Preference shares:		
i. No. of Equity shares outstanding	3,200	1,750
ii. Exchange ratio	1:1	1:1
iii. No. of shares to be issued	3,200	1,750
iv. Issue Price	₹ 12.5	₹ 12.5
v. Value of Shares to be issued	₹ 40,000	₹ 21,875
b. In Equity shares:		
i. No. of Equity shares outstanding	8,500	7,250
ii. Exchange ratio	2:1	2:1
iii. No. of shares to be issued	17,000	14,500
iv. Issue Price	₹ 15	₹ 15
v. Value of Shares to be issued	₹ 2,55,000	₹ 2,17,500
c. Total Purchase Consideration (a+b)	**₹ 2,95,000**	**₹ 2,39,375**

In the books of P Ltd.

1. Amalgamation of D Ltd.

- Nature of Amalgamation - Merger
- Method of Accounting - Pooling of Interest

	Particulars			**Debit**	**Credit**
a.	For Busines Purchase				
	Business Purchase A/c		Dr.	2,95,000	
	To Liquidator of D Ltd.				2,95,000
b.	Incorporated of assets and liabilities				
	Consideration	2,95,000			
	Less: Paid up share capital	(1,17,000)			
	Amount to be adjusted against reserves	1,78,000			
	Less: General reserve	(24,000)			
	Profit and Loss balance (Dr.)	1,54,000			

	Particulars		Debit	Credit
c.	Land and Building A/c	Dr.	79,500	
	Investments A/c	Dr.	7,500	
	Stock A/c	Dr.	32,500	
	Debtors A/c	Dr.	30,500	
	Bill Receivable A/c	Dr.	2,500	
	Profit and Loss A/c	Dr.	1,54,000	
	Cash and bank A/c	Dr.	30,000	
	To Revaluation Reserve A/c			12,500
	To Bills Payable A/c			2,000
	To Sundry Creditors A/c			14,500
	To Debenture A/c			5,000
	To Business Purchase A/c			2,95,000
	To Export Profit Reserve A/c			7,500
d.	For Discharge of Consideration			
	Liquidator of D Ltd. A/c	Dr.	2,95,000	
	To Equity Share Capital A/c			1,70,000
	To Preference Share Capital A/c			32,000
	To Securities Premium A/c			93,000

*Note: Securities Premium includes both Equity & Preference shares Premium

II. Amalgamation of F Ltd.

- Nature of Amalgamation - Merger
- Method of Accounting - Pooling of Interest

	Particulars			Debit ₹	Credit ₹
a.	For Business Purchase:				
	Business Purchase A/c		Dr.	2,39,375	
	To Liquidator of F Ltd.				2,39,375
b.	For of Assets and Liabilities taken over:				
	Amount of Reserves to be incorporated.				
	Consideration	2,39,375			
	Less: Paid up Share capital	(90,000)			
	Amount to be adjusted				
	against Reserves	1,49,375			
	Less: General Reserve	(16,000)			
	Profit and Loss Balance (Dr.)	1,33,375			
c.	Land and Building A/c		Dr.	43,300	
	Investments A/c		Dr.	5,000	
	Stock A/c		Dr.	26,900	
	Debtors A/c		Dr.	27,000	

	Particulars		Debit ₹	Credit ₹
	Cash and Bank A/c	Dr.	25,100	
	Profit and Loss A/c	Dr.	1,33,375	
	To Revaluation Reserve A/c			8,000
	To Export Profit Reserve A/c			3,000
	To 13% Debentures A/c			2,800
	To Sundry Creditors A/c			7,500
	To Business Purchase A/c			2,39,375
d.	For Discharge of consideration			
	Liquidator of F Ltd. A/c	Dr.	2,39,375	
	To Equity Share Capital A/c			1,45,000
	To Preference Share Capital A/c			17,500
	To Securities Premium A/c			76,875

III. Others:

Particulars		Debit	Credit
For Discharge of Debenture Liability			
13% Debenture A/c	Dr.	7,800	
To 15% Debentures A/c			6,760
To Profit and Loss A/c			1,040

WN # 2: *Discharge of Debentures:*

					₹
a.	13% Debenture Outstanding	=	5,000 + 2,800	=	7,800
b.	Interest Payable	=	650 + 364	=	1,014
c.	15% Debenture to be issued	=	4,333 + 2,427	=	6,760

$$\frac{650}{15\%} + \frac{364}{15\%}$$

d. Amount to be credited to

profit and loss account [(a)-(c)] = 667 + 373 1,040

Note:

In "Amalgamation in the nature of Merger" all the assets and liabilities are to be taken at Book values. Change in the rate of interest will amount to violation of the above condition i.e. it is in the nature of purchase. But as the problem specifically require to solve "in the nature of merger", the problem is solved accordingly.

Name of the Company: P Ltd.				
Balance Sheet as at 31.03.2015				
Ref No.	Particulars		Note No.	As at 1st April, 2015
				₹
	I.	**Equity and Liabilities**		
	1	**Shareholders' funds**		
		(a) Share capital	1	3,64,500
		(b) Reserves and surplus	2	(85,460)
	2	**Share application money pending allotment**		NIL
	3	**Non-current liabilities**		
		(a) Long-term borrowings	3	6,760
	4	**Current Liabilities**		
		(a) Trade payables	4	22,000
		(b) Other current liabilities	5	2,000
		Total (1+2+3+4)		3,09,800
	II.	**Assets**		
	1	**Non-current assets**		
		(a) Fixed assets		
		(i) Tangible assets	6	1,22,800
		(b) Non-current investments		12,500
	2	**Current assets**		
		(a) Inventories		59,400
		(b) Trade receivables	7	57,500
		(c) Cash and cash equivalents	8	55,100
		(d) Short-term loans and advances		2,500
		Total (1+2)		3,09,800

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

(₹)

Note 1. Share Capital	As at 1st April, 2015
Equity Shares of ₹10 each	315,000
9% Preference Shares of ₹10 each	49,500
Total	3,64,500

RECONCILATION OF SHARE CAPITAL

FOR EQUITY SHARE:-	As at 1st April, 2015	
	Nos	Amount (₹)
Opening Balance as on 01.04.15		
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash)	31,500	3,15,000
	31,500	3,15,000
Less: Buy Back of shares	-	-
	31,500	3,15,000

FOR 9% PREFERENCE SHARE:-	As at 1st April, 2015	
	Nos	Amount (₹)
Opening Balance as on 01.04.15		
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash)	4,950	49,500
	4,950	49,500
Less: Buy Back of shares	-	-
	4,950	49,500

Note 2. Reserves and Surplus	**As at 1st April, 2015**
Securities Premium (85,000+72,500+8,000+4,375)	169,875
Revaluation Reserve	20,500
Export Profit Reserve (20,000+30,000)	10,500
Profit and Loss A/c (1,54,000+1,33,375-1,040)	(2,86,335)
Total	-85,460

Note 3. Long-term borrowings	**As at 1st April, 2015**
15% Debentures of ₹100 each	6,760
Total	6,760

Note 4. Trade Payables	**As at 1st April, 2015**
Sundry Creditors	22,000
Total	22,000

Note 5. Other Current Liabilities	**As at 1st April, 2015**
Bills Payables	2,000
Total	2,000

Note 6. Tangible Assets	**As at 1st April, 2015**
Land and Buildings	1,22,800
Total	1,22,800

Note 7. Trade Receivables	**As at 1st April, 2015**
Debtors (30,500 + 27,000)	57,500
Total	57,500

Note 8. Cash and Cash Equivalents	**As at 1st April, 2015**
Cash and Bank	55,100
Total	55,100

Note 9. Other Current Assets	**As at 1st April, 2015**
Bills Receivable	2,500
Total	2,500

Illustration 9:

Given below Balance Sheets of Ram Ltd and Rahim Ltd. as on 31.3.2012. Rahim Ltd. was merged with Ram Ltd. with effect from 01.04.2015.

Balance Sheets as on 31.3.2015

(₹)

Liabilities	Ram Ltd.	Rahim Ltd.	Assets	Ram Ltd.	Rahim Ltd.
Share Capital:			Sundry Fixed Assets (Tangible)	9,50,000	4,00,000
Equity Shares of			Investments (Non-trade)	2,00,000	50,000
₹ 10 each	7,00,000	2,50,000			
General Reserve	3,50,000	1,20,000	Stock	1,20,000	50,000
Profit and Loss A/c	2,10,000	65,000	Debtors	75,000	80,000
Export Profit Reserve	70,000	40,000	Advance Tax	80,000	20,000
12% Debentures	1,00,000	1,00,000	Cash and Bank balances	2,75,000	1,30,000
Sundry Creditors	40,000	45,000			
Provision for Taxation	1,00,000	60,000	Preliminary Expenses	10,000	—
Proposed Dividend	1,40,000	50,000			
	17,10,000	**7,30,000**		**17,10,000**	**7,30,000**

Ram Ltd. would issue 12% Debentures to discharge the claims of the debenture holders of Rahim Ltd. at par. Non-trade investments of Ram Ltd. fetched @ 25% while those of Rahim Ltd. fetched @ 18%. Profit (pre-tax) by Ram Ltd and Rahim Ltd. during 2012-13, 2013-14 and 2014-15 and were as follows:

Year	Ram Ltd.	Rahim Ltd.
	₹	₹
2012-13	5,00,000	1,50,000
2013-14	6,50,000	2,10,000
2014-15	5,75,000	1,80,000

Goodwill may be calculated on the basis of capitalisation method taking 20% as the pretax normal rate of return. Purchase consideration is discharged by Ram Ltd. on the basis of intrinsic value per share. Both companies decided to cancel the proposed dividend.
Required Balance Sheet of Ram Ltd. after merger.

Solution:

WN # 1: *Purchase Consideration:*

(i) Shares outstanding in Rahim Ltd. 25,000

(ii) Intrinsic Value per Share of Rahim Ltd. [WN # 2] ₹ 36.20

(iii) Value of Shares (a×b) ₹ 9,05,000

(iv) Intrinsic value per share of Ram Ltd. [WN # 2] ₹ 40.40

(v) No. of shares to be issued by Ram Ltd.

₹ 9,05,000 / ₹ 40.40 = 22,400.99

Shares	Cash for fractions
22400	0.99 × 40.40 = 40

(iv) Purchase consideration

(a) 22400 shares @ 40.40

Capital [₹10 / Share]	2,24,000		
Premium [₹ 30.40 / Share]	6,80,960	=	9,04,960
(b) Cash for fractional shares		=	40
(c) Total purchase consideration payable		=	9,05,000

WH # 2: ***Intrinsic Value per share:***

(₹)

	Ram Ltd.		Rahim Ltd.	
(i) Assets				
(a) Goodwill	13,65,000		3,80,000	
(b) Sundry Fixed assets	9,50,000		4,00,000	
(c) Investments	2,00,000		50,000	
(d) Stock	1,20,000		50,000	
(e) Debtors	75,000		80,000	
(f) Advance Tax	80,000		20,000	
(g) Cash and Bank Balance	2,75,000	30,65,000	1,30,000	11,10,000
(ii) Liabilities				
(a) 12% Debentures	1,00,000		1,00,000	
(b) Sundry creditors	40,000		45,000	
(c) Provision for tax	1,00,000	(2,40,000)	60,000	(2,05,000)
(iii) Net Assets (i-ii)		28,25,000		9,05,000
(iv) No. of Outstanding Shares		70,000		25,000
(v) Intrinsic Value per share (iii)/(iv)		40.40		36.20

W # 3: ***Valuation of Goodwill***

A. Capital Employed (₹)

	Ram Ltd.		Rahim Ltd.	
(i) Assets:				
(a) Sundry Fixed assets	9,50,000		4,00,000	
(b) Investment (Non-trade)	-		-	
(c) Stock	1,20,000		50,000	
(d) Debtors	75,000		80,000	
(e) Advance tax	80,000		20,000	
(f) Cash and Bank balance	2,75,000	15,00,000	1,30,000	6,80,000
(ii) Liabilities:				
(a) 12% Debentures	1,00,000		1,00,000	
(b) Sundry creditors	40,000		45,000	
(c) Provision for tax	1,00,000	2,40,000	60,000	2,05,000
(iii) Capital Employed: (i) - (ii)		**12,60,000**		**4,75,000**

B. Average Pre-tax Profit: (₹)

Particulars	Ram Ltd.	Rahim Ltd.
(i) 2012-13	5,00,000	1,50,000
(ii) 2013-14	6,50,000	2,10,000
(iii) 2014-15	5,75,000	1,80,000
(iv) Total (a+b+c)	17,25,000	5,40,000
(v) Simple Average [(iv)/3]	5,75,000	1,80,000
(vi) Less: Non-trading income	(50,000)	(9,000)
(vii) **Average pre-tax profit**	**5,25,000**	**1,71,000**

C. Computation of Goodwill:

Particulars	Ram Ltd. ₹	Rahim Ltd. ₹
a. Capitalised value of average profits		
$\frac{5,25,000}{0.20}$; $\frac{1,71,000}{0.20}$	26,25,000	8,55,000
b. Capital Employed	12,60,000	4,75,000
c. Goodwill (a-b)	**13,65,000**	**3,80,000**

Journal Entries - Books of Ram Ltd.

- Nature of Amalgamation – PURCHASE
- Method of Accounting – PURCHASE METHOD

Particulars		Debit	Credit
a. For Business Purchase :			
Business Purchase A/c	Dr.	9,05,000	
To Liquidator of Rahim Ltd. A/c			9,05,000
b. For Assets and Liabilities taken over			
Goodwill A/c	Dr.	3,80,000	
Fixed Assets A/c	Dr.	4,00,000	
Investments A/c	Dr.	50,000	
Stock A/c	Dr.	50,000	
Debtors A/c	Dr.	80,000	
Advance tax A/c	Dr.	20,000	
Cash and Bank A/c	Dr.	1,30,000	
To 12% Debenture holders A/c			1,00,000
To Creditors A/c			45,000
To Provision for Taxation A/c			60,000
To Business Purchase A/c			9,05,000
c. For Discharge of Purchase Consideration:			
Liquidator of Rahim Ltd.	Dr.	9,05,000	
To Equity Share capital A/c			2,24,000
To Securities premium A/c			6,80,000
To Cash A/c			40
d. Contra Entry			
Amalgamation Adjustment A/c	Dr.	40,000	
To Export Profit Reserve A/c			40,000

Name of the Company: Ram Ltd.					
Balance Sheet as at 1.04.2015					
Ref No.	**Particulars**		**Note No.**	**As at 1st April, 2015**	**As at 31st March, 2015**
				₹	₹
	I.	**Equity and Liabilities**			
	1	**Shareholders' funds**			
		(a) Share capital	1	9,24,000	
		(b) Reserves and surplus	2	14,90,960	
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**			
		(a) Long-term borrowings	3	2,00,000	
	4	**Current Liabilities**			
		(a) Trade payables	4	85,000	
		(b) Short-term provisions	5	1,60,000	
		Total (1+2+3+4)		**28,59,960**	
	II.	**Assets**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets	6	13,50,000	
		(ii) Intangible assets	7	3,80,000	
		(b) Non-current investments	8	2,50,000	
		(c) Long-term loans and advances	9	1,00,000	
		(d) Other non-current assets	10	40,000	
	2	**Current assets**			
		(a) Inventories	11	1,70,000	
		(b) Trade receivables	12	1,55,000	
		(c) Cash and cash equivalents	13	4,04,960	
		(d) Other current assets	14	10,000	
		Total (1+2)		**28,59,960**	

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

(₹)

Note 1. Share Capital	**As at 1st April, 2015**	**As at 31st March, 2015**
Authorised, Issued, Subscribed and Paid up Share Capital 92,400 Equity Shares of ₹10 each (of which 22,400 shares were issued for consideration other than cash)	9,24,000	
Total	**9,24,000**	

RECONCILATION OF SHARE CAPITAL

FOR EQUITY SHARE:-	**As at 1stApril, 2015**		**As at 31st March, 2015**	
	Nos	Amount (₹)	Nos	Amount (₹)
Opening Balance as on 01.04.15	70,000	7,00,000	NIL	NIL
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash)	22,400	2,24,000	NIL	NIL
	92,400	9,24,000	NIL	NIL
Less: Buy Back of shares	-	-	-	-
	92,400	9,24,000	NIL	NIL

Note 2. Reserves and Surplus		As at 1st April, 2015	As at 31st March, 2015
Securities Premium		6,80,960	
General Reserve		3,50,000	
Profit and Loss A/c	₹2,10,000		
Add: Proposed Dividend Cancelled	₹1,40,000	3,50,000	
Export Profit reserve (70,000+40,000)		1,10,000	
Total		14,90,960	

Note 3. Long-term borrowings	As at 1st April, 2015	As at 31st March, 2015
12% Debentures of ₹100 each (1,00,000+1,00,000)	2,00,000	
Total	2,00,000	

Note 4. Trade Payables	As at 1st April, 2015	As at 31st March, 2015
Sundry Creditors	85,000	
Total	85,000	

Note 5. Short term Provisions	As at 1st April, 2015	As at 31st March, 2015
Provision for Tax (1,00,000 + 60,000)	1,60,000	
Total	1,60,000	

Note 6. Tangible Assets	As at 1st April, 2015	As at 31st March, 2015
Sundry Fixed assets (9,50,000+4,00,000)	13,50,000	
Total	13,50,000	

Note 7. Intangible assets	As at 1st April, 2015	As at 31st March, 2015
Goodwill	3,80,000	
Total	3 ,80,000	

Note 8. Noncurrent Investments	As at 1st April, 2015	As at 31st March, 2015
Investment	2,50,000	
Total	2,50,000	

Note 9. Long-term Loans and advances	As at 1st April, 2015	As at 31st March, 2015
Advance Tax	1,00,000	
Total	1,00,000	

Note 10.Other Noncurrent assets	As at 1st April, 2015	As at 31st March, 2015
Amalgamation Adjustment A/c	40,000	
Total	40,000	

Note 11. Inventories	As at 1st April, 2015	As at 31st March, 2015
Stock (1,20,000+50,000)	1,70,000	
Total	1,70,000	

Note 12. Trade receivables	As at 1st April, 2015	As at 31st March, 2015
Debtors (75,000+80,000)	1,55,000	
Total	1,55,000	

Note 13. Cash and Cash Equivalents	As at 1st April, 2015	As at 31st March, 2015
Cash and Bank balance (2,75,000+1,30,000-40)	4,04,960	
Total	4,04,960	

Note 14. Other Current Assets	As at 1st April, 2015	As at 31st March, 2015
Preliminary Expenses	10,000	
Total	10,000	

Illustration 10:

The following are the Balance sheets of Fat Ltd. and Thin Ltd. for the year ending on 31st March, 2015.

(Figures in ₹ Crores)

	Fat Ltd.	Thin Ltd.
Equity Share capital. @ ₹ 10 each	50	40
Preference Share capital - in 12% preference shares of ₹ 100 each	–	60
Reserves and surplus	200	150
	250	250
Loan - Secured	100	100
Total	**350**	**350**
Fixed assets (at cost less depreciation) - Tangible	150	150
Current assets less Current liabilities	200	200
Total	**350**	**350**

Note: Secured Loan to repayable within 12 months.
The present worth of Fixed assets of Fat Ltd. is ₹ 200 crores and that of Thin Ltd. is ₹ 429 crores. Goodwill of Fat Ltd. is ₹ 40 crores and of Thin Ltd. is ₹ 75 crores.

Thin Ltd. absorbs Fat Ltd. by issuing equity shares at par in such a way that intrinsic networth is maintained.

Goodwill account is not to appear in the books. Fixed assets are to appear at old figures.

(a) Show the Balance Sheet after absorption.

(b) Draft a statement of valuation of shares on intrinsic value basis and prove the accuracy of your workings.

Solution:

Part-I: Purchase consideration

WN # 1: ***Intrinsic Value of Equity Shares***

(₹ *in Crores)*

Particulars	Fat Ltd.	Thin Ltd.
a) **Assets:**		
i. Goodwill	40	75
ii. Fixed assets	200	429
iii. Current asset less Current liabilities	200	200
	440	704
b) **Liabilities**		
i. Secured Loans	(100)	(100)
ii. 12% Preference Share capital	-	(60)
c) Net Assets attributable to Equity shareholders	340	544
d) Number of Shares (in Crores)	5	4
e) Value per share of ₹ 10 each	₹ 68	₹ 136

WN # 2: ***Determination of Exchange Ratio and the number of shares to be issued***

Exchange Ratio is based on intrinsic value per share of the companies

	Fat Ltd.	:	Thin Ltd.
i. Intrinsic value	₹ 68	:	₹ 136
ii. Exchange ratio	1	:	2

1 share of Thin Ltd. for 2 shares of Fat Ltd.

Therefore, Number of shares to be issued = Number of shares of Fat Ltd. × %
= 5 crores × 50% (i.e. ratio is 1:2 =50%)
= 2.5 crores

Journal Entries in the books of Thin Ltd.

- Nature of Amalgamation - Purchase
- Method of Accounting - Purchase

(₹ in Crores)

Particulars		Debit ₹	Credit ₹
1. For Business Purchase			
Business Purchase A/c	Dr.	25	
To Liquidator of Fat Ltd.			25
2. For assets and liabilities taken over:			
Fixed Assets A/c	Dr.	150	
Net Current Assets A/c	Dr.	200	
To Secured Loans A/c			100
To Capital Reserve A/c			225
To Business Purchase A/c			25
3. For Discahrge of Purchase Consideration:			
Liquidator of Fat Ltd. A/c	Dr.	25	
To Equity Share Capital A/c			25

Name of the Company: Thin Ltd.					
Balance Sheet as at 31.03.2015 (After absorption)					
Ref No.	**Particulars**		**Note No.**	**After absorption**	**Before absorption**
				₹ in Crore	₹ in Crore
	I.	**Equity and Liabilities**			
	1	**Shareholders' funds**			
		(a) Share capital	1	125	
		(b) Reserves and surplus	2	375	
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**		NIL	
	4	**Current Liabilities**			
		(a) Short-term borrowings	3	200	
		Total (1+2+3+4)		**700**	
	II.	**Assets**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets	4	300	
	2	**Current assets**			
		(a) Other current assets	5	400	
		Total (1+2)		**700**	

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

₹ in Crore

Note 1. Share Capital	**After absorption**	**Before absorption**
Authorised, issued, subcribed and paid up 6.5 crore equity shares of ₹10 each (of the above shares, 2.5 crores equity shares are allotted as fully paid up for consideration other than cash)	65	
12% Preference Share capital (60 lakhs shares of ₹100 each)	60	
Total	125	

RECONCILATION OF SHARE CAPITAL

FOR EQUITY SHARE:-	**After absorption**		**Before absorption**	
	Nos	Amount (₹)	Nos	Amount (₹)
Opening Balance as on 01.04.14	4	40.00	NIL	NIL
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash)	2.50	25.00	NIL	NIL
	6.5	65.00	NIL	NIL
Less: Buy Back of shares	-	-	-	-
	6.5	65.00	NIL	NIL

FOR 12% PREFERENCE SHARE:-	**As at 31st March, 2015**		**As at 31st March, 2014**	
	Nos	Amount (₹)	Nos	Amount (₹)
Opening Balance as on 01.04.11	6	60.00	NIL	NIL
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash)		-	NIL	NIL
	6	60.00	NIL	NIL
Less: Buy Back of shares	-	-	-	-
	6	60.00	NIL	NIL

Note 2. Reserves and Surplus	After absorption	Before absorption
Capital Reserve Other Reserve	225 150	
Total	375	

Note 3. Short-term borrowings	After absorption	Before absorption
Secured Loan (100+100)	200	
Total	200	

Note 4. Tangible assets	After absorption	Before absorption
Fixed Assets (150+150)	300	
Total	300	

Note 5. Other Current Assets	After absorption	Before absorption
Current Assets less Current Liabilities(200+200)	400	
Total	400	

* Secured loan is repayable with in 12 months.

WN 3: ***Statement to prove the accuracy of workings.***

(₹ in Crores)

(i)	Equity Share capital (after absorption)	65
	Add: Reserves Surplus (after absorption)	375
	Add: Unrecorded value of goodwill (40+75)	115
	Add: Unrecorded incremental value of Fixed assets (50+279)	329
	Value of the Business	884
(ii)	Number of Equity shares (4 + 2.5)	6.5 Crores
(iii)	Intrinsic value of an equity share (884/6.5)	₹ 136

Illustration 11:

S and M had been carrying on business independently, agree to amalgamate and form a company N Ltd. with an authorised Share capital of ₹ 2,00,000 divided into 40,000 equity shares of ₹ 5 each.

On 31st March, 2015, the respective Balance Sheets of S and M were as follows:

Particulars	**S** ₹	**M** ₹
Fixed Assets	3,17,500	1,82,500
Current Assets	1,63,500	83,875
	4,81,000	**2,66,375**
Less: Current liabilities	2,98,500	90,125
	1,82,500	**1,76,250**

Additional Information:

Revalued figures of Fixed and Current assets were as follows:

Particulars	S	M
Fixed Assets	6,55,000	2,95,000
Current Assets	1,49,750	78,875

The debtors and creditors include ₹ 21,675 owed by S to M.

The purchase consideration is satisfied by issue of the following shares and debentures:

i. 30,000 equity shares of N Ltd. to S and M in the proportion to the profitability of their respective business based on the average net profit during the last three years which were as follows:

Particulars	S	M
2013 Profit	2,24,788	1,36,950
2014 (Loss) / Profit	(1,250)	1,71,050
2015 Profit	1,88,962	1,79,500

ii. 15% debentures in N Ltd. at par to provide an income equivalent to 10% return on capital employed in their respective business as on 31st March 2015 after revaluation of assets.

You are required to:

1. Compute the amount of debentures and shares to be issued to S and M.
2. A Balance sheet of N Ltd. showing the position immediately after amalgamation.

Solution:

Part I: Calculation of shares to be issued and No. of debentures to be issued:

WN # 1: Calculation of average profit for the past 3 years.

$$S = \frac{2,24,788 - 1,250 + 1,88,962}{3} = ₹\ 1,37,500$$

$$M = \frac{1,36,950 + 1,71,050 + 1,79,500}{3} = ₹\ 1,62,500$$

Determination of shares to be distributed to each company

Distribution: 30,000 Equity Shares of N Ltd. are to be distributed between the S Ltd. and M Ltd. in their profitability ratio. i.e. 1375: 1625

Shares to be Issued to S Ltd. = $\frac{1,375}{3,000}$ x 30,000 = 13,750 Shares.

Shares to be Issued to M Ltd. = $\frac{1,625}{3,000}$ x 30,000 = 16,250 Shares.

WN # 2: Calculation of the number of debentures to be issued:

i. Calculation of 10% return of capital employed:- (at revalued figures)

Particulars	S	M
a. Fixed Assets	6,55,000	2,95,000
b. Current Assets	1,49,750	78,875
	8,04,750	3,73,875
c. Current liabilities	(2,98,500)	(90,125)
d. Capital employed	5,06,250	2,83,750

Particulars	S	M
e. Return on capital employed @ 10%	50,625	28,375
f. Number of 15% debenture to be issued in order to get same return of ₹ 50,625 and ₹ 28,375 respectively. $(\frac{50,625}{15\%}, \frac{28,375}{15\%})$	3,37,500	1,89,167

WN # 3: Calculation of Purchase consideration and Goodwill or Capital reserve from the amalgamation:

(₹)

Particulars	S	M	Total
I. Purchase Consideration:			
a. Value of Equity Shares (WN # 1) (13,750 x 5; 16,250 x 5)	68,750	81,250	1,50,000
b. 15% Debentures (WN # 2)	3,37,500	1,89,200	5,26,700
c. Total	**4,06,250**	**2,70,450**	**6,76,700**
II. Net Assets taken over:			
a. Fixed assets (Revalued Figures)	6,55,000	2,95,000	9,50,000
b. Add: Current assets (*78,875 - 21,675 Inter Co. Owings)	1,49,750	57,200*	2,06,950
c. Less: Current liabilities (**2,98,500 - 21,675 Inter Co. Owings) **	(2,76,825)	(90,125)	(3,66,950)
d. Total (a+b+c)	**5,27,925**	**2,62,075**	**7,90,000**
III. Goodwill / (Capital reserve) (I - II)	**(1,21,675)**	**8,375**	**(1,13,300)**

Name of the Company: N Ltd.				
Balance Sheet as at 31.03.2015				
Ref No.	**Particulars**		**Note No.**	**As at 31st March, 2015**
				₹
	I.	**Equity and Liabilities**		
	1	**Shareholders' funds**		
		(a) Share capital	1	1,50,000
		(b) Reserves and surplus	2	1,13,300
	2	**Share application money pending allotment**		Nil
	3	**Non-current liabilities**		
		(a) Long-term borrowings	3	5,26,700
	4	**Current Liabilities**		
		(a) Other current liabilities		3,66,950
		Total (1+2+3+4)		**11,56,950**
	II.	**Assets**		
	1	**Non-current assets**		
		(a) Fixed assets		
		(i) Tangible assets	4	9,50,000
	2	**Current assets**		
		(a) Other current assets		2.06.950
		Total (1+2)		**11,56,950**

1. Share Capital	As at 31st March, 2015
Authorised Capital: Equity Shares of ₹5 each	2,00,000
Issued Capital 30,000 shares of ₹ 5 each [All the above shares were issued to for a consideration other than cash]	1,50,000
Total	1,50,000

RECONCILATION OF SHARE CAPITAL

FOR EQUITY SHARE:-	As at 31st March, 2015	
	Nos	Amount (₹)
Opening Balance as on 01.01.12	-	-
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash)	30,000	1,50,000
	30,000	1,50,000
Less: Buy Back of shares	-	-
	30,000	1,50,000

2. Reserves and Surplus	As at 31st March, 2015
Capital Reserve (WN # 3)	1,13,300
Total	1,13,300

3. Long-term borrings	As at 31st March, 2015
15% Debentures (W N # 2) (3,37,500 + 1,89,200)	5,26,700
Total	5,26,700

4. Tangible Assets	As at 31st March, 2015
Fixed assets	9,50,000
Total	9,50,000

Illustration 12:

It has been decided that P Ltd. will absorb the entire undertaking of S Ltd. and T Ltd. as on 1.4.2012 The outside shareholders in the latter companies are to be issued equity shares in P Ltd. on the basis of an agreed issue price of ₹ 200 per share. For this purpose, the interests of such shareholders are to be determined according to the intrinsic values of the shares of the respective companies. N Ltd. is a subsidiary of T Ltd. and is also to be merged into P Ltd. appropriately.

The Balance Sheets of the companies as at 31.3.2015, stood as under:

(₹ Lakhs)

	P	S	T	N
Sources of Funds:				
Share capital				
Equity shares ₹ 100 each	1,500	1,000	800	400
Reserves	2,000	540	702	400
Loans	1,600	900	1,000	700
Total	**5,100**	**2,440**	**2,502**	**1,500**

(₹ Lakhs)

	P	S	T	N
Application of Funds:				
Land	200	100	50	10
Buildings	500	400	100	200
Machinery	1,500	800	500	500
Other Fixed Assets	400	100	200	50
Investments				
4 lakhs shares of S	500			
2 lakhs shares of T	300			
4 lakhs shares of N	-	-	400	
Others	100	-	-	
Net Current Assets	1,600	1,040	1,252	740
Total	**5,100**	**2,440**	**2,502**	**1,500**

Note: Loans asumed to be of less than 12 months hence treated as short term borrowing (ignoring interst)

For the purpose of the scheme, it is agreed to give effect to the following value appreciations of the assets of the companies to be absorbed.

Land	-	100%
Buildings	-	50%
Machinery	-	20%

In order to obtain the consent of the creditors of T Ltd., it becomes necessary to accept a claim of ₹20 lakhs hitherto classified as contingent. 60% of the claim is accepted by T Ltd. and the balance is to be settled by P Ltd.

You are required to:

i. Compute the number of shares to be issued by P Ltd. to eligible outsiders

ii. Show journal entries.

iii. Draft the Balance sheet of P Ltd. after the absorption.

Solution:

Part 1. *Calculation of Purchase consideration.*

WN # 1: Calculation of Intrinsic value of shares.

₹ in Lakhs.

		S	T	N
a.	Land (↑100%)	200	100	20
b.	Building (↑50%)	600	150	300
c.	Machinery (↑20%)	960	600	600
d.	Others Fixed Assets	100	200	50
e.	Net current Asset	1040	1252	740
f.	Investment in N Ltd. (100% subsidiary company)	—	1010	—
	[4 Lakhs shares × ₹ 252.50]	2900	3312	1710
g.	Loans	(900)	(1000)	(700)
h.	Contingent loan (60% of 20)	—	(12)	—
i.	Value of Net Assets	2,000	2,300	1010
j.	No. of shares Outstanding	10	8	4
k.	Intrinsic value per share (i/j)	200	287.50	252.50

WN # 2: Purchase consideration ₹ in Lakhs.

	Particulars	S	T
a.	No. of shares outstanding	10	8
b.	Less: Already held by P Ltd.	(4)	(2)
c.	No. of shares held by outsiders	6	6
d.	Value payable at intrinsic value [WN # 2(c) x WN # 1 (k)]	₹ 1,200	₹ 1,725
e.	No. of shares to be issued at value of ₹ 200	6	8.625

Part II - In the books of purchasing Co. P Ltd.

A. Take over of S Ltd.

- Nature of Amalgamation - Purchase
- Method of Accounting - Purchase

(₹ in Lakhs)

	Particulars		Debit	Credit
a.	For Purchase Consideration Due :			
	Business Purchase A/c (6 × 200)	Dr.	1,200	
	To Liquidator of S Ltd's. A/c			1,200
b.	For Assets and liabilities takeover:			
	Land A/c	Dr.	200	
	Building A/c	Dr.	600	
	Machinery A/c	Dr.	960	
	Other Fixed Assets A/c	Dr.	100	
	Net Current Assets A/c	Dr.	1040	
	To Capital Reserve A/c (balancing figure)			300
	To Loans A/c			900
	To Business purchase A/c			1,200
	To Investments in S Ltd.			500
c.	Discharge of consideration			
	Liquidator of S Ltd. A/c	Dr.	1,200	
	To Equity Share Capital A/c (6 x 100)			600
	To Securities Premium A/c (6 x 100)			600

B. Take over of T Ltd.

- Nature of Amalgamation - Purchase
- Method of Accounting - Purchase

₹ in Lakhs

	Particulars		Debit	Credit
a.	For Purchase Consideration Due:			
	Business Purchase A/c	Dr.	1,725	
	To Liquidator of T Ltd. A/c			1,725
b.	For takeover of assets and liabilities:			
	Land A/c	Dr.	120	
	Building A/c	Dr.	450	
	Machinery A/c	Dr.	1200	
	Other Fixed Assets A/c	Dr.	250	
	Net Current Assets A/c	Dr.	1992	
	To Capital Reserve A/c (balancing figure)			267
	To Loans A/c			1712
	To Contingent loan payable A/c			8
	To Business purchase A/c			1725
	To Investments in T Ltd. A/c			300
c.	Settlement of contingent liability:			
	Contingent liability payable A/c	Dr.	8	
	To Net current asset (cash)			8
d.	For discharge of consideration:			
	Liquidator of T Ltd. A/c	Dr.	1,725	
	To Equity Share Capital A/c (8.625 × 100)			862.5
	To Securities Premium A/c (8.625 × 100)			862.5

Name of the Company: P Ltd.
Balance Sheet as at 1.4.2015

Ref No.		Particulars	Note No.	As at 1st April, 2015	As at 31st March, 2015
				₹	₹
	I.	**Equity and Liabilities**			
	1	**Shareholders' funds**			
		(a) Share capital	1	2,962.50	
		(b) Reserves and surplus	2	4029.50	
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**		NIL	
	4	**Current Liabilities**			
		(a) Short-term borrowings	3	4,212	
		Total (1+2+3)		**11,204**	
	II.	**Assets**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets	4	6,480	
		(b) Non-current investments		100	
	2	**Current assets**			
		(a) Other current assets	5	4,624	
		Total (1+2)		**11,204**	

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

(₹)

Note 1. Share Capital	As at 1st April, 2015	As at 31st March, 2015
Authorized,Issued subscribed and fully paid up equity shares of ₹ 10 each[Out of the above 6 lakhs shares to S Ltd. And 8 lakhs shares to T Ltd. Were issued for consideration other than cash]	2,900	
Total	2,900	

RECONCILATION OF SHARE CAPITAL

FOR EQUITY SHARE:-	As at 1st April, 2015		As at 31st March, 2015	
	Nos	Amount (₹)	Nos	Amount (₹)
Opening Balance as on 01.04.11	15	1,500.00	NIL	NIL
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash)	14	1,400.00	NIL	NIL
	29	2,900.00	NIL	NIL
Less: Buy Back of shares	-	-	-	-
	29	2,900.00	NIL	NIL

2. Reserves and Surplus	As at 1st April, 2015	As at 31st March, 2015
Capital Reserve (300+267)	567.00	
Securities Premium (600+862.5)	1,462.50	
Other Reserves	2,000.00	
Total	4029.50	

3. Short-term Loans	As at 1st April, 2015	As at 31st March, 2015
Loans(1600+900+1012+700)	4,212	
Total	4212	

4. Tangible Assets	As at 1st April, 2015	As at 31st March, 2015
Land (200+200+100+20)	520	
Buildings (500+600+150+300)	1,550	
Machinery (1500+960+600+600)	3,660	
Other Fixed assets (400+100+200+50)	750	
Total	6,480	

5. Other Current Assets	As at 1st April, 2015	As at 31st March, 2015
Net Current assets (1,600+1,040+1,252+740-8)	4,624	
Total	4,624	

Note: Loan are assurred to be of less than 12 months Hence, Short term (ignoring interest)

Illustration 13:

The summarised Balance sheets of A Ltd. and its subsidiary B Ltd. as on 31.3.2015 are as follows:

	A Ltd. ₹	B Ltd. ₹
Equity Share Capital (₹ 10 each)	1,00,00,000	20,00,000
Reserves and Surplus	1,40,00,000	60,00,000
Secured Loans	40,00,000	–
Current liabilities	60,00,000	20,00,000
	3,40,00,000	**1,00,00,000**
Fixed Assets	1,20,00,000	35,00,000
Investment in B Ltd.	7,40,000	–
Sundry Debtors	70,00,000	10,00,000
Inventories	60,00,000	50,00,000
Cash and Bank	82,60,000	5,00,000
	3,40,00,000	**1,00,00,000**

Note: Secured loans are assumed to be of less than 12 months (ignoring intrest)

A Ltd. holds 76% of the paid up capital of B Ltd. The balance shares in B Ltd. are held by a foreign Collaborating Company. A memorandum of understanding has been entered into with the foreign company providing for the following.

a. The shares held by the foreign company will be sold to A Ltd. The price per share will be calculated by capitalising the yield at 16%. Yield, for this purpose, would mean 40% of the average of pre-tax profits for the last 3 years, which were ₹ 35 lakhs, ₹ 44 lakhs and ₹65 lakhs.

b. The actual cost of shares to the foreign company was ₹ 2,40,000 only. The profit that would accrue to them would be taxable at an average rate of 20%. The tax payable be deducted from the proceeds and A Ltd. will pay it to the Government.

c. Out of the net consideration, 50% would be remitted to the foreign company immediately and the balance will be an unsecured loan repayable after one year. It was also decided that A Ltd. would absorb B Ltd. simulataneously by writing down the Fixed assets of B Ltd. by 5%. The Balance sheet figures included. a sum of ₹ 1,50,000 due by B Ltd. to A Ltd.

The entire arrangement was approved by all concerned for giving effect to on 1.4.2015. You are required to show the Balance Sheet of A Ltd. as it would appear after arrangement is put through on 1.4.2015.

Solution:

- Nature of Amalgamation - Purchase Method
- Method of Accounting - Purchase Method

WN # 1: *Computation of Purchase consideration:*

a. Yield of B Ltd.

$$= \frac{(35+44+65)}{3} \times 40\% = ₹\ 19.20 \text{ Lakhs}$$

b. Price per share of B Ltd.

(₹ in Lakhs)

Particulars	Amount
Yield of B Ltd. (₹ in lakhs)	19.20
Capitalisation rate	16%
Value of B Ltd. (₹ in lakhs)	120.00
No. of Shares Outstanding (lakhs)	2.00
Price per share (₹) (120.00/20.00) (₹ 120 lakhs /2.00 lakh shares)	60

c. Purchase Consideration:

Particulars	(₹ in Lakhs) Amount
Shares held by Foreign Collaborator (2,00,000 x 24%)	48,000 shares
Price per share	₹ 60
Purchase Consideration	₹ 28,80,000

WN # 2: ***Discharge of Purchase Consideration:***

a. Tax Payable:

	(₹ in Lakhs)
Purchase Consideration	28.80
Less: Cost of Acquisition	(2.40)
Capital Gains	26.40
Tax payable @ 20%	5.28

b. Mode of payment of purchase consideration

Purchase Consideration	28.80
Less: Income Tax payable	(5.28)
	23.52

To be remitted immediately	To be retained as Unsecured Loans
50%	50%
₹ 11.76	₹ 11.76

WN # 3: ***Calculation of Goodwill / Capital Reserve on Absorption***

A. Calculation of Net Assets: ₹ in lakh

	Particulars	Amount	Amount
a.	Assets taken over:		
	i. Fixed assets	35	
	Less: 5% reduction in value	(1.75)	33.25
	ii. Sundry Debtors		10.00
	iii. Inventories		50.00
	iv. Cash and Bank balances		5.00
			98.25
b.	Current liabilities		20.00
c.	**Net Assets taken over (a-b)**		**78.25**

WN # 3: ***Calculation of Goodwill / Capital Reserve on Absorption***

A. Calculation of Net Assets: ₹ in lakh

	Particulars	Amount	Amount
a.	Assets taken over:		
	i. Fixed assets	35	
	Less: 5% reduction in value	(1.75)	33.25
	ii. Sundry Debtors		10.00
	iii. Inventories		50.00
	iv. Cash and Bank balances		5.00
			98.25
b.	Current liabilities		20.00
c.	**Net Assets taken over (a-b)**		**78.25**

B. Goodwill / Capital Reserve: ₹ in lakh

Particulars	Amount
Net Assets taken over	78.25
Less: Purchase Consideration	(28.80)
Less: Investments in B Ltd.	(7.40)
Capital Reserve	**42.05**

WN # 4: ***Computation of Cash and Bank Balances after absorption***

Particulars	₹ in Lakhs
Balance in A Ltd.	82.60
Cash and Bank Balance of B. Ltd.	5.00
Less: Remittance to Foreign Collaborating Company	(11.76)
Less: TDS paid	(5.28)
Cash and Bank balance	**70.56**

Name of the Company: A Ltd.
Balance Sheet as at 1.04.215

Ref No.		Particulars	Note No.	As at 1st April, 2015	As at 31st March, 2015
				(₹ in Lakh)	(₹ in Lakh)
	I.	**Equity and Liabilities**			
	1	**Shareholders' funds**			
		(a) Share capital	1	100.00	
		(b) Reserves and surplus	2	182.05	
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**		NIL	
	4	**Current Liabilities**			
		(a) Short-term borrowings	3	51.76	
		(b)Other current liabilities	4	78.50	
		Total (1+2+3)		**412.31**	
	II.	**Assets**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets	5	153.25	
	2	**Current assets**			
		(a) Inventories	6	110.00	
		(b) Trade receivables	7	78.50	
		(c) Cash and cash equivalents	8	70.56	
		Total (1+2)		412.31	

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

(₹ in Lakhs)

Note 1. Share Capital	**As at 1st April, 2015**	**As at 31st March, 2015**
Authorised, Issued, Subscribed and paid up Equity share of ₹10 each	100.00	
Total	100.00	

RECONCILATION OF SHARE CAPITAL

FOR EQUITY SHARE:-	**As at 1st April, 2015**		**As at 31st March, 2012**	
	Nos	Amount (₹)	Nos	Amount (₹)
Opening Balance as on 01.04.15	10	100.00	NIL	NIL
Add: Fresh Issue (incld Bonus shares, Right shares, split shares, shares issued other than cash)	-	-	NIL	NIL
	10	100.00	NIL	NIL
Less: Buy Back of shares	-	-	-	-
	10	100.00	NIL	NIL

Note 2. Reserves and Surplus	**As at 1st April, 2015**	**As at 31st March, 2015**
Capital reserve	42.05	
Other reserve	140.00	
Total	182.05	
Note 3. Short term borrowings	**As at 1st April, 2015**	**As at 31st March, 2015**
Secured Loans	40.00	
Unsecured Loans (WN # 2)	11.76	
Total	51.76	

Note 4. Other Current Liabilities	**As at 1st April, 2015**	**As at 31st March, 2015**
Current Liabilities:-		
A Ltd.	60.00	
B Ltd.	20.00	
Less: Inter Co. owings	(1.50)	
Total	78.50	

Note 5. Tangible Assets	**As at 1st April, 2015**	**As at 31st March, 2015**
Fixed assets (120+33.25)	153.25	
Total	153.25	

Note 6. Inventories	**As at 1st April, 2015**	**As at 31st March, 2015**
Inventories (60+50)	110.00	
Total	110.00	

Note 7. Trade Receivables	**As at 1st April, 2015**	**As at 31st March, 2015**
Sundry debtors (70+10) i.e 80.00 Less: Inter Company owings (1.50)	78.50	
Total	78.50	

Note 8. Cash and Cash Equivalents	**As at 1st April, 2015**	**As at 31st March, 2015**
Cash and Bank (WN # 4)	70.56	
Total	70.56	

Illustration 14:

The Balance Sheets of S Ltd. and P Ltd. as on 31.03.15 are as under:

(₹ in Lakhs)

Liabilities	S	P	Assets	S	P
Equity Shares of ₹ 100 each	25.00	50.00	Fixed Assets	110.00	50.00
Reserves	131.00	29.25	Investments	16.25	25.00
12% Debentures	11.00	5.50	Current Assets	40.25	3.25
Creditors	8.00	2.75	Miscellaneous	8.50	9.25
			Expenditure		
	175.00	**87.50**		**175.00**	**87.50**

Investments of S Ltd. represents 12,500 shares of P Ltd. investments of P Ltd. are considered worth ₹ 30 lakhs.

P Ltd. is taken over by S Ltd. on the basis of the intrinsic value of shares in their respective books of accounts. Prepare a statement showing the number of shares to be allotted by S Ltd. to P Ltd. and the balance sheet of S Ltd. after absorpotion of P Ltd.

Solution:

Part. I: Purchase consideration

WN # 1 Net Assets

(₹ in lakhs)

	S Ltd.	P Ltd.
A. Assets		
i) Fixed Assets	110.00	50.00
ii) Investments	18.75*	30.00
iii) Current Assets	40.25	3.25
	169.00	83.25
B. Liabilities		
i) 12% Debentures	11.00	5.50
ii) Creditors	8.00	2.75
	19.00	8.25
C. Net Assets [A-B]	150.00	75.00

* Investments of 'S' Ltd = 12,500 × ₹ 150 [WN # 2]

= ₹ 18.75 Lakhs.

WN # 2: Intrinsic Value

	S Ltd.	P. Ltd.
Net assets	150.00 Lakhs	75.00 Lakhs
No. of equity shares	25,000	50,000
Intrinsic value	₹ 600	₹ 150.00

WN # 3: *Purchase consideration (No. of shares alloted)*

No. of equity shares outstanding in P Ltd	50,000
Less: Already held by S Ltd.	12,500
No. of equity shares of outsiders	37,500
Intrinsic value of P Ltd.	₹ 150
Purchase consideration (37,500 × 150)	56,25,000
Instrinsic value per share of S Ltd.	₹ 600
No. of shares to be allotted	56,25,000/600
	9,375 shares

Equity Share Capital = 9,375 × 100 = 9,37,500

Securities Premium = 9,375 × 500 = 46,87,500

Part - II: In the books of S Ltd.

- Nature of Amalgamation - Purchase
- Method of Accounting - Purchase

	Particulars		Debit	Credit
1.	**For Purchase Consideration Due:**			
	Business Purchase A/c	Dr.	56,25,000	
	To Liquidator of P Ltd. A/c			56,25,000
2.	**For assets and liabilities taken over:**			
	Fixed Assets A/c	Dr.	50,00,000	
	Investments A/c	Dr.	30,00,000	
	Current Assets A/c	Dr.	3,25,000	
	To 12% Debentures A/c			5,50,000
	To Creditors A/c			2,75,000
	To Business Purchase A/c			56,25,000
	To Investment in shares of P Ltd. A/c			16,25,000
	To Capital Reserve (Balancing Figure)			2,50,000
3.	**Discharge of purchase consideration:**			
	Liquidator of P Ltd. A/c	Dr.	56,25,000	
	To Share Capital A/c			937500
	To Securities Premium A/c			46,87,500

Name of the Company: S Ltd.					
Balance Sheet as at 31.03.2015					
Ref No.	**Particulars**		**Note No.**	**After absorption**	**Before absorption**
				₹ in lakhs	₹ in lakhs
	I.	**Equity and Liabilities**			
	1	**Shareholders' funds**			
		(a) Share capital	1		34.375
		(b) Reserves and surplus	2		180.375
	2	**Share application money pending allotment**			NIL
	3	**Non-current liabilities**			
		(a) Long-term borrowings	3		16.50
	4	**Current Liabilities**			
		(a) Trade payables	4	10.75	
		Total(1+2+3)		242.00	
	II.	**Assets**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets	5	160.00	
		(b) Non-current investments	6	30.00	
	2	**Current assets**			
		(a) Other current assets	7	52.00	
		Total(1+2)		242.00	

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

₹ in lakhs

Note 1. Share Capital	After absorption	Before absorption
Authorised, Issued, Subscribed & Paid up:- 34,375 equity shares of ₹100/- each [of the above shares 9,375 equity shares are allotted as fully paid up for consideration other than cash]	34.38	
Total	34.38	

RECONCILATION OF SHARE CAPITAL

FOR EQUITY SHARE:-	After absorption		Before absorption	
	Nos	Amount (₹)	Nos	Amount (₹)
Opening Balance as on 01.04.14	0.25	25.00	NIL	NIL
Add: Fresh Issue (Incld Bonus shares , Right shares, split shares, shares issued other than cash)	0.09	9.38	NIL	NIL
	0.3438	34.38	NIL	NIL
Less: Buy Back of shares	-	-	-	-
	0.3438	34.38	NIL	NIL

Note 2. Reserves and Surplus	After absorption	Before absorption
Reserves	131.00	
Capital reserve	2.50	
Securities Premium	46.875	
Total	180.375	

Note 3. Long term borrowings	After absorption	Before absorption
Secured Loan	46.87	
12% Debentue	16.50	
Total	63.37	

Note 4. Trade Payable	After absorption	Before absorption
Creditors	10.75	
Total	10.75	

Note 5. Tangible assets	After absorption	Before absorption
Fixed Assets (110+50)	160.00	
Total	160.00	

Note 6. Non Current investments	After absorption	Before absorption
Investments	30.00	
Total	30.00	

7. Other Current assets	After absorption	Before absorption
Current assets	43.50	
Miscellaneous expenditure	8.50	
Total	52.00	

Illustration 15:

Following are the Balance sheets of two companies, B Ltd. and D Ltd. as at March 31, 2015.

Liabilities	B Ltd. ₹	D Ltd. ₹	Assets	B Ltd. ₹	D Ltd. ₹
Equity Share Capital:			Sundry Assets	7,50,000	3,50,000
(Shares of ₹ 10 each)	5,00,000	30,00,00	10,000 Shares in		
Reserve	1,00,000	55,000	B Ltd.	—	1,00,000
Creditors	1,50,000	95,000			
Total	7,50,000	4,50,000	Total	7,50,000	4,50,000

B Ltd. was to absorb D Ltd. on the basis of intrinsic value of the shares, the purchase consideration was to be discharged in the form of fully paid shares, entries to be made at par value only. A sum of ₹ 20,000 is owed by B Ltd. to D Ltd. Also included in the stocks of B Ltd. ₹ 30,000 goods supplied by D Ltd. cost plus 20%. Give Journal entires in the books of both the Companies.

Solution:

Part I: In the Books of D Ltd.

Particulars		Debit ₹	Credit ₹
1. Realisation A/c	Dr.	3,50,000	
To Sundry Assets A/c			3,50,000
[Being the assets taken over by B Ltd. transferred to Realisation A/c]			
2. Creditors A/c	Dr.	95,000	
To Realisation A/c			95,000
[Being Creditors taken over by B Ltd. transferred Realisation A/c]			
3. B Ltd. A/c	Dr.	2,12,500	
To Realisation A/c			2,12,500
[Being purchase consideration (WN # 2) receivable]			
4. Shares in B Ltd. A/c	Dr.	2,12,500	
To B Ltd. A/c			2,12,500
[Being discharge of purchase consideration]			
5. Shareholders A/c	Dr.	42,500	
To Realisation A/c			42,500
[Being realisation loss transferred to Shareholder A/c]			
6. Share Capital A/c	Dr.	3,00,000	
Reserves A/c	Dr.	55,000	
To Shareholders A/c			3,55,000
[Being Share capital and Reserves transferred to Shareholders A/c]			
7. Shareholders A/c	Dr.	3,12,500	
To Shares in B Ltd.			3,12,500
[Being the settlement to shareholders for the amount due]			

Calculation of Purchase consideration - Net Assets Method

WN # 1: Intrinsic value of share

	Particulars	B Ltd (₹)	D Ltd. (₹)
a)	Sundry Assets	7,50,000	3,50,000
b)	Investments in B Ltd. 10,000 shares @ ₹ 12 each	—	1,20,000
c)	Creditors	(1,50,000)	(95,000)
d)	Net Assets	6,00,000	3,75,000
e)	No. of shares outstanding	50,000	30,000
f)	Intrinsic Value of shares [d ÷ e]	12	12.5

WN # 2: Purchase Consideration

	Particulars	Amount
a)	No. of shares of D Ltd.	30,000
b)	Value of shares @ ₹ 12.50	₹ 3,75,000
c)	No. of shares issuable based on intrinsic value of ₹ 12 (3,75,000 ÷ 12)	31,250
d)	No. of shares held by D Ltd.	(10,000)
e)	Net shares to be issued	21,250
f)	Total consideration at par (21,250 x ₹ 10)	₹ 2,12,500

Part - II: In the books of B Ltd.

- Nature of Amalgamation - Merger
- Method of Accounting - Pooling of Interest

Particulars		Debit ₹	Credit ₹
1. For Purchase Consideration Due:			
Business Purchase A/c	Dr.	2,12,500	
To Liquidator of D Ltd.'s A/c			2,12,500
2. a. For of assets and liabilities taken over			
i. Aggregate consideration to share holders of Selling Company			
* Shares already held by D Ltd.	1,00,000		
* Shares now issued	2,12,500		
ii. Paid up capital of D Ltd.	3,12,500		
	(3,00,000)		
iii. Excess	12,500		
iv. Above excess to be adjusted against reserves of D Ltd.	12,500		
v. Balance of reserves to be incorporated (55,000 - 12,500)	42,500		

Particulars		Debit ₹	Credit ₹
b. Assets A/c	Dr.	3,50,000	
To Creditors A/c			95,000
To Reserves A/c			42,500
To Business Purchase A/c			2,12,500
3. Discharge of Purchase consideration			
Liquidator of D Ltd.'s A/c	Dr.	2,12,500	
To Equity Share Capital A/c			2,12,500
4. Others			
a. Cancellation of Inter company owings			
Creditors A/c	Dr.	20,000	
To Sundry Assets A/c			20,000
b. Adjusted of Stock Reserve			
Reserve A/c	Dr.	5,000	
To Stock Reserve			5,000

Name of the Company: B Ltd.					
Balance Sheet as at 31.13. 2015					
Ref No.	**Particulars**		**Note No.**	**After absorption**	**before absorption**
				₹	₹
	I.	**Equity and Liabilities**			
	1	**Shareholders' funds**			
		(a) Share capital	1	7,12,500	
		(b) Reserves and surplus	2	1,37,500	
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**		NIL	
	4	**Current Liabilities**			
		(a) Trade payables	3	2,25,000	
		Total (1 + 2 + 3)		**10,75,000**	
	II.	**Assets**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets	4	10,75,000	
	2	**Current assets**		NIL	
		Total (1 + 2)		**10,75,000**	

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

(₹)

Note 1. Share Capital	**After absorption**	**Before absorption**
A. Authorised Capital		
B. Issued,and paid up Capital Eqity Share Capital(Share of ₹10 each) [out of which 21,250 shares were issued for consideration other than cash)	7,12,500	
Total	7,12,500	

RECONCILATION OF SHARE CAPITAL

FOR EQUITY SHARE:	After absorption		Before absorption	
	Nos	Amount (₹)	Nos	Amount (₹)
Opening Balance as on 01.01.14	50000	5,00,000	NIL	NIL
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash)	21,250	2,12,500	NIL	NIL
	71,250	7,12,500	NIL	NIL
Less: Buy Back of shares	-	-	-	-
	71,250	7,12,500	NIL	NIL

Note 2. Reserves and Surplus	After absorption	Before absorption
Reserve (1,00,000+42,500-5,000)	1,37,500	
Total	1,37,500	

Note 3. Trade Payables	After absorption	Before absorption
Creditors	2,25,000	
Total	2,25,000	

Note 4. Tangible assets	After absorption	Before absorption
Sundry Assets (7,50,000+3,50,000-20,000-5,000)	10,75,000	
Total	10,75,000	

Illustration 16:

The following are the Balance Sheets of A Ltd. and B Ltd. as on 31st March, 2015.

Liabiltiies	**A Ltd.** ₹	**BLtd.** ₹	**Assets**	**A Ltd.** ₹	**BLtd.** ₹
Share capital			**Fixed Assets**	7,00,000	2,50,000
Equity shares of	6,00,000	3,00,000	Investment:		
₹ 10 each			6,000 shares of B Ltd.	80,000	-
10% Preference	2,00,000	1,00,000	5,000 shares of A Ltd.	-	80,000
shares of ₹ 10 each			**Current Assets:**		
Reserves and surplus	3,00,000	2,00,000	Stock	2,40,000	3,20,000
Secured loans:			Debtors	3,60,000	1,90,000
12% Debentures	2,00,000	1,50,000	Bills receivable	60,000	20,000
Current liabilities			Cash at bank	1,10,000	40,000
Sundry creditors	2,20,000	1,25,000			
Bills payable	30,000	25,000			
	15,50,000	**9,00,000**		**15,50,000**	**9,00,000**

Fixed assets of both the companies are to be revalued at 15% above book value. Stock in—trade and Debtors are taken over at 5% lesser than their book value. Both the companies are to pay 10% Equity dividend, Preference dividend having been already paid.

After the above transactions are given effect to, A Ltd. will absorb B Ltd. on the following terms.

i. 8 Equity shares of ₹ 10 each will be issued by A Ltd. at par against 6 shares of B Ltd.

ii. 10% Preference Shareholders of B Ltd. will be paid at 10% discount by issue of 10% Preference Shares of ₹ 100 each at par in A Ltd.

iii. 12% Debentureholders of B Ltd. are to be paid at 8% premium by 12% Debentues in A Ltd. issued at a discount of 10%.

iv. ₹ 30,000 is to be paid by A Ltd. to B Ltd. for Liquidation expenses. Sundry creditors of B Ltd. include ₹ 10,000 due to A Ltd.

Prepare:

(a) Absorption entries in the books of A Ltd.

(b) Statement of consideration payable by A Ltd.

Solution:

Part - I Purchase consideration payable by A Ltd.

A.	**Equity share holders:**	
	No of equity shares of B Ltd.	30,000
	Less:- Held by A Ltd.	6,000
	No. of equity shares held by outsiders	24,000
	Exchange ratio	8:6
	No. of equity shares to be issued by A Ltd. (24,000 × 8/6)	32,000
	Less: Already held by B Ltd. in A Ltd.	(5,000)
	No. of equity shares to be issued now	27,000
	Value of shares to be issued 27,000 × 10	= ₹ 2,70,000
B.	**Preference share holders:**	
	Preference Share capital of B Ltd.	1,00,000
	Payable at discount of 10% [100,000 - (10% of 100,000)]	90,000
	10% Preference shares to be issued at par by A Ltd. to B Ltd.	₹ 90,000
C.	**Purchase consideration (A+B)**	₹ 3,60,000

Part II - Absorption entries in the books of A Ltd.

A. Pre - Amalagamation Events:- (₹)

Particulars		Debit	Credit
1. Revaluation of Fixed assets			
Fixed Assets A/c	Dr.	1,05,000	
To Revaluation Reserve A/c			1,05,000
2. Dividend received from B Ltd. on 600 shares			
Bank A/c	Dr.	6,000	
To Reserves and Surplus			6,000
3. Dividend on equity Share capital @ 10%			
i. Due entry			
Reserves and Surplus	Dr.	60,000	
To Proposed Dividend A/c			60,000
ii. Payment entry			
Proposed Dividend A/c	Dr.	60,000	
To Bank A/c			60,000

B. Amalgamation Events

Nature of Amalgamation - Purchase

Method of Accounting - Purchase (₹)

Particulars		Debit	Credit
1. For Purchase Consideration Due:			
Business purchase A/c	Dr.	3,60,000	
To Liquidator of B Ltd.			3,60,000
2. For assets and liabilities taken over			
Fixed Assets (115% of 2,50,000)	Dr.	2,87,500	
Stock A/c (95% of 3,20,000)	Dr.	3,04,000	
Debtors A/c (190000 x 95 %)	Dr.	1,80,500	
Bills Receivable A/c	Dr.	20,000	
Bank A/c *	Dr.	15,000	
To 12% Debentures of B Ltd A/c			1,62,000
To Sundry creditors A/c			1,25,000
To Bills payable A/c			25,000
To Business Purchase A/c			3,60,000
To Investment in B Ltd. A/c			80,000
To Capital Reserve A/c (Balancing Figure)			55,000
3. For Discharge of Purchase consideration			
Liquidator of B Ltd A/c	Dr.	3,60,000	
To Equity Share Capital A/c			2,70,000
To 10% Preference Share Capital A/c			90,000
4. Liquidation expenses incurred by B Ltd, later reimbursed by A Ltd.			
Capital Reserve A/c	Dr.	30,000	
To Bank A/c			30,000

Particulars		Debit	Credit
5. Discharge to debenture holders of B Ltd.			
12% Debenture Holders A/c	Dr.	1,62,000	
Discount on Issue of debentures A/c	Dr.	18,000	
To 12% Debentures A/c.			1,80,000
6. Cancellation of inter company owings			
Sundry Creditors A/c	Dr.	10,000	
To Sundry Debtors A/c			10,000
* Bank Balance of B Ltd.			
Balance as per Balance Sheet			40,000
Add: Dividend Received from A Ltd (10% on 50,000)			5,000
Less: Dividend paid on Share capital (10% on 3,00,000)			[30,000]
			15,000

#	12% Debentures of B Ltd.	1,50,000
	Payable at 8% premium	1,50,000 × 108%
	=	1,62,000

Internal Reconstruction

Illustration 17:

The Balance Sheet of X Ltd. before reconstruction is:

Liabilities	₹	Assets	₹
		Building at cost	
12,000 7% Preference		Less: Depreciation	4,00,000
shares of ₹50 each	6,00,000	Plant at cost	
7,500 Equity shares of ₹ 100		Less: Depreciation	2,68,000
each	7,50,000	Trade Marks and Goodwill	
		at Cost	3,18,000
(Note: Preference dividend is		Stock	4,00,000
in arrear for five years)		Debtors	3,28,000
Loan	5,73,000	Preliminary expenses	11,000
Sundry creditors	2,07,000	Profit and Loss A/c	4,40,000
Other liabilities	35,000		
Total	**21,65,000**	**Total**	**21,65,000**

Note: Loan is assumed to be of less than 12 months, hence treated as short term borrowings (ignoring interest)

The Company is now earning profits short of working capital and a scheme of reconstruction has been approved by both classes of shareholders. A summary of the scheme is as follows:

a. The Equity Shareholders have agreed that their ₹ 100 shares should be reduced to ₹ 5 by cancellation of ₹ 95 per share. They have also agreed to subscribe in each for the six new Equity Shares of ₹ 5 each for two Equity Share held.

b. The Preference Shareholders have agreed to cancel the arrears of dividends and to accept for each ₹50 share, 4 new 5 per cent Preference Shares of ₹10 each, plus 3 new Equity Shares of ₹ 5 each, all credited as fully paid.

c. Lenders to the Company of ₹ 1,50,000 have agreed to convert their loan into share and for this purpose they will be allotted 12,000 new preference shares of ₹10 each and 6,000 new equity share of ₹ 5 each.

d. The Directors have agreed to subscribe in cash for 20,000, new Equity Shares of ₹ 5 each in addition to any shares to be subscribed by them under (a) above.

e. Of the cash received by the issue of new shares, ₹2,00,000 is to be used to reduce the loan due by the Company.

f. The equity Share capital cancelled is to be applied:

   i. to write off the preliminary expenses;

   ii. to write off the debit balance in the Profit and Loss A/c ; and

   iii. to write off ₹35,000 from the value of Plant.

Any balance remaining is to be used to write down the value of Trade Marks and Goodwill.

Show by journal entries how the financial books are affected by the scheme and prepare the balance sheet of company after reconstruction. The nominal capital as reduced is to be increased to the old figures of ₹ 6,50,000 for Preference capital and ₹7,50,000 for Equity capital.

Solution: (₹)

Particulars		**Debit**	**Credit**
1. Reduction of Equity capital			
Equity Share capital A/c (Face Value ₹ 100)	Dr.	7,50,000	
To Equity Share capital (Face value ₹ 5) A/c			37,500
To Reconstruction A/c			7,12,500
2. Right issue: (7,500 × 3 = 22,500 Shares)			
(a) Bank A/c	Dr.	1,12,500	
To Equity Share Application A/c			1,12,500
(b) Equity Share Application A/c	Dr.	1,12,500	
To Equity Share Capital A/c			1,12,500
3. Cancellation of arrears of preference dividend			
NO ENTRY (as it was not provided in the Books of Accounts)			

Note:

(a) On cancellation, it ceases to be a contingent liability and hence no further disclosure

(b) Preference shareholders have to forego voting rights presently enjoyed at par with equity share holders

Particulars		Debit	Credit
4. Conversion of preference shares			
7% Preference Share Capital A/c	Dr.	6,00,000	
Reconstruction A/c (balancing figure)	Dr.	60,000	
To 5% Preference Share Capital (12,000×4×10)			4,80,000
To Equity Share Capital (12,000 × 3 × 5)			1,80,000
5. Conversion of Loan			
Loan A/c	Dr.	1,50,000	
To 5% Preference Share Capital A/c			1,20,000
To Equity Share Capital A/c			30,000
6. Subscription by directors:			
(a) Bank A/c	Dr.	1,00,000	
To Equity Share Application A/c			1,00,000
(b) Equity Share Application A/c	Dr.	1,00,000	
To Equity Share Capital A/c			1,00,000
7. Repayment of loan			
Loan A/c	Dr.	2,00,000	
To Bank			2,00,000
8. Utilisation of reconstruction surplus			
Reconstruction A/c	Dr.	6,52,500	
To Preliminary Expenses A/c			11,000
To Profit and Loss A/c			4,40,000
To Plant A/c			35,000
To Trademark and Goodwill A/c			1,66,500

Reconstruction Account

Dr. Cr.

Particulars	Amount	Particulars	Amount
To Preference shareholders	60,000	By Equity Share capital (FV ₹ 50)	7,12,500
To Preliminary expenses	11,000		
To Profit and Loss A/c	4,40,000		
To Plant A/c	35,000		
To Trademark and Goodwill	1,66,500		
	7,12,500		**7,12,500**

Bank Account

Dr. Cr.

Particulars	Amount	Particulars	Amount
To Equity share application A/c	1,12,500	By Loan A/c	2,00,000
To Equity share application A/c	1,00,000	By Balance c/d	12, 500
	2,12,500		**2,12,500**

Name of the Company: X Ltd.
Balance Sheet as at :............ (and Reduced)

Ref No.	Particulars		Note No.	After Reconstruction	Before Reconstruction
				(₹)	(₹)
	I.	**Equity and Liabilities**			
	1	**Shareholders' funds**			
		(a) Share capital	1	10,60,000	
		(b) Reserves and surplus	2	NIL	
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**		NIL	
	4	**Current Liabilities**			
		(a) Short-term borrowings	3	2,23,000	
		(b) Trade payables	4	2,07,000	
		(c) Other current liabilities	5	35,000	
		Total (1+2+3+4)		**15,25,000**	
	II.	**Assets**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets	6	6,33,000	
		(ii) Intangible assets	7	1,51,500	
	2	**Current assets**			
		(a) inventories	8	4,00,000	
		(b) trade receivables	9	3,28,000	
		(c) Cash and cash equivalents	10	12,500	
		(d) Short-term loans and advances	11	-	
		Total (1+2)		**15,25,000**	

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

(₹)

Note 1. Share Capital	After Reconstruction	Before Reconstruction
Authosired Share Capital		
60,000 5% Preference Shares of ₹ 10 each	6,00,000	
92,000 Equity shares of ₹ 5 each	7,50,000	
	13,50,000	
Issued, subscribed and paid-up		
1,50,000 Equity shares of ₹ 5 each	4,60,000	
60,000 5% Preference Shares of ₹ 10 each	7,50,000	
Total	13,50,000	

FOR EQUITY SHARE:-	After Reconstruction		Before Reconstruction	
	Nos	Amount (₹)	Nos	Amount (₹)
Opening Balance as on ...	7500	37,500.00	NIL	NIL
Add: Fresh Issue (Incld Bonus shares , Right shares, split shares, shares issued other than cash)	84,500.00	422,500.00	NIL	NIL
	92000	460,000.00	NIL	NIL
Less: Buy Back of shares	-		-	-
	92000	460,000.00	NIL	NIL

FOR 5% PREFERENCE SHARE:-	After Reconstruction		Before Reconstruction	
	Nos	Amount (₹)	Nos	Amount (₹)
Opening Balance as on ...	60000	600,000.00	NIL	NIL
Add: Fresh Issue (Incld Bonus shares , Right shares, split shares, shares issued other than cash)	-	-	NIL	NIL
	60000	600,000.00	NIL	NIL
Less: Buy Back of shares	-	-	-	-
	60000	600,000.00	NIL	NIL

Note 2. Reserves and Surplus	After Reconstruction	Before Reconstruction
Profit and Loss A/c	(4,40,000)	
Less: Written off	4,40,000	
Total	0.00	

Note 3. Short term borrowings	After Reconstruction	Before Reconstruction
Loan	5,73,000	
Less: Reduced	3,50,000	
Total	2,23,000	

Note 4. Trade Payables	After Reconstruction	Before Reconstruction
Sundry Creditors	2,07,000	
Total	2,07,000	

Note 5. Other Current Liabilities	After Reconstruction	Before Reconstruction
Other Liabilities	35,000	
Total	35,000	

Note 6. Tangible Assets	After Reconstruction	Before Reconstruction
Building at cost Less Depreciation	4,00,000	
Plant at Cost		
Less: Depreciation		
(2,68,000-35,000)	2,33,000	
Net Block	6,33,000	

Note 7. Intangible assets	After Reconstruction	Before Reconstruction
Trade Mark at Goodwill at cost Less: Reduction	3,18,000 1,66,500	
Total	1,51,500	

8. Inventories	After Reconstruction	Before Reconstruction
Inventories	4,00,000	
Total	4,00,000	

9. Trade receivables	After Reconstruction	Before Reconstruction
Debtors	3,28,000	
Total	3,28,000	

10. Other Current Assets	After Reconstruction	Before Reconstruction
Preliminary Expenses Less: Reduced	11,000 11,000	
Total	0.00	

11. Cash & Cash Equivalents	After Reconstruction	Before Reconstruction
Bank	12,500	
Total	12500	

Note: Loan is assumed to be of less than 12 months. Hence, treated as short term borrowings (ignoring interest)

Illustration 18:

M Ltd. is in the hands of a Receiver for debenture holders who holds a charge on all assets except uncalled capital. The following statement shows the position as regards creditors as on 31st March, 2015:

Liabilities	₹	Assets	₹
Share capital	3,60,000	Property, Machinery	
in shares of ₹60 each		and Plant etc. (Cost ₹ 3,90,000)	
₹ 30 paid up	-		
First Debentures	3,00,000	estimated at	1,50,000
Second Debentures	6,00,000	Cash in hand	2,70,000
Unsecured Creditors	4,50,000	Investment	3,60,000
		Uncalled Capital	1,80,000
		Deficiency	7,50,000
	17,10,000		**17,10,000**

A holds the First Debentures for ₹ 3,00,000 and Second Debentures for ₹ 3,00,000. He is also an unsecured creditor for ₹ 90,000. B holds Second Debentures for ₹ 3,00,000 and is an unsecured creditor for ₹ 60,000.

The following scheme of reconstruction is proposed:-

1. A is to cancel ₹ 2,10,000 of the total debt owing to him, to advance ₹ 30,000 in cash and to take First Debentures (in cancellation of those already issued to him) for ₹ 5,10,000 in satisfaction of all his claims.
2. B is to accept ₹ 90,000 in cash in satisfaction of all claims by him.
3. Unsecured creditors (other than A and B) are to accept four shares of ₹7.50 each, fully paid in satisfaction of 75% of every ₹60 of their claim. The balance of 25% is to be postponed and to be payable at the end of three years from the date of Court's approval of the scheme. The nominal Share capital is to be increased accordingly.
4. Uncalled capital is to be called up in full and ₹ 52. 50 per share cancelled, thus taking the shares of ₹ 7.50 each.

Assuming that the scheme is duly approved by all parties interested and by the Court, give necessary journal entries and the Balance Sheet of the Company after the scheme has been carried into effect.

Solution:

WN # 1: Calculation of P & L Debit Balance at the time of Reconstruction

Liabilities	₹	**Assets**	₹
Share capital	1,80,000	Fixed assets	3,90,000
1 st Debenture	3,00,000	(Book value)	
2nd Debenture	6,00,000	Cash	2,70,000
Unsecured creditors	4,50,000	Profit and Loss A/c (Bal. fig.)	8,70,000
	15,30,000		**15,30,000**

Particulars		**Debit** ₹	**Credit** ₹
1. Restructuring of A's liability:			
a. Ascertainment of amount due			
1st DebenturesA/c	Dr.	3,00,000	
2nd Debentures A/c	Dr.	3,00,000	
Unsecured Creditors A/c	Dr.	90,000	
To A's A/c			6,90,000
b. Waiver			
A's A/c	Dr.	2,10,000	
To Reconstruction A/c			2,10,000
c. Cash brought in			
Bank A/c	Dr.	30,000	
To A's A/c			30,000
d. Conversion of liability			
A's A/c	Dr.	5,10,000	
To 1st Debentures A/c			5,10,000

Particulars		Debit ₹	Credit ₹
2. Restructuring of B's liability:			
2nd Debentures A/c	Dr.	3,00,000	
Unsecured creditors A/c	Dr.	60,000	
To Bank A/c			90,000
To Reconstruction A/c			2,70,000
3. Restructuring of other unsecured creditors*			
(4,50,000 - 90,000 - 60,000 = 3,00,000)			
Unsecured Creditors A/c	Dr.	3,00,000	
To Equity Share capital A/c			1,50,000
To Loan (Unsecured) A/c			75,000
To Reconstruction A/c			75,000
4. Share capital			
a. Call money due:			
Share call A/c	Dr.	1.80,000	
To Share capital A/c			1,80,000
b. Share Call Money Received:			
Bank A/c	Dr.	1,80,000	
To Share call A/c			1,80,000
c. Capital Reduction:			
Equity Share Capital A/c (Face value ₹ 60)	Dr.	3,60,000	
To Equity Share capital (Face value ₹7.50)			45,000
To Reconstruction A/c			3,15,000
5. Utilisation of reconstruction surplus			
Reconstruction A/c	Dr.	8,70,000	
To Profit and Loss A/c			8,70,000
a. Scheme of settlement unit of liability is			60
b. 75% share (60 x .75)			45
i. 4 Equity shares @ ₹ 7.5			30
ii. Waiver			15
c. 25% share (60 x .25)			15
[Can be carried forward as unsecured loan] Note: Liability is settled in the Ratio of 30:15:15 (i.e. 2:1:1)			

Balance Sheet (and Reduced)

Liabilities	₹	Assets	₹
Share capital	1,95,000	Fixed assets	3,90,000
Debentures	5,10,000	Cash	3,90,000
Unsecured Loans	75,000		
	7,80,000		**7,80,000**

Dr. **Reconstruction Account** **Cr.**

Particulars	₹	Particulars	₹
To Profit and Loss A/c	8,70,000	By A's A/c	2,10,000
		By B's A/c	2,70,000
		By Unsecured creditors	75,000
		By Equity Share Capital	3,15,000
	8,70,000		**8,70,000**

Dr. **Cash/Bank Account** **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d	270000	By B's A/c	90,000
To A's A/c	3,00,00	By Balance c/d	3,90,000
To Share call A/c	1,80,000		
	4,80,000		**4,80,000**

Illustration 19:

A Ltd. is engaged in the manufacture of D and N. It has two wholly owned subsidiaries. B Ltd. and C Ltd. which have never traded. The draft financial statement of parent company shows:

Balance Sheet as on 31st March, 2015

Liabilities	₹	Assets	₹
Share Capital	40,000	Fixed Assets	21,400
Reserves and surplus	48,800	Investment in B Ltd.	10,000
Secured loan	12,000	Investment in C Ltd.	10,000
Sundry creditors	90,000	Current assets	
Owing to subsidiaries	20,000	Stock and Work-in-progress	43,400
Proposed dividend	4,000	Sundry debtors	93,600
		Cash at bank	36,400
	2,14,800		**2,14,800**

Note: Secured loan and owing to subsidiary is assumed to be of less than 12 months, hence treated as long term borrowings (ignoring interest).

Profit and Loss Account for the year ended 31st March, 2015

	₹
Net Profit	37,200
Dividend Paid	4,000
Transfer to Reserve	33,200

The two managing directors Mr. Kali and Mr. Prem who own 40% and 60% respectively of the Share capital of A Ltd. will become individually concerned with B Ltd. and C Ltd. respectively in order to allow them to develop their own interests.

They have agreed to a scheme of reconstruction whereby the respective trade and assets apart from cash at bank and liabilities will be transferred to the two subsidiaries. The resulting inter-company debts will be waived and A Ltd. will be placed into liquidation. The liquidator will retain ₹ 5,200 of the cash at bank to meet the costs of liquidation and reorganisation and pay dividend. He will distribute the remaining cash at bank and shares in two subsidiaries to A Ltd's shareholders Mr. Kali and Mr. Prem.

As far as his cash distribution pool permits, each director will then purchase, at net assets value, those shares in his own company distributed by the liquidator to his former colleague. It has been agreed that B Ltd. will receive a first tranch of the assets of A Ltd. comprising stock and work in progress of ₹ 15,000. C Ltd. will take over the liability for the Secured Loan. The remainder of the net assets will be transferred to the subsidiary companies in the ratio of 75% to B Ltd. and 25% of C Ltd. with the group freehold property, included in the Fixed assets at ₹ 15,000 being revalued at the open market value of ₹ 42,000 and being transferred to C Ltd.as a part of its share.

You are required to:

a. Produce the proforma balance sheets of the two former subsidiary immediately after reorganisation.

b. Calculate the final share holdings in each of the two companies.

Solution:

Purchase Consideration:

Particulars	**B Ltd.** ₹	**C Ltd.** ₹
Stock in trade	15,000	—
Secured Loan	—	(12,000)
Remaining Net Assets in the Ratio of 75:25 (WN#1)	60,300*	20,100*
	75,300	8,100
Total Purchase Consideration	₹ 83,400	

WN # 1: Net Asset Value:

Particulars	₹	₹
a. Fixed Asset:	15,000	
Add: Increase due to Revaluation	27,000	
Others (21,400 – 15,000)	6,400	48,400
b. Stock and Work-in-progress	43,400	
Less: Separately taken by B Ltd.	15,000	28,400
c. Sundry Debtors		93,600
d. Total Assets (a+b+c)		1,70,400
e. Sundry Creditors		(90,000)
f. Net Assets		80,400
g. B Ltd. Share (75% of Net Assets)		60,300
h. A Ltd. Share (25% of Net Assets)		20,100

Shareholders Account

Dr. Cr.

	Kali (40%)	**Prem (60%)**		**Kali (40%)**	**Prem (60%)**
To Cash	12,480@	18,720@	By Share capital	16,000	24,000
To B Ltd.	33,360		By Reserve	19,520	29,280
To C Ltd.		50,040	By Realisation (Profit)	10,320#	15,480#
	45,840	**68,760**		**45,840**	**68,760**

Cash

Particulars	(₹)
Opening balance	36,400
Retained by liquidator	(5,200)
Closing balance	31,200
Kalii's share [40% of (c)]	12,480
Prem's share [60% of (c)]	18,720

Realisation Profit

Particulars	(₹)
Dividend	4,000
Revaluation on Fixed assets (42,000 – 15,000)	27,000
Liquidation expenses:	(5,200)
Net realisation profit	25,800
Kali [40% of (d)]	10,320
Prem [60% of (d)]	15,480

WN # 2: Statement showing Goodwill or Capital Reserves

	Particulars	B Ltd. (₹)	C Ltd. (₹)
a.	Purchase Consideration	75,300	8,100
b.	Less: Net Assets as at the date of acquisition representedby:	10,000	10,000
	- Share capital		
c.	Goodwill		1,900
d.	Capital Reserves	65,300	

Name of the Company: B Ltd & C ltd

Proforma Balance Sheet as on 31st March, 2015

(₹)

Ref No.		Particulars	Note No.	B Ltd.	C Ltd.
	1	**EQUITY AND LIABILITIES**			
		(a) Share capital		10,000	10,000
		(b) Reserves and surplus		65,300	–
	2	Share application money pending allotment		Nil	Nil
	3	**Non-current liabilities**			
		(a) Long-term borrowings		Nil	12,000
	4	**Current Liabilities**			
		(a) Trade payables		68,100	Nil
		(b) Other current liabilities		Nil	21,900
		Total (1+2+3+4+)		**1,43,400**	**43,900**
	II	**ASSETS**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets		6,400	42,000
		(ii) Intangible assets		–	1,900
	2	**Current assets**			
		(a) inventories		43,400	–
		(b) trade receivables		93,600	–
		Total (1+2)		**1,43,400**	**43,900**

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Illustration 20:

The business of P Ltd. was being carried on continuously at losses. The following are the extracts from the Balance Sheet of the Comapny as on 31st March, 2015.

Balance Sheet as on 31st March, 2015

Liabilities	Amount ₹	Assets	Amount ₹
Authorised, Issed and Subscribed Capital:		Goodwill	50,000
30,000 Equity Shares of ₹ 10 each fully paid	3,00,000	Plant	3,00,000
2,000 8% Cumulative Pref. Shares of ₹ 100 each fully paid	2,00,000	Loose Tools	10,000
Securities Premium	90,000	Debtors	2,50,000
Unsecured Loan(From Director)	50,000	Stock	1,50,000
Sundry creditors	3,00,000	Cash	10,000
Outstanding Expenses (including Directors' remuneration ₹ 20,000)	70,000	Bank	35,000
		Preliminary Expenses	5,000
		Profit & Loss Account	2,00,000
	10,10,000		**10,10,000**

Note: 1) Dividends on Cumulative Preference Shares are in arrears for 3 years.

2) Unsecured loans (from director) is assumed to be of less than 12 months hence, treated as short term borrowings.(ignoring interest)

The following scheme of reconstruction has been agreed upon and duly approved by the Court.

1. Equity shares to be converted into 1,50,000 shares of ₹ 2 each.
2. Equity shareholders to surrender to the Company 90 per cent of their holding.
3. Preference shareholders agree to forego their right to arrears to dividends inconsideration of which 8 percent Preference Shares are. to be converted into 9 per cent Preference Shares.
4. Sundry creditors agree to reduce their claim by one fifth in consideration of their getting shares of ₹ 35,000 out of the surrendered equity shares.
5. Directors agree to forego the amounts due on account of unsecured loan and Director's remuneration.
6. Surrendered shares not otherwise utilised to be cancelled.
7. Assets to be reduced as under:

Goodwill by	₹ 50,000
Plant by	₹ 40,000
Tools by	₹ 8,000
Sundry Debtors by	₹ 15,000
Stock by	₹ 20,000

8. Any surplus after meeting the losses should be utili sed in writing down the value of the plant further.
9. Expenses of reconstruction amounted to ₹ 10,000.
10. Further 50,000 Equity shares were issued to the existing members for increasing the working capital. The issue was fully subscribed and paid-up.

A member holding 100 equity shares opposed the scheme and his shares were taken over by the Director on payment of ₹ 1,000 as fixed by the Court.

You are required to pass the journal entries for giving effect to the above arrangement and also to draw up the resultant Balance Sheet of the Company.

Solution:

Particulars		Debit ₹	Credit ₹
a. Sub Division of Shares			
Equity Share Capital (₹ 10 each) A/c	Dr.	3,00,000	
To Equity Share Capital (₹ 2 each) A/c			3,00,000
b. Surrender of Shares			
Equity Share Capital (₹ 2) A/c	Dr.	2,70,000	
To Shares Surrendered A/c			2,70,000
c. Conversion of Preference Share Capital			
8% Cumulative Preference Share Capital A/c	Dr.	2,00,000	
To 9% Cumulative Preference Share Capital A/c			2,00,000
d. Surrendered shares issued to creditors under reconstruction scheme			
Shares Surrendered A/c	Dr.	35,000	
To Equity Share Capital A/c			35,000
e. Expenses Paid			
Expenses A/c	Dr.	10,000	
To Bank A/c			10,000
f. Cancellation of unissued surrendered shares			
Shares Surrendered A/c	Dr.	2,35,000	
To Capital Reduction A/c			2,35,000
g. Amount sacrificed by Directors			
Unsecured Loan A/c	Dr.	50,000	
Sundry Creditors A/c	Dr.	60,000	
Outstanding Expenses A/c	Dr.	20,000	
To Capital Reduction A/c			1,30,000
h. Assets Written off			
Capital Reduction A/c	Dr.	3,65,000	
To Goodwill A/c			50,000
To Loose tools A/c			8,000
To Sundry debtors A/c			15,000
To Stock - in - trade A/c			20,000
To Profit and Loss A/c			2,00,000
To Preliminary expenses A/c			5,000
To Expenses A/c			10,000
To Plant A/c			57,000
i. Issue of Shares			
Applications received			
Bank A/c	Dr.	1,00,000	
To Share Application A/c			1,00,000
Allotment of Shares			
Share Application A/c	Dr.	1,00,000	
To Share Capital A/c			1,00,000
(Being 50000 equity shares of ₹ 2 each issued as fully paid as per Board's Resolution dated...)			

Note 1: a. Cancellation of Preference dividend need not be journalised; on cancellation it cease to be contingent liability and hence no further disclosure.

b. Preference shareholders have to forego policy rights presently enjoyed at par with Equity Shareholders.

Note 2: The transfer of 100 shares by the dissentient shareholders to the director concerned need not be journalised.

Note 3: It has been assumed that the share premium account is to be kept infact since the scheme is silent about it.

Ref No.		Particulars	Note No.	As at 31st March, 2015	As at 31st March, 2014
Name of the Company: P Ltd.					
Balance Sheet as at 31.03.2015					
				₹	₹
	I.	**Equity and Liabilities**			
	1	**Shareholders' funds**			
		(a) Share capital	1	3,65,000	
		(b) Reserves and surplus	2	90,000	
	2	**Share application money pending allotment**		NIL	
	3	**Non-current liabilities**		NIL	
	4	**Current Liabilities**		NIL	
		(a) Trade payables	3	2,40,000	
		(b) Other current liabilities	4	50,000	
		Total (1+2+3+4)		7,45,000	
	II.	**Assets**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets	5	2,43,000	
	2	**Current assets**			
		(a) Inventories	6	1,32,000	
		(b) Trade receivables	7	2,35,000	
		(c) Cash and cash equivalents	8	1,35,000	
		Total(1+2)		7,45,000	

(₹)

Note 1. Share Capital	**As at 31st March, 2015**	**As at 31st March, 2014**
Particulars	**Amount (₹)**	**Amount (₹)**
Authorised: 1,50,000 equity shares of ₹ 2 each fully paid up	3,00,000	
2,000 8% cumulative preferrence shares of ₹ 100 each	2,00,000	
	5,00,000	
Issued, Subscribed and Paidup Subscribed Capital: 82,500Equity shares of ₹ 2 each fully paid up (of the above 17,500 shares have been issued other than cash under the scheme of reconstruction)	1,65,000	
2,000 9 % Cumulative Pref. Shares of ₹ 100 each fully paid up	2,00,000	
Total	3,65,000	

RECONCILATION OF SHARE CAPITAL				
FOR EQUITY SHARE:-	As at 31st March, 2015		As at 31st March, 2014	
	Nos	Amount (₹)	Nos	Amount (₹)
Opening Balance as on 01.04.14	82,500	165,000,000	NIL	NIL
Add: Fresh Issue (Incld Bonus shares, Right shares, split shares, shares issued other than cash)			NIL	NIL
	82,500	165,000,000	NIL	NIL
Less: Buy Back of shares	-	-	-	-
	82,500	165,000,000	NIL	NIL

Note 2. Reserves and Surplus	As at 31st March, 2015	As at 31st March, 2014
Securities Premium	90,000	
Total	90,000	

Note 3. Trade Payables	As at 31st March, 2015	As at 31st March, 2014
Sundry creditors	2,40,000	
Total	2,40,000	

Note 4.Other Current Liabilities	As at 31st March, 2015	As at 31st March, 2014
Outstanding Expenses	50,000	
Total	50,000	

Note 5. Tangible assets		As at 31st March, 2015	As at 31st March, 2014
Plant	₹ 3,00,000	2,43,000	
less: Amount written off under the sceme of reconstruction	₹ 57,000		
Total		2,43,000	

Note 6. Inventories	As at 31st March, 2015	As at 31st March, 2014
Stock-in trade	1,30,000	
Loose tools	2,000	
Total	1,32,000	
Note 7. Trade receivables	**As at 31st March, 2015**	**As at 31st March, 2014**
Debtors	2,35,000	
Total	2,35,000	

Note 8. Cash and Cash Equivalents	As at 31st March, 2015	As at 31st March, 2014
Cash at Bank	1,25,000	
Cash in Hand	10,000	
Total	1,35,000	

Illustration 21:

XYZ Ltd. has the following capital structure on of 31st March, 2015.

	Particulars	₹ in Crores
a.	Equity Share capital (Shares of ₹ 10 each)	300
b.	Reserves:	
	General Reserve	270
	Security Premium	100
	Profit and Loss A/c	50
	Export Reserve (Statutory reserve)	80
c.	Loan Funds	800

The shareholders have on recommendation of Board of Directors approved vide special resolution at their meeting on 10th April 2015 a proposal to buy back maximum permissible equity shares considering the huge cash surplus following A/c of one of its divisions.

The market price was hovering in the range of ₹ 25 and in order to induce existing shareholders to offer their shares for buy back, it was decided to offer a price of 20% above market.

Advice the company on maximum number of shares that can be bought back and record journal entries for the same assuming the buy back has been completed in full within the next 3 months.

If borrowed funds were ₹ 1200 Lakhs, and 1500 Lakhs respectively would your answer change?

Solution:

Maximum shares that can be bought back

		Situtation I	*Situtation II*	*Situtation III*
a.	Shares outstanding test (WN # 1)	7.5	7.5	7.5
b.	Resources test (WN # 2)	6	6	6
c.	Debt Equity ratio test (WN # 3)	10.67	4	—
d.	Maximum number of shares for buy back - LEAST of the above	6	4	—

Particulars		*Situation I*		*Situation II*	
		Debit	*Credit*	*Debit*	*Credit*
a. Shares bought back A/c	Dr.	180		120	
To Bank A/c			180		120
[Being purchase of shares from public]					
b. Share capital A/c	Dr.	60		40	
Securities premium A/c Dr.		100		80	
General reserve A/c (balancing figure)	Dr.	20		—	
To Shares bought back A/c			180		120
[Being cancellation of shares bought on buy back]					
c. General Reserves A/c		60		40	
To Capital Redemption Reserve A/c			60		40
[Being transfer of reserves to capital redemption reserve to the extent capital is redeemed]					

Note: Under situation III, the company does not qualify the debt equity ratio test. Therefore the company cannot perform the buy back of shares.

WORKING NOTES :

WN # 1: ***Shares outstanding test***

	Particulars	Amount
a.	No. of shares outstanding	30 crores
b.	25% of shares outstanding	7.5 crores

WN # 2: ***Resources test***

(₹ in Crores)

	Particulars	Amount
a.	Paid up capital	300
b.	Free reserves	420
c.	Shareholders fund (a+b)	720
d.	25% of shareholders fund	180
e.	Buyback price per share	₹ 30
f.	Number of shares that can be bought back	6 Crores

WN # 3: ***Debt Equity ratio test :***

(₹ in Crores)

		Situtation I	*Situtation II*	*Situtation III*
a.	Borrowed Funds	800	1,200	1,500
b.	Minimum equity to be maintained after buy back in the ratio 2:1	400	600	750
c.	Present equity	720	720	720
d.	Maximum possible dilution in equity	320	120	—
e.	Maximum shares that can be bought back @ ₹ 30/- per share	10.67	4	—

Conversion :

Illustration 22:

X Co. Ltd. was incorporated on 1st July, 2014 to take over the business of Mr. A as and from 1st April, 2011, Mr. A's Balance Sheet, as at that date, was as under:

Liabilities	₹	Assets	₹
Trade creditors	36,000	Building	80,000
Capital	1,94,000	Furniture and Fittings	10,000
		Debtors	90,000
		Stock	30,000
		Bank	20,000
	2,30,000		2,30,000

Debtors and Bank balance are to be retained by the vendor and creditors are to be paid off by him. Realisation of debtors will be made by the company on a commission of 5% on cash collected. The company is to issue A with 10,000 equity shares of ₹ 10 each, ₹ 8 per share paid up and cash of ₹ 5,000.

The company issued to the public for cash 20,000 equity shares of ₹ 10 each on which by 31 st March, 2015, ₹ 8 per share was called and paid up except in the case of 1,000 shares on which the 3rd call of ₹ 2 per share had not been realised. In the case of 2,000 shares, the entire face value of the shares has been realised. The share issue was underwritten for 2% commission, payable in shares fully paid up.

In addition to the balances arising out of the above, the following balances were shown by the books of account of X Co. Ltd. on 31st March, 2015.

	₹
Discount (including ₹ 1,000 allowed on vendor's debtors)	6,000
Preliminary Expenses	10,000
Director's Fees	12,000
Salaries	48,000
Debtors (including vendor's debtors)	1,60,000
Creditors	48,000
Purchases	3,20,000
Sales	4,60,000

Stock on 31st March, 2015 was ₹ 52,000. Depreciation at 10% on Furniture and Fittings and at 5% on building is to be provided. Collections from debtors belonging to the vendor were ₹ 60,000 in the period.

Prepare the Trading and Profit and Loss account for the period ended 31 st March, 2015 of X Co. Ltd. and its Balance Sheet as at that date.

Solution:

Part I: Calculation of purchase consideration.

Particulars	₹
a. Consideration paid in the form of cash	56,000
b. Consideration paid in the form of equity shares of X Co. Ltd	80,000
10,000 Shares of ₹ 10 each, ₹ 8 paid up	
c. Total consideration	1,36,000

Part II : In the Books of Mr. A.

Realisation Account

Dr. Cr.

Particulars	₹	**Particulars**	₹
To Building	80,000	By X Co. Ltd (Purchase consideration)	1,36,000
To Furniture	10,000		
To Stock	30,000		
To Profit on Realisation	16,000		
	1,36,000		1,36,000

Journal Entries

Particulars		Debit ₹	Credit ₹
a. For Purchase Consideration Due:			
X Co. Ltd. A/c	Dr.	1,36,000	
To Realisation A/c			1,36,000
b. Receipt entry			
Equity shares in X Ltd. A/c	Dr.	80,000	
Cash I Bank A/c	Dr.	56,000	
To X Co. Ltd. A/c			1,36,000
c. Other receipts from X Ltd - Debtors collection			
i. Recovery of debtors.			
X Co. Ltd. (Vendor Drs)	Dr.	90,000	
To Debtors A/c			90,000
ii. Receipt of cash and commission paid.			
Discount on Debtors A/c	Dr.	1,000	
Commission to X Co. Ltd A/c	Dr.	3,000	
Cash/Bank A/c	Dr.	57,000	
To X Co. Ltd A/c			61,000
[Since the debtors are held by Mr. A, the discount given to debtors are to be borne by Mr. A. Commission = Cash collected × 5% = 60,000 × 5% = 3,000 ... Balance in vendor debtors A/c (90,000–61,000=29,000)			
d. Settlement to creditors			
Creditors A/c	Dr.	36,000	
To Bank A/c			36,000
[Since creditors are also held by Mr. A. and not taken over by X Co. Ltd.]			

Cash / Bank Account

Dr. Cr.

Particulars	₹	Particulars	₹
To balance b/d	20,000	By Creditors	36,000
To X. Co. (Purchase Consideration)	56,000	By balance c/d	97,000
To X Co. (Debtors Collection)	57,000		
	1,33,000		1,33,000
To bal b/d	97,000		

Balance sheet of Mr. A as at 1st April 2014

Liabilities	₹	Assets	₹
Capital	1,94,000	Investment in equity shares of X	
Add: Realisation Profit	16,000	Co. Ltd (₹ 8 paid)	80,000
Less: Discount to debtors	(1,000)	Vendor Debtors (X Ltd.)	29,000
Less: Commission Paid.	(3,000)	Cash / Bank	97,000
	2,06,000		2,06,000

Part III - In the books of X Co. Ltd.

Particulars			Debit	Credit
a.	Take over business of Mr. A			
i.	For Purchase Consideration Due:			
	Business Purchase A/c	Dr.	1,36,000	
	To Mr. A			1,36,000
ii.	For Assets taken over			
	Goodwill A/c (balancing figure)	Dr.	16,000	
	Building A/c	Dr.	80,000	
	Furniture and fixture A/c	Dr.	10,000	
	Stock A/c	Dr.	30,000	
	To Business Purchase A/c			1,36,000
iii.	Discharge of Purchase Consideration			
	Mr. A A/c	Dr.	1,36,000	
	To Equity Share capital A/c			80,000
	To Bank / Cash A/c			56,000
b.	Public Issue of shares			
i.	Bank A/c	Dr.	1,36,000	
	To Equity shares capital A/c			1,36,000
	[Being ₹ 8/- per share received on 17,000 shares (20,000 - 1,000 - 2,000)]			
ii.	Bank A/c	Dr.	6,000	
	Calls in Arrears A/c	Dr.	2,000	
	To Equity Share capital A/c			8,000
	[Being receipt of ₹ 6 - on 1000 shares. ₹ 2 on 3rd call had not been realised]			
iii.	Bank A/c	Dr.	20,000	
	To Equity Share capital A/c			16,000
	To Calls in advance A/c			4,000
	[Being on 2,000 shares, the entire amount of Share capital received. ₹ 2 per share not called up transferred to calls in advance A/c)			
	Underwriting commission A/c	Dr.	4,000	
	To Equity Share capital A/c			4,000
	[Being 2% on the face value of the public issue paid as underwriting commission. Commission discharged as fully paid equity shares. 20,000 shares × ₹ 10 each = 2,00,000 2% × 2,00,000 = 4,000]			

Debtors Account

Dr. Cr.

Particulars	₹	Particulars	₹
To Sales (Assuming fully credit)	4,60,000	By Discount (6,000 - 1,000) By Cash received (balancing figure) By Balance c/d (1,60,000 - 29,000)*	5,000 3,24,000 1,31,000
	4,60,000		4,60,000

Vendor Debtors Taken over:

Particulars	₹
i. Particulars Debtors taken over from Mr. A	90,000
ii. Less: Discount given	(1,000)
iii. Less: Cash collected	(60,000)
iv. Balance in vendor debtors	29,000

Creditors Account

Dr. Cr.

Particulars	₹	Particulars	₹
To Cash (Balancing figure) To Balance c/d	2,72,000 48,0000	By Purchases (assuming fully on credit)	3,20,000
	3,20,000		3,20,000

Cash / Bank Account

Dr. Cr.

Particulars	₹	Particulars	₹
To Realisation from debtors	3,24,000	By Purchase consideration to Mr.A	56,000
To Receipt from vendor debtors	60,000	By Remittance of vendor Debtors collection (60000 – 3000)	57,000
To Equity Share capital (1,36,000 + 6,000 + 20,000)	1,62,000	By Payment to creditors	2,72,000
		By Preliminary expenses	10,000
		By Directors fees	12,000
		By Salaries	48,000
		By Balance c/d (balancing figure)	91,000
	5,46,000		5,46,000

Computation of Goodwill on acquisition

Particulars	₹	₹
Purchase Consideration		
- in shares of ₹ 10 each	80,000	
- in cash	56,000	1,36,000
Less: Assets taken over:		
- Building		(80,000)
- Furniture and Fittings	10,000	
- Stock	30,000	(40,000)
Goodwill		16,000

Trading Account of X Co. Ltd. for the year ended 31st March, 2015

Dr. Cr.

Particulars	₹	Particulars	₹
To Opening Stock	30,000	By Sales	4,60,000
To Purchase	3,20,000	By Closing Stock	52,000
To Gross profit c/d	1,62,000		
	5,12,000		5,12,000

Profit and Loss Account of X Co. Ltd. for period from 1st July 2014 to 31st March 2015.

Dr. Cr.

Particulars	1.4.14 to 30.06.15	1.7.14 to 31.3.15	Particulars	1.4.14 to 30.6.15	1.7.14 to 31.3.15
To Discount	-	5,000	By Gross profit	40,500	1,21,500
To Directors fees	.	12,000	By Commission	.	3,000
To Salaries	-	48,000	Received		
To Depreciation	1,250	3,750			
To Capital Reserve	39,250	-			
To P & L A/c	-	55,750			
	40,500	1,24,500		40,500	1,24,500

Note:

a. Entire salary and discount pertains to post incorporation period.

b. Depreciation:

i. Pre-incorporation:

Building: $80,000 \times 5\% \times \frac{3}{2}$ = 1,000

Furniture: $10,000 \times 10\% \times \frac{3}{2}$ = 250 1,250

ii. Post-incorporation:

Building: 80,000 × 5% × 9/12 = 3,000

Furniture: 10,000 × 10% × 9/12 = 750 3,750

* Profit during 1.4.14 to 30.6.15 reduces the cost of Acquisition and hence transferred to Capital reserve.

Name of the Company: X CO. Ltd.				
Balance Sheet as at 31.03.2012				
Ref No.	**Particulars**		**Note No.**	**As at 31st March, 2015**
				₹
	I.	**Equity and Liabilities**		
	1	**Shareholders' funds**		
		(a) Share capital	1	2,42,000.00
		(b) Reserves and surplus	2	79,000.00
	2	**Share application money pending allotment**		NIL
	3	**Non-current liabilities**		NIL
	4	**Current Liabilities**		
		(a) Trade payables	3	48,000.00
		(b) Other current liabilities	4	4,000.00
		Total (1+2+3+4)		3,73,000.00
	II.	**Assets**		
	1	**Non-current assets**		
		(a) Fixed assets		
		(i) Tangible assets	5	85,000.00
	2	**Current assets**		
		(a) Inventories	6	52,000.00
		(b) Trade receivables	7	1,31,000.00
		(c) Cash and cash equivalents	8	91,000.00
		(d) Other current assets		14,000.00
		Total (1+2)		3,73,000.00

Note (1): Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Note (2): Since both Capital Reserve and goodwill arise out of the business acquisition, they can be netted off against each other.

(₹)

Note 1. Share Capital	**As at 31st March, 2015**
30,000 equity shares @ ₹ 8 each	2,40,000.00
Less: Calls in arrear (1000 *₹ 2)	2,000.00
	2,38,000.00
(Out of the above shares 10,000 shares were issued to Mr. A for consideration other than cash)	
Add: 400 shares of ₹ 10 each	4,000.00
(to be issued to underwriter for consideration other than cash)	
Total	2,42,000.00

RECONCILATION OF SHARE CAPITAL

FOR EQUITY SHARE:-	**As at 31st March, 2015**	
	No.	Amount
30,000 shares of ₹ 8 each	30,000	240,000.00
Add: 400 shares of ₹ 10 each (issued to underwrite other than cash)	400	4,00.00
	30,400	244,000.00
Less: Calls in Arrear	1,000	2,000.00
	29,400	242,000.00

Note 2. Reserve and Surplus	**As at 31st March, 2015**
Capital Reserve	-
Pre incorporation profit	39,250.00
Less: Goodwill for business purchase	16,000.00
	23,250.00
Profit & Loss	55,750.00
Total	79,000.00

Note 3. Trade Payable	**As at 31st March, 2015**
Sundry creditors	48,000.00
Total	48,000.00

Note 4. Other Current Liabilities	**As at 31st March, 2015**
Calls in advance	4,000.00
Total	4,000.00

Note 5. Tangible Assets		**As at 31st March, 2015**
Building	80,000.00	
Less: Depreciation @ 5%	4,000.00	76,000.00
Furniture	10,000.00	
Less: depreciation @ 10%	1,000.00	9,000.00
Total		85,000.00

Note 6. Inventories	**As at 31st March, 2015**
Stock	52,000.00
Total	52,000.00

Note 7. Trade Receivable	**As at 31st March, 2015**
Sundry debtors	131,000.00
Total	131,000.00

Note 8. Cash and cash equivalent	**As at 31st March, 2015**
Cash	91,000.00
Total	91,000.00

Note 9. Other Current assets	**As at 31st March, 2015**
Misc. Expenses	
Preliminary Exp	10,000.00
Underwriting commission	4,000.00
Total	14,000.00

Illustration 23:

The following are the Balance Sheets of RS Ltd. and XY Ltd. as on 31.3.2015: (₹ in '000s)

Liabilities	RS Ltd. ₹	XY Ltd. ₹	Assets	RS Ltd. ₹	XY Ltd. ₹
Share Capital:			Fixed Assets net of depreciation	8,100	2,550
Equity Shares of ₹ 100 each fully paid up	6,000	3,000	Investments	2,100	–
Reserves and Surplus	2,400	–	Sundry Debtors	1,200	450
10% Debentures	1,500	–	Cash and Bank	750	–
Loan from Financial Institutions	750	1,200	Profit and Loss Account	–	2,400
Bank Overdraft	–	300			
Sundry Creditors	900	900			
Proposed Dividend	600				
	12,150	5,400		12,150	5,400

It was decided that XY Ltd. will acquire the business of RS Ltd. for enjoying the benefit of carry forward of business loss. After acquisition, XY Ltd. will be renamed as XYZ Ltd. The following scheme has been approved for the merger:

(i) XY Ltd. will reduce its shares to ₹ 10 and then consolidate 10 such shares into one share of ₹ 100 each (New Share).

(ii) Financial institutions agreed to waive 15% of the loan of XY Ltd.

(iii) Shareholders of RS Ltd. will be given one new share of XY Ltd. in exchange of every share held in RS Ltd.

(iv) RS Ltd. will cancel 20% holding of XY Ltd. Investments were held at ₹ 750 thousands.

(v) After merger the proposed dividend of RS Ltd. will be paid to the shareholders of RS Ltd.

(vi) Authorised Capital of XY Ltd. will be raised accordingly to carry out the scheme.

(vii) Sundry creditors of XY Ltd. includes payable to RS Ltd. ₹ 3,00,000.

Pass the necessary entries to implement the scheme in the books of RS Ltd. and XY Ltd. and prepare a Balance Sheet of XYZ Ltd.

Solution:

Journal Entries in the books of RS Ltd.

(₹ '000)

		Dr.	Cr.
10% Debentures A/c	Dr.	1,500	
Loan from Financial Institutions A/c	Dr.	750	
Sundry Creditors A/c	Dr.	900	
Proposed Dividend A/c	Dr.	600	
Realisation A/c	Dr.	8,400	
To Fixed Assets A/c			8,100
To Investments A/c			2,100
To Sundry Debtors A/c			1,200
To Cash and Bank A/c			750
(Transfer of assets and liabilities to realisation account)			

(₹ '000)

		Dr.	Cr.
Share Capital A/c	Dr.	6,000	
Reserve and Surplus A/c	Dr.	2,400	
To Equity Shareholders A/c			8,400
(Transfer of share capital, reserve and surplus to shareholders account)			
Equity Shareholders A/c	Dr.	750	
To Realisation A/c			750
(Cancellation of 20% holding of XY Ltd. held as investments)			
Shares in XYZ Ltd.	Dr.	6,000	
To Realisation A/c			6,000
(Issue of shares by XYZ Ltd. in the ratio of 1: 1)			
Equity Shareholders A/c	Dr.	1,650	
To Realisation A/c			1,650
(Transfer of loss on realisation)			
Equity Shareholders A/c	Dr.	6,000	
To Shares in XYZ Ltd.			6,000
(Distribution of Shares of XYZ Ltd. among the shareholders)			

Journal Entries in the books of XY Ltd.

(₹ '000)

		Dr.	Cr.
Equity Share Capital (Face value ₹ 100) A/c	Dr.	3,000	
To Equity Share Capital (Face value ₹ 10) A/c			300
To Reconstruction A/c			2,700
(Face value of equity shares of ₹ 100 each reduced to ₹ 10 each)			
Equity Share Capital (Face value ₹ 10 each) A/c	Dr.	300	
To Equity Share Capital A/c			300
(Face value – ₹ 100 each)			
(Consolidation of 30,000 equity shares of ₹ 10 each to 3,000 equity shares of ₹ 100 each)			
Loan from Financial Institutions A/c	Dr.	180	
To Reconstruction A/c			180
(Waiver of 15%of loan by financial institutions)			
Reconstruction A/c (2,700 + 180)	Dr.	2,880	
To Profit and Loss A/c			2,400
To Capital Reserve			480
(Balance of Reconstruction account availed to write off the Profit and Loss Account)			
Proposed Dividend A/c	Dr.	600	
To Bank A/c			600
(Payment of Proposed dividend to shareholders of RS Ltd.)			

(₹ '000)

		Dr.	Cr.
Fixed Assets A/c	Dr.	8,100	
Other Investments A/c	Dr.	1,350	
Sundry Debtors A/c	Dr.	1,200	
Cash and Bank A/c	Dr.	750	
To Reserves A/c			1,710
To 10% Debentures A/c			1,500
To Loan from Financial Institutions A/c			750
To Sundry Creditors A/c			900
To Proposed Dividend A/c			600
To Business Purchase A/c			5,940
(Incorporation of various assets and liabilities acquired from RS Ltd. after cancellation of investment held by RS Ltd. in XY Ltd., profit on acquisition credited to Reserves Account)			
Business Purchase A/c	Dr.	5,940	
To Liquidator of RS Ltd.			5,940
(Consideration Payable on business acquired from RS Ltd.)			
Liquidator of RS Ltd.	Dr.	5,940	
To Equity Share Capital of XYZ Ltd.			5,940
(Discharge of purchase consideration in the form of equity shares of XYZ Ltd.)			
Sundry Creditors A/c	Dr	300	
To Sundry Debtors A/c			300
(Cancellation of intercompany owings)			

Name of the Company: XYZ Ltd.

Balance Sheet as at 31st March, 2015 (immediately after acquisition)

(₹ In '000)

Ref No.	Particulars		Note No.	As at 31st March, 2015	As at 31st March, 2014
	1	**EQUITY AND LIABILITIES**			
		(a) Share capital	1	6,240	
		(b) Reserves and surplus	2	2,190	
	2	**Share application money pending allotment**			
	3	**Non-current liabilities**			
		(a) Long-term borrowings	3	3,420	
	4	**Current Liabilities**			
		(a) Trade payables	4	1,500	
		Total (1+2+3+4)		13,350	
	II	**ASSETS**			
	1	**Non-current assets**			
		(a) Fixed assets			
		(i) Tangible assets	5	10,650	
		(b) Non-current investments	6	1350	
	2	**Current assets**			
		(a) trade receivables	7	1,350	
		Total (1+2)		13,350	

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

(₹ in '000)

Note 1. Share Capital	As at 31st March, 2015	As at 31st March, 2014
Authorized share capital		
Issued, Subscribed and paid-up share capital		
62,400 Equity share of ₹ 100 each (5,940+60+240)	6,240	
Total	6,240	

RECONCILIATION OF SHARE CAPITAL

FOR EQUITY SHARE	As at 31st March, 2015		As at 31st March, 2014	
	Nos.	Amount (₹)	Nos.	Amount (₹)
Opening Balance as on 01.04.14	62,400	6,240		
Add: Fresh Issue (Including Bonus shares, right shares, split shares, share issued other than cash)				
	62,400	6,240		
Less: Buy Back of share				
Total	62,400	6,240		

Note 2. Reserve & Surplus	As at 31st March, 2015	As at 31st March, 2014
General Reserve	1,710	
Capital Reserve	480	
Total	2,190	

Note 3. Long-term borrowings	As at 31st March, 2015	As at 31st March, 2014
10% Debenture- secured	1,500	
Loan from financial Institution	1,770	
Bank overdraft (750 - 600 - 300)	150	
Total	3,420	

Note 4. Trade Payables	As at 31st March, 2015	As at 31st March, 2014
Sundry Creditors- (900+900-300)	1,500	
Total	1,500	

Note 5. Tangible Assets	As at 31st March, 2015	As at 31st March, 2014
Fixed assets (8,100+2,550)	10,650	
Total	10,650	

Note 6. Non-Current Investment	As at 31st March, 2015	As at 31st March, 2014
Other Investment	1,350	
Total	1,350	

Note 7.Trade receivables	As at 31st March, 2015	As at 31st March, 2014
Sundry Debtors (1200+450-300)	1,350	
Total	1,350	

Working Notes:

			₹
1.	Original Share Capital of XY Ltd.		
	30,000 Equity Shares of ₹ 100 each		30,00,000
	Share Capital of XY Ltd. after Reduction		
	30,000 Equity Shares of ₹ 10 each		3,00,000
2.	Share Capital of XY Ltd. after Reconsolidation		
	3,000 Equity Shares of ₹ 100 each		3,00,000
3.	Reduced value of holdings of RS Ltd. in XY Ltd.		
	RS Ltd. was holding 20% of XY Ltd., that is,		
	6,000 Equity Shares of ₹ 100 each		6,00,000
	which has now reduced to 600 Equity Shares of ₹ 100 each		60,000
4.	Calculation of Purchase Consideration		
	Equity Share Capital of RS Ltd. 60,000 Equity Shares of ₹ 100 each		60,00,000
	Exchange Ratio = 1: 1		
	No. of Equity Shares to be given	60,000	
	Less: No. of Equity Shares already held by RS Ltd.	600	
		59,400	
	Purchase consideration		
	59,400 Equity Shares of ₹ 100 each		59,40,000
5.	Aggregate Reserves in the new company on acquisition		
	Reserves of RS Ltd. acquired		24,00,000
	Less: Loss on investments held by RS Ltd.		
	Value of investments cancelled	7,50,000	
	Less: Reduced value of shares of XY Ltd.	60,000	6,90,000
	Amount of Reserves to be carried to Balance Sheet		17,10,000
6.	Share Capital in Combined Balance Sheet of XYZ Ltd.		
	Holding of RS Ltd. (600 Equity Shares @ ₹ 100 each)		60,000
	Other Existing Shares (2400 Equity Shares of ₹ 100 each)		2,40,000
	Given as Purchase Consideration (59,400 equity shares @ ₹ 100 each)		59,40,000
			62,40,000

7. It has been assumed that the bank overdraft and cash balance can be adjusted.

ILLUSTRATIONS ON INTERNAL RECONSTRUCTION

Illustration 24:

The following is the Balance Sheet of Rocky Ltd. as at March 31,2015:

Liabilities	₹ in lakhs	Assets	₹ in lakhs
Fully paid Equ. shares of ₹10 each	500	Goodwill	15
Capital Reserve	6	Land and Building	184
12% Debenture	400	Plant and Machinery	286
Debenture Interest Outstanding	48	Furniture and fixtures	41
Trade Creditors	165	Stock	142
Directors' Remuneration Outstanding	10	Debtors	80
Other Outstanding Expenses	11	Cash at Bank	27
Provisions	33	Discount on Issue of Debentures	8
		Profit and Loss Account	390
	1,173		1,173

The following scheme of internal reconstruction was framed, approved by the Court, all the concerned parties and implemented:

(i) All the equity shares be converted into the same number of fully – paid equity shares of ₹2.50 each.

(ii) Directors agree to forgo their outstanding remuneration.

(iii) The debenture holders also agree to forgo outstanding interest in return of their 12% debentures being converted into 13% debentures.

(iv) The existing shareholders agree to subscribe for cash, fully paid equity shares of ₹2.50 each for ₹125 lakhs.

(v) Trade creditors are given the option of either to accept fully-paid equity shares of ₹2.50 each for the amount due to them or accept 80% of the amount due in cash. Creditors for ₹65 lakhs accept equity shares, whereas those for ₹100 lakhs accept ₹80 lakhs in cash in full settlement.

The Assets are revalued as:

	₹ in lakhs
Land and Building	230
Plant and Machinery	220
Stock	120
Debtors	76

Pass Journal Entries for all the above – mentioned transactions.

Solution:

In the Books of Roy Ltd.
Journal

Date	Particulars		L.F	Debit	Credit
2015, March 31	Equity Share Capital (₹10 each) A/c To Equity Share Capital (₹2.50 each) A/c To Reconstruction A/c (Conversion of all the equity shares into the same number of fully paid equity shares of ₹2.50 each as per scheme of reconstruction)	Dr.		500	 125 375
	Directors' Remuneration Outstanding A/c To Reconstruction A/c (Outstanding remuneration forgone by the director as per scheme of reconstruction)	Dr		10	 10
	12%DebenturesA/c Debenture Interest Outstanding A/c To 13% Debentures A/c To Reconstruction A/c (Conversion of 12% debentures into 13% debentures, Debenture holders forgoing outstanding debenture interest)	Dr Dr		400 48	 400 48
	Bank A/c To Equity Share Application A/c (Application money received)	Dr		125	 125
	Equity Share Application A/c To Equity Share Capital (₹2.50 each) A/c (Application money transferred to share capital as per Board's Resolution dated)	Dr		125	 125
	Trade Creditors A/c To Equity Share Capital (₹2.50 each) A/c To Bank A/c To Reconstruction A/c (A part of trade creditors accepts equity shares for full amount, others accept cash equal to 80% of claim in full settlement)	Dr		165	 65 80 20
	CapitalReserve A/c To Reconstruction A/c (Capital Reserve being used for purpose of reconstruction)	Dr		6	 6
	Land and Building A/c To Reconstruction A/c (Value of land and building appreciated as per scheme of reconstruction)	Dr		46	 46

Date	Particulars	L.F	Debit	Credit
	Reconstruction A/c Dr		505	
	To Goodwill A/c			15
	To Discount on Issue of Debentures A/c			8
	To Profit and Loss A/c			390
	To Plant and Machinery A/c			66
	To Stock A/c			22
	To Debtors A/c			4
	(Writing- off losses and reduction in the values of assets made as per scheme of reconstruction)			

Illustration 25:

The Balance Sheet of Bad Luck Co. Ltd as at 31.03.2015 is:

Liabilities	₹	Assets	₹
1,00,000 Equity shares of ₹10 each, Fully paid –up	10,00,000	Goodwill	2,00,000
		Other Assets	9,00,000
10%, 4,000 Debentures of ₹100 each	4,00,000	Profit & Loss A/c	5,00,000
Interest on Debentures	40,000		
Sundry Creditors	1,60,000		
	16,00,000		16,00,000

For the purpose of reconstruction of the company, necessary resolutions are passed on the following lines:

(i) The Equity Shares are to be sub-divided into shares of ₹1 each and each shareholder shall surrender 60% of his holding.

(ii) Out of the surrendered shares, 60,000 shares will be converted to 8% Preference shares of ₹10 each.

(iii) Debenture holders will reduce their total claims by ₹1,40,000 and , in considerations , the Debenture holders are to get the entire Preference Share Capital converted from shares surrendered.

(iv) Creditors' claims are to be reduced to the extent of ₹1,00,000 and , in consideration, they are to receive Equity shares of ₹1 each amounting to ₹40,000 from the shares surrendered.

(v) Goodwill and Profit and Loss A/c (Dr) are to be written – off completely.

(vi) The remaining surrendered shares shall be cancelled.

You are required to give the Journal entries.

Solution:

In the Books of Bad Luck Co. Ltd.
Journal

Date	Particulars	L.F	Debit (₹)	Credit (₹)
2014 April,1	Equity Share (₹10) Capital A/c Dr To Equity Share (₹1) Capital A/c (1,00,000 equity shares of ₹10 each, fully paid, sub-divided into 10,00,000 equity shares of ₹1 each, fully paid, as per Special Resolution No …… dated ….. as confirmed by the court)		10,00,000	 10,00,000
	Equity Share (₹1) Capital A/c Dr To Share Surrendered A/c (6,00,000 equity shares of ₹1 each, fully paid , surrendered to the company as per Special Resolution No…… dated…. as confirmed by the court)		6,00,000	 6,00,000
	Share Surrendered A/c Dr To 8% Pref. Share Capital A/c (Out of the shares surrendered , 60,000 shares of ₹1 each converted into 8% Pref. shares as per reconstruction scheme ….. as confirmed by court)		60,000	 60,000
	10% Debenture A/c Dr Interest on Debentures A/c Dr To Capital Reduction A/c (Amount of 1,000, 10% Debentures and accrued interest sacrificed by the debenture holders, transferred to Capital Reduction A/c as per Special Resolution No….. dated …. As confirmed by the court)		1,00,000 40,000	 1,40,000
	Sundry Creditors A/c Dr To Capital Reduction A/c (Amount sacrificed by creditors, transferred to Capital Reduction A/c as per Special Resolution No… dated …. As confirmed by the court)		60,000	 60,000
	Share Surrendered A/c Dr To Equity Share (₹1) Capital A/c (40,000 equity shares of ₹1 each out of shares surrendered, issue to the creditors as per Special Resolution No… dated…. As confirmed by the court)		40,000	 40,000
	Share Surrendered A/c Dr To Capital Reduction A/c (Balance of shares surrendered, not used, transferred to Capital Reduction A/c as per Special Resolution No….. dated….. as confirmed by the court)		5,00,000	 5,00,000
	Capital Reduction A/c Dr To Goodwill A/c To Profit & Loss A/c (Amount of Capital Reduction utilized for writing-off Goodwill and debit balance of Profit & Loss A/c)		7,00,000	 2,00,000 5,00,000

Illustration 26:

The Balance Sheet of Teesta Iron Products Ltd. as on 31st March, 2015 is:

Liabilities	₹	Assets		₹
Authorized Capital		**Fixed Assets**		
35,000 Equity Shares of ₹10 each	3,50,000	Freehold Properties		1,00,000
35,000, 9% Cumulative Preference		Plant & Machinery		1,30,000
Shares of ₹10 each	3,50,000	Patents		40,000
	7,00,000			
Issued & Subscribed Capital		**Subsidiary Company**		
15,000 Equity Shares of 10 each, ₹6		Shares at Cost	96,000	
per share paid-up	90,000	Advances	34,000	1,30,000
30,000, 9% Cumulative Preference				
Shares of ₹10 each, fully paid	3,00,000	**Current Assets**		
		Stock at Cost	1,20,000	
Current Liabilities		Debtors	80,000	
Trade Creditors		Cash at Bank	10,000	
Bank Overdraft	3,50,000			2,10,000
	60,000	Profit& Loss Account		
				1,90,000
	8,00,000			8,00,000

Note: The Preference dividend are in arrears for 4 years.

The scheme of reconstruction to take effect from 1st April, 2015 has been duly approved and authorized by the Court:

(a) The unpaid capital on the Equity Shares to be called-up forthwith.

(b) The Equity Shares are to be sub-divided into shares of ₹1 each and each shareholder shall surrender 80% of his holding.

(c) The 9% Cumulative Preference Shares, together with all arrears of dividend, are to be surrendered and cancelled; the holders, in turn, to receive one 10% Mortgage Debenture of ₹100 each on the terms that, for every 15 shares held, they shall: (i) pay ₹80 in cash ; (ii) be issued with one ₹100 Mortgage Debenture;(iii) receive 30 fully paid Equity Shares of ₹1each being a redistribution of those surrendered by equity shareholders.

(d) The unpaid capital on the Shares in subsidiary company to be called –up on 12,000 Shares of ₹2 each and paid by parent company.

(e) Surrendered Equity Shares not otherwise utilized to be cancelled.

(f) The adverse balance of Profit & Loss Account and the Patents to be written-off; ₹60,000 to be written –off on the Shares in subsidiary company, create 10% provision for bad debts on debtors. Stock to be reduced by ₹10,000 and the balance of the sums made available by the scheme to be used to write down the Plant & Machinery.

(g) Authorized Capital remains the same except Equity Shares which will be ₹1 each.

You are required to pass Journal Entries for giving effect to the arrangements.

Solution:

In the Books of Teesta Iron Products Ltd.

Journal

Date	Particulars	L.F	Debit (₹)	Credit (₹)
2015 April,1	Equity Share Final Call A/c Dr To Equity Share Capital A/c (Final call made on 15,000 Equity Shares @₹4 per Share as per Special Resolution No ….. date…. And confirmed by the court)		60,000	 60,000
	Bank A/c Dr To Equity Share Final Call A/c (The Call money received)		60,000	 60,000
	Equity Share (₹10) Capital A/c Dr To Equity Share (₹1) Capital A/c (15,000 Equity Shares of ₹10 each subdivided into 1,50,000 Equity Shares of ₹1 each as per Special Resolution No…. dated………….. and confirmed by the court)		1,50,000	 1,50,000
	Equity Share Capital A/c(80% of 1,50,000) Dr To Shares Surrendered A/c (80% of shareholding surrendered by Equity Shareholders as per Special resolution No …….. dated …. And confirmed by the court)		1,20,000	 1,20,000
	9% Cumulative Preference Share Capital A/c Dr. To Shares Surrendered A/c. (30,000,9% Cumulative Preference Shares of ₹10 each surrendered by Preference Shareholders as per Special Resolution No …. Dated …. And confirmed by the court)		3,00,000	 3,00,000
	Shares Surrendered A/c Dr. Bank A/c [30,000 x 80 /15] Dr. To 10% Mortgage Debenture A/c [30,000 x 100 /15] To Equity Share capital A/c [30,000 x 30 x ₹ 1/15] (2,000,10% Mortgage Debenture of ₹ 100 each and 60,000 Equity Shares of ₹1 each issued as fully paid at par to Preference Shareholders out of shares surrendered and cash received from them @ ₹80 for every 15 shares as per Special Resolution No…. dated …. And confirmed by the court)		1,00,000 1,60,000	 2,00,000 60,000
	Investment in Subsidiary Co A/. Dr. To Bank A/c (12,000 x ₹2) (Call money paid @ ₹ 2 each on 12,000 shares held as investments)		*24,000	 *24,000
	Shares Surrendered A/c (Balance) Dr. To Capital Reduction A/c (Balance of Shares surrendered A/c transferred to Capital Reduction A/c as per Scheme)		3,20,000	 3,20,000

Date	Particulars	L.F	Debit (₹)	Credit (₹)
	Capital Reduction A/c Dr. To Profit & Loss A/c To Patents A/c To Investments in Shares in Subsidiary Company A/c To Provision for Bad Debts A/c To Stock A/c To Plant & Machinery A/c (bal,. fig) (Values of Sundry Assets written-off against Capital Reduction A/c as per Scheme)		3,20,000	 1,90,000 40,000 60,000 8,000 10,000 12,000
	Bank Overdraft A/c Dr. To Bank A/c (Bank Overdraft paid)		60,000	 60,000

Illustration 27:

Swan Ltd. adopts the following scheme of Capital Reduction;

(a) Each shareholders shall surrender to the company 80% of his holding for the purpose of re-issue to Debenture holders and creditors so far as required and otherwise for cancellation. The share capital of the company consists of 1,00,000 shares of ₹10 each fully paid.

(b) The claim of the debenture holders shall be reduced and they shall receive 45,000 shares of ₹10 each in full satisfaction of their claim of ₹10,00,000 including interest accrued ₹60,000.

(c) The Creditors' claim of ₹4,20,000 shall be reduced by 3/5 ths of the amount and the balance shall be satisfied by allotting equity shares from the shares surrendered.

(d) Shares surrendered and not re-issued shall be cancelled.

(e) The debit balance of Profit & Loss Account amounting to ₹15,25,000 shall be written-off.

Solution:

In the Books of Swan Ltd.(Reduced)

Journal

Date	Particulars	L.F	Debit (₹)	Credit (₹)
	Equity Share Capital (₹10) A/c Dr. To Share Surrendered A/c (80% of the Equity Shares were surrendered by the Equity Share holders as per Special Resolution No……. and sanctioned by the court)		8,00,000	 8,00,000
	Debenture A/c Dr. Outstanding Interest on Debenture A/c Dr. To Capital Reduction A/c (Debenture and outstanding interest on Debentures transferred to Capital Reduction A/c for issuing of new Equity Shares as per special resolution dated…… and sanctioned by the court)		9,40,000 60,000	 10,00,000

	Shares Surrendered A/c Dr. To Equity Share Capital (₹10) A/c (45,000 Equity Shares of ₹10 each issued to equity shareholders as per special resolution no……. and sanctioned by the court)		4,50,000	4,50,000
	Sundry Creditors A/c Dr. To capital Reduction A/c (Dues of Sundry Creditors transferred to Capital Reduction A/c for issues for new equity shares as per special resolution No…. and sanctioned by the court)		4,20,000	4,20,000
	Share Surrendered A/c Dr. To Equity Share Capital A/c (16,800 Equity Shares of ₹10 each were issued to Sundry creditors in full satisfaction of their claim per special resolutions dated …………………… and sanctioned by the court)		1,68,000	1,68,000
	Shares Surrendered A/c Dr. To Capital Reduction A/c (Balance of Share surrendered transferred to Capital Reduction A/c)		1,82,000	1,82,000
	Capital Reduction A/c Dr. To Profit and Loss A/c To Capital Reserve A/c (P & L A/c written –off against Capital Reduction A/c and Balance transferred to Capital Reserve)		16,02,000	15,25,000 77,000

Illustration 28:

The business of Usha Ltd. was being carried on continuously at losses. The following are the extracts from the Balance Sheet of the company as on 31st March 2015.

Liabilities	₹	Assets	₹
Authorized , Issued and Subscribed Capital		Goodwill	1,00,000
		Plant	6,00,000
60,000 , Shares of ₹10 each fully paid	6,00,000	Furniture	20,000
4,000 , 9% Cumulative Preference Shares of ₹100 each, fully paid	4,00,000	Debtors	5,00,000
		Stock	3,00,000
Securities Premium	1,80,000	Bank	90,000
Unsecured Loan (from director)	1,00,000	Preliminary Expenses	10,000
Sundry Creditors	6,00,000	Profit & Loss Account	4,00,000
Outstanding Exp (Including Directors Remuneration ₹40,000)	1,40,000		
	20,20,000		20,00,000

Note: Dividend on Cumulative Preference Shares are in arrears for the last three years.

The following scheme of reconstruction has been agreed upon and duly approved by the Court.

1. Equity Share to be converted into 3,00,000 Equity Shares of ₹2 each and then the Equity Shareholders are to surrender to the company 90% of their holding.
2. Preference Shareholders agree to forgo their right to arrears of dividend in consideration of which their 9% Preference Shares are to be converted into equal no of 10% Preference Shares.
3. Sundry Creditors agree to reduce their claim by 1/15th in consideration of their getting shares of ₹70,000 out of the surrendered Equity Shares.
4. Directors agree to forgo the amounts due on account of unsecured loan and director's remuneration.
5. The surrendered shares not utilized are to be cancelled.
6. Assets are to be reduced as under: Goodwill by ₹1,00,000 ; Plant by ₹1,14,000; Furniture by ₹6,000; Sundry Debtors by ₹30,000 and tock by ₹50,000.
7. Expenses of reconstruction amounted to ₹20,000.
8. Furniture, 1,00,000Equity Shares of ₹2 each were issued to the existing members for increasing the working capital. This issue was fully subscribed and paid-up. The authorized capital was suitably increased.
9. A member holding 100 equity shares opposed the scheme and his shares were taken over by a director on payment of ₹1,000 as fixed by the Court.

You are required to pass Journal Entries giving effect to the above arrangements.

Note: There will be no separate entry for a dissenting shareholders who holds 100 shares since these are taken over by a director.

Solution:

In the Books of Usha Ltd
Journal

Date	Particulars	L.F	Debit (₹)	Credit (₹)
2009 Mar.31	Equity Share Capital A/c(₹10) Dr. To Equity Share Capital A/c(₹2) (60,000 Equity Shares of ₹10 each sub-divided into 3,00,000 Equity Shares of ₹2 each as per Special Resolution No…… dt….)		6,00,000	6,00,000
	Equity Share Capital A/c (90% of 6,00,000) Dr. To Shares Surrendered A/c (90% of their shareholding surrendered by Equity Shareholders as per Scheme of Reconstruction)		5,40,000	5,40,000
	9% Cumulative Preference Share Capital A/c Dr. To 10%Cumulative Pre. Share capital A/c (9% Cumulative Preference Shares converted into 10% Cumulative Preference shares of equal value)		4,00,000	4,00,000
	Shares Surrendered A/c Dr. To Equity Share Capital A/c (35,000 Equity Shares of ₹2 each allotted to creditors for surrendering @ 1/5th of their claim.		70,000	70,000

	Shares Surrendered A/c Dr. To Reconstruction A/c (Balance of Share Surrendered A/c transferred)		4,70,000	 4,70,000
	Unsecured Loan A/c Dr. Outstanding Expenses A/c Dr. Sundry Creditors A/c Dr. To Reconstruction A/c (Sundry liabilities which are sacrificed transferred)		1,00,000 40,000 1,20,000	 2,60,000
	Securities Premium A/c Dr. To Reconstruction A/c (Securities Premium A/c eliminated)		1,80,000	 1,80,000
	Reconstruction A/c Dr. To Goodwill A/c To Plant A/c To Furniture A/c To Sundry Debtors A/c To Stock A/c To Profit & Loss A/c To Preliminary Expenses A/c To Bank A/c (Expenses) A/c To Capital Reserve A/c(bal. fig) (Sundry losses and expenses written-off as per reconstruction scheme)		9,10,000	 1,00,000 1,14,000 6,000 30,000 50,000 4,00,000 10,000 20,000 1,80,000
	Bank A/c Dr. To Equity Share Capital A/c (1,00,000 equity shares of ₹2 each issued as per Board's resolution No…. dt…)		2,00,000	 2,00,000

7.5 PROFIT PRIOR TO INCORPORATION

In many cases, a new company is formed exclusively to acquire an existing business unit and take it over as a going concern, from a date prior to its own incorporation. In such cases, the business unit is purchased first, and the registration of the acquiring company takes place later. For example, AB Pvt. Ltd. is incorporated on 1st October, 2012 to take over the running business of Das Bros. from 1st January, 2012. The profit earned (or loss suffered) during the pre-incorporation period (in our example: 1st January to 30th September 2012) is called profit (loss) prior to incorporation. Legally, this profit is not available for distribution as dividend, since a company cannot earn profit before it comes into existence. However, profit earned after incorporation is available for distribution as dividend. Profit earned before incorporation is a capital profit and profit earned after incorporation is a revenue profit.

It is a common practice that the date of incorporation should be taken as the basis for calculation of pre-acquisition profit.

Methods of Computing Profit Prior to Incorporation

They are different methods of computing profit prior to incorporation. They are:

First Method

Step 1 Prepare a Profit and Loss Account for the pre-incorporation period.

Step 2 Prepare a Profit and Loss Account for post-incorporation period.

The entries are:

(i)	Land & Building Account	Dr.	At the value on the date of incorporation
	Plant & Machinery Accoun	Dr.	
	Sundry Debtors Account	Dr.	
	Stock Account	Dr.	
	Cash at Bank	Dr.	
	Cash in Hand	Dr.	
	To Liabilities Account		
	To Vendors Account		
(ii)	Vendors Account	Dr.	Purchase consideration
	To Equity Share Capital Account		

Second Method

Under this method profit is calculated as follows:

Step 1 Prepare a Trading Account for the entire period (pre- and post-incorporation periods combined).

Step 2 Allocate gross profit and expenses (indirect) between pre- and post-incorporation period on the basis of the following principles:

(i) Gross profit is allocated in the ratio of sales of each period.

(ii) Fixed portion of an expenses is allocated on the basis of time.

(iii) Expenses related to sales, e.g., traveller's commission, discount allowed; on the basis of sales.

(iv) Expenses related to time, e.g., rent, rates and taxes; insurance; depreciation, salaries of general staff, to that period's profit. Some example are :

(a) Preliminary expenses, director's fees, debenture interest, etc. are to be charged against post-incorporation profit.

(b) Partner's salaries, interest on partners' capital, etc are to be charged against the profit of pre-incorporation period.

Appointment Basis may be :

	Allocated on Basis of Time		Allocated in Ratio of Sales
1.	Rent, Rates and Taxes	1.	Gross Profit
2.	Depreciation	2.	Bad Debts
3.	Salaries of General Staff	3.	Discount Allowed
4.	Insurance	4.	Carriage Outwards
5.	Interest on Purchase Consideration	5.	Selling Expenses
6.	Audit Fees	6.	Commission on Sales
7.	General Expenses	7.	Advertisement Expenses
8.	Printing and Stationery	8.	Delivery Expenses
9.	Office Expenses	9.	Free Samples
10.	Fixed Expenses	10.	After-sales service cost
11.	Miscellaneous Expenses	11.	Salaries to Salesmen
12.	Fixed Distribution Expenses	12.	Sales Promotion Expenses
13.	Administrative Expenses	13.	Variable Distribution Expenses
14.	General Travelling Expenses		

Step 3 Net profit/loss of respective periods are calculated after deducting apportioned expenses and acquisition entries are passed at the end of the accounting year.

<u>Accounting Treatment of Pre-incorporation Profit/Loss :</u>

Profit Prior to Incorporation

Any profit prior to incorporation may be :

(a) Credited to Capital Reserve Account

(b) Credited to Goodwill Account to reduce the amount of goodwill arising from acquisition of business.

(c) Utilised to write down the value of fixed assets acquired.

Loss Prior to Incorporation

Any loss prior to incorporation may be dealt with as follows :

(a) Debited to Goodwill Account

(b) Debited to Capital Reserve Account arising from acquisition of business.

(c) Debited to a Suspense Account, which can be written-off later as fictitious asset.

Accounting Treatment of Post-incorporation Profit/Loss

Any profit/loss after incorporation is transferred to Profit and Loss Appropriation Account. Post-incorporation profit can be distribution as dividend.

Illustration 29:

The Partners of Saheb & Co decided to convert partnership into a Private Limited Company called Kings Agencies P Ltd. with effect from 1st January. The consideration was agreed at ₹11,70,000 based on the Firm's Balance Sheet as on that date.

However, due to some procedural difficulties, the Company could be incorporated only on 1st April. Meanwhile, the business was continued on behalf of the Company and the consideration was settled on that day with interest at 12% p.a. The same books of account were continued by the Company, which closed its account for the first time on 31st March of the next year and prepared the following summarized Profit and Loss Account.

Particulars	₹	₹
Sales		2,34,00,000
Less: Cost of Goods Sold and Other Expenses		
Cost of Goods Sold	1,63,80,000	
Salaries	11,70,000	
Depreciation	1,80,000	
Advertisement	7,02,000	
Discounts	11,70,000	
Managing Director's Remuneration	90,000	
Miscellaneous Office Expenses	1,20,000	
Office-cum-Show Room Rent	7,20,000	
Interest-	9,51,000	2,14,83,000
Profit		19,17,000

The Company's only borrowal was a loan of ₹50,00,000 at 12% p.a. to pay the Purchase Consideration due to the Firm and for Working Capital requirements.

The Company was able to double the average monthly Sales of the Firm from 1st April but the Salaries trebled from that date. It had to obtain additional space from 1st July, for which rent was ₹30,000 per month.

Prepare a Profit and Loss Account in columnar form apportioning costs and revenue between pre-incorporation and post-incorporation periods. Also, suggest how the pre-incorporation profits are to be dealt with.

Solution:

1. Calculation of Ratios for apportionment purposes

Particulars	Pre-incorpn.	Post-Incorpn.
(a) Period in Months (**Time Ratio**)	1st Jan-31st Mar	1st April-31st Mar next
	= 3 months	= 12 months
(b) Sales per month ratio (given)	₹ 1	(double of earlier period) i.e .₹ 2
(c) Overall Sales ratio (a)x(b)	3 x 1 = 3	12 x 2 = 24
Upon simplification, Sales Ratio is	1	8
(d) Salary per month ratio (given)	₹1	(treble of earlier period) i.e. ₹ 3
(e) Total Salary Ratio (a) x(d)	3 x 1 = 3	12 x 3 = 36
Upon simplification, Salary Ratio is	1	12

Particulars	Pre-incorpn.	Post-Incorpn.
(f) Rent for additional premises (from 1st July)	-	30000 x 9 = 2,70,000
(g) So, Balance Rent (7,20,000-2,70,000) in 3:12 (time)	90,000	3,60,000
(h) Total Rent Cost (f)+(g)	**90,000**	**6,30,000**
(i) Interest allocable to Company	-	6,00,000
(₹ 50Lakhs x 12% from 1st Apr to 31st Mar next)		
(j) Hence, Balance Interest for Pre-Incorporation Period	**3,51,000**	

Notes:

Expenses apportioned on Sales Ratio Basis: (a) Cost of Goods old;(b) Advertisement; and (c) Discounts.

Expenses apportioned on Time Ratio Basis: (a) Depreciation,(b) Miscellaneous Office Expenses.

2.Profit & Loss Account of Kings Agencies P Ltd. For 15 months ended 31st March (in ₹ 000's)

Particulars	1stJan-31st Mar	1st Apr-31st Mar next	Particulars	1st Jan-31st Mar	1st Apr-31st Mar next
To Cost of Goods Sold (1:8)	1,820	14,560	By Sales	2,600	20,800
To Salaries (1:12)	90	1,080	By Net Loss	19	
To Depreciation (1:4)	36	144	- Pre Incorp.Loss		
To Advertisement (1:8)	78	624			
To Discounts (1:8)	130	1,040			
To MD's Remuneration (direct)	-	90			
To Misc. Office Exps. (1:4)	24	96			
To Rent **(W N 1)**	90	630			
To interest **(W N 1)**	351	600			
To Net Profit- Post Incorp Pft	-	**1,936**			
Total	**2,619**	**20,800**	**Total**	**2,619**	**20,800**

Treatment of Negative Profit prior to Incorporation:

The Loss may be considered as a reduction from any **Capital Reserve** arising on acquisition.

Alternatively, such loss may be as **Goodwill** and shown under Assets.

Illustration 30:

Sutanu formed a Private Limited Company under the name of Sutanu (P) Ltd. to take over his existing business as from 1st January, 2015 but the Company was not incorporated until 1st April,2015. No entries relating to transfer of the business were entered in the books, which were carried on without a break until 31st December, 2015.

The following Trial Balance was extracted from the books as on 31st December (end of the year)

Particulars	**Debit**	**Credit**
Stock in Trade as at 1st January (Opening Stock)	4,300	
Purchases and Sales	18,900	27,800
Carriage Outwards	330	
Travelers' Commission	750	
Office Salaries and Expenses	2,100	
Rent and Rates	1,200	
Sutanu's Capital Account as at 1st January (Opening Balance)		23,000
Directors' Fee	1,800	
Fixed Assets	13,400	
Current Liabilities		3,700
Current Assets (other than Stock-in-Trade)	11,200	
Preliminary Expenses	520	
Total	54,500	

Accounting for Business Acquisitions-

You are also given the following information:

- Stock as at 31.12.15 (end of the year) is ₹4,400.
- Purchase Consideration was agreed at ₹30,000, to be settled by Issue of 3,000 Equity Shares of ₹10 each.
- The Gross Profit Margin is constant and the monthly sales in January, November and December are double the monthly sales for the remaining months of the year.
- Assume that Carriage Outwards and Traveler's Commission vary in direct proportion to Sales.

You are required to prepare Trading and Profit and Loss Account for the year ended 31st December apportioning the periods before and after Incorporation and a Balance Sheet as on that date. Ignore depreciation and taxation. .

Solution:

1. Calculation of Ratios for Apportionment purposes

Particulars	**Pre-Incorpn.**	**Post-Incorpn**
(a) Period in Months (Time radio)	1st Jan-31st Mar = 3 Months	1st April-31st Dec = 9Months
(b) No. of Months in which Sales is Two Times the Normal Level	1 (January)	2 (Nov & Dec)
(c) No. of Months of Normal Sales level	2	7
(d) Sales Ratio [(bx2)+c]	**4**	**11**

- Expenses divided on the basis of Sales Ratio: (a) Carriage Outward and (b) Travelers Commission (given).
- Expenses divided on Time Ratio i.e. 3:9: (a) Office Salaries and Expenses; (b) Rent and Rates.

2. **Trading and Profit and Loss Account of Sutanu (P) Ltd for the year ending 31st December**

Dr **Cr**

Particulars	**Jan-Mar**	**Apr-Dec**	**Particulars**	**Jan-Mar**	**Apr-Dec**
	₹	₹		₹	₹
To opening Stock		4,300	By Sales		27,800
To Purchases		18,900	By Closing Stock		4,400
To Gross Profit c/d (**WN 1)**					
- Jan to Mar (4/15x9,000)	2,400				
-Apr to Dec (11/15x9,000)	6,600	9,000			
Total		**32,000**	**Total**		**32,000**
Particulars	**Jan to Mar**	**Apr to Dec**	**Particulars**	**Jan to Mar**	**Apr to Dec**
To Office Salaries and Expenses (3:9)	525	1,575	By Gross Profit b/d	2,400	6,600
To Rent and Taxes (3:9)	300	900			
To Carriage Outwards (4:11)	88	242			
To Travelers' Commission (4:11)	200	550			
To Directors fees (direct)	-	1,800			
To Capital reserve-Pre-Incorpn Profit	1,287				
To Net- Post Incorpn Profit		1,533			
Total	**2,400**	**6,600**	**Total**	**2,400**	**6,600**

Note: Preliminary Exps. May also be charged either against Pre-Incorpn Profit or against Post – Incorpn Profit.

3.Goodwill = Amount of Purchase Consideration less Balance in Sutanu's Capital A/c on 1st Jan

= ₹30,000 Less ₹23,000 = ₹7,000

4. Capital Reserve Account

Dr **Cr**

Particulars	₹	**Particulars**	₹
To Preliminary Expenses-w/off To Goodwill- transfer	520 767	By P & L A/C – Pre Incorpn Profit.	1,287
Total	1,287	Total	1,287

5.Balance Sheet of Sutanu (P) Ltd as at 31st December

Name of the Company: P Ltd.

Balance Sheet as at : 31.12.15

Ref No.		**Particulars**	**Note No.**	**As at 31.12.15 (₹)**
I		**EQUITY AND LIABILITIES**		
	1	**Shareholders' fund**		
		(a) Share capital	1	30,000
		(b) Reserves and surplus-	2	1,533
	2	**Share application money pending allotment**		NIL
	3	**Non-current liabilities**		NIL
	4	**Current Liabilities**		
		(a) Other current liabilities	3	3,700
		Total		**35,233**

Ref No.		Particulars	Note No.	As at 31.12.15 (₹)
II		**ASSETS**		
	1	Non-current assets		
		(a) Fixed assets		
		(i) Tangible assets	4	13,400
		(ii) Intangible assets	5	6,233
	2	**Current assets**		
		(a) Inventories	6	4,400
		(b) Other current assets	7	11,200
		Total		**35,233**

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Workings:

1. (a). Issued and Subscribed capital	**31.12.15**
3,000 Equity shares @ ₹ 10 each fully paid (issued for consideration other than cash)	30,000
Total	30,000

2. Reserve and Surplus	**31.12.15**
Profit & Loss A/c	1,533
Total	1,533

3. Other Current Liabilities	**31.12.15**
Current Liabilities	3,700
Total	3,700

4. Tangible Assets	**31.12.15**
Other Fixed Assets	13,400
Total	13,400

5.Intangible Assets	**31.12.15**
Goodwill	7,000
Less: Capital Reserve	767
Total	6,233

6. Inventories	**31.12.15**
Stock	4,400
Total	4,400

7. Other Current Assets	**31.12.15**
Other Current Assets	11,200
Total	11,200

Illustration 31:

Pre & Post Incorpn Profits – Financial Statements –

Mourya Ltd. incorporated on 1st May,2015 received the certificate to commence business on 31st May,2015 It had acquired a running business from Gopal and Co. with effect from 1st January,2015. The Purchase Consideration was ₹50,00,000 of which ₹10,00,000 was to be paid in cash and ₹40,00,000 in the form of fully paid shares.

The Company also issued shares for ₹40,00,000 for cash. Machinery Costing ₹25,00,000 was then installed. Assets acquired from the Vendors were: Machinery ₹30,00,000; Stock ₹6,00,000; and Patents ₹4,00,000.

During the year ended 31st December, 2015 the total sales were ₹1,80,00,000, the Sales per month in the first half year being one half of what they were in the latter half year.

The Net Profit of the Company, after charging the following expenses, was ₹10,00,000:

Particulars	₹
Depreciation	5,40,000
Director's Fees	86,000
Preliminary Expenses	10,000
Office Expenses	2,40,000
Selling Expenses	1,98,000
Interest to Vendors	50,000

Ascertain the pre-incorporation and post-incorporation Profits and prepare the Balance Sheet of the Company as on 31st December, 2015. The Closing Stock was valued at ₹7,00,000.

Solution.

	Particulars	₹ 000s'
	Net Profit after Expenses and Depreciation	10,00
Add;	Expenses and Depreciation Charged	
	Depreciation	5,40
	Director's Fees	86
	Preliminary Expenses	10
	Office Expenses	2,40
	Selling Expenses	1,98
	Interest to Vendors	50
	Gross Profit	21,24

Calculation of Sales Ratio and Times Ratio

Particulars	**Pre-Incorporation Period**	**Post- Incorporation Period**
Number of Months= Time Ratio	1st Jan-30th Apr=4 Months	1st May - 31st Dec = 8 Months
Sales per month ratio (1/2 : 1) between first and second half years	₹1/2 each for the four months	₹1/2 for May and June; ₹1 each for the balance six months
Overall Sales Ratio	1/2x4 months =2	(1/2 x 2 months) + (1 x 6months) =7

Trading & Profit & Loss A/c of Mourya Ltd for the year ended 31st December, 2015

Dr. **Cr.**

Particulars		**₹**	**Particulars**		**₹**
To Opening Stock (taken over)		6,00	By Sales		1,80,000
To Purchases (balancing fig)		**1,59,76**	By Closing Stock		7,00
To Gross Profit (**See WN 1)**		21,24			
Total		**1,87,00**	**Total**		**1,87,00**
Particulars	**Pre Inc**	**Post Inc**	**Particulars**	**Pre Inc**	**Post Inc**
To Depreciation (Time 1:2)	1,80	3,60	By Gross Profit b/d	4,72	16,52
To Directors' Fees (Direct)	-	86	(in Sales Ration of 2:7)		
To Prelim. Exp.w/off (Direct)	-	10			
To Office Exp.(Time 1:2)	80	1,60			
To Selling Exp.(Sales 2:7)	44	1,54			
To Interest to Vendors (Note)	40	10			
To Capital Reserve- bal. fig. Pre-Incorporation Profit	1,28				
To Net Profit- balancing fig. Post Incorporation Profit		8,72			
Total	**4,72**	**16,52**	**Total**	**4,72**	**16,52**

Note: It is assumed that the Purchase Consideration due Vendors is Finally settled on 31st May i.e Certificate of Commencement of Business. Accordingly, interest is apportioned in the ratio of time months due i.e. **4:1** between Pre-Incorporation and Post-Incorporation Periods.

Cash/Bank Account

Dr. **Cr.**

Receipts	**₹ 000's**	**Payments**	**₹ 000's**
To Equity Share Capital	40,000	By Vendors A/c	10,00
To Sales	1,80,000	By Machinery	25,00
		By Expenses (excluding Depreciation)	5,84
		By Purchases- b/f from Trading A/c	1,59,76
		By balance c/d- balancing figure	19,40
Total	**2,20,00**	**Total**	**2,20,00**

Note: It is assumed that the Company's transactions are all for cash as there are no Debtors and Creditors.

Balance Sheet of Mourya Ltd as at 31st December, 2015
Name of the Company: Mourya Ltd.

(Amount ₹ in '000)

Ref No.		Particulars	Note No.	As at 31.12.15 (₹)
I		**EQUITY AND LIABILITIES**		
	1	**Shareholders' fund**		
		(a) Share Capital	1	8,000
		(b) Reserves and surplus-	2	872
	2	**Share application money pending allotment**		NIL
	3	**Non-current liabilities**		NIL
	4	**Current Liabilities**		NIL
		Total		**8,872**
II		**ASSETS**		
	1	**Non-current assets**		
		(a) Fixed assets		
		(i) Tangible assets	3	4,960
		(ii) Intangible assets	4	1,272
	2	**Current Assets**		
		(b) Inventories	5	700
		(d) Cash and cash equivalents	6	1,940
		Total		**8,872**

Note - Relevant items of Assets/ Liabilities are reflected in Balance Sheet and Schedule III. Hence sub-item not having any value for the given illustration is not shown/ represented in Balance Sheet.

Workings: **(₹ in '000)**

1. (a) Issued and Subscribed capital	**31.12.15**
Equity shares @ ₹ 10 each fully paid (40,00,000+40,00,000) (out of which 2,000 shares were issued for consideration other than cash)	8,000
Total	8,000

2. Reserve and Surplus	**31.12.15**
Profit & Loss A/c	872
Total	872

3. Tangible Assets	**31.12.15**
Machinery (30,00,000+25,00,000)	5,500
Less: Depreciation	540
Total	4,960

4. Intangible Assets		**31.12.15**
Goodwill	1,000	
Less: Pre Incorporation Profit	128	872
Patent		400
Total		1,272

5. Inventories	**31.12.15**
Stock	700
Total	700

6. Cash & Cash Equivalent	**31.12.15**
Cash	1,940
Total	1,940

Note: Goodwill on acquisition = Purchase Consideration- Net Assets (Machinery, Stock and Patents) taken over = 50,000-(30,000+6,000+4,000)=10,000. Pre – incorporation Profits are adjusted against this Goodwill.

Illustration 32:

A, B and C are in partnership sharing Profits and Losses in the ratio1/2:1/3:1/6. The Partnership Deed states that each Partner is entitled to 6% Interest on Capital. The Firm was taken over by Swagata Ltd, for a total consideration of ₹8,10,000. On the date of takeover, the Firm's Net Assets, represented by the Partner's Capital Accounts were - A- ₹ 3,10,000; B- ₹ 2,50,000 and C- ₹ 1,90,000.

The Firm wants to indicate the mode of settlement of Purchase Consideration to the Company, keeping in mind that the Partners interests should be equitably retained in the Company. The Company can issue Equity Shares of ₹10 each and Preference Shares (rate to be decided) of ₹100 each. You are required to decide upon the scheme for settlement of Purchase Consideration.

Solution.

Note: Goodwill on the date of taken over = Purchase Consideration Less Value of Net Assets

= ₹ 8,10,000 - ₹ 7,50,000 = ₹ 60,000

Statement of Capital Balances and Purchase Consideration

Particulars	A	B	C	Total
Capital as given	3,10,000	2,50,000	1,90,000	7,50,000
Add : Goodwill on takeover credited in profit sharing ratio (3:2:1)	30,000	20,000	10,000	60,000
Revised Capital Balance	3,40,000	2,70,000	2,00,000	8,10,000
Profit sharing ratio	½	1/3	1/6	
Capital of the firm, taking A's Capital as base	3,40,000	3,40,000 x 2/3 = 2,26,667	3,40,000 x 2/6 = 1,13,333	6,80,000
Hence, Excess Capital Contribution (A – B)	Nil	43,333	86,667	1,30,000
Scheme for settlement of Purchase Consideration				
(i) Equity shares for the Capital Balance	3,40,000	2,26,660	1,13,330	6,79,990
Number of equity shares to be issued (₹ 10)	34,000 nos.	22,666 nos.	11,333 nos.	67,999 nos.
(ii) 6% Preference share capital (₹ 100 each) for the excess capital contribution	Nil	43,300	86,600	1,29,900
No. of Preference shares to be issued (₹ 100)	34,000 nos.	22,666 nos.	11,333 nos.	67,999 nos.
(iii) Cash paid for fractions/ rounding off	Nil	7 + 33 = 40	3 + 67 = 70	110
(iv) Total Purchase Consideration	3,40,000	2,70,000	2,00,000	8,10,000

Note : Since interest on partner's capital is allowed at 6%, the rate of Preference Dividend should also be 6%. Hence, Partner's can now share the Company's Profits in the same ratio as earlier (by way of equity dividend) after allowing for preference dividend (in lieu of interest on excess capital contribution).

Illustration 33:

Lata, Mita and Nita carry business in partnership under the style on M/s LMN Co. sharing profits and losses in the ratio of 5:3:2. They have floated Dinobondhu Pvt. Ltd. for the purpose of takeover of their business.

On 30th September, Dinobondhu Pvt. Ltd. took over the business for a total consideration of ₹ 5,00,000. The purchase consideration was to be discharged by the allotment of Equity Shares of ₹ 10 each at par in the profit sharing ratio and 15% Debentures of ₹100 each at par for surplus capital.

The following is the Balance Sheet of the Firm as on 31st March (i.e., date of takeover)

Liabilities		₹	Assets		₹
Current Liabilities:			**Current Assets:**		
Creditors		50,000	Cash		6,000
			Bank		14,000
PARTNERS' CAPITALS:			Debtors	60,000	
Lata	1,01,000		Less: Provision for Doubtful Debts	2,000	58,000
Mita	1,51,000		Stock		42,000
Nita	1,33,000	3,85,000			
			Fixed Assets - Written Down Value		3,00,000
			Expenditure in relation to Dinobondhu Pvt. Ltd.		
			Formation Expenses		12,000
			Bank A/c in the name of Dinobondhu Pvt Ltd. Deposit of par value of 300 Equity Shares of ₹10 each subscribed equally by Lata, Mita and Nita as subscribers to the Memorandum		
			and Articles of Association,		3,000
		4,35,000			**4,35,000**

The Directors of Dinobondhu Pvt. Ltd. revalued the Fixed Assets of LMN Co. at ₹4,00,000.

You are asked to:

- State the number of Equity Shares and Debentures allotted by Dinobondhu Pvt. Ltd. to Lata, Mita and Nita.
- Show Journal Entries In connection with the above transactions in the books of Horizon Pvt. Ltd.

Solution.

Computation of Profit on Sale of Business

Particulars	₹	₹
Purchase Consideration – given		5,00,000
Less : Net assets of the business		
Total assets (as per balance sheet)	4,35,000	
Less : Balance in bank accounts in the name of Dinobondhu Pvt. Ltd.	3,000	
Sundry creditors	50,000	3,82,000
Profit of sale of business		**1,18,000**

Note : It is assumed that the purchase consideration includes 300 shares allotted to the partners as subscribers to the Memorandum or Association. Therefore, the value of such shares (₹ 3,000) has been reduced from the Capital accounts' of the Partners to the extent subscribed by them, to determine the Profit on Sale of Business.

Distribution of Purchase consideration

Particulars	Lata	Mita	Nita
Balance in capital accounts	1,01,000	1,51,000	1,33,000
Less : Value of shares in Dinobondhu Pvt. Ltd. subscribed by partners	1,000	1,000	1,000
Capital representing the net assets of M/s. LMN & Co.	1,00,000	1,50,000	1,32,000
Add : Profit on Sale of Business 9in the profit sharing ratio) 5:3:2	59,000	35,400	23,600
Adjusted balance in Capital Accounts (A)	1,59,000	1,85,400	1,55,600
Profit sharing ratio (B)	5	3	2
Capital ÷ Profit sharing ratio (A ÷ B)	31,800	61,800	77,800
Capitals in profit sharing ratio based on Lata's Capital (C)	1,59,000	95,400	63,600
Value of shares to be issued including initial allotment of 300 shares	31,800 x 5	31,800 x 3	31,800 x 2
Surplus Capital (A – C) – Value of debentures to be issued	Nil	90,000	92,000
Number of equity shares to be issued in total (C ÷ ₹ 10)	15,900	9,540	6,360
Less : Already issued	100	100	100
Number of shares to be issued now	15,800	9,440	6,260
Number of debentures issued	-	900	920

Note : If it is assumed that the purchase consideration excludes the initial allotment of 300 shares, then equity shares to be issued will be as follows :

Lata – 15,900 shares ; Mita – 9,540 shares and Nita – 6,360 shares.

Journal entries in the books of Dinobondhu Pvt. Ltd.

S. No.	Particulars		Dr.	Cr.
1	Bank A/c.	Dr.	3,000	
	To, Equity Share Capital A/c.			3,000
	(being the allotment of 300 equity shares of ₹ 10 each for Lata, MIta and Nita as subscribers to Memorandum)			
2	Business Purchase A/c.	Dr.	4,97,000	
	To, Vendors of LMN Co A/c.			4,97,000
	(being the purchase of M/s. LMN & Co.'s business for ₹ 4,97,000 i.e., after considering shares for ₹ 3,000 issued to the subscribers to the Memorandum of Association, …… vide agreement dated………)			
3	Goodwill A/c. (balancing figure)	Dr.	15,000	
	Fixed assets A/c. (at revalued amount) A/c.	Dr.	4,00,000	
	Stocks A/c.	Dr.	42,000	
	Debtors A/c.	Dr.	60,000	
	Bank A/c.	Dr.	14,000	
	Cash A/c.	Dr.	6,000	
	Preliminary expenses A/c.	Dr.	12,000	
	To, Sundry Creditors A/c.			50,000
	To, Provision for doubtful debts A/c.			2,000
	To, Business Purchase A/c.			4,97,000
	(being the recording of various assets and liabilities taken over from M/s. LMN & Co., s per agreement dated ……….. incorporated in the books of account and the difference in Purchase Consideration and Net Assets transferred to Goodwill A/c.)			
4	Vendors of LMN Co A/c.	Dr.	4,97,000	
	To, Equity Share Capital A/c.			3,15,000
	To, 15% Debentures A/c.			1,82,000
	(being allotment of 31,500 shares and 1,820 debentures to vendors in settlement of purchase consideration vide agreement dated ……………..)			

Note : The Vendor A/c. is credited to the extent of ₹ 4,97,000 only and not ₹ 5,00,000. This is because Equity Shares for ₹ 3,000 has already been issued and the consideration received and debited to Bank. If it is assumed that the initial allotment is not part of the purchase consideration, then the amount here will be ₹ 5,00,000.

Study Note - 8

LIQUIDATION OF COMPANIES

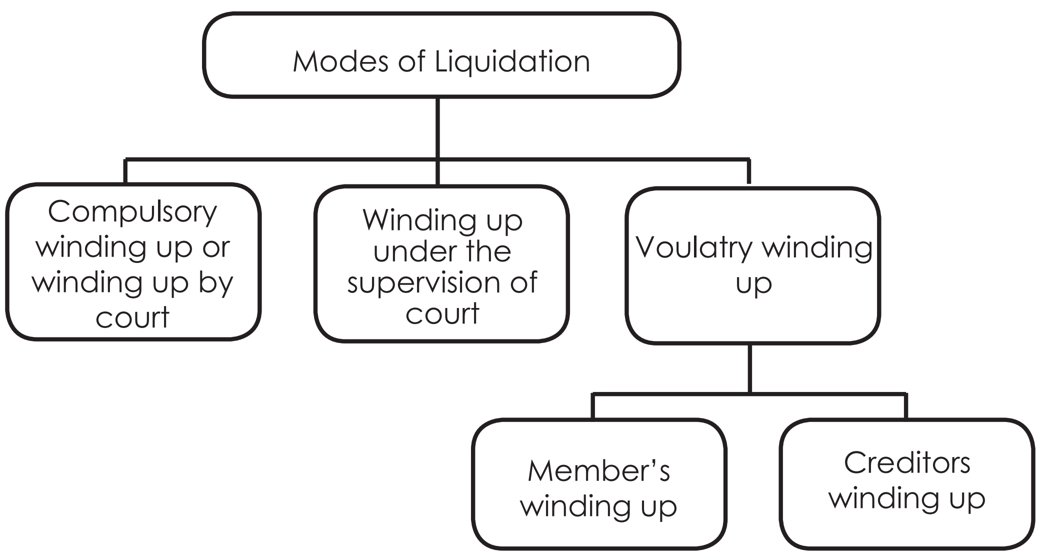
This Study Note includes

8.1 Modes of Liquidation
8.2 Liquidators' Statement of Account
8.3 Deficiency Account, in the context of Liquidation of Companies
8.4 Overriding Preferential Payments U/S 326 of the Companies Act, 2013
8.5 Preferential Payments U/S 327 of the Companies Act, 2013
8.6 Liquidators' Final Statement of Account

Liquidation - Introduction:

A company comes into being through a legal process and also comes to an end by law. Liquidation is the legal procedure by which the company comes to an end. Thus a company being a creation of law cannot die a natural death. A company, when found necessary, can be liquidated. As we know that insolvency proceedings are not applicable for all company and hence liquidation proceedings are applied to a company.

8.1 MODES OF LIQUIDATION



8.1.1 Compulsory winding up:

A company may, on a petition under section 272, be wound up by the Tribunal,—

(a) if the company is unable to pay its debts;

(b) if the company has, by special resolution, resolved that the company be wound up by the Tribunal;

(c) if the company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality;

(d) if the Tribunal has ordered the winding up of the company under Chapter XIX;

(e) if on an application made by the Registrar or any other person authorised by the Central Government by notification under this Act, the Tribunal is of the opinion that the affairs of the company have been conducted in a fraudulent manner or the company was formed for fraudulent and unlawful purpose or the persons concerned in the formation or management of its affairs have been guilty of fraud, misfeasance or misconduct in connection therewith and that it is proper that the company be wound up;

(f) if the company has made a default in filing with the Registrar its financial statements or annual returns for immediately preceding five consecutive financial years; or

(g) if the Tribunal is of the opinion that it is just and equitable that the company should be wound up.

A company shall be deemed to be unable to pay its debts,—

(a) if a creditor, by assignment or otherwise, to whom the company is indebted for an amount exceeding one lakh rupees then due, has served on the company, by causing it to be delivered at its registered office, by registered post or otherwise, a demand requiring the company to pay the amount so due and the company has failed to pay the sum within twenty-one days after the receipt of such demand or to provide adequate security or re-structure or compound the debt to the reasonable satisfaction of the creditor;

(b) if any execution or other process issued on a decree or order of any court or tribunal in favour of a creditor of the company is returned unsatisfied in whole or in part; or

(c) if it is proved to the satisfaction of the Tribunal that the company is unable to pay its debts, and, in determining whether a company is unable to pay its debts, the Tribunal shall take into account the contingent and prospective liabilities of the company.

8.1.2 Petition for Winding Up [Section 272]

(1) Subject to the provisions of this section, a petition to the Tribunal for the winding up of a company shall be presented by—

 (a) the company;

 (b) any creditor or creditors, including any contingent or prospective creditor or creditors;

 (c) any contributory or contributories;

 (d) all or any of the persons specified in clauses (a), (b) and (c) together;

 (e) the Registrar;

 (f) any person authorised by the Central Government in that behalf; or

 (g) in a case falling under clause (c) of sub-section (1) of section 271, by the Central Government or a State Government.

(2) A secured creditor, the holder of any debentures, whether or not any trustee or trustees have been appointed in respect of such and other like debentures, and the trustee for the holders of debentures shall be deemed to be creditors within the meaning of clause (b) of sub-section (1).

(3) A contributory shall be entitled to present a petition for the winding up of a company, notwithstanding that he may be the holder of fully paid-up shares, or that the company may have no assets at all or may have no surplus assets left for distribution among the shareholders after the satisfaction of its liabilities, and shares in respect of which he is a contributory or some of them were either originally allotted to him or have been held by him, and registered in his name, for at least six months during the eighteen months immediately before the commencement of the winding up or have devolved on him through the death of a former holder.

(4) The Registrar shall be entitled to present a petition for winding up under sub-section (1) on any of the grounds specified in sub-section (1) of section 271, except on the grounds specified in clause (b), clause (d) or clause (g) of that sub-section.

Provided that the Registrar shall not present a petition on the ground that the company is unable to pay its debts unless it appears to him either from the financial condition of the company as disclosed in its balance sheet or from the report of an inspector appointed under section 210 that the company is unable to pay its debts.

Provided further that the Registrar shall obtain the previous sanction of the Central Government to the presentation of a petition.

Provided also that the Central Government shall not accord its sanction unless the company has been given a reasonable opportunity of making representations.

(5) A petition presented by the company for winding up before the Tribunal shall be admitted only if accompanied by a statement of affairs in such form and in such manner as may be prescribed.

(6) Before a petition for winding up of a company presented by a contingent or prospective creditor is admitted, the leave of the Tribunal shall be obtained for the admission of the petition and such leave shall not be granted, unless in the opinion of the Tribunal there is a prima facie case for the winding up of the company and until such security for costs has been given as the Tribunal thinks reasonable.

(7) A copy of the petition made under this section shall also be filed with the Registrar and the Registrar shall, without prejudice to any other provisions, submit his views to the Tribunal within sixty days of receipt of such petition.

8.1.3 Voluntary Winding Up

After knowing about the modes of compulsory winding up of a company let us now discuss the modes of voluntary winding up.

A company may be wound up voluntarily [Section 304],—

(a) if the company in general meeting passes a resolution requiring the company to be wound up voluntarily as a result of the expiry of the period for its duration, if any, fixed by its articles or on the occurrence of any event in respect of which the articles provide that the company should be dissolved; or

(b) if the company passes a special resolution that the company be wound up voluntarily.

8.2 LIQUIDATORS' STATEMENT OF ACCOUNT

In case of Compulsory wound-up, the Company Liquidator shall keep proper books in such manner, as may be prescribed, in which he shall cause entries or minutes to be made of proceedings at meetings and of such other matters as may be prescribed.

Any creditor or contributory may, subject to the control of the Tribunal, inspect any such books, personally or through his agent.

While preparing the liquidator's statement of account, receipts are shown in the following order :

(a) Amount realised from assets are included in the prescribed order.

(b) In case of assets specifically pledged in favour of creditors, only the surplus from it, if any, is entered as 'surplus from securities'.

(c) In case of partly paid up shares, the equity shareholders should be called up to pay necessary amount (not exceeding the amount of uncalled capital) if creditors' claims/claims of preference shareholders can't be satisfied with the available amount. Preference shareholders would be called upon to contribute (not exceeding the amount as yet uncalled on the shares) for paying of creditors.

(d) Amounts received from calls to contributories made at the time of winding up are shown on the Receipts side.

(e) Receipts per Trading Account are also included on the Receipts side.

Payments made to redeem securities and cost of execution and payments per Trading Account are deducted from total receipts.

Payments are made and shown in the following order :

(a) Legal charges;

(b) Liquidator's expenses;

(c) Debentureholders (including interest up to the date of winding up if the company is insolvent and to the date of payment if it is solvent);

(d) Creditors :

  (i) Preferential (in actual practice, preferential creditors are paid before debenture holders having a floating charge);

  (ii) Unsecured creditors;

(e) Preferential shareholders (Arrears of dividends on cumulative preference shares should be paid up to the date of commencement of winding up); and

(f) Equity shareholders.

Commencement of Winding Up by Tribunal [Section 357]:

Where, before the presentation of a petition for the winding up of a company by the Tribunal, a resolution has been passed by the company for voluntary winding up, the winding up of the company shall be deemed to have commenced at the time of the passing of the resolution, and unless the Tribunal, on proof of fraud or mistake, thinks fit to direct otherwise, all proceedings taken in the voluntary winding up shall be deemed to have been validly taken.

In any other case, the winding up of a company by the Tribunal shall be deemed to commence at the time of the presentation of the petition for the winding up.

Exclusion of Certain Time in Computing Period of Limitation [Section 358]:

Notwithstanding anything in the Limitation Act, 1963, or in any other law for the time being in force, in computing the period of limitation specified for any suit or application in the name and on behalf of a company which is being wound up by the Tribunal, the period from the date of commencement of the winding up of the company to a period of one year immediately following the date of the winding up order shall be excluded.

Statement of Affairs as on **(Amount in ₹)**

Particulars	**ERV**
Assets not specifically pledged as per List A: (ERV = Estimated Realizable Value)	
Cash in hand	
Marketable Securities	
Calls in Arrears	
Trade Debtors, Stock in Trade etc.	
Machinery etc.	
Total	**(A)**

Assets specifically pledged as per List B

Details of asset	**ERV**	**Due to Secured Creditors**	**Deficiency ranking as unsecured**	**Surplus carried to last column**	
Estimated Surplus from Assets specifically pledged (as calculated above) Estimated Total Assets available for Preferential Creditors, Debenture holders having a Floating Charge and Unsecured Creditors (A+B)					(B)

Summary of Gross Assets

Gross Receivable Value of assets specifically pledged Assets not specifically pledged	(C) (A)
Total	**(D) = (A) + (C)**

Gross Liabilities (to be deducted from Surplus or added to Deficiency)

₹	Particulars	₹
	Secured Creditors as per List B to the extent to which claims are estimated to be covered by assets specifically pledged	
	Preferential Creditors as per List C	
	Estimated Balance of Assets available for Debenture holders secured by a	
	Floating Charge and Unsecured Creditors	
	Debenture holders secured by a Floating Charge as per List D	....
	Estimated Surplus / (Deficiency) as regards Debenture holders	....
	Unsecured Creditors as per List E	....
(E)		
	Estimated Surplus / (Deficiency) as regards Creditors [being the difference	....
	between Gross Assets and Gross Liabilities] [(D) - (E)I	
	Issued & Called up Capital:	....
	Preference Share Capital as per List F	....
	Equity Share Capital as per List G	....
	Estimated Surplus / (Deficiency) as regards Members	

3. What are the Lists associated with the Statement of Affairs?

The following lists are associated with the Statement of Affairs

List	Particulars
A	Full particulars of every description of property **not specifically pledged** and included in any other list.
B	Assets **specifically pledged** and Creditors fully or partly secured.
C	List of Preferential Creditors for Rates, Taxes, Salaries, Wages and otherwise.
D	List of Debenture holders secured by a floating charge
E	List of Unsecured Creditors
F	List of Preference Shareholders
G	List of Equity Shareholders
H	Deficiency Account

8.3 DEFICIENCY ACCOUNT , IN THE CONTEXT OF LIQUIDATION OF COMPANIES

a) Deficiency Account is prepared in the case of a Company in Liquidation to explain in a nutshell how the Company lost money during its existence. This amount explains the Deficiency or Surplus.

b) The Official Liquidator will specify a date **(three years earlier)** beginning with the date by,' which information is to be supplied for preparation of an account to explain the Deficiency or Surplus.

c) On that specified date, there would be a Reserve (if Assets exceed Capital and Liabilities) or **a Deficit** Accumulated Loss as a Debit Balance in P&L A/c (if Assets are less than Capital and Liabilities).

d) This Reserve or Deficit is the starting point for the preparation of the Deficiency Account.

e) The Deficiency Account has two parts. The First Part starts with the **Deficit** (on the given date) and contains every item that increases Deficiency (or reduces Surplus such as losses, dividends etc.). The Second Part starts with the **Surplus** on the given date and includes all profits. The net effect of all adjustments i.e. Losses, Dividends, Profits, Incomes etc. constitutes the Net Surplus / Deficiency as regards Members, as shown by the Statement of Affairs.

8.4 OVERRIDING PREFERENTIAL PAYMENTS U/S 326 OF THE COMPANIES ACT, 2013

Overriding Preferential Payments [Section 326]:

Notwithstanding anything contained in this Act or any other law for the time being in force, in the winding up of a company,—

(a) workmen's dues; and

(b) debts due to secured creditors to the extent such debts rank under clause (iii) of the proviso to sub-section (1) of section 325 pari passu with such dues,

shall be paid in priority to all other debts.

Provided that in case of the winding up of a company, the sums towards wages or salary referred to in sub-clause (i) of clause (b) of sub-section (3) of section 325, which are payable for a period of two years preceding the winding up order or such other period as may be prescribed, shall be paid in priority to all other debts (including debts due to secured creditors), within a period of thirty days of sale of assets and shall be subject to such charge over the security of secured creditors as may be prescribed.

The debts payable under the proviso to sub-section (1) shall be paid in full before any payment is made to secured creditors and thereafter debts payable under that sub-section shall be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions.

8.5 PREFERENTIAL PAYMENTS U/S 327 OF THE COMPANIES ACT, 2013

Preferential Payments [Section 327]:

In a winding up, subject to the provisions of section 326, there shall be paid in priority to all other debts,—

(a) all revenues, taxes, cesses and rates due from the company to the Central Government or a State Government or to a local authority at the relevant date, and having become due and payable within the twelve months immediately before that date;

(b) all wages or salary including wages payable for time or piece work and salary earned wholly or in part by way of commission of any employee in respect of services rendered to the company and due for a period not exceeding four months within the twelve months immediately before the relevant date, subject to the condition that the amount payable under this clause to any workman shall not exceed such amount as may be notified;

(c) all accrued holiday remuneration becoming payable to any employee, or in the case of his death, to any other person claiming under him, on the termination of his employment before, or by the winding up order, or, as the case may be, the dissolution of the company;

(d) unless the company is being wound up voluntarily merely for the purposes of reconstruction or amalgamation with another company, all amount due in respect of contributions payable during the period of twelve months immediately before the relevant date by the company as the employer of persons under the Employees' State Insurance Act, 1948 or any other law for the time being in force;

(e) unless the company has, at the commencement of winding up, under such a contract with any insurer as is mentioned in section 14 of the Workmen's Compensation Act, 1923, rights capable of being transferred to and vested in the workmen, all amount due in respect of any compensation or liability for compensation under the said Act in respect of the death or disablement of any employee of the company.

    Provided that where any compensation under the said Act is a weekly payment, the amount payable under this clause shall be taken to be the amount of the lump sum for which such weekly payment could, if redeemable, be redeemed, if the employer has made an application under that Act;

(f) all sums due to any employee from the provident fund, the pension fund, the gratuity fund or any other fund for the welfare of the employees, maintained by the company; and

(g) the expenses of any investigation held in pursuance of sections 213 and 216, in so far as they are payable by the company.

Where any payment has been made to any employee of a company on account of wages or salary or accrued holiday remuneration, himself or, in the case of his death, to any other person claiming through him, out of money advanced by some person for that purpose, the person by whom the money was advanced shall, in a winding up, have a right of priority in respect of the money so advanced and paid-up to the amount by which the sum in respect of which the employee or other person in his right would have been entitled to priority in the winding up has been reduced by reason of the payment having been made.

The debts enumerated in this section shall—

(a) rank equally among themselves and be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions; and

(b) so far as the assets of the company available for payment to general creditors are insufficient to meet them, have priority over the claims of holders of debentures under any floating charge created by the company, and be paid accordingly out of any property comprised in or subject to that charge.

Subject to the retention of such sums as may be necessary for the costs and expenses of the winding up, the debts under this section shall be discharged forthwith so far as the assets are sufficient to meet them, and in the case of the debts to which priority is given under clause (d) of sub-section (1), formal proof thereof shall not be required except in so far as may be otherwise prescribed.

In the event of a landlord or other person distraining or having distrained on any goods or effects of the company within three months immediately before the date of a winding up order, the debts to which priority is given under this section shall be a first charge on the goods or effects so distrained on or the proceeds of the sale thereof.

Provided that, in respect of any money paid under any such charge, the landlord or other person shall have the same rights of priority as the person to whom the payment is made.

Any remuneration in respect of a period of holiday or of absence from work on medical grounds through sickness or other good cause shall be deemed to be wages in respect of services rendered to the company during that period.

For the purposes of this section, section 326 and section 327,—

(a) "workmen", in relation to a company, means the employees of the company, being workmen within the meaning of clause (s) of section 2 of the Industrial Disputes Act, 1947;

(b) "workmen's dues'', in relation to a company, means the aggregate of the following sums due from the company to its workmen, namely:—

(i) all wages or salary including wages payable for time or piece work and salary earned wholly or in part by way of commission of any workman in respect of services rendered to the company and any compensation payable to any workman under any of the provisions of the Industrial Disputes Act, 1947;

(ii) all accrued holiday remuneration becoming payable to any workman or, in the case of his death, to any other person in his right on the termination of his employment before or by the effect of the winding up order or resolution;

(iii) unless the company is being wound up voluntarily merely for the purposes of reconstruction or amalgamation with another company or unless the company has, at the commencement of the winding up, under such a contract with insurers as is mentioned in section 14 of the Workmen's Compensation Act, 1923, rights capable of being transferred to and vested in the workmen, all amount 8 of 1923. due in respect of any compensation or liability for compensation under the said Act in respect of the death or disablement of any workman of the company;

(iv) all sums due to any workman from the provident fund, the pension fund, the gratuity fund or any other fund for the welfare of the workmen, maintained by the company;

(c) "workmen's portion'', in relation to the security of any secured creditor of a company, means the amount which bears to the value of the security the same proportion as the amount of the workmen's dues bears to the aggregate of the amount of workmen's dues and the amount of the debts due to the secured creditors.

8.6 LIQUIDATORS' FINAL STATEMENT OF ACCOUNT

1 . **Final Accounts:** At the close of the winding up proceedings in a voluntary liquidation (or compulsory winding up by the Court), the Liquidators are required to place before the final meeting of Shareholders or, Creditors (or the Court, as the case may be) a Consolidated Account of amounts received and paid.

2. **Name:** This Statement submitted by the Liquidator is known as **"Liquidator's Statement of Account"** in a voluntary winding up. In case of a winding up by the Court, this Statement is known as, "Official Liquidator's Final Account".

3. **Receipts & Payments Format:** The above account is prepared in the following manner

Receipts	₹	**Payments**	₹
(a) Amount received from realization of assets (Assets are included in the prescribed order of liquidity). (b) In case of assets specifically charged in favour of Creditors e.g. Mortgage Loan on Land and Buildings, only the **surplus** from it, if any, is entered as "Surplus from Securities". (c) Calls in Arrears and Call Money due in order to ensure that the loss or surplus, if any, is equitably borne by all classes of Equity Shareholders. (d) Net Result of Trading Activity if any,		Payment are shown in the following order - (a) Legal Charges; (b) Liquidator's Remuneration; (c) Liquidation Expenses; (d) Debenture holders (including interest upto the date of winding up if the Company is insolvent and upto the date of payment if it is solvent); (e) Creditors; (f) Preferential Creditors (in actual practice, Preferential Creditors are paid before Debenture holders having a Floating	

Receipts	₹	Payments	₹
upto the date of account, is entered on the Receipts Side, Profits being added and Losses being deducted. (e) Payments made to redeem securities & cost of execution, i.e. cost of collecting debts, are reduced from Total Receipts.		Charge). Unsecured Creditors, Shareholders for dividends declared but not yet paid; (g) Preference Shareholders (including arrears of dividends on Cumulative Preference Shares upto the date of winding up.; and (h) Equity Shareholders.	

4. Call Money and Extent of Liability:

(a) In case of Partly Paid Shares, the need for making a call should be examined.

(b) Firstly, Equity Shareholders should be called up to pay the necessary amount (not exceeding the amount of Uncalled Capital) if Creditors' claim / claims of Preference Shareholders cannot be satisfied with the amount available.

(c) Preference shareholders would be called upon to contribute (not exceeding the amount as yet uncalled on the shares) for paying off Creditors.

(d) Loss suffered by each class of shareholders, i.e. the amount that cannot be repaid, should be proportionate to the nominal value of the share.

5. What is meant by List B of Contributories?

a) Persons: Shareholders who had transferred Partly Paid Shares (otherwise than by operation of law or by death) within one year, prior to the date of winding up may be called upon to pay an amount to pay off such Creditors as existed on the date of transfer of shares. These Transferors are called as B List Contributories.

b) Liability: Their liability is restricted to the amount not called up when the shares were transferred. They cannot be called upon to pay more than the entire face value of the share. For example, if Shares having Face Value ₹ 100 were paid up ₹ 60, the B List Contributory can be called up to pay a maximum of ₹ 40 only.

c) Conditions: Liability of B List Contributories will crystallize only (a) when the existing assets available with the liquidator are not sufficient to cover the liabilities; (b) when the existing shareholders fail to pay the amount due on the shares to the Liquidator.

Illustration 1:

Sri. "Samik" is appointed Liquidator of "Inova" Ltd, in Voluntary liquidation, on 01.07.2012. Following balances are extracted from the books on that date:

Liabilities	₹	Assets	₹
Capital:		Machinery	45,000
24,000 Shares of ₹ 5 each	1,20,000	Leasehold Properties	60,000
Reserve for Bad Debts	15,000	Stock-in-trade	1,500
Debentures	75,000	Book Debts	90,000
Bank Overdraft	27,000	Investments	9,000
Liabilities for purchases	30,000	Call-in-arrear	7,500
		Cash in hand	1,500
		Profit and Loss A/c	52,500
Total	**2,67,000**	**Total**	**2,67,000**

Prepare a Statement of Affairs to be submitted to the meeting of the Creditors. The following assets are valued as under by that date:

Machinery	90,000	Investments	6,000
Leasehold Properties	1,09,000	Stock in trade	3,000

Bad Debts are ₹ 3,000 and the doubtful debts are ₹ 6,000 which are estimated to realize ₹ 3,000. Bank Overdraft is secured by a deposit of title deeds of Leasehold Properties. Preferential Creditors are ₹ 1,500. Telephone Rent outstanding ₹ 120.

Solution:

In the matter of the Companies Act, 2013 &
In the matter of Inova Ltd (Liquidation)
Statement of Affairs as on 01.07.2012 (Amount in ₹)

Particulars	₹
Assets not specifically pledged as per List A: (ERV = Estimated Reasliable Value)	
Cash in hand	1,500
Marketable Securities / Investments	6,000
Calls in Arrears	7,500
Trade Debtors (90,000 – Bad ₹ 3,000 – Unrealisable portion of Doubtful Debts ₹ 3,000)	84,000
Stock in Trade	3,000
Machinery	90,000
Total	**1,92,000**

Assets specifically pledged as per List B

	ERV	Due to Secured Creditors	Deficiency ranking as unsecured	Surplus carried to last column	
Leasehold properties	1,09,000	27,000	—	82,000	
Estimated Surplus from Assets specifically pledged (as calculated above)					82,000
Estimated Total Assets available for Preferential Creditors, Debentureholders having a Floating Charge and Unsecured Creditors (1,92,000 + 82,000)					2,74,000

Summary of Gross Assets

Gross receivable value of assets specifically pledged	1,09,000
Assets not specifically pledged	1,92,000
Total	**3,01,000**

Gross Liabilities (to be deducted from Surplus or added to Deficiency)

₹	Particulars	₹
27,000	Secured Creditors as per List B to the extent to which claims are estimated to	
1,500	be covered by assets specifically pledged	1,500
75,000	Preferential Creditors as per List C	2,72,500
30,120	**Estimated Balance of Assets available for Debentureholders secured by a**	75,000
1,33,620	Floating Charges and Unsecured Creditors (2,74,000 - 1,500)*	1,97,500
	Debentureholders secured by a Floating Charge as per List D	30,120
	Estimated Surplus as regards Debentureholders (2,72,500 – 75,000)	
	Unsecured Creditors as per List E	
	Liability for Purchases 30,000	
	Outstanding Telephone Rent 120	

	Estimated Surplus as regards Creditors [being the difference between Gross Assets and Gross Liabilities] (3,01,000 – 1,33,620) or (1,97,500 – 30,120)	1,67,380
	Issued & Called up Capital: Preference Share Capital as per List F 24,000 Equity Shares of ₹ 5 each, fully paid as per List G **Estimated Surplus as regards Members**	 Nil 1,20,000 47,380

The figures of Surplus must be read subject to the following notes – (a) There is no Unpaid Capital liable to be called up. (b) The estimates are subject to Costs of Winding Up and to any Surplus or Deficiency on trading pending realization of the assets.

Illustration 2:

Capital Ltd. is to be liquidated. Their summarized balance Sheet as at 30.9.12, appears as under:

Liabilities	Amount	Assets	Amount
2,50,000 Equity Shares of ₹ 10 each	25,00,000	Land and Buildings	5,00,000
Secured Debentures (On Land & Buildings)	10,00,000	Other Fixed Assets	20,00,000
Unsecured Loans	20,00,000	Current Assets	45,00,000
Trade Creditors	35,00,000	Profit and Loss A/c	20,00,000
Total	**90,00,000**	**Total**	**90,00,000**

Contingent Liabilities are: (a) Bills Discounted ₹ 1,00,000; and (b) Excise Duty Demand ₹ 1,50,000

On investigation, it is found that the Contingent Liabilities are certain to devolve and that the Assets are likely to be realized as (a) Land & Building ₹ 11,00,000; (b) Other Fixed Assets ₹ 18,00,000; (c) Current Assets ₹ 35,00,000. Taking the above into account, prepare the Statement of Affairs.

Solution:

In the matter of the Companies Act, 2013 &
In the matter of Capital Ltd (in Liquidation)
Statement of Affairs as on 30.09.2012 (Amount in ₹)

Particulars	₹
Assets not specifically pledged as per List A: (ERV = Estimated Reasliable Value) Other Fixed Assets Current Assets	 18,00,000 35,00,000
Total	**53,00,000**

Assets specifically pledged as per List B

	ERV	Due to Secured Creditors	Deficiency ranking as unsecured	Surplus carried to last column	₹
Land & Building	11,00,000	10,00,000	—	1,00,000	
Estimated Surplus from Assets specifically pledged (as calculated above)					1,00,000
Estimated Total Assets available for Preferential Creditors, Debentureholders having a Floating Charge and Unsecured Creditors (53,00,000 + 1,00,000)					54,00,000

Summary of Gross Assets

Gross receivable value of assets specifically pledged Assets not specifically pledged	11,00,000 53,00,000
Total	**64,00,000**

Gross Liabilities (to be deducted from Surplus or added to Deficiency)

Gross Liab	Particulars	₹
10,00,000	Secured Creditors as per List B to the extent to which claims are estimated	
1,50,000	to be covered by assets specifically pledged	1,50,000
Nil	Preferential Creditors as per List C – Excise Duty Demand	52,50,000
20,00,000	**Estimated Balance of Assets available for Debentureholders** secured by	Nil
35,00,000	a Floating Charges and Unsecured	52,50,000
1,00,000	Creditors (54,00,000 – 1,50,000)	
67,50,000	Debentureholders secured by a Floating Charge as per List D	56,00,000
	Estimated Surplus as regards Debentureholders	
	Unsecured Creditors as per List E	
	Unsecured Loans 20,00,000	
	Trade Creditors 35,00,000	
	Contingent Liability on Bills Discounted 1,00,000	
	Estimated Surplus as regards Creditors [being the difference between Gross Assets and Gross Liabilities] (5250000 – 5600000) or (6750000 – 6400000)	- 3,50,000
	Issued & Called up Capital:	
	Preference Share Capital as per List F	Nil
	2,50,000 Equity Shares of ₹ 10 each, fully paid as per List G	25,00,000
	Estimated Deficiency as regards Members	- 28,50,000

Illustration 3: In a liquidation which commenced on 1st January of a year, certain Creditors could not receive payment out of the realization of assets and out of the contribution from "A" List Contributories. The following are the details of certain transfers which took place prior to V' January (i.e. in the last year):

Shareholders	Number of shares transferred	Date of ceasing to be a Member	Creditors remaining unpaid and outstanding at the date of ceasing to be a Member (₹)
Ram	1,000	1st February	6,000
Shyam	1,500	1st April	7,500
Jadu	300	1st August	8,000
Madhu	200	1st December	9,500

All the shares were of ₹ 10 each ₹ 6 paid up. Ignoring Expenses, Remuneration to Liquidator etc., show the amount to be realized from the various persons listed above.

Solution:

Statement of Liability of B List Contributories

Name of Shareholder		Ram	Shyam	Jadu	Madhu	Amount payable to Creditors
Number of Shares held		1,000	1,500	300	200	
Creditors payable on the date of ceasing to be member						
Date Amount Payable to Creditors	**Ratio**					
01/02 Given in Question 6,000	10:15:3:2	2,000	3,000	600	400	6,000
01/04 (7500 – 6000) 1,500	15:3:2		1,125	225	150	1,500
01/08 (8000 – 7500) 500	3:2			300	200	500
01/12 (9500 – 8000) 1,500	Only by D				1,500	1,500

(a)	**Total of above**	**2,000**	**4,125**	**1,125**	**2,250**	**9,500**
(b)	Maximum Liability on Shares held (₹ 4 per share)	4,000	6,000	1,200	800	
(c)	Amount paid (a) or (b) whichever is Lower	2,000	4,125	1,125	800	8,050

Against Madhu's liability of ₹ 2,250, he can be called upon to pay only ₹ 800; the loss of ₹ 1,450 will have to be suffered by the Creditors.

Illustration 4: In a winding up which commenced on 12th April of a certain calendar year, certain Creditors could not receive payments out of the realization of assets and out of contribution from 'A' List of Contributories. Following are the details of certain share transfers that took place prior to liquidation and the amount of creditors remaining unpaid.

Shareholders	No. of shares transferred	Date when ceased to be a member	Creditors remaining unpaid and outstanding on the date of ceasing to be a member (₹)
Ajit	2000	4th February	8,000
Barun	1800	12th June	12,000
Chintu	1200	20th September	17,400
Deep	1000	15th October	18,600
Rahim	500	3rd December	22,000

All the shares were of ₹ 10 each on which ₹ 5 per share had been called and paid up. Ignoring Expenses of Liquidation, Remuneration to Liquidator etc., work out the amount to be realized from the above contributories.

Solution :

The winding up commenced on 12th April. Hence, only those persons who had transferred their shares within a period of 12 months preceding the date of winding up is liable for Contribution under List B. In this, Ajit is not a B list Contributory since his shares have been transferred much earlier than the 12 month period.

The other Transferors are liable subject to the restriction that an individual should not be made liable for more than unpaid value on the shares.

Statement of Liability of B List Contributories

(Amount in ₹)

Name of Shareholder		Barun	Chintu	Deep	Rahim	Amount payable to Creditors
Number of Shares held		1,800	1,200	1,000	500	
Creditors payable on the date of ceasing to be member						
Date Amount Payable to Creditors	**Ratio**					
12/06 Given 12,000	18:12:10:5	4,800	3,200	2,667	1,333	12,000
20/09 (17400 – 12000) 5,400	12:10:5		2,400	2,000	1,000	5,400
15/10 (18600 – 17400) 1,200	10:5			800	400	1,200
03/12 (22000 – 18600) 3,400	Only by E				3,400	3,400
(c) Total of above		4,800	5,600	5,467	6,133	22,000
(d) Maximum Liability on Shares held (₹ 5 per share)		9,000	6,000	5,000	2,500	
(c) Amount paid (a) or (b) whichever is Lower		4,800	5,600	5,000	2,500	17,900

Deep and Rahim can be called upon to pay only ₹ 5,000 and ₹ 2,500 respectively. The Creditors totaling ₹ 4,100 (₹ 3,400 on 3rd December and ₹ 700 on 15th October) will not be receiving any payment.

Illustration 5: "Ganga" Ltd went into voluntary liquidation and the proceedings commenced on 02.05.2012. Certain Creditors could not receive payment out of the realization of assets and out of the contributions from the contributories of the 'A' list. The following details of share transfers are made available to you.

Shareholders	No. of shares transferred	Date when ceased to be a member	Creditors remaining unpaid and outstanding on the date of ceasing to be a member (₹)
A	1000	1st March 2011	6,000
B	1250	15th August 2011	8,000
C	500	1st October 2011	10,750
D	2,000	1st December 2011	13,000
E	250	1st April 2012	15,000

All the shares were of ₹ 10 each on which ₹ 5 per share had been paid up. From the above information, determine the liability of the List B Contributories.

Solution :

The winding up commenced on 2nd May. Hence, only those persons who had transferred their shares within a period of 12 months preceding the date of winding up is liable as a B List Contributory. In this case, A is not a B list Contributory since his shares have been transferred much earlier than the 12 month period.

The other Transferors are liable subject to the restriction that an individual should not be made liable for more than unpaid value on the shares.

Statement of Liability of B List Contributories

(Amount in ₹)

Name of Shareholder		B	C	D	E	Amount payable to Creditors
Number of Shares held		1,250	500	2,000	250	
Creditors payable on the date of ceasing to be member						
Date Amount Payable to Creditors	**Ratio**					
15/08/11 Given 8,000	125:50:200:25	2,500	1,000	4,000	500	8,000
01/10/11 (10750 – 8000) 2,750	50:200:25		500	2,000	250	2,750
01/12/11 (13000 – 10750) 2,250	200:25			2,000	250	2,250
01/01/12 (15000 – 13000) 2,000	Only by E				2,000	2,000
(e) Total of above		2,500	1,500	8,000	3,000	15,000
(f) Maximum Liability on Shares held (₹ 5 per share)		6,250	2,500	10,000	1,250	
(c) Amount paid (a) or (b) whichever is Lower		2,500	1,500	8,000	1,250	13,250

Incremental Creditor of ₹ 2,000 on 01.04.2012 will get only ₹ 250 from E. Since the Maximum Amount recoverable from E is ₹ 1,250 of which creditors outstanding earlier will be entitled to ₹ 1,000 on 1st December.

Illustration 6:

The following is the Balance Sheet of Y Limited as at 31st March, 2011:

Liabilities		Assets	₹
Share Capital:		**Fixed Assets :**	
2,000 Equity Shares of ₹ 100		Land & Buildings	4,00,000
each ₹ 75 per share paid up	1,50,000	Plant and Machineries	3,80,000
6,000 equity shares of ₹ 100		Current Assets :	
each ₹ 60 per share paid up	3,60,000	Stock at cost	1,10,000
Sundry Debtors	2,20,000		
2,000 10% Preference Share of		Cash at Bank	60,000
₹ 100 each fully paid up	2,00,000	Profit and Loss A/c	2,40,000
10% Debentures (having a floating			
charge on all assets)	2,00,000		
Interest accrued on Debentures			
(also secured as above)	10,000		
Sundry Creditors	4,90,000		
	14,10,000		14,10,000

On that date, the company went into Voluntary Liquidation. The dividends on preference shares were in arrear for the last two years. Sundry Creditors include a loan of ₹ 90,000 on mortgage of Land and Buildings. The assets realised were as under :-

	₹
Land and Buildings	3,40,000
Plant & Machineries	3,60,000
Stock	1,20,000
Sundry Debtors	1,60,000

Interest accrued on loan on mortgage of buildings upto the date of payment amounted to ₹ 10,000. The expenses of Liquidation amounted to ₹ 4,600. The Liquidator is entitled to a remuneration of 3% on all the assets realised (except cash at bank) and 2% on the amounts distributed among equity shareholders. Preferential creditors included in sundry creditors amount to ₹ 30,000. All payments were made on 30th June, 2011. Prepare the liquidator's final statement of account.

Solution:

Liquidator's Final Statement of Account

Receipts	₹	₹	Payments	₹	₹
Cash at Bank		60,000	Liquidation expenses		4,600
Assets realised :					
Sundry Debtors	1,60,000		Liquidator's remuneration (W.N. 1)		30,400
Stock	1,20,000		Debentureholders :		
Plant & Machinery	3,60,000	6,40,000	10% debentures	2,00,000	
Surplus from Land &			Interest accured (W.N. 2)	15,000	2,15,000
Buildings:			Preferential creditors		30.000
Amount realised	3,40,000		Unsecured creditors		3,70,000

Less : Secured			Preference shareholders:		
Creditors	1,00,000	2,40,000	10% Preference Share		
			Capital	2,00,000	
			Arrear dividend	40,000	2,40,000
			Equity Shareholders (W.N. 3) :		
			₹ 17.50 per share on 2,000 shares	35,000	
			₹ 2.50 per share on 6,000 shares	15,000	50,000
		9,40,000			9,40,000

Working Notes :

(1) Liquidator's remuneration :

	₹
3% on Assets realised (3% of ₹ 9,80,000)	29,400
2% of the amounts distributed among Equity Shareholders (2/102 × ₹ 51,000)	1,000
	30,400

(2) Interest accrued on 10% debentures

Interest accrued as on 31.3.2011	10,000
Interest accrued upto the date of payment (upto 30th June, 2011)	5,000
	15,000

(3) Amount payable to Equity Shareholders

Equity Share Capital	5,10,000
Less: Surplus available for Equity Shareholders	50,000
Loss to be borne by them	4,60,000
Loss per Equity share (₹ 4,60,000/8,000)	57.50
Amount payable to Equity shareholders :	
Each Equity share of ₹ 75 paid up	17.50
Each Equity share of ₹ 60 paid up	2.50

Illustration 7:

The following was the Balance Sheet of X Limited as on 31.3.2011:

Balance Sheet of X Limited as at 313.2011

Liabilities	₹	Assets	₹
Share Capital		Fixed Assets	
14%, 40,000 preference shares of		Land	40,000
₹ 100 each fully paid up	4,00,000	Buildings	1,60,000
8,000 equity shares of ₹ 100 each,		Plant and Machinery	5,40,000
₹ 60 per share paid up	4,80,000	Patents	40,000
Reserves and Surplus	NIL	Investments	NIL
Secured Loans		Current assets, loans and advances	
1. 14% debentures	2,30,000	A. Current Assets	
(Having a floating charge		Stock at cost	1,00,000
on all assets)		Sundry debtors	2,30,000
Interest accrued on above		Cash at bank	60,000
debentures	32,200	B. Loans and Advances	NIL
(Also having a floating		Miscellaneous expenses	
charge as above)		Profit and Loss A/c	2,40,000

2. Loan on mortgage of land and building	1,50,000		
Unsecured Loan	NIL		
Current Liabilities and provisions			
3. Current liabilities			
Sundry creditors	1,17,800		
	14,10,000		14,10,000

On 31.3.2011 the company went into voluntary liquidation. The dividend on 14% preference shares was in arrears for one year. Sundry creditors include preferential creditors amounting to ` 30,000.

The assets realised the following sums

Land ₹ 80,000; Buildings ₹ 2,00,000; Plant and machinery ₹ 5,00,000; Patent ₹ 50,000; Stock ₹ 1,60,000; Sundry debtors ₹ 2,00,000.

The expenses of liquidation amounted to ₹ 29,434. The liquidator is entitled to a commission of 2% on all assets realised (except cash at bank) and 2% on amounts among unsecured creditors other than preferential creditors. All paymnts the on 30th June, 2011. Interest on mortgage loan shall be ignored at the time of payment.

Prepare the liquidator's final statement of account.

Solution:

X Ltd.

Liquidator's Final Statement of Account

Receipts	**Value Realised** ₹	**Payments**		**Payment** ₹
Assets Realised :				
Cash at Bank	60,000	Liquidator's Remuneration (W.N. 1)		25,556
Sundry Debtors	2,00,000	Liquidation Expenses		29,434
Stock	1,60,000	Debentureholders :		
Plant and Machinery	5,00,000	14% Debentures	2,30,000	
Patents	50,000	Interest Accrued (W.N. 2)	40,250	2,70,250
Surplus from Securities (W.N. 3)	1,30,000	Creditors : Preferential	30,000	
		Unsecured	87,800	1,17,800
		Preference Shareholders :		
		Preference Share Capital	4,00,000	
		Arrears of Dividend	56,000	4,56,000
		Equity Shareholders (W.N.4) :		
		₹ 25.12 per share on 8,000 shares		2,00,960
	11,00,000			11,00,000

Working Notes : ₹

1. **Liquidator's remuneration :**

	₹
2% on assets realised (2% of ₹ 11,90,000)	23,800
2% on payments to unsecured creditors (2% on ₹ 87,800)	1,756
	25,556

2. Interest accrued on 14% Debentures :

Interest accrued as on 31.3.2011	32,200
Interest accrued upto the date of payment i.e. 30.6.2011	8,050
	40,250

3. Surplus from Securities :

Amount realised from Land and Buildings (₹ 80,000 + ₹ 2,00,000)	2,80,000
Less : Mortgage Loan	1,50,000
	1,30,000

4. Amount payable to Equity Shareholders :

Equity share capital (paid up)	4,80,000
Less : Amount available for equity shareholders	2,00,960
Loss to be born by equity shareholders	2,79,040
Loss per equity share (₹ 2,79,040/8,000)	34.88
Amount payable to equity shareholders for each equity share (60-34.88)	25.12

Notes : (1) Commission due to the liquidator has been calculated on the total realisation on the supposition that the securities (land and buildings) are realised by the liquidator on behalf of the lender.

(2) Preference shares have been taken as cumulative.

Illustration 8:

The position of Valueless Ltd. on its liquidation is as under:

Issued and paid up Capital:

3,000 11% preference shares of ₹ 100 each fully paid.

3,000 Equity shares of ₹ 100 each fully paid.

1,000 Equity shares of ₹ 50 each ₹ 30 per share paid.

Calls in Arrears are ₹ 10,000 and Calls received in Advance ₹ 5,000. Preference Dividends are in arrears for one year. Amount left with the liquidator after discharging all liabilities is ₹ 4,13,000. Articles of Association of the company provide for payment of preference dividend arrears in priority to return of equity capital. You are required to prepare the Liquidators final statement of account.

Solution

Liquidators' Final Statement of Account

Receipts	₹	**Payments**	₹
Cash	4,13,000	Return to contributors:	
Realisation from: Calls in arrears	10,000	Preference dividend Preference shareholders	33,000 3,00,000
Final call of ₹ 5 per equity share of ₹ 50 each (₹ 5 × 1,000)		Calls in advance	5,000
	5,000	Equity shareholders of ₹ 100 each (3,000 × ₹ 30)	90,000
	4,28,000		4,28,000

Working Note:

		₹
Cash account balance		4,13,000
Less: Payment for dividend	33,000	
Preference shareholders	3,00,000	
Calls in advance	5,000	3,38,000
		75,000
Add: Calls in arrears		10,000
		85,000
Add: Amount to be received from equity shareholders of ₹ 50 each (1,000 × 20)		20,000
Amount disposable		1,05,000

Number of equivalent equity shares:

3,000 shares of ₹ 100 each = 6,000 shares of ₹ 50 each

1,000 shares of ₹ 50 each = 1,000 shares of ₹ 50 each

= 7,000 shares of ₹ 50 each

$$\text{Final payment to equity shareholders} = \frac{\text{Amount left for distribuion}}{\text{Total Number of equivalent equity shares}}$$

= ₹ 1,05,000 / 7,000 shares = ₹ 15 per share to equity shareholders of ₹ 50 each.

Therefore for equity shareholders of ₹ 100 each $\left(₹ 15 \times \frac{100}{50}\right)$

= ₹ 30 per share to equity shareholders of ₹ 100 each.

Calls in advance must be paid first, so as to pay the shareholders on prorata basis. Equity shareholders of ₹ 50 each have to pay ₹ 20 and receive ₹ 15 each. As a result, they are required to pay net ₹ 5 per share.

Illustration 9:

The following particulars relate to a Limited Company which has gone into voluntary liquidation. You are required to prepare the Liquidator's Statement of Account allowing for his remuneration @ 2½% on all assets realized excluding call money received and 2% on the amount paid to unsecured creditors including preferential creditors.

Share capital issued:

10,000 Preference shares of ₹100 each fully paid up.

50,000 Equity shares of ₹ 10 each fully paid up.

30,000 Equity shares of ₹ 10 each, ₹ 8 paid up.

Assets realized ₹ 20,00,000 excluding the amount realized by sale of securities held by partly secured creditors.

	₹
Preferential creditors	50,000
Unsecured creditors	18,00,000
Partly secured creditors (Assets realized ₹ 3,20,000)	3,50,000
Debentureholders having floating charge on all assets of the company	6,00,000
Expenses of liquidation	10,000

A call of ₹ 2 per share on the partly paid equity shares was duly received except in case of one shareholder owning 1,000 shares.

Also calculate the percentage of amount paid to the unsecured creditors to the total unsecured creditors.

Solution:

(a) (i) Liquidator's Final Statement of Account

		₹				₹
To	Assets Realised	20,00,000	By	Liquidator's remuneration		
To	Receipt of call money on 29,000 equity shares @ 2 per share	58,000		2.5% on 23,20,000 2% on 50,000 2% on 13,12,745 (W.N.3)	58,000 1,000 26,255	85,255
			By	Liquidation Expenses		10,000
			By	Debenture holders having a floating charge on all assets		6,00,000
			By	Preferential creditors		50,000
			By	Unsecured creditors		13,12,745
		20,58,000				20,58,000

(ii) Percentage of amount paid to unsecured creditors to total unsecured creditors

$$= \frac{13,12,745}{2,00,00,000} \times 100 = 65.64\%$$

Working Notes:

1. Unsecured portion in partly secured creditors = ₹ 3,50,000 - ₹ 3,20,000
   = ₹ 30,000
2. Total unsecured creditors = 18,00,000 + 30,000 (W.N.1)
   = ₹ 18,30,000
3. Liquidator's remuneration on payment to unsecured creditors

   Cash available for unsecured creditors after all payments including payment to preferential creditors & liquidator's remuneration on it = ₹ 13,39,000

   Liquidator's remuneration on unsecured creditors = $\frac{2}{102} \times 13,39,000 = 26,255$

   or on ₹ 13,12,754 x 2/100 = ₹ 26,255

Illustration 10:

The following is the Balance Sheet of "Forum Ltd". as on 30.09.2012:(Amount in ₹)

Liabilities	₹	**Assets**	₹
Share Capital:		Land and Building	1,20,000
11% Preference Shares of ₹ 10 each	1,00,000	Sundry Current Assets	3,95,000
10,000 Equity Shares of ₹10 each, fully paid	1,00,000	Profit & Loss Account	38,500
5,000 Equity Shares of ₹ 10 each, ₹ 7.50 paid	37,500	Debenture Issue expenses not written off	2,000
13% Debentures	1,50,000		
Mortgage Loan	80,000		
Bank Overdraft	30,000		
Creditors for Trade	32,000		

Liabilities	₹	**Assets**	₹
Arrears of Income tax (Assessments concluded in July 2004)			
Assessment Year 2010-2011 - 21,000			
Assessment Year 2011-2012 - 5,000	26,000		
Total	**5,55,500**	**Total**	**5,55,500**

Other Information

- Mortgage Loan was secured against Land and Buildings. Debentures were secured by a Floating Charge on all the other assets.
- The Company was unable to meet the payments and therefore the Debenture holders appointed a Receiver and this was followed by a resolution for Members Voluntary Winding Up.
- The Receiver for the Debenture holders brought the Land and Buildings to auction and realized ₹ 1,50,000. He also took charge of Sundry Assets of the value of ₹ 2,40,000 and realized ₹ 2,00,000.
- The Liquidator realized ₹ 1,00,000 on the sale of the balance of Sundry Current Assets.
- The Bank Overdraft was secured by a personal guarantee of two of the Directors of the Company and on the Bank raising a demand, the Directors paid off the dues from their personal resources.
- Costs incurred by the Receiver were ₹ 2,000 and by the Liquidator ₹ 2,800.
- The Receiver was not entitled to any remuneration but the Liquidator was to receive 3% Fee on the value of assets realized by him.
- Preference Shareholders had not been paid dividend for the period after 30.9.2010 and interest for the last half-year was due to Debenture holders.

From the above information, prepare the Liquidator's Receipts and Payments Account.

Solution:

Determination of Surplus received by Liquidator from Receiver

Receipts	₹	**Payments**	₹
Land and Buildings	1,50,000	Debenture Interest (1,50,000 x 13% x 6/12)	9,750
Sundry Current Assets	2,00,000	Income Tax Arrears (21,000 + 5,000)	26,000
		Expenses of Receiver Given	2,000
		Mortgage Loan Given	80,000
		Debenture holders Principal Amount	1,50,000
		Balance Surplus handed over to Liquidator (b/f)	82,250
Total	**3,50,000**		**3,50,000**

Liquidator's Receipts & Payments Account

Receipts	₹	**Payments**		₹
Surplus received from Receiver **(WN 1)**	82,250	Remuneration to Liquidator (1,00,000 x 3%)		3,000
		Cost of Liquidation		2,800
Sundry Assets realized	1,00,000	**Unsecured Creditors:**		
Calls on Contributories:		Trade Creditors	32,000	
From 5,000 Partly Paid Shares at ₹ 2.17 per share **(See WN 3 below)**	10,850	Directors (for Bank Overdraft paid)	30,000	62,000
		Preference Shareholders:		
		Share Capital	1,00,000	
		Arrears of Dividend (2 yrs)	22,000	1,22,000
		Equity Shareholders' Final Payment:		
		Return of money to holders of 10,000 Fully Paid Shares at ₹ 0.33 each		**3,300**
Total	**1,93,100**	**Total**		**1,93,100**

Calls from Holders of Partly Paid Shares

Particulars		₹
a.	Total of Receipts before considering Call Money (82,250 + 1,00,000)	**1,82,250**
b.	Total Payments before final payment to Equity Shares (2,800 + 3,000 + 62,000 + 1,22,000)	**1,89,800**
c.	Deficit from above from Calls made on Equity Shares (**a-b**)	(7,550)
d.	Notional Call on 5,000 Partly Paid Shares at ₹ 2.50 each	12,500
e.	Surplus Cash Balance after Notional Call (comparing c and d)	**4,950**
f.	Number of Shares deemed fully paid (10,000 + 5,000)	15,000
g.	Hence, Refund on Fully Paid Shares ₹ 4,950 / 15,000 Shares (e ÷ f)	33 paise
h.	Therefore, **Required Call on Partly Paid Shares** (2.50 – 0.33)	₹ **2.17**

Illustration 11:

The Balance Sheet of "Forum" Limited as on 31.03.2012 was as under

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
1,000, 6% Preference Shares of ₹100 each, fully paid	1,00,000	Machinery	1,90,000
2,000 Equity shares of ₹100 each, fully paid	2,00,000	Furniture	10,000
2,000 Equity shares of ₹100 each, ₹75 paid	1,50,000	Current Assets:	
Bank loan - (Secured on Stocks)	1,00,000	Stock	1,20,000
Current Liabilities and Provisions:		Debtors	2,40,000
Creditors	3,50,000	Cash at Bank	50,000
Income tax Payable	10,000	Profit and Loss Account	3,00,000
Total	9,10,000	Total	9,10,000

The Company went into liquidation on 01.04.2012. The assets realized as follows (a) Machinery ₹ 1,66,600; (b) Furniture `8,000; (c) Stocks ₹ 1,10,000 and (d) Debtors ₹ 2,30,000.

Liquidation Expenses amounted to ₹ 4,000. The Liquidators are entitled to a Commission at 2% on amount paid to Unsecured Creditors. Calls on Partly Paid Shares were made and received except the amount due on 200 shares was found to be irrecoverable.

Prepare Liquidator's Statement of Account.

Solution: Liquidators' Final Statement of Account

Receipts		₹	Payments	₹
Cash at Bank		50,000	Liquidator's Commission at 2%on 3,50,000	7,000
Realisation of Assets:			Liquidator's Expenses – given	4,000
Machinery		1,66,000	Preferential Creditors: Income Tax Paid	10,000
Furniture		8,000	Unsecured Creditors	3,50,000
Stock	1,10,000		Unsecured Creditors	1,00,000
Less: Bank Loan setoff	1,00,000	10,000	Preferential Shareholders:	20,000
Debtors		2,30,000	1,000 6% Pref. Shares ₹ 100 fully paid.	
Call Money on 1,800 Equity Shares at ₹ 15 per share (WN 2)		27,000	By Final payment to Equity Shareholders:	
			2,000 Equity Shares of ₹ 100 each fully paid up at ₹ 10 per share	
Total		**4,91,000**		**4,91,000**

Note: Call Money due on 200 shares was found irrecoverable. Hence, Call Money from 1,800 Equity Shares only has been shown on Receipts side. Fully paid Shareholders have been refunded at ` 10 per share.

Calls from Holders of Partly Paid Shares

Particulars	₹
a. Total of Receipts before considering Call Money (from the above account)	4,64,000
b. Total Payments before final payment to Equity Shares (from the above account)	4,71,000
c. Deficit from above before Calls made on Equity Shares (a-b)	(-) 7,000
d. Notional Call on 1,800 Partly Paid Shares at ₹ 25 each (2,000 Shares – 200 Irrecoverable)	45,000
e. Surplus Cash Balance after Notional Call (comparing c and d)	38,000
f. Number of Shares deemed fully paid (2,000 + 1,800)	3,800
g. Hence, Refund on Fully Paid Shares (e ÷ f)	₹ 10
h. Therefore, Required Call on Partly Paid Shares (` 25 Notional Call – ₹ 10 Loss)	₹ 15

Illustration 12. The position of a Company on its liquidation is as under:

1. Issued and Paid Up Capital:

   2,000 11% Preference shares of ₹ 100 each fully paid.

   2,000 Equity shares of ₹ 100 each fully paid.

   1,500 Equity shares of ₹ 50 each ₹ 30 per share paid.

2. Calls in arrears are ₹ 5,000 whereas Calls received in advance is ₹ 4,000
3. Preference dividends are in arrears for one year.
4. Amount left with the liquidator after discharging all liabilities is ₹ 3,01,000.
5. The Company's Articles provide for payment of arrear Preference Dividends in priority to return of Equity Capital.

You are required to prepare the Liquidator's Final Statement of Accounts, with the above information

Solution: **Liquidators' Final Statement of Account**

Receipts	₹	Payments	₹
Cash in hand - given	3,01,000	Calls in Advance refund – given	4,000
Calls in Arrears - given	5,000	Arrears of Preference Dividend at 11% on 2,00,000	22,000
		Preference Share Capital	2,00,000
		Equity Shares Capital – on 2,000 fully paid up Shares at ₹ 40 (**See WN 2**)	80,000
Total	**3,06,000**		**3,06,000**

Calculation of Deficiency Percentage for final payment purposes

Particulars		₹
a.	Total of Receipts before considering Call Money (from the above account)	3,06,000
b.	Total Payments before final payment to Equity Shares (from the above account)	2,26,000
c.	Surplus from above before Calls made on Equity Shares (a-b)	80,000
d.	Notional Call on 1,500 Partly Paid Shares at ₹ 20 each (₹ 50 Face Value – ₹ 30 paid up)	30,000
e.	Surplus Cash Balance after Notional Call (comparing c and d)	1,10,000
f.	Total Amount of Equity Shares Capital, after Notional Call [(2,000x100)+(1,500X50)]	2,75,000
g.	Percentage of Payment possible to Equity Shareholders (Amt Available ÷ Total Amt)	40%
h.	Hence, Deficiency Percentage	60%
i.	Deficiency per ₹ 100 Paid Up Share = ₹ 60; Deficiency per ₹ 50 Paid Up Share = ₹ 30	60 : 30
j.	Amount refundable for ₹ 100 paid up share = Paid Up Value ₹ 100 – Deficiency ₹ 60	₹ 40

Call Adjustments:

- Calls in advance is to be refunded since the loss on Partly Paid Up Share is just ₹ 30, the amount paid up.
- Calls in arrears ₹ 5,000 is to be collected.

Illustration 13: "Jyoti" Ltd. went into voluntary liquidation on 31.12.2010 when their Balance Sheet read as follows:

Liabilities	**Amount**	**Assets**	**Amount**
Issued and Subscribed Capital:		Land and Building	2,50,000
5,000, 10% Cum. Pref. Shares of ₹ 100 each fully paid	5,00,000	Machinery and Plant	6,25,000
2,500 Equity Shares of ₹ 100 each, ₹ 75 paid	1,87,500	Patents	1,00,000
7,500 Equity Shares of ₹ 100 each, ₹ 60 paid	4,50,000	Stocks	1,37,500
15% Debentures secured by Floating Charge	2,50,000	Sundry Debtors	2,75,000
Interest outstanding on Debentures	37,500	Cash at bank	75,000
Creditors	3,18,750	Profit and loss A/c	2,81,250
Total	**17,43,750**	**Total**	**17,43,750**

Preference Dividends were in arrears for 2 years and the Creditors included Preferential Creditors of ₹ 38,000.

The assets realized as follows (a) Land and Building ₹ 3,00,000; (b) Machinery and Plant ₹ 5,00,000; (c) Patents ₹ 75,000; (d) Stock ₹ 1,50,000 and (e) Sundry Debtors ₹ 2,00,000.

Liquidation expenses were ₹ 27,250. Liquidator is entitled to commission of 3% on assets realized except cash.

Assuming the final payments including those on debentures were made on 30.06.2011, show the Liquidator's Final Statement of Account.

Solution:

Liquidator's Final Statement of Account

Receipts	**Amount**	**Amount**	**Receipts**	**Amount**
Assets realized:			Liquidator's Remn. (1225000X3%)	36,750
Bank	3,00,000	75,000	Liquidation Expenses	27,250
Other Assets	5,00,000	12,25,000	Debentureholders	2,50,000
Land & Building	75,000	19,875	Debentures	37,500
Machinery & Plant	1,50,000		Interest accrued as per B/Sheet	
Patents	2,00,000		Interest from 01.01.11-30.06.11	18,750
Stock			Preferential Creditors (given)	38,000
Sundry Debtors			Unsecured Creditors (Bal. Crs.)	2,80,750
Call on Equity Shares			Preference Shareholders	
(7,500 x ₹ 2.65)			Preference Capital 5,00,000	
			Arrears of Dividend 1,00,000	6,00,000
			Equity Share Holders	
			₹ 12.35 each on 2,500 shares	30,875
Total		**13,19,875**	**Total**	**13,19,875**

Calls from Holders of Partly Paid Shares

Particulars		₹
a.	Total of Receipts before considering Call Money (from the above account)	13,00,000
b.	Total Payments before final payment to Equity Shares (from the above account)	12,89,000
c.	Surplus from above before Calls made on Equity Shares (a-b)	11,000
d.	Notional Call on 7,500 Partly Paid Shares at ₹ 15 each	1,12,500
e.	Surplus Cash balance after Notional Call (comparing c and d	1,23,500
f.	Number of Shares deemed paid at ₹ 75 per share (2,500 + 7,500)	10,000
g.	Hence, Refund on Fully Paid Shares (e ÷ f)	12.35
h.	Therefore, Required Call on Partly Paid Shares (₹ 15 National Call – ₹ 12.35Loss)	₹ 2.65

Illustration 14:

Super Ltd. was placed in voluntary liquidation on 31.12.2010, when its Balance Sheet was as follows:

Liabilities	**Amount** (₹)	**Assets**	**Amount**(₹)
Issued Share capital		Freehold Factory	5,80,000
50,000 Equity Shares of ₹10 each fully paid		Plant and Machinery	2,89,000
Less Calls in Arrear amounting to ₹ 25,000	4,75,000		
6,000 5% Cum. Preference Shares of ₹ 100 each fully paid	6,00,000	Motor Vehicles	57,500
Securities Premium account	50,000	Stock	1,86,000
5% Debentures Account	1,00,000	Debtors	74,000
Interest on Debentures	2,500	Profit and Loss A/c	2,14,000
Bank Overdraft	58,000		
Creditors	1,15,000		
Total	**14,00,500**	**Total**	**14,00,500**

Preference Dividends are in arrears from 2007 onwards.

The Company's Articles provide that on liquidation, out of the surplus assets remaining after payment of liquidation costs and outside liabilities, there shall be paid firstly all arrears of Preference Dividend, secondly the amount paid up on the Preference shares together with a premium thereon of ₹10 per share, and thirdly and balance the remaining shall be paid to the Equity Shareholders.

The Bank Overdraft was guaranteed by the Directors who were called upon by the Bank to discharge their liability under the guarantee. The Directors paid the amount to the Bank.

The Liquidator realized the assets as follows

Assets	Amount(₹)
Freehold Property	7,00,000
Plant and Machinery	2,40,000
Motor Vehicles	59,000
Stock	1,50,000
Debtors	60,000
Calls in Arrears	25,000

Creditors were paid less discount of 5%. The Debenture and Accrued Interest were repaid on 31.03.2011.

Liquidation Costs were ₹ 3,820 and the Liquidator's remuneration was 2 % on the amounts realized.

Prepare the Liquidator's Statement of account.

Solution

Liquidator's Final Statement of Account for the period ending 31.03.2011

Receipts	**Amount (₹)**	**Payments**	**Amount (₹)**	**Amount (₹)**
Assets realized		— Liquidators Remuneration (12,34,000×2%)		24,680
— Debtors	60,000	— Liquidator's Costs	1,00,000	3,820
— Calls in arrears	25,000	— Debentureholders having a floating		
— Stock	1,50,000	charge:		
— Freehold Property	7,00,000	Principal		1,03,750
—Plant and Machinery	2,40,000	Interest upto 31.03.2011 (2,500+1,250)	3,750	
— Motor Vehicles	59,000	— Unsecured Creditors	58,000	
		Bank OD- reimbursement to Directors		1,67,250
		Others (1,15,000 less 5% discount)	1,09,250	
		— Preference Shareholders	6,60,000	
		Share Capital+10% Premium on Redemption		7,80,000
		Arrears of Dividend (6,00,000×5%×4 yrs)	1,20,000	
		— Equity Shareholders (balancing figure)		
		(50,000 Equity Shares at ₹ 3.09 per share)		1,54,500
Total	**12,34,000**	**Total**		**12,34,000**

Illustration 15:

The following was the Balance Sheet of "Geometry" Limited as on 31.03.2011

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
14%, 4,000 Pref. Shares of ₹100 fully paid up	4,00,000	Land	40,000
8,000 Equity Shares of ₹ 100, ₹ 60 paid up	4,80,000	Buildings	1,60,000
Secured Loans		Plant and Machinery	5,40,000
14% Debentures (Floating Charge on all assets)	2,30,000	Patents	40,000
Interest accrued on above Debentures	32,200	Current Assets	
(also having a floating charge as above)		Stock at Cost	1,00,000
Loan on mortgage of land and building	1,50,000	Sundry Debtors	2,30,000
Current Liabilities and Provisions		Cash at Bank	60,000
Sundry Creditors	1,17,800	Profit and Loss A/c	2,40,000
Total	**14,10,000**	**Total**	**14,10,000**

On 31.03.2011, the Company went into voluntary liquidation. Dividend on 14% Preference Shares was in arrears for one year. Sundry Creditors include Preferential Creditors amounting to ₹ 30,000.

The assets realized the following sums Land ₹ 80,000; Buildings ₹ 2,00,000; Plant & Machinery ₹ 5,00,000; Patent ₹ 50,000; Stock ₹ 1,60,000; Sundry Debtors ₹ 2,00,000.

The expenses of liquidation amounted to ₹ 29,434. The Liquidator is entitled to a commission of 2% on all assets realized (except Cash at Bank) and 2% on amounts distributed among Unsecured Creditors other than Preferential Creditors. All payments were made on 30.06.2011. Interest on Mortgage Loan shall be ignored at the time of payment. From the above, prepare the Liquidator's Final Statement of Account.

Solution

Liquidator's Final Statement of Account

Receipts	Amount (₹)	Amount (₹)	Payments	Amount (₹)
Assets Realised:			— Liquidator's Remuneration	
— Cash at Bank	2,00,000	60,000	[2% on (9,10,000+2,80,000)]=23,800	25,556
— Sundry Debtors	1,60,000	9,10,000	[2% on 87,800 shown below]=1,756	
— Stock	5,00,000	1,30,000	— Liquidation Expenses (given)	29,434
— Plant & Machinery	50,000		— Debentureholders:	2,30,000
— Patents	80,000		14% Debentures	32,200
Surplus from Securities:	2,00,000		Interest accrued as per B/S	8,050
— Sale of Land	2,80,000		Interest at 14% from 1.4.11—30.6.11	
— Sale of Buildings	1,50,000		— Preferential Creditors (given)	30,000
Total Amount realized			— Unsecured Creditors (bal Crs.)	87,800
Less: Mortgage Loan			— Preference Shareholders:	4,00,000
			Preference Share Capital	56,000
			Arrears of Dividend at 14% for 1 year	
			— Equity Shareholders(bal fig)	
			On 8,000 shares @₹ 25.12 per share	2,00,960
Total		**11,00,000**	**Total**	**11,00,000**

Illustration 16: The following is the Balance Sheet of "Moon" Ltd. as at 31.3.2011:

Liabilities	₹	Assets	₹
Share Capital :		Fixed Assets:	
2,000 Equity Shares of ₹ 100, ₹ 75 paid up	1,50,000	Land & Buildings	4,00,000
6,000 Equity Shares of ₹ 100, ₹ 60 paid up	3,60,000	Plant & Machineries	3,80,000
2,000 10% Pref. Share of ₹ 100, fully paid up	2,00,000	Current Assets:	
10% Debentures (floating Charge on all assets)	2,00,000	Stock at Cost	1,10,000
Int. accrued on Deb. (also secured as above)	10,000	Sundry Debtors	2,20,000
Sundry Creditors	4,90,000	Cash at Bank	60,000
		Profit and Loss A/c	2,40,000
Total	**14,10,000**	**Total**	**14,10,000**

On that date, the Company went into Voluntary Liquidation. The dividends on Preference Shares were in arrears for the last two years. Sundry Creditors include a loan of ₹ 90,000 on Mortgage of Land and Buildings. The assets realized were as under: (a) Land & Buildings ₹ 3,40,000; (b) Plant & Machinery ₹ 3,60,000; (c) Stock ₹ 1,20,000;and (d) Sundry Debtors ₹ 1,60,000.

Interest accrued on Loan on Mortgage of Buildings upto the date of payment amounted to ₹ 10,000. The expenses of Liquidation amounted to ₹ 4,600. The Liquidator is entitled to a remuneration of 3% on all the assets realized (except cash at bank) and 2% on the amounts distributed among Equity Shareholders. Preferential Creditors included in Sundry Creditors amount ₹ 30,000. All payments were made on 30.06.2011.

Prepare the Liquidator's Final Statement of Account.

Solution:

Liquidator's Final Statement of Account

Receipts	Amount	Amount	Receipts	Amount
Assets realized:			Liquidator's Remn.[3% on(6,40,000 +	
Cash at Bank	1,60,000	60,000	3,40,000)]	29,4000
Sundry Debtors	1,20,000	6,40,000	[2% as computed in WN 4]	1,000
Stock	3,60,000	2,40,000	Liquidation Expenses (given)	4,600
Plant & Machinery	3,40,000		Debentureholders	2,15,000
Surplus from	90,000		10% Debentures 2,00,000	30,000
Securities	10,000		Interest accrued as per B/S 10,000	3,70,000
Land & Buildings			Further Interest **(WN 2)** 5,000	2,40,000
Less: Mortgage Loan			Preferential Creditors (given)	15,000
Less Interest upon date of A/c			Unsecured Creditors **(WN 3)**	35,000
			Preference Shareholders	
			Preference Share Capital 2,00,000	
			Dvd Arrears at 10% for 2 yrs 1,00,000	
			Equity Share Holders **(WN 4)**	
			On 6,000 Shares at ₹ 2.50 per share	
			On 2,000 Shares at ₹17.50 per share	
Total		**9,40,000**	**Total**	**9,40,000**

2. Interest on Debentures: As the Company is solvent, Interest on Debentures should be paid up to the date of final settlement i.e., for the period 01.04.2011 to 30.06.2011 i.e. ₹ 2,00,000 x 10% x 3/12 = 5,000.

3. Balance Unsecured Creditors=Creditors as per B/s – Mortgage Loan – Preferential Creditors
= (4,90,000 – 90,000 – 30,000) = 3,70,000

4. Payment to Equity Shareholders and Liquidators' Remuneration:

Particulars	₹
a. Total of Receipts before considering Call Money (from the above account)	9,40,000
b. Total Payments before final payment to Equity Shares & Liquidators' Remn. at 2% thereon (29,400 + 4,600 + 2,15,000 + 30,000 + 3,70,000 + 2,40,000)	8,89,000
c. Surplus from above before Liquidators' Remuneration & Calls made on Equity Shares (a-b)	51,000
d. Liquidators' Remuneration on payment to Equity Share = 2% of amount paid = 2/102 x 51,000	1,000
e. Surplus from above before Calls made on Equity Shares (c-d)	50,000
f. Notional Call on 6,000 Partly Paid Shares at ₹ 15 each (to make all shares ₹ 75 paid up)	90,000
g. Surplus Cash balance after Notional Call (comparing e and f)	1,40,000
h. Number of Shares deemed paid at ₹ 75 per share (2,000 + 6,000)	8,000
i. Hence, Refund on every ₹ 75 paid up Share (g ÷ h)	₹ 17.50
j. Loss per ₹ 75 paid up Equity Share = Paid Up Value ₹ 75 – Refund as above ₹ 17.50	₹ 57.50

The final settlement is made in any of the following ways –

(a) Calling ₹ 15 on 6,000 Shares presently ₹ 60 paid up, so as to make all Shares ₹ 75 paid up, and then refunding ₹ 17.50 per share for all 8,000 Shares.

(b) Refunding ₹ 17.50 per Share (₹ 75 – ₹ 57.50 Loss) for 2,000 Shares; and Refunding ₹ 2.50 per Share (₹ 60 – ₹ 57.50 Loss) for the balance 6,000 Shares, without calling the further money from those Shares.

Alternative (b) is adopted in the above presentation.

Section C
Auditing

Study Note - 9

AUDITING CONCEPTS

This Study Note includes

9.1 Evolution of Auditing
9.2 Definitions
9.3 Nature of Auditing
9.4 Scope of Auditing
9.5 Comparison between Book Keeping, Accounting and Auditing
9.6 Relationship and Distinction Between Auditing and Accounting
9.7 Auditor
9.8 Audit and Investigation
9.9 Aspects to be Covered in Audit
9.10 Objectives of Auditing
9.11 Basic Principles Governing an Audit
9.12 Significance of Audit
9.13 Advantages of Audit
9.14 Inherent Limitations of an Audit
9.15 Auditor's Engagement
9.16 Functional Classification of Audit - External Audit and Internal Audit
9.17 Types of Audit
9.18 Audit Evidence
9.19 Concept of True and Fair
9.20 Concept of "Materiality" in Planning and Performing the Audit
9.21 Contemporary Issues in Auditor's Independence — Issues, Tools, Institutions (Basic Knowledge)
9.22 Disclosure of Accounting Policies

9.1 EVOLUTION OF AUDITING

In the early days of commerce and business there was no existence of the concept of auditing. This was, may be due to the small nature of business and day to day personal control of the proprietor.

Audit can be traced back in the period 3600-3200 B.C. Initially, the audit was mainly done that of public accounts only. From historical records it appears that the ancient Egyptians, Greeks and Romans were used to the government accounts audit.

The accounts of the corporation of the city of London were audited in 12th Century. Later in Shakespeare's "Timon of Athens" the steward Flavins makes the remark "If you suspect my husbandry or falsehood, call me before the exactest auditor, and set me on the proof" which indicates the existence of an audit in the 14th century also.

In 1314, auditors were officially appointed to check the public accounts in England.

In 1494, Luca Pacioli, a French celebrated mathematician, brought the concept of Double Entry book-keeping and auditing in practice. Gradually and especially after the Industrial Revolution in the 18th century, the nature, type and size of business organizations changed. The large scale business came into existence causing dilution in the regular and direct control of the proprietor. This made it necessary to get the transactions made by the staff and representatives of owners, checked and verified by an independent person and this has given rise to concept of auditing.

In 1866, the England's Exchequer and Audit Department was created by Act of Parliament. In 1870, The Institute of Accountants in the form of a society was formed in England. It got a Royal Charter in 1880 and was turned into The Institute of Chartered Accountants in England and Wales, but before that in 1854, with a Royal Charter, The Institute of Accountants and Actuaries in Glasgow.

In India, the sophisticated system of accounting and auditing can be found in the reign of Mauryas, Guptas and Moughals too. The first legislation relating to companies in India that is the Joint Stock Companies Act, 1857 introduced the provisions of annual audit but was made optional. Latter, The Companies Act, 1913, made it compulsory. This Act was replaced in 1956 by the Indian Companies Act, 1956, the act and the subsequent amendments not only made the audit compulsory but sought to ensure that only the independent professionals with requisites qualifications are appointed as statutory auditors of Companies. In 1965, the amendment in the Act took place and concept of Cost Audit was introduced, while the amendment in the Income Tax Act, 1961, took place in 1984 introduced the concept of Tax Audit, Sales Tax (VAT), Trust Act, Co-operative Societies Act etc. brought the concept of different audits into practice. Provision for Special Valuation audit section 14A and Section 14AA of Central Excise Act, 1944 regarding valuation and Cenvat respectively introduced in Central Excise Act, 1944 with effect from 26.05.95 and 14.5.97. In addition there is an Audit by the office of Controller and Auditor General of India under CAG, DPC(Act). Again the Companies Act, has been revised as Companies Act, 2013.

A number of technological, economic changes, social events, globalization, liberalization, privatization etc. have influenced auditing to a great extent in the course of development of auditing and caused considerable changes and improvements in the techniques, principles, standards, reporting, professional ethics and responsibilities of auditor.

9.2 DEFINITIONS

The term "audit" has been derived from the Latin words "audire" which means to listen. In those ancient days, the person appointed to check the accounts, used to hear the explanations required from responsible officers and that's why, the person who heard the explanations was called as an "auditor". However, now a days, due to drastic changes in business, accounting systems, size and the provisions of different laws, this "hearing" concept of auditing is considerably changed and become more exhaustive and therefore, different authors have defined "auditing" differently, few of the important definitions are as under—

(i) **Taylor and Perry -** "Audit is defined as an investigation of some statements of figures involving examination of certain evidence, so as to enable an auditor to make a report on the statement.

(ii) **F.R.M De Paula-** "An audit denotes the examination of Balance Sheet and Profit and Loss Account prepared by others together with the books of accounts and vouchers relating there to in such a manner that the auditor may be able to satisfy himself and honestly report that, in his opinion, such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of affairs of the particular concern according to the information and explanations given to him and as shown by the books".

(iii) **Prof. Montgomerly-** "Auditing is a systematic examination of the books and records of business or other organization, in order to ascertain or verify and to report upon the facts regarding its financial operations and the result thereof.

(iv) **M.L.Shandilya-** "Auditing may be defined as inspecting, comparing, checking, reviewing, vouching, ascertaining, scrutinizing, examining and verifying the books of accounts of a business concern with a view to have a correct and true idea of its financial state of affairs.

(v) **Spicer & Pegler-** "Audit such an examination of the books of accounts and vouchers of a business, as will enable the auditor to satisfy himself that the Balance Sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business, and whether the profit and loss account gives a true and fair view of the profit or loss for the financial period according to the best of his information and explanations given to him and as shown by the books, and if not, in what respect he is not satisfied".

(vi) ICAI defines Auditing as- ''A systematic and independent examination of data, statement, records, operation and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognizes the proposition before him for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report''. According to them, ''…auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent independent person''.

(vii) According to SA 200 on- "Basic Principles Governing an Audit:" An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such examination is conducted with a view to expressing an opinion thereon".

In the close scrutiny of the different definitions we found that there are different ways of expressing the concept auditing but having lot of similarity therein.

9.2.1 The meaning of an Audit contains

(i) An intelligent and critical examination of the books of accounts of business.

(ii) It is done by an independent qualified person.

(iii) It is done with the help of vouchers, documents, information and explanations received from the clients.

(iv) The auditor satisfies himself with the authenticity of the financial accounts prepared for a particular period.

(v) The auditor reports that-

(a) The Balance Sheet exhibits a true and fair view of the state of affairs of the concern.

(b) The profit and loss account reveals the true and fair view of the profit or loss for the financial period.

(c) The accounts have been prepared in conformity with the concerned law.

(d) If he is not satisfied then reports in what respect he is not satisfied.

9.2.2 The Essential Features of Auditing

The essential features of auditing can thus be listed as

(i) It involves evaluation of the relevance, reliability and adequacy of evidence in support of verifiable information.

(ii) It is analytical, critical and investigative.

(iii) The information audited may be financial or non-financial.

(iv) There should be standards or criteria for evaluation of the information.

(v) The auditor should be competent and independent.

(vi) It ensures reliability of information and authenticity of assertions made in the financial statements relating to enterprises, whether profit-oriented or not and whether it is required by law or not, to enable the auditor to form his opinion on these statements with regard to true and fair view disclosed there in.

9.3 NATURE OF AUDITING

Auditing has generally been associated with only accounting and financial records. Thus, IAASB defines the term 'audit' as follows: "The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework". Similarly, Mautz defines auditing as being "concerned with the verification of accounting data, with determining the accuracy and reliability of accounting statements and reports." The emphasis is clearly on verification of accounting data with a view to reporting on the reliability of the accounting statements. Verification of accounting data involves a careful evaluation of evidence available to the auditor in support of various transactions. Thus, an auditor examines internal evidence, i .e., the records, vouchers and books of account. To assess the quality of the internal evidence, he also tests and evaluates the relevant systems in the organization. He also obtains external evidence such as confirmation of bank balances. In some cases, he may decide to conduct physical counts and surveys or even call for independent expert opinion regarding technical matters.

Developments in the last few decades have extended the scope of auditing. Auditing today is no longer concerned only with financial accounting records; it may also involve a review of compliance with law, costing records, operations and performances. Therefore, a more comprehensive definition is required to describe modern auditing. ICAI has defined auditing as "a systematic and independent examination of data , statements, records , operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report. "This definition does not confine auditing to accounting records. It recognizes that auditing can extend to such areas as managerial performances, cost data and operations.

Another good description of auditing is given by Arens, Elder and Beasley. According to them, "auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent independent person." This definition emphasises the following points.

(i) The information under audit need not necessarily be accounting information. However, information must be in a verifiable form.

(ii) There should be standards or criteria for evaluation of the information.

(iii) The auditor should not only be a competent person but he should also have an independent mental attitude.

It is thus clear that auditing involves evaluating the relevance, reliability and adequacy of evidence in support of verifiable information. It is not a process of mechanical comparison of items in the financial statements with the entries in the books of account. Nor does it involve a mere mechanical ticking of entries in the books of account with the vouchers or other records. It is a process of collection and critical evaluation of evidence. It is "analytical; it is critical, investigative. Thus, auditing has its principal roots, not in accounting which it reviews, but in logic on which it leans heavily for ideas and methods."

An auditor collects and evaluates evidence in order to make a report. The audit report is the end product of auditing. The extent to which an auditor should conduct his examination or the precise audit steps that he should adopt in an auditing situation depends on the circumstances of each case. Unfortunately, many beginners in the profession adopt a mechanical attitude in framing audit programmes. They think that the audit steps listed in textbooks for a particular category of transactions are valid in all auditing situations. For example, if cash receipts have to be checked, the steps mentioned in textbooks are considered adequate and appropriate, irrespective of whether one is auditing the accounts of a club or those of a college, or of a dairy with milk booths at various places. It is often not realised that the audit steps mentioned in textbooks are merely illustrative in character. Therefore, one has to first grasp the concepts of auditing and then apply them to a particular situation.

9.4 SCOPE OF AUDITING

Development in the last two decades have extended the scope of auditing. Therefore, a more comprehensive definition of auditing given by Schlosser may also be considered. According to him, auditing is a "systematic examination of financial statements, records and related operation to determine adherence to generally accepted accounting principles, management policies of stated requirements". The earlier definition of auditing by Mautz emphasizes the verification of accounting statements. While retaining that emphasis, Scholsser's definition extends the scope of auditing by including in it an examination of allied operations. Similarly the purpose of auditing has been extended to examination of allied operations to 'management policies or stated requirements'. This, where as the previous definition mainly covers Mautz independent professional audit, Schlosser's definition also covers cost audit, internal audit, Government audit, management audit, operational audit and the like.

The auditor is not supposed to perform the duties which are beyond the scope of his competence. However he is expected to exercise due diligence and professional care in his work as expected of him. Accounting is concerned with the recording of the transaction and preparation of statements of account but auditing involves a detailed and critical examination of accounts prepared by others. In fact, auditing begins where accounting ends.

Constraints on the scope of the audit of financial statements that impair the auditor's ability to express an unqualified opinion on such financial statement should be set out in the report. Qualified opinion or disclaimer of opinion should be expressed as appropriate.

According to Schlosser, audit now also covers cost audit, management audit, internal audit, energy audit, excise audit, VAT audit and government audit too. Today audit is not confined to the business houses only, but also to non-business organizations. Auditor is in the nature of a watch-dog and a trustee of the nation's finances.

As per SA-200A on "Objectives and Scope of Audit of Financial Statements" the scope of an audit of financial statements will be determined by the auditor having regard to the terms of the engagement, the requirements of relevant legislations and pronouncement of the Institute of Chartered Accountants of India. Of course the terms of engagement cannot restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncement of the institute. The auditor's work involves exercise of judgment for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgments and estimates made by the management in preparing the financial statements. Further more, much of the evidence available to the auditor can enable him to draw only reasonable conclusion therefrom. Because of these factors, absolute certainty in auditing is rarely attainable.

Hence, it becomes quite clear that the scope of audit is widening and there is a change in emphasis in audit objectives too.

9.5 COMPARISON BETWEEN BOOK KEEPING, ACCOUNTING AND AUDITING

9.5.1 Book Keeping is the art of recording a transaction in the books of original entry, such as Journals and Ledgers. This work is mechanical in nature and is usually performed by junior clerks who are sometimes called book keepers. It does not require any specialized knowledge of the principles of accountancy. The work of book-keepers is supervised by the accountant.

Accounting involves the preparation of final accounts to show the results of operations of the business at the end of a particular period. The person responsible for accounting should have specialized knowledge about the principles of accounting, and is called an accountant. His work is not confined to supervising the work of book-keepers, but also to analyze, review and draw conclusions from the final accounts.

Auditing is a careful and critical examination of the books of accounts and the resulting financial statements to determine their accuracy. It is conducted by a person known as the auditor, who is responsible to form an opinion on the truthfulness and fairness of the financial statements (Profit & Loss Account and Balance Sheet) in his audit report.

9.6 RELATIONSHIP AND DISTINCTION BETWEEN AUDITING AND ACCOUNTING

9.6.1 The relationship between accounting and auditing has been explained by Kell and Ziegler in "Modern Auditing" as follows:

Accounting	Auditing
i. Analyze events and transactions	Review client's internal control system
ii. Record and summarize data in accounting records	Obtain and evaluate evidence on statement assertions
iii. Make financial statement assertions	Determine fairness of statements in conformity with recognized accounting principles
iv. Prepare financial statements as per recognized accounting principles	Prepare audit report on finding
v. Distribute Financial statements and Auditor's report to shareholders	Deliver audit report to client

9.6.2 Auditing and accounting are related. Auditing begins where accounting ends, but they are distinct from each other.

The basic distinction between accounting and Auditing is as under:

Accounting	Auditing
i. It is the collection, classification and summarization of data for preparation of books of accounts, and to make financial statements.	Auditing is an analytical and critical examination of books of accounts, financial records and the financial statements prepared thereon.
ii. It is the recording of transactions at the time of occurrence.	It is the post examination of recorded transactions.
iii. It measures the business events in monetary terms, records them, and communicates the financial results through Financial Statements.	Auditing reviews financial records to form an opinion on the authenticity of Financial Statements.
Iv. The primary responsibility is of the management towards the shareholders/ owners, to maintain the Financial records in such a manner that Financial Statements can be prepared from the records.	The auditor is an independent person appointed by the business entity to review the Financial Statements and to give an opinion thereon.
v. An accountant is not expected to review/ report on the Financial Statement but to report the compilation of records to the management.	An auditor is required to submit a report with his opinion on 'true and fair' assertions made in the Financial Statements to the owners.
vi. An accountant works for/ under the management.	The auditor is an independent person answerable/ liable to the owners/ shareholders and not just to the management.
vii. No such liability	In certain circumstances, the auditor could be held liable to third parties also.

viii. Maintenance of accounts may not be mandatory for small individuals or partnership firms, e.g. under section 44AA of the Income Tax Act, but could be mandatory under other laws, e.g. for Companies under the Companies Act.	Audit could be exempt for various individuals or small partnerships, e.g. under section 44AB of the Income Tax Act, and even in case where maintaining books of accounts is a statutory requirement under section 44AA, but may be mandatory under other laws, e.g. for Companies under the Companies Act.

9.7 AUDITOR

The person conducting the audit is known as the auditor. To be an auditor, the person should be professionally qualified. For example, under the Companies Act, 2013, only Chartered Accountants are professionally qualified to conduct the audit of the accounts of the companies.

A successful auditor must possess the following qualities:

(i) An auditor should have a sound knowledge of various disciplines associated with the audit such as accountancy, economics, mathematics etc.

(ii) As per SA-200 on Basic Principles Governing an Audit issued by ICAI, an auditor must possess the integrity and be objective and independent in his approach to the audit work.

(ii) The auditor must have the knowledge of the general principles of the Law governing the auditee enterprise. For example, while auditing a company the knowledge of the Companies Act, 2013 is necessary. If an enterprise is governed by some special statue as in case of Banking Companies, the knowledge of that special statue (Banking Regulation Act in case of Banking Companies) is also imperative.

(iv) An auditor should also have an understanding of the special features which are peculiar to a particular business. SA 300 (Revised) and SA 310 issued by ICAI lay down principles in this regard.

(v) Though technical knowledge is necessary to conduct an audit, only those persons whose technical knowledge is backed by basic human qualities can prove to be successful auditors.

(vi) In the case of London & General Bank, Lord Justice Lindley said that “an auditor must be honest, that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true.

9.8 AUDIT AND INVESTIGATION

It is to be noted that both auditing and investigation have a fact finding character. Both involve a systematic and critical examination of the available evidence, yet these are quiet distinct from each other as follows:

(i) **Meaning -** Auditing is an independent and systematic examination of the evidence underlying the accounting or other data in accordance with the generally accepted auditing practices to ascertain the true and fair view of the financial statements of an enterprise. An investigation may be defined as an examination of accounts and records with a view to ascertain any fact for some special purpose which varies from assignment to assignment.

(ii) **Scope -** The audit has a wide scope. In statutory audit, the scope is determined by the relevant law and in case of a private audit (e.g. management audit) by a client. The scope of investigations, on the other hand, is limited as regards the period or areas to be covered.

(iii) **Objective -** In audit, the accounts and records are verified as to their truth and fairness, whereas, investigation is for special purpose (e.g. investigation on the behalf of incoming partner

(iv) Audit Procedure - The audit is conducted in accordance with the generally accepted auditing procedure but investigations involve an extended auditing procedure.

(v) Evidence - An investigator can draw his conclusions only on the basis of substantial or sometimes conclusive evidence while an auditor will evaluate the accounting records predominantly based on persuasive evidence.

(vi) Approach - Auditor is skeptical and not suspicious whereas an investigator starts with suspicion and collects evidence to either confirm or dispel that suspicion.

(vii) Periodicity - Auditing is a routine exercise (normally conducted annually) but the investigations may spread over a period longer than one year.

9.9 ASPECTS TO BE COVERED IN AUDIT

"The principal aspects to be covered in an audit concerning the final statements of accounts are as follows:

(i) Accounting and Internal Control System - The auditor should obtain an understanding of the accounting and the internal control system operating in the enterprise. Such an understanding will enable the auditor to ascertain the degree to which reliance can be placed on the information obtained during the audit. Further, the auditor should review the system from time to time to ascertain its adequacy and comprehensiveness.

(ii) Examination of books, records etc.- The auditor should check the arithmetical accuracy of the books of accounts as well as the authenticity and the validity of transactions entered into the books of accounts. He should ensure that the entries in the books of accounts are adequately supported by underlying papers, documents and other evidence. Further, none of the entries in the books of accounts has been omitted in the process of compilation and nothing which is not in the books of accounts has found place in the financial statements.

(iii) Compliance with the Generally Accepted Accounting Standards and Applicable Statutory Regulations - The financial statements should be prepared in accordance with the requirements of applicable laws and should comply with the relevant accounting standards, guidance notes issued by ICAI etc. For example, a proper distinction should be made between the items of capital and revenue nature, in case a company declares dividend it should comply with the requirements of the Companies Act and the relevant Rules.

(iv) Reporting - Once the audit is carried out, the audit findings need be communicated to the appropriate personal body (e.g. shareholders in case of company). An audit report states the opinion of the auditor as to the true and fair view of the financial position and operating results of the enterprise.

9.10 OBJECTIVES OF AUDITING

While discussing the nature of auditing, we have seen that the propositions which an auditor is called upon to review vary. In one situation, the auditor may review the financial statements of an enterprise to express an opinion as to whether or not they reflect a true and fair view of its state of affairs and working results. This kind of audit is generally known as independent financial audit. In another case, the auditor may be called upon to review the operations of an enterprise to evaluate their cost-effectiveness (as in the case of internal or operations audit). In yet another type of audit, the auditor may verify whether the taxable income has been properly computed or not (tax audit). Similarly, an auditor may be called upon to express an opinion on cost statements (cost audit). These examples can be multiplied. Depending on the nature of propositions which an auditor is called upon to review, the objectives of auditing also vary.

According to SA 200 Overall Objective of the Independent Auditor and the Conduct of an audit in accordance with SAs, ''in conducting an audit of financial statements, the overall objectives of the auditor are:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

(b) To report on the financial statements, and communicates as required by the SAs, in accordance with the auditor's findings''.

An audit is conducted with two main objectives:

i. **Primary Objective:** The main objective of an audit is to determine whether the financial statements presents a ''true & fair view'' of the financial position and financial performance of a business during the period. The Balance Sheet shows the financial position on a particular date (say, the last day of the financial year), and the profit & loss Accounts shows the financial performance of the business over that period (income and expenditure during the whole financial year). Section 143 of the companies Act, 2013 requires the auditor of the company to state if in his opinion the financial statements present ''true and fair view'' of the state of the company's affairs at the end of its financial year, and of the profit and loss for its financial year. Such an opinion by the auditor increases the reliability of the Company's financial statements.

ii. **Secondary Objective:** The auditor is also responsible for detecting frauds and errors in the books of accounts and financial records of the client's business. Such detection of frauds and errors is called the secondary objective of audit because the primary responsibility for safeguarding the business assets rests with the management. If the auditor suspects the presence of material misstatements or defalcations in the records of the business, he is expected to look into the matter with greater detail by applying various audit procedures to satisfy himself about their existence or inexistence. He is also to report on the existence of such misstatement and their magnitude through his audit report.

iii. The auditor evaluates the internal control systems in an organization and brings any deficiencies into the management's notice, so that the management can work on developing better controls in the business through which material misstatements can be prevented. The absence of errors and frauds in the accounting records will ensure that the financial statements reflect a true and fair view of the financial position and performance of the entity.

9.11 BASIC PRINCIPLES GOVERNING AN AUDIT

SA 200 issued by ICAI gives the following basic principles that govern the auditor's responsibilities whenever an audit is carried out:

(i) **Integrity, objectivity and independence:-** The auditor should be straight-forward, honest, sincere and free form any influence on his audit work.

(ii) **Confidentiality:-** He should not disclose the client's information to anybody without the client's permission or under any regulatory requirement.

(iii) **Skills and competence:-** The audit should be performed and audit report be prepared by adequately trained, experienced and competent person.

(iv) **Work performed by others:-** The auditor should carefully supervise the work performed by others (such as his subordinates, other auditors, experts etc.) as remains responsible for the work delegated by him to his assistants, other auditors or experts.

(v) **Documentation:-** Proper working papers should be maintained by the auditor to evidence the audit work.

vi) **Planning:-** The auditor should obtain the knowledge about client's business to determine the nature, timing and the extent of the audit procedures.

vii) **Audit evidence:-** The auditor should obtain sufficient appropriate audit evidence through performing the compliance and substantive procedures.

viii) **Accounting system and internal controls:-** An understanding of the accounting system and the related internal controls help in determining the nature, timing and extent of other audit procedures.

ix) **Audit conclusions and reporting:-** On the basis of conclusions drawn from the audit evidence obtained the auditor should give unqualified report or qualified report or adverse report or the disclaimer report.

9.12 SIGNIFICANCE OF AUDIT

The problem that has always existed when the manager report to owners is the credibility of the report. The report may — (a) contain errors, (b) not disclose frauds, (c) be inadvertently misleading, (d) be deliberately misleading, (e) fail to disclose relevant information, (f) fail to conform to regulations.

The solution to this problem of credibility in reports and accounts lies in appointing an independent person called an auditor to investigate the report and submit his findings.

A further point is that modern companies can be very large with multi-national activities. The preparation of the accounts of such groups is a very complex operation involving the bringing together and summarizing of accounts of subsidiaries with different conventions, legal systems and accounting and control systems. The verification of such accounts by independent experts trained in the assessment of financial information is beneficial to those who control and operate such organizations as well as to owners and outsiders.

Many financial statements must conform to statutory and other requirements. The most notable thing is that all company accounts have to conform to the requirements of the Companies Act. In addition, all accounts should conform to the requirements of accounting standards. It is essential that an audit should be carried out on financial statements to ensure that they conform to these requirements.

The tasks of an auditor are of great importance to all concerned. The auditor must prepare his audit report impartially and effectively based on facts and actual figures. The following significance can be expected from auditing:

9.12.1 From Legal Point of View

(i) **Filing of income tax return** — Income Tax authorities generally accept the profit and loss account that has been prepared by a qualified auditor and they do not go into details of the accounts.

(ii) **Borrowing of money from external sources** — Money can be borrowed easily on the basis of audited balance sheet from the external sources. Most of the financial institution sanctions various loans on the basis of audited financial statements.

(iii) **Statement of insurance claim** — in case of flood, fire, other natural calamities and the like unexpected happenings the insurance company may settle the claim for loss or damages on the basis of audited accounts of the previous year.

(iv) **Sales tax payments** — The audited books of accounts may generally be accepted by the sales tax authorities.

(v) **Action against bankruptcy** — The audited accounts serve as a basis to determine action in bankruptcy and insolvency cases.

9.12.2 From Internal Control Point of View

(i) **Quick discovery of errors and frauds** — Errors and frauds are located at an early date, so that in future no attempt is made to commit such frauds as one is rather careful not to commit an error or a fraud as the accounts are subject to regular audit.

(ii) Moral check on the employees — The auditing of the accounts keeps the accounts clerks and the accountants regular and vigilant as they know that the auditor would complain against them if the accounts are not prepared upto date or if there is any irregularity.

(iii) Advice to the management — It may happen that the management may consult the auditor and seek advice on certain technical points although it is not the duty of the auditor to give advice.

(iv) Uniformity in accounts — If the accounts have been prepared on an uniform basis, accounts of one year can be compared with other years and if there is any discrepancy, the cause may be enquired into.

9.12.3 From External Affairs Point of View

(i) Settlement of accounts — The audited accounts would facilitate the settlement of accounts of a deceased partner.

(ii) Valuation of assets and goodwill — If the business is to be sold as a going concern basis, there may not be much difficulty regarding the valuation of assets and goodwill as the accounts have already been audited by an independent person.

(iii) Future trend of the business — From the audited books of accounts, the future trend of the business can be assessed easily with certainty.

9.13 ADVANTAGES OF AUDIT

The advantages of audit are as follows:

(i) Audit is a tool, which different stakeholders can use to protect their interests in the enterprise.

(ii) Audit is not only a corrective measure but has a deterrent effect. It serves as a moral check on the employees from committing defalcations or embezzlements.

(iii) The employees of the organisation remain alert and vigilant as regards the updating of books of accounts and other records.

(iv) Audited accounts are considered more reliable by different cadres of Government. For example, the tax audit report filed with the Taxation authorities.

(v) It facilitates detection of wastages and losses and helps in instituting corrective actions.

(vi) Audited accounts are taken to be more reliable and useful during corporate restructuring exercises, valuations etc.

(vii) Banks, Financial Institutions and Government require audited accounts before granting any financial assistance to the enterprise..

(viii) Audited accounts are taken to be more helpful in the settlement of accounts between the partners and thus avoiding any dispute amongst them.

9.14 INHERENT LIMITATIONS OF AN AUDIT

There are some inherent limitations of audit:

As per SA 200A on Objective and Scope of Audit, the objective of an audit is to express an opinion as to the true and fair view of the financial statements. The user should not believe that this option is as assurance as to the future viability of the enterprise or the efficiency or effectiveness with which the management has conducted the affairs of the enterprise. Again, the scope of audit is determined by the terms of engagement, requirement of relevant legislation and pronouncements of ICAI. Thus the appointing authority cannot restrict the scope of an audit in relation to those matters which are prescribed by the relevant legislation and the pronouncements of ICAI. While the auditor is responsible for forming and expressing his opinion on the financial statements, the responsibility for their preparation is that of the enterprise. Management's responsibility includes the maintenance of adequate accounting records and internal controls, selection and application of accounting policies and the safeguarding the assets of the enterprise. The audit of financial statements does not relieve the management of its responsibilities. Despite these guidelines issued by the ICAI, it is very important to note the following inherent limitations of audit.

(i) An audit does not guarantee that all the material misstatements will be detected because of the following inherent limitations of audit:

  (a) Test nature of the audit;

  (b) The audit evidence available to the auditor is persuasive rather than conclusive in nature;

  (c) Inherent limitations of internal control, e.g. certain levels of management may be in a position to override controls.

(ii) Professional skepticism — Professional skepticism means an approach that would ensure that if something is wrong it is detected. This behavior of auditor helps him in identifying and evaluating (a) matters that increase the risk of material misstatements resulting from fraud or error, (b) circumstances that make the auditor to suspect material misstatements, (c) the question of management's representations reliability. The auditor is entitled to accept the records and documents as genuine unless there is some evidence to the contrary.

9.15 AUDITOR'S ENGAGEMENT

In case of a statutory audit the objective and scope of an audit is clearly described in the relevant law. However, in a non-statutory audit it has to be stated with absolute clarity so as to avoid any kind of ambiguity as to the objective and scope of audit. A misunderstanding may arise about the exact scope of the work. For example, the client may be under an impression that while the auditor is preparing the accounts, the audit is also being carried out. Therefore, in order to avoid any kind of misunderstanding or dispute it is in the interests of both the auditor as well as the client to exactly define the scope of the engagement and reduce the same in writing by way of audit engagement letter. An auditor's engagement letter signifies the confirmation by the auditor of his acceptance of appointment as auditor, the documentation of the objective and scope of audit or other work, and the extent of his responsibilities to the client and the form of any reports. ICAI has issued SAS 4410, SRS 4400 and SRE 2400 in this regard. Although the form and content of the engagement letter differs from client to client but in general the following references should be made in audit engagement letter:

(i) The objective and the scope of the engagement.

(ii) Management's responsibility for the financial statements.

(iii) The existence of inherent limitations of audit and resulting material misstatements that may remain undiscovered,

(iv) The need for use of services of internal auditors and/ or other experts that may arise during the course of the engagement.

(v) The requirement of management confirmation letter as regards representations made by them concerning audit.

(vi) Restriction of the auditor's liability, if any.

(vii) Basis for computation of audit fees and billing arrangements.

(viii) The form of reports or other communication of results of the engagement.

The importance of audit engagement letter was highlighted in the case of Leech v Stokes. In this case the auditors were instructed to prepare the annual profit and loss account of a firm of solicitors for submission to the tax authorities. The evidence showed that proper books of account were not maintained and though the firm collected large sums by way of rent on behalf of its clients, no proper cash book and client's ledger were maintained. On the basis of record of bills against clients as well as summary of firm's expenses, the profit and loss account was prepared. Subsequently, it was found that there was misappropriation of the rents collected and the auditors were sued for negligence in their work. The judgement, given purely on the basis of facts, held the auditors not guilty, as in their letter they had clearly indicated the restricted nature of their engagement.

9.16 FUNCTIONAL CLASSIFICATION OF AUDIT - EXTERNAL AUDIT AND INTERNAL AUDIT

Functionally, an audit can be classified into external audit and internal audit. The major points of distinction between the two are as follows:

(i) The external auditors are appointed by the owners of the organisation, e.g., shareholders in case of a company. When external auditors are appointed under a particular statue, they are called as statutory auditors. But internal auditors are appointed by the management of the organisation. The internal auditors may be appointed on contractual basis or they may be appointed as employees of the organisation.

(ii) The scope of work of an external auditor is determined by the particular statue under which they are appointed but the internal auditors have to work within the scope defined the management which generally includes review and appraisal of accounting, financial and administrative controls.

(iii) The main concern for an external auditor is to collect the adequate and reliable evidence to support his opinion as to the truth and fairness of the representations made in the financial statements. The internal auditors, on the other hand, are concerned with the compliance of various policies, rules and procedures of the enterprise, compliance with applicable laws and generally accepted accounting principles.

(iv) The external auditors are directly responsible to the owners and in some cases to the third parties but the internal auditors do not have any freedom to report to the outsiders.

It may be noted that unlike external auditors, internal auditors are generally not considered as independent of the management. But one of the basic philosophies of audit is that the auditor must be independent. Thus, in order to derive benefit from audit in its right earnest even internal auditor must be independent to the extent practicable.

9.17 TYPES OF AUDIT

Audits can be of various types. They can be classified on the basis of independence or interference of the client, and also on the basis of function performed. The basic classification is given as under:

I. Depending on independence and interference of the client

(a) **Statutory Special Audit** by auditors (investigators) appointed by the Government to report to the respective government authorities on specific issues. This has the least interference of the client. The auditor is generally supposed to submit a report to the appropriate authorities on matters and in the form specified to him, within a specified timeframe. This audit may relate to one or more financial years.

(b) **Statutory Audit, or Cost Audit, or Tax Audit** by independent auditors appointed by the Company, or Board of Directors, or the client. This has high degree of independence. However the level of independence is specified in the governing statutes. The manner, content, time for submission of the audit report and the person to whom it is to be reported are governed by the respective statutes.

(c) Internal Audit by an auditor, who may or may not be an independent auditor, appointed by the management depending on the nature and scope defined and mutually decided in the terms of engagement.

II. Depending on functional classification

(a) Statutory Audit of a Company or a LLP

(b) Statutory Cost Audit

9.18 AUDIT EVIDENCE

While auditing, the auditor come across various assertions of the management. The auditor has to evaluate these assertions so that he would be able to express his opinion on the financial statements. This evaluation can be made in the light of some facts and reasons. These facts and reasons are called `Audit Evidence'. The auditor should evaluate whether he has obtained sufficient appropriate audit evidence so that reasonable conclusions can be drawn there from. It is to be noted that sufficiency an appropriateness are interrelated and apply to evidence obtained from both substantive and compliance procedures. Sufficiency refers to the quantum of audit evidence obtained and appropriateness relates to its relevance and reliability. The following factors influence auditor's judgement while obtaining audit evidence:

(a) the nature of the item;

(b) the adequacy of internal controls;

(c) the nature and size of the business carried on by the entity;

(d) Situations which may exert an unusual influence on the management;

(e) The financial position of the entity;

(f) The materiality of the item;

(g) The experience gained during the previous audits;

(h) The results of auditing procedures, including fraud or error which may have been found;

(i) The type of information available;

(j) The trend indicated by accounting ratios and analysis.

9.18.1 Need for Audit Evidence

Audit evidence provides the auditor a reasonable assurance in respect of the assertions made by the management. While obtaining evidence through substantive procedures, the different assertions made by the management can be as follows:

(a) Existence – that an asset or a liability exists at a given date;

(b) Rights and Obligations - that an asset is a right of the entity and a liability is an obligation of the entity at a given date;

(c) Occurrence-that a transaction or event took place which pertains to the entity during the relevant period;

(d) Valuation - that an asset or liability is recorded at an appropriate carrying value;

(e) Measurement.-that a transaction is recorded in the proper amount and revenue or expense is allocated to the proper period;

(f) Presentation and Disclosure - an item is disclosed, classified and described in accordance with recognized accounting policies and practices and relevant statutory requirements. if any.

While obtaining evidence through compliance procedures, the different assertions made by the management can be as follows:

(a) Existence -that the internal controls exist;

(b) Effectiveness - t hat the internal controls are operating effectively;

(c) Continuity - that the internal controls have been so operated throughout the period of intended reliance.

9.18.2 Reliability of Audit Evidence

The reliability of audit evidence depends on its source - internal or external and on its nature - visual, documentary or oral. While the reliability of audit evidence is dependent on the circumstances under which it is obtained, the following generalizations may be useful in assessing the reliability of audit evidence:

(a) External evidence (e.g. confirmation received from a third party) is generally more reliable than internal evidence;

(b) Internal evidence is more reliable when related internal control is satisfactory;

(c) Evidence in the form of documents and written representation is usually more reliable than oral representations;

(d) Evidence obtained by the auditor himself is more reliable than that obtained through the entity.

9.18.3 Methods to Obtain Audit Evidence

Auditor obtains evidence in performing compliance and substantive procedures by any one or more of the following methods –

(a) Inspection -It consists of examining records, documents, or tangible assets. Inspection of records and documents provides evidence of varying degrees of reliability depending on their nature, source and the effectiveness of internal controls over their processing.

(b) Observation -It consists of witnessing a process or procedure being performed by others.

(c) Inquiry and Confirmation -Inquiry consists of seeking appropriate information from a knowledgeable person inside or outside the entity, Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records.

(d) Computation -It consists of checking the arithmetical accuracy of source documents and accounting records or performing independent calculations.

(e) Analytical Review -It consists of studying significant ratios and trends and investigating unusual fluctuations and items.

9.18.4 Compliance procedures or Tests of controls

Tests of control are those activities performed by the auditor during the control testing stage that gather evidence as to the operational effectiveness of internal control procedures upon which the auditor has planned reliance.

Management impliediy asserts that internal control procedures are effective as to both their design and operation. If controls are effective, then the auditor can plan reliance on the controls and reduce the time spent in gathering audit evidence. This is because the objective of an audit is similar in many respects to the objectives of internal control procedures. One of the primary objectives of a financial statement audit is to gather evidence as to whether account balances and classes of transaction are materially complete, valid and accurate. This is very similar to the primary objective of internal control procedures - to provide management with assurance that account balances and classes of transaction are complete, valid and accurate. Thus, if controls are effective, the auditor can plan reliance on the controls and reduce the amount of evidence that he would otherwise gather as to the completeness, validity and accuracy of account balances and classes of transaction.

In the audit planning stage, the auditor gathers evidence as to the effectiveness of design of control procedures and decides which control procedure, if any, upon which he will plan reliance. In the control testing stage, the auditor gathers evidence as to the effectiveness of operation of those controls upon which the auditor has planned reliance. The activities that the auditor employs to gather this evidence are referred to collectively as tests of control (sometimes referred to as compliance tests or compliance procedures).

Tests of control include observation of an internal control procedure being performed, inspection of evidence that the control procedure was performed (and performed at the appropriate time), and inquiry about how and when the procedure was performed. Where the information system is computerized, evidence may also be gathered using CAATs such as a generalized audit software or an embedded audit module.

9.18.5 Substantive procedures

Substantive procedures (or substantive tests) are those activities which are performed by the auditor during the substantive testing stage of the audit that gather evidence as to the completeness, validity and/ or accuracy of account balances and underlying classes of transactions.

Management impliedly asserts that account balances and underlying classes of transaction do not contain any material misstatements: in other words, that they are materially complete, valid and accurate. Auditors gather evidence about these assertions by undertaking activities referred to as substantive procedures.

For example, an auditor may:

(i) physically examine inventory on balance date as evidence that inventory shown in the accounting records actually exists (validity assertion);

(ii) arrange for suppliers to confirm in writing the details of the amount owing at balance date as evidence that accounts payable is complete (completeness assertion); and

(iii) make inquires of management about the collectibility of customers' accounts as evidence that trade debtors is accurate as to its valuation (accuracy assertion).

Evidence that an account balance or class of transaction is not complete, valid or accurate is evidence of a substantive misstatement.

There are two categories of substantive procedures - analytical procedures and tests of detail. Analytical procedures generally provide less reliable evidence than the tests of detail. It may be noted that analytical procedures are applied in several different audit stages, whereas tests of detail are only applied in the substantive testing stage.

9.19 CONCEPT OF TRUE AND FAIR

The concept of true and fair is a fundamental concept in auditing. The phrase "true and fair" in auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit. This requires that the auditor should examine the accounts with a view to verify that all assets, liabilities, income and expenses are stated as amounts which are in accordance with accounting principles and policies which are relevant and no material amount, item or transaction has been omitted. What constitutes "true and fair", however, has not been defined in any legislation. In the context of audit of a company, however, section 129 of the Companies Act provides that the accounts of a company shall be deemed as not disclosing a true and fair view, if they do not disclose any matters which are required to be disclosed by virtue of provisions of

Schedule III to the Act, or by virtue of a notification or an order of the Central Government modifying the disclosure requirements.

It must be noted that the disclosure requirements as laid down by the law are the minimum requirements. If certain information is vital for showing a true and fair view, the accounts should disclose it even though there may not be a specific legal provision to do so. Thus, what constitutes a 'true and- tie view is a matter of an auditor's judgment in the particular circumstances of a case. In more specific terms, to ensure true and fair view, an auditor has to see the following:

(i) That the assets are neither undervalued or overvalued, according to the applicable accounting principles;

(ii) no material asset is omitted

(iii) The charge, if any, on assets are disclosed;

(iv) Material liability should not be omitted;

(v) The profit and loss account discloses all the matters required to be disclosed by Part II of Schedule III and the balance sheet has been prepared in accordance with part I of Schedule III;

(vi) All unusual, exception or non- recurring items have been disclosed separately.

9.20 CONCEPT OF "MATERIALITY" IN PLANNING AND PERFORMING THE AUDIT

Materiality *is one of the basic* fundamental concepts in the process of Accounting and Auditing. It is a continuous process and covers in its ambit all the stages from recording to classification and presentation. An auditor has to constantly judge whether a particular item or transaction is material or not.

SA 320 on Materiality in Planning and Performing an Audit lays down that *"The concept of materiality is applied by the auditor* both in planning *and performing the audit, and in* evaluating the *effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the* financial *statements."* It lays down a Standard on Auditing (SA) on the concept of audit materiality in relationship with audit risk affecting the planning and procedures of the auditors.

Materiality of an item may influence the economic decision of the user: It is a relative terra, the knowledge of which may influence the economic decision of the users of the Financial Statements. It requires that the auditor should consider materiality and its relationship with audit risk while conducting an audit and therefore an auditor requires more reliable evidence to support material items.

No item is material in all circumstances, what may be material in one circumstance may not be material *in* another.

It may be a statement, silence (or *omission) or a* misstatement *in the* Financial Statements, materially affected if such statement is erroneously stated or omitted to be stated therein and economic decision of the users taken on the basis of such information is influenced by such misstatement or omission.

The main factors to be considered for determining materiality of an item are:

(i) Individually: It may be determined individually. E.g., a payment of ₹ 1000 may be material in a small business, but even Rs. 1 lac could be immaterial for a big business entity.

(ii) Aggregate: It may be determined in aggregate. E.g., total income from investment in mutual funds could be more material than looking into each individual investment.

(iii) Legal Considerations: It depends on the statutory or legal considerations. E.g., where the terms of appointment of a whole time director are not according to law, the remuneration paid to him is a material item even if the financial implication is not much.

(iv) Legal Definition: It may be defined or described in law itself. E.g., Schedule III requires separate disclosure of items of all expenses exceeding 1% of turnover or to write off capital assets purchased for less than ₹ 5000.

(v) **Relative overall impact:** It may depend on the relative degree of relevance to the overall accounts or the group, or class of transactions to which it pertains. E.g., short recoveries from debtors.

(vi) **Qualitative:** It may be qualitative and not often reckoned with respect to quantitative details alone. E.g., improper disclosure of an accounting policy in the Notes to the Annual Financial Statements may affect economic decisions.

(vii) **Insignificant quantity but special context:** It maybe of an insignificant quantity otherwise, but material in special circumstances. E.g., rounding off to the nearest rupee the fraction of 0.666 as 0.67 in computer software. It may be material in future due to cumulative effect even if insignificant now.

9.21 CONTEMPORARY ISSUES IN AUDITOR'S INDEPENDENCE — ISSUES, TOOLS, INSTITUTIONS (BASIC KNOWLEDGE)

By the term "auditor's independence" we mean that the judgment of the auditor is not subordinated to the wishes or directions of any person who might have engaged him or to his own self-interest.

It is impossible to define and describe the term 'independence' in a precise manner. Basically it is a condition of mind and personal in character. However the professional conduct of the auditor's support auditor's independence. Auditors, by their function of reporting on financial statements, lend creditability to those statements. Parties interested in such statements put implicit faith and trust on those statements based on the opinion of the auditor. So for the auditors, independence has a special meaning and significance. Unbiased audit can be carried out only when the auditor is able to resist all pulls and pressures. The auditor should not only be independent in fact, but also must appear to be so; otherwise his report would be suspected and would lack creditability.

Independence is an attitude of mind. However not only should a professional accountant maintain independence but he should also appear to be independent to all reasonable persons. Thus independence must be real, present and evident.

Independence is a well-accepted standard of auditing. The Code of Ethics for Professional Accountants of IFAC states that when undertaking an assurance engagement such as audit, the auditor should be independent of the client. There are some specific conditions laid in the Companies Act in India which disqualify a person from acting as an auditor of a company because he may not be able to remain independent under those conditions. Similarly under the same act, the right to auditor is given, as a general rule, to the body shareholders. Thus the act provides a number of safeguards to ensure the independence of the auditor.

The provision relating to setting up of an independent audit committee of board of directors also marks a significant step towards greater independence of auditors.

As per Basic Principles Governing an Audit, independence of auditor is one of the basic principles. While the auditor is an appointee to the client, his responsibility is also to safeguard the interests of those who might make decisions based on his report and audited financial statements. In view of his extensive responsibilities to the third parties, the auditor must be independent of his client. He must be free from any influence by any person connected with the auditee enterprise. The relationship between the auditor and the client should be such that firstly he himself is satisfied about his client and secondly, no unbiased person would be forced to the conclusion that on an objective assessment of the circumstances, there is likely to be an abridgement of the auditor's independence.

9.21.1 Advantages of Independent Auditors: The principle advantage of an independent audit lies in the society being able to get an informed, objective and unbiased opinion on the financial statements of an organization which is used in making significant economic decisions by interested segments of the society, i.e. shareholders, creditors, bankers, financial institutions etc. It is to be noted that only the auditor is in a position to examine the accounts and transactions of an organization with a view to form an opinion. His report is therefore, the only real safeguard available to various parties interested in the financial affairs of the organization.

The need for the auditor's independence is well-recognized in the Chartered Accountant's Act,1949 as well as in the Cost and Works Accountants Act,1959. For example, clause 10 of Part I of the First Schedule to the Chartered Accountants Act prohibits, except in certain specified cases, the acceptance of contingent fees, i.e. the fees which is either based on a percentage of profits or are otherwise dependent on the findings or the results of the employment. By a further notification, The Institute of Chartered Accountant of India has specified that a member of the institute shall be deemed to be guilty of professional misconduct if he expresses an opinion on financial statement of any business or enterprise in which one or more persons who are his 'relatives' have either by themselves or in conjunction with such member of a substantial interest, unless he discloses the interest also in his report.

9.21.2 Provisions for Safeguarding Independent Auditors: Several provisions have been included in the Companies Act with the objective of securing independence of the auditor. In general, these provisions endow the auditor with certain statutory rights, define certain relationships that may entail a compromise in maintaining independence, requiring that normally the auditor would be appointed in the general body meeting by the shareholders and making the removal of auditor difficult by laying down procedures under the Companies Act. The rights of the auditor are statutorily defined in several sections and they cannot be curtailed or limited by the management or even by the shareholders.

The management has no authority to terminate the appointment of any auditor. The auditor when appointed shall be entitled to hold office till the conclusion of the next annual general meeting. Though mid-term removal of the auditor is not ruled out, it can be accomplished only by the shareholders in the general meeting and with the previous approval of the central government. It is also worth mentioning that the duties cast on the auditor cannot be diluted by any agreement between the organisation and the auditor. There can thus be no temptation for the auditor to do less than what the laws require.

Despite the safeguards provided in the Companies Act and the Chartered Accountants Act/Cost and Works Accountants Act, some people have been voicing the fear that a close association may develop between the company auditors and management in certain cases. This is primarily because though the shareholders appoint the auditor and fix his remuneration, shareholders in India are not, in general, aware or concerned about their rights. Thus they are not able to take decisions independently of the management. Accordingly the public financial institutes, nationalized banks, government companies or a government have a decisive say in the appointment of auditors in a company in which they hold 25 percent or more of the subscribed capital. Many of the large companies are covered under this provision.

9.22 DISCLOSURE OF ACCOUNTING POLICIES

Accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of the financial statements. The view presented in the financial statements of an enterprise as to its state of affairs and operating results may be significantly affected by following different accounting policies in the preparation of financial statements. Thus, a adequate disclosure of accounting policies is very necessary so that the view presented in the financial statements can be apprehended by the users of the financial statements.

The Institute of Chartered Accountants of India has issued AS-1 on Disclosure of Accounting Policies in this regard. The purpose of this Accounting Standard is to promote better understanding of the financial statements by laying down the principles as to the manner of disclosure of accounting policies.

Fundamental Accounting Assumptions

It is generally assumed that the financial statements are prepared on the basis of fundamental accounting assumptions. AS-1 on Disclosure of Accounting Policies lists the following three fundamental accounting assumptions:

(i) **Going Concern -** It means that the enterprise has an intention to carry on its operations for the foreseeable future (i.e. coming 1 or 2 years). There is no intention on the part of the enterprise to discontinue the business nor has any need arisen as to the liquidation of the organisation. It is because of this fundamental assumption that depreciation etc. is provided in the books of accounts.

(ii) **Consistency -** Accounting policies are followed on consistent basis from one period to another. For example, ABC Ltd. values i ts inventory on FIFO basis. The same basis of valuation is adopted in subsequent year also.

(iii) **Accrual -** Revenues and cost are accrued, i.e., they are recognised when they are earned or incurred. Actual receipt or payment is not necessary. In other words, the accounts are maintained on 'mercantile system' only.

The accounting policies should be selected in such a manner that w hen financial statements are prepared on the basis of such policies, they reflect a true and fair view of the state of affairs and the operating results of the enterprise. The accounting policies are selected on the basis of following factors:

(i) **Prudence -** It states to 'provide for all losses and anticipate no profits.' At the time of preparation of financial statements the preparer may face various uncertainties, for example, as to recoverability of receivables, warranty claims etc. Thus, estimates are made for uncertainties and provided for in the books of accounts. For example, provision for bad and doubtful debts.

(ii) **Substance over Form -** The transaction should be accounted for in accordance with its actual happening and the economic reliability. The legal form is not relevant. For example, in case of hire purchase transaction, the assets purchased under hire purchase are shown under the asset side of the balance sheet of the hire purchaser even though he is not the legal owner. The reason being the ultimately the legal ownership of the asset would be transferred to the hire purchaser.

(iii) **Materiality -** Financial statements should disclose all the items and facts which are sufficient enough to influence the decisions of the user of the financial statements.

AS-I further states that any change in accounting policy which has a material effect should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable and if it is not ascertainable, either wholly or in part, the fact should be indicated. If a change is made in accounting policy(s) which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in subsequent periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

Note:-

Some of the areas where different accounting policies may be followed by the management are as follows:

(i) Valuation of inventories - FIFO, Weighted Average,

(ii) Methods of providing depreciation -Straight Line, WDV,

(iii) Translation of foreign currency items -Average rate, TT rate,

(iv) Treatment of retirement benefits,

(v) Expenditure during the construction period,

(vi) Government grants, etc.

Study Note - 10

TYPE OF AUDIT

This Study Note includes

10.1 Introduction
10.2 Classification of Type of Audit
10.3 Voluntary Audit or Private Audit
10.4 Advantages of Auditing for Sole Proprietors
10.5 Advantages of Auditing for Partnership Firms & Others
10.6 Statutory Audit
10.7 Government Audit
10.8 Difference between Private (Voluntary) Audit and Statutory (Mandatory) Audit
10.9 Difference between Statutory Audit and Government Audit
10.10 Difference between Audit of a Company and a Firm
10.11 Independent Financial Audit
10.12 Internal Audit
10.13 Difference between Statutory Audit and Internal Audit
10.14 Cost Audit
10.15 Management Audit
10.16 Tax Audit
10.17 Secretarial Audit
10.18 Forensic Audit
10.19 Difference between Statutory Audit and Forensic Audit
10.20 Information Security Audit
10.21 Social Audit
10.22 Environmental Audit
10.23 Efficiency-Cum-Performance Audit
10.24 Propriety Audit
10.25 Operational Audit
10.26 Continuous Audit
10.27 Information Systems Audit
10.28 Annual Audit
10.29 Interim Audit
10.30 Balance Sheet Audit
10.31 Difference between Balance Sheet Audit and Annual Audit
10.32 Difference between Balance Sheet Audit and Continuous Audit
10.33 Complete, Partial and Detailed (in Depth) Audit
10.34 Statutory Report

10.1 INTRODUCTION

Rapid industrial growth and increased competition among businesses has led to organizations focusing intensely on expansion and diversification of their operations. Consequently, the organizational structures and procedures are becoming complex. This has given rise to a need for the conduct of various types of audit for detecting and improving deficiencies, so that an organization is able to sustain in this competitive environment.

10.2 CLASSIFICATION OF TYPE OF AUDIT

(i) Organisational Structure
  (a) Voluntary Audit
    - Sole Proprietorship
    - Partnership Firm
    - LLP/ NGOs
  (b) Statutory Audit
  (c) Government Audit
(ii) Objective
  (a) Independent Financial Audit
  (b) Internal Audit
  (c) Cost Audit
  (d) Management Audit
  (e) Tax Audit
  (f) Secretarial Audit
  (g) Forensic Audit
  (h) Information Security Audit
  (i) Social Audit
  (j) Environment Audit
  (k) Performance Audit
  (l) Propriety Audit
  (m) Operational Audit
(iii) Timing
  (a) Continuous Audit
  (b) Annual Audit
  (c) Interim Audit
  (d) Balance Sheet Audit
(iv) Scope
  (a) Complete Audit
  (b) Partial Audit
  (c) Detailed audit

The above broad classification is sometimes inter-locked

E.g: (a) Tax Audit and Cost Audit are statutory audits.
  (b) Balance Sheet Audit has defined scope.
  (c) Scope of Audits may be decided by the terms of engagement or by the statute governing the Audit.

10.3 VOLUNTARY AUDIT OR PRIVATE AUDIT

'' Though audit is not necessary for each form of ownership, yet they go for audit''.

'' Audit of accounts may not be compulsory, yet one may get the books of accounts audited for various reasons''.

Audit refers to the process of examination of books and records together with the evidence relating to an entity, whether it is required by law or not, for the purpose of formation of opinion with regard to true and fair view disclosed by Financial Statements.

Broadly there are two classifications of audits:

(i) Statutory Audit

(ii) Voluntary Audit or Private Audit

(A) Statutory audits are mandatory in nature. Audit of companies is mandatory under the provisions of the Companies Act, 2013. Audit of insurance companies, banking companies and cooperative societies are also compulsory under the specific statutes, as applicable.

(B) Voluntary audits are non-statutory audits. There is no statutory requirement for audits of sole trader, partnership firm (except for a statutory tax audit u/s 44AB required as per the Income Tax Act, 1961, e.g. when such an entity exceeds the turnover of certain limit). The sole proprietors and partnership firms may get their accounts audited voluntarily on their own because of certain advantages.

10.4 ADVANTAGES OF AUDITING FOR SOLE PROPRIETORS

(i) It evaluates the internal control system and strengthens it by removing weaknesses, if any.

(ii) It increases the reliability and authenticity of Financial Statements.

(iii) It helps in timely finalization of Annual Financial Statements and tax assessments.

(iv) It keeps a moral check on the working of employees.

(v) It helps them in obtaining f and s easily from financial institutions, based on more reliable Financial Statements available to the banks and financial institutions.

(vi) It helps in settling:

- Trade disputes
- Labour disputes
- Insurance claims

10.5 ADVANTAGES OF AUDITING FOR PARTNERSHIP FIRMS & OTHERS

10.5.1 The added advantages besides other advantages are:

(i) It helps in settlement of accounts among the partners on the basis of more reliable accounting records.

(ii) It protects the interest of minors, sleeping partners/partners who are not involved in day to day operations, and keeps a check on persons who are working on behalf of others.

(iii) It helps in partnership firms for settlement of goodwill at the time of admission, retirement and death of partners.

Due to these advantages, even the entities which are not under any statutory obligation of statutory audit get their accounts voluntarily audited.

10.5.2 The primary objective is to form an opinion on the truth and fairness of the Financial Statements of the enterprise. The secondary objective could be to detect frauds and errors, settlement of goodwill, settlement of labour disputes, facilitation in tax assessment, etc.

Both objectives of audit are not dependent on each other. The primary and secondary objectives are interdependent and not independent.

10.6 STATUTORY AUDIT

10.6.1 Statutory audit is the checking of accounts required by law. A statute or law may require having an annual audit of financial records of a company or any other entity. The law may require the audit to be conducted in the specified manner. The manner of reporting, contents of the report and the authority to which the report of auditors should be presented are all specified by the statute. Statutory audits are mandatory in nature. The statutory auditor is generally the principal auditor in an organization.

i. In the case of companies, the Companies Act, 2013 governs the audit of accounts, its reporting, and manner of preparing the audit report.

ii. In the case of audit of a government body, the scope and audit programmes are set by the Comptroller and Auditor General and the Companies Act, 2013.

iii. In the case of audit of an insurance company or a nationalized bank, the audit is governed by specific statutes and IRDAIRBI guidelines. Co-operative banks are also governed by the Co-operative Societies Act, 1912.

10.6.2 The statutory auditor of a company is appointed by the board/shareholders in the General Meeting and shareholders cannot delegate this power to directors even by passing a special resolution.

10.6.3 A statutory auditor can be appointed by the Central Government if shareholders fail to appoint an auditor. A statutory audit should be performed by a qualified chartered accountant holding a Certificate of Practice and not by any other person.

10.6.4 Advantages of Statutory Audit

The auditor expresses his independent opinion after following relevant audit procedures and checking the external and internal evidences necessary for the conduct of audit. He comments on the truthfulness and fairness of statement of affairs of the organization as on certain date and also about the fact that no misstatement or misrepresentation has been made in the Financial Statements under report.

10.6.5 Such an independent opinion by the auditor increases the reliability, authenticity and credibility of the Financial Statements which may further be used by different users for various purposes such as:

(i) The members/shareholders/stakeholders, for their economic decisions and for exercising their voting rights.

(ii) For timely tax assessments.

(iii) For determining the purchase or sale consideration in case of ongoing concern.

(iv) Settlement of partners' accounts in case of admission, retirement or death of partner on account of goodwill or otherwise.

(v) Before the court, in case of settlement of disputes with employees, creditors or debtors.

(vi) For determining the actual value of business or shares in case of merger, acquisition, etc.

(vii) For getting financial assistance from financial institutions, banks or investors.

(viii) In case of non-profit organizations, for getting government grants and availing tax exemptions.

(ix) Evaluation of the internal control systems and strengthening it by removing the inherent weaknesses, and checking the efficacy of the internal checks.

(x) For checking the integrity of the management which manages the funds and affairs on behalf of the real owners or shareholders.

(xi) For other users of financial statements like creditors, investors and government agencies, it ensures that any assertions in the Financial Statements are neither overstated/understated nor misrepresented.

(xii) For the proper distribution of profits by way of payment of wages and other benefits.

(xiii) For ensuring of proper distribution of profits as dividends.

(xiv) For ensuring that all legal requirements are fulfilled and statutory compliances are met.

(xv) For settlement of insurance claims or other recoveries from government bodies or otherwise.

10.7 GOVERNMENT AUDIT

10.7.1 Meaning: UN Handbook on Government Auditing in Developing Countries states that "Government auditing is the objective, systematic, professional and independent examination of financial, administrative and other operations of a public entity for the purpose of evaluating and verifying them, presenting a report containing comments, conclusions and recommendations and expressing the appropriate professional opinion in respect of financial statements."

10.7.2 Authorization: The Comptroller & Auditor General of India (CAG) is the Supreme Audit Institution.

10.7.3 Types of Government Audit

(a) Transaction audit

  i. Expenditure Audit

  ii. Receipts Audit

(b) Efficiency cum Performance Audit

10.7.4 Expenditure Audit: The basic standards set for audit of expenditure are to ensure that there is provision of funds authorized by competent authority fixing the limits within which expenditure can be incurred. Some standards are briefly explained below:

i. **Audit against Rules & Orders:** It is also known as Regularity Audit. Under this, the auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and orders framed by the competent authority.

ii. **Audit of Sanctions:** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorizing such expenditure. In case expenditure exceeds the sanctioned limit, objection is raised.

iii. **Audit against Provision of Funds:** It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the sanctioned amount as well as examine whether the money has been spent for the specified purpose.

iv. **Audit of financial propriety:** The auditor has to ensure that the expenditure incurred are with respect to the recognized standards of financial propriety i.e. quantity, quality, morality and ethics.

10.8 DIFFERENCE BETWEEN PRIVATE (VOLUNTARY) AUDIT AND STATUTORY (MANDATORY) AUDIT

Sl. No.	Private audit	Statutory Audit
i.	Discretionary for the management.	Mandatory and prescribed by different statute/ laws.
ii.	Conducted with the object of: Review of internal controls Checks on employees Checking financial or non financial operations	Conducted with the objective of ensuring truthfulness and fairness of the Financial Statements.
iii.	Proprietary oriented approach.	Compliance oriented approach.
iv.	Scope is decided by the management Scope is prescribed by the governing and auditor through the Letter of Engagement.	Scope is prescribed by the governing law.
v.	Report: To the management No prescribed format Within the time as mutually agreed	Report: To shareholders/owners In the format prescribed under law. Within the time as prescribed by the statute.

10.9 DIFFERENCE BETWEEN STATUTORY AUDIT AND GOVERNMENT AUDIT

SL. No.	Statutory Audit	Government Audit
i.	Applicable to (a) All private companies (b) All co-operative societies (c) Proprietorship and partnership concerns in some cases. E.g. Tax audit under section 44AB of the Income Tax Act.	Applicable to (a) Government departments (b) Statutory corporations (c) Government companies
ii.	(a) In case of private companies: shareholders. (b) In case of sole proprietor and partnership: proprietor or partners. (c) In case of trust: trustee or Managing Committee. (d) In case of co-operative societies: Managing Committee with prior approval of the Registrar.	(a) In case of government departments: Comptroller and Auditor General (b) In case of statutory corporation: as per the provisions of the special statute for that corporation. (c) In case of government company: Company Law Board, on the advice of the Comptroller and Auditor General.
iii.	Report is submitted to the owners/ shareholders in a format prescribed by the Companies Act, 2013, in the case of Companies.	Report is submitted to the shareholders and a copy is given to the Comptroller and Auditor General in a format prescribed by the CAG.

10.10 DIFFERENCE BETWEEN AUDIT OF A COMPANY AND A FIRM

Sl.No.	Company	Firm
i.	The audit of a company is governed by the provisions of the Companies Act, 2013 (governed by statute).	The audit of a firm is governed by the agreement between the auditor and the client, with reference to the partnership agreement.
ii.	The scope of the audit is well defined by the Act and cannot be reduced by including a clause in the Articles of Association.	The scope of the audit can be extended or reduced by the partners.
iii.	Generally appointed by the shareholders in the Annual General Meeting, but may also be appointed by the Board of Directors, Central Government, or the CAG, in certain cases as specified under the Act.	Partners appoint the auditor.
iv.	All the disclosures required to be made under the Act in the Financial Statements have to be checked.	All the disclosures which are necessary to be made in accordance with recognized accounting principles and practices have to be checked.
v	The audit report has to be submitted to the shareholders of the company.	The audit report has to be submitted to the partners or to any other person as specified in the terms of his appointment.

10.11 INDEPENDENT FINANCIAL AUDIT

An independent financial audit may be conducted by a qualified auditor at the request of a client, which may be a sole-proprietorship, partnership, non-profit organization or any other entity. Its objective is to comment on the truthfulness and fairness of the Financial Statements, and it may be compulsory under some Acts which govern the entity.

10.12 INTERNAL AUDIT

10.12.1 Meaning: ICAI describes Internal Audit as "an independent management function, which involves a continuous and critical appraisal of the functioning of entity with a view to suggest improvements thereto and to add value and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system. Internal Audit, therefore, provides assurance that there is transparency in reporting, a part of good governance".

10.12.2 Internal Audit being an independent appraisal function ensures objectivity and consultation which enhances the value and improves an organization's operations. It not only includes matters related to finance but also critical appraisal of the policies and procedures of the company.

10.13 DIFFERENCE BETWEEN STATUTORY AUDIT AND INTERNAL AUDIT

Sl.No.	Statutory Audit	Internal Audit
i	Mandatory and prescribed by different statutes like for companies, co-operative societies, nationalized banks , banking & insurance companies.	Generally not mandatory. They are discretionary for the management of sole proprietors, partnerships and others.
ii	Statutory Audit is conducted with the objective of ensuring truthfulness and fairness of the Financial Statements of an entity.	Internal audit is conducted with the objective of review of internal controls, checks and financial or non Financial operations of the organization.
iii	Scope is prescribed by governing law.	Scope is decided by the management and auditor, and documented through the Letter of Engagement.
iv	The auditor is an independent person and is appointed by the Board of Directors/ shareholders/Central Govt. The audit is conducted on behalf of the shareholders/ govt., as the case may be.	Internal audit can be conducted by any independent agency or by employees of the enterprise. It is conducted on behalf of the management.
V	To ascertain after critical examination of evidences and records whether Financial Statements are true & fair and no misrepresentation is made therein. To express an independent opinion thereon about the state of health of the entity. Compliance oriented approach.	To ensure that the internal controls are working efficiently, and are in place. To check the accuracy & completeness of records and early detection of errors. Proprietary oriented approach.
Vi	A qualified CA in whole time practice or a firm of CAs in practice can be a statutory auditor	No qualification is prescribed.

Vii	Term ends at the conclusion of the next AGM (annual general meeting). However, the auditor can be reappointed if not disqualified.	The term is generally mutually decided.
viii	Report to shareholders/ owners in a format prescribed under law.	Report to the management. No prescribed format.

10.14 COST AUDIT

It is an audit process for verifying the cost of manufacture or production of any article, on the basis of accounts as regards utilisation of material or labour or other items of costs, maintained by the company.

In simple words the term cost audit means a systematic and accurate verification of the cost accounts and records and checking of adherence to the objectives of the cost accounting.

As per ICWA London' "cost audit is the verification of the correctness of cost accounts and of the adherence to the cost accounting plan."

10.14.1 In cost audit, auditor has to perform the following duties –

- Examine the correctness of the cost records maintained by the concern and
- To report as to whether the cost accounting plans have been adhered to or not.

10.14.2 Advantage of cost Audit

(a) To the Management –

i. Management gets reliable data for its day-to-day operations like price fixing, control, decision making, etc.

ii. A close and continuous check an all wastage's will be kept through a proper system of reporting to management.

iii. Inefficiencies in the working of the company will be brought to light to facilitate corrective action.

iv. Management by exception becomes possible through allocation of responsibilities to individual managers.

v. System of budgetary control and standard costing will be greatly facilitated.

vi. Reliable check on valuation of closing stock and work-in-progress can be established.

vii. Helps in detection of frauds and errors.

(b) To the shareholders –

Cost Audit ensures that proper records are kept as to purchases and utilisation of material and expenses incurred on wages, etc. It also makes sure that the valuation of closing stock and work-in-progress is on a fair basis. Thus, the shareholders are assured of a fair return on their investment.

10.14.3 Disadvantage of Cost Audit

These are following disadvantages of cost accounting.

i. Accountants cannot estimate price of assets at current values.

ii. Only covers cost of business does not overcome overall profitability.

iii. Manipulations in accounts still exist.

iv. Standards of accounting vary from business to business.

10.15 MANAGEMENT AUDIT

Management audit is a comprehensive and thorough examination of an organization or one of its components. The audit is implemented to identify problems or significant weaknesses in the organization or corporation, thus providing management with a tool to address and repair the problem area.

The management audit is now widely accepted in the business field. For more than 40 years, corporations and non-profit organizations have utilized the management audit as a comprehensive tool.

The management audit is defined by its scope and objectives. The scope is broad and generally includes all functions of the organization, including objectives and strategy, corporate structure, organizational planning, the budgeting process, human and financial resources management, decision making, research and development, marketing, equipment and operations, and management information systems . This breadth extends to recent, present, and future operations and covers external issues as well as internal concerns. Objectives of the management audit include the development of recommendations and improvements, as well as increased awareness of the credibility and acceptance of the audit's results. The process is more an audit of management, in order to enhance corporate profits and financial stability.

The audit follows a logical, step-by-step format, including initial interviews with key managers. A study team uses the interview process to define the scope of the audit, including the areas or functions to be studied. Next, the team requests various forms of documentation, including budgets, planning documents, corporate reports, financial statements, policy and procedure manuals, biographical material, and various other documents. Following this stage, the study team then prepares a schedule and detailed plan of study, all aimed at proceeding to the internal fact finding step. Fact-finding relies once again on interviews, documentation, and personal observation of facilities and organizational work patterns. By the time these steps are completed, the study team develops a thorough understanding of organizational structure and operations.

The team generally turns next to an external review, using interviews to determine the opinions and attitudes key people outside the organization have about its operations. Examples of those interviewed are customers, representatives of financial institutions, and employees of federal agencies having contact with the audited organization. These interviews provide the team with more objective evaluations, and lead to an analysis of all the information and data now gathered. Organizational performance is profiled, then efficiency and effectiveness are evaluated and compared against industry norms. While many criteria can be measured quantitatively, team members have to use sound judgment and objectivity when evaluating issues that cannot be measured. In turn, the organization's management has to be receptive to the audit process and demonstrate clear acceptance of audit findings.

The study team then develops conclusions and recommendations which are communicated to the organization's management. These final two stages—conclusions/recommendations and communication—are essential to the management audit process. The audit is expected to identify corporate strengths and weaknesses, sources of problems, and potential problem areas. Recommendations for correction are presented to top management. The final report comes in the form of an overall plan of action, which includes prioritized recommendations, the specific units and individuals expected to carry out the recommendations, a schedule for action, and expected results. When conducted with thoroughness, objectivity, and timeliness, the management audit becomes a powerful tool for corporate and organizational executives who seek to improve effectiveness and efficiency.

An important aspect of the management audit is the composition of the study team. Both internal and external analysts are frequently used on audit teams; the composition depends on several factors, including the need for independent appraisal, the lack of human or financial resources to conduct the audit, and the need to provide an external audit to contrast against internal findings. In some instances, associations such as the American Institute of Management (AIM) provide audit teams. The AIM has developed ten categories of the management audit, and many audits apply these same categories. They include:

i. economic function
ii. corporate structure
iii. health of earnings
iv. service to stockholders
v. research and development
vi. directorate analysis
vii. fiscal policies
viii. production efficiency
ix. sales vigor
x. executive evaluation

Management audits are not limited to business corporations. Nonprofit organizations—including educational institutions, hospitals, and churches—often use the management audit to attempt to improve operations. When conducted effectively, and when recommendations are applied properly, the management audit has proved its usefulness as a management technique.

10.16 TAX AUDIT

The main objective of the tax audit is to compute the taxable income according to the law and for maintaining transparency in the financial statements filed by the assessees with the Income-tax department.

The tax audit u/s. 44AB of the Income-tax Act 1961 is significant practice area for Chartered Accountants. Since the introduction of tax audit, we have been given responsibilities to discharge the duties as tax auditors for the proper compliance of tax law by the assessees.

The Institute of Chartered Accountants of India has defined auditing as follows –

"A systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognises the propositions before him for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report".

Under the existing provisions of section 44AB, every person carrying on business is required to get his accounts audited if the total sales, turnover or gross receipts in the previous year exceed sixty lakh rupees. Similarly, a person carrying on a profession is required to get his accounts audited if the total sales, turnover or gross receipts in the previous year exceed fifteen lakh rupees.

In order to reduce the compliance burden on small businesses and on professionals, it is proposed to increase the threshold limit of

i. total sales, turnover or gross receipts, specified under section 44AB for getting accounts audited, from sixty lakh rupees to one crore rupees in the case of persons carrying on business and
ii. from fifteen lakh rupees to twenty five lakh rupees in the case of persons carrying on profession.

It is also proposed that for the purposes of presumptive taxation under section 44AD, the threshold limit of total turnover or gross receipts would be increased from sixty lakh rupees to one crore rupees.

Year wise limit for section 44AB tax audit from financial year 2009-10 is given here under .Two years back the limit was extended by 50 %

S. No.	Financial year	Limit (Business)	Professional
1	2009-10	40 Lakh	10 Lakh
2	2010-11,2011-12	60 Lakh	15 Lakh
3	2012-13 Onwards	100 Lakh	25 Lakh

These amendments will take effect from 1st April, 2013 and will, accordingly, apply to the assessment year 2013-14 and subsequent assessment years.

10.17 SECRETARIAL AUDIT

Secretarial Audit for bigger companies [Section 204]

(1) Every listed company and a company belonging to other class of companies as may be prescribed shall annex with its Board's report made in terms of sub-section (3) of section 134, a secretarial audit report, given by a company secretary in practice, in such form as may be prescribed.

(2) It shall be the duty of the company to give all assistance and facilities to the company secretary in practice, for auditing the secretarial and related records of the company.

(3) The Board of Directors, in their report made in terms of sub-section (3) of section 134, shall explain in full any qualification or observation or other remarks made by the company secretary in practice in his report under sub-section (1).

(4) If a company or any officer of the company or the company secretary in practice, contravenes the provisions of this section, the company, every officer of the company or the company secretary in practice, who is in default, shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

Functions of company secretary [Section 205]

(1) The functions of the company secretary shall include,—

(a) to report to the Board about compliance with the provisions of this Act, the rules made thereunder and other laws applicable to the company;

(b) to ensure that the company complies with the applicable secretarial standards;

(c) to discharge such other duties as may be prescribed.

Explanation.—For the purpose of this section, the expression "secretarial standards" means secretarial standards issued by the Institute of Company Secretaries of India constituted under section 3 of the Company Secretaries Act, 1980 and approved by the Central Government.

(2) The provisions contained in section 204 and section 205 shall not affect the duties and functions of the Board of Directors, chairperson of the company, managing director or whole-time director under this Act, or any other law for the time being in force..

10.18 FORENSIC AUDIT

10.18.1 Major accounting scandals involving Enron, Worldtel, Parmalat and Satyam have been widely reported. In all these cases, the methods and purpose of manipulations in the Financial Statements were peculiar to the motives of such manipulations.

10.18.2 The Companies (Auditors' Report) Order, 2003, requires auditors to report, amongst others, "whether any fraud on or by the company has been noticed or reported during the year. If yes, the nature and the amount involved are to be indicated". In this background, the techniques of forensic auditing have gained importance.

10.18.3 Forensic audit involves examination of legalities by blending the techniques of propriety audit, regularity, investigative and financial audits. The objective is to find out whether or not true business value has been reflected in the Financial Statements and in the course of examination to find whether any fraud has taken place.

10.19 DIFFERENCE BETWEEN STATUTORY AUDIT AND FORENSIC AUDIT

SL.No.	Statutory Audit	Forensic Audit
i.	Express an opinion on the truthfulness and fairness of the Financial Statements.	Determine if any fraud has been committed in the client's business.
ii.	Substantive and compliance procedures are used.	Substantive procedures, audit-in depth, trend, past-data analysis are used.
iii.	Accounts relating to the relevant accounting year are checked.	Accounts may be checked for as many numbers of years as required to detect the cause of the fraud, if any.
iv.	Check the arithmetical accuracy and compliance with procedures.	Propriety aspect is focused on.
v.	Qualifications may be given in case of adverse findings.	The amount of fraud, the persons behind it and the legal implication are mentioned in the audit report.

10.20 INFORMATION SECURITY AUDIT

10.20.1 Information Security Audit is an audit of the level of information security in an organization. The controls in any business organization can be classified as technical, physical and administrative controls. Thus, information security audit involves checking of security controls from the physical security of data centres to the logical security of databases.

10.20.2 When centred on the IT aspects of information security, it can be seen as a part of an information technology audit, However, information security encompasses much more than IT.

10.21 SOCIAL AUDIT

10.21.1 Organizations, these days, focus on attaining economic growth through performing processes that ensure social and environmental development simultaneously. A social audit is a way of measuring, understanding, reporting and improving an organization's performance towards meeting its social and ethical objectives.

10.21.2 Objectives of Social Audit

i) Assessing the needs of the society and resources available for fulfilling them.

ii) Spreading awareness among beneficiaries about the business' efforts towards attaining social objectives.

iii) Increasing efficacy and effectiveness of the organization's corporate social responsibility (CSR) programmes.

iv) Scrutiny of policy decisions, keeping in view the interests of stakeholders.

10.21.3 Advantages of Social Audit

i) Encourages community participation among different business entities.

ii) Ensures continuous efforts towards environmental protection and use of environment friendly production processes.

iii) Builds customer satisfaction and trust through ethical business practices.

iv) Promotes collective decision making and sharing responsibilities.

v) Develops human resources by working towards improvement of workers' and the underprivileged persons' working/ living conditions.

10.22 ENVIRONMENTAL AUDIT

10.22.1 Definition and Meaning

According to the United States Environmental Protection Agency (USEPA), environmental audit may be defined as a systematic, documented, periodic and objective review by a regulated entity of facility operations and practices related to meeting environmental requirements,"

The Confederation of British Industry has defined environmental auditing as "the systematic examination of the interactions between any business operation and its surroundings."

10.22.2 Scope and Object

i. All emissions to air, land and water

ii. Legal constraints

iii. The effects on the neighboring community, landscape and ecology

iv. The public's perception of the operating company in the local area

v. It provides expert opinion on hazards in the environment

vi. Associated risks

vii. 'The measures that may need to be taken for the management and control of risks.

10.22.3 Different steps of an Environment Audit

The International Chamber of Commerce presents the different steps of an environmental audit as follows:

1. Pre-audit activities:
   - i. Selection and scheduling of facility to audit.
   - ii. Selection of audit team.
   - iii. Contact with facility.
   - iv. Planning of the audit.
2. Site activities:
   - i. Understanding of internal controls.
   - ii. Assessment of internal controls.
   - iii. Gathering of audit evidence.
   - iv. Evaluation of audit findings.
   - v. Report of findings to facility.
3. Post audit activities:
   - i. Production of a draft report.
   - ii. Production of a final report.
   - iv. Preparation and implementation of an action plan.
   - iv. Monitoring of action plan.

10.22.4 ISO I4001 is a voluntary international standard for Environmental Management Systems (EMS). It provides the requirements for an EMS and gives general guidelines for its maintenance. An EMS meeting the requirements of ISO 14001:2004 is a management tool enabling an organization of any size or type to:

Identify and control the environmental impact of its activities, products or services.

Improve its environmental performance continually.

Implement a systematic approach to setting environmental objectives and targets, to achieving these and to demonstrating that they have been achieved.

10.23 EFFICIENCY-CUM-PERFORMANCE AUDIT

It is an objective examination of the financial and operational performance of an entity. It includes identification of opportunities of greater economy as well as removal of weaknesses after evaluation. Actual performance is compared with the standards set by the entity. If the auditor at the time of evaluation comes across any deviations with respect to the pre-determined standards, it is further investigated.

10.23.1 Scope of EPA

i. **Economy Audit:** It ensures that entity has acquired the financial, human and physical resources economically. It implies that resources have been procured in appropriate quantity, quality and at minimum cost.

ii. **Efficiency Audit:** It ensures the economical execution of various schemes and policies. It refers to the relationship between inputs and output i.e. the goods and services produced and resources used to produce them, yielding the expected results.

iii. **Effectiveness:** It is an appraisal of the performance of schemes and projects with reference to the overall targeted objectives as well as efficiency of the ways and methods adopted for the attainment of objectives.

10.23.2 Approach

Various steps undertaken by the auditor while conducting EPA are identification of topic, obtain necessary information, preliminary study, planning and execution of audit, reviewing internal control system and reporting.

10.24 PROPRIETY AUDIT

10.24.1 A propriety audit is not just concerned with the truthfulness and fairness of the Financial Statements and books of accounts of the client, but also ensures that the transactions entered into by the client, business practices and activities undertaken are not against public interest. Its objective is to see that the business lives upto standards of proper conduct. Legal, economic and financial are all equally important aspects that require to be looked into during the course of the audit.

10.24.2 It is an essential element of a Government Audit. The Comptroller and Auditor General examines the propriety of all government expenditures to ensure that they have been incurred in the interest of the general public, and are not influenced by personal interests of the government authorities sanctioning it.

10.24.3 Under the provisions of the Companies (Auditors' Report) Order, 2003, a company auditor is required to examine the propriety of some financial transactions and comment on the same through his audit report.

10.24.4 Section 143 of the Companies Act, 2013 requires the auditor to look into some specified matters to ensure that the Directors of the company do not engage in misappropriation and siphoning of funds.

10.25 OPERATIONAL AUDIT

Operational Audit involves examination of all the operations and activities of the entity under audit.

10.25.1 Objective

The objects of operational audit include the following:

'The examination of the control structure of the entity. The relation of department controls to general policies and its relation with control of other departments.

It provides an appraisal of whether the department is operating in conformity with prescribed standards and procedures laid down by the management.

It checks whether standards of efficiency and economy are maintained. It is concerned with formulation of plans and checking of the implementation of systems and controls in respect of other departments of the entity

It checks whether capacity utilization in production department and achievement of short term targets in marketing departments and other activities are so economically performed to achieve the preset overall goals of the entity.

10.25.2 Scope

Operational audit, in its initial stages, was developed as a branch of internal auditing. Internal audit focuses on accounting operations of the entity but operational audit has a wider scope of working and covers all other operations, such as production and marketing too.

10.25.3 Advantages

Operational audit is one of the management tools to get first hand information. It is more useful in an entity where the management is at a distance from actual operations. It is very useful in large organizations where management cannot control the actual operations due to layers of delegation of responsibility. The management information system has various tools like routine performance report from department heads, internal audit reports, surprise checks, periodic inspections and investigation to control the managers responsible for their departments. The operational audit is also one of the tools used in large or geographically vast entities to control the operation at first stage and to fill up the gaps of information provided by department heads through periodic reports.

10.26 CONTINUOUS AUDIT

Definition: According to the IIA (The Institute of Internal Auditors, USA), continuous auditing is "a method used to perform control and risk assessments automatically on a more frequent basis. Continuous auditing changes the audit paradigm from periodic reviews of a sample of transactions to ongoing audit testing of 100 percent of transactions. ft becomes an integral part of modern auditing It many levels... technology is a key to enabling such an approach."

Continuous audit may be defined as the examination and verification of a firm's financial transactions and their supporting documents, continuously throughout the year, at regular or irregular intervals.

A continuous audit driven system generates alarm triggers that provide advance notice about anomalies and errors detected by the system. It is performed usually by the firm's internal auditors to eliminate the year-end workload.

10.26.1 The Basic Features of Continuous Audit

i. It is a process conducted throughout the year.

ii. It is conducted at regular or irregular intervals.

iii. It focuses on testing 100% of transactions.

iv. Technology is important to enabling it.

v. It provides advance notice about errors and irregularities detected.

vi. Surprise visits by the auditor are involved.

10.26.2 Necessary of Continuous Audit

Continuous audit is necessary where:

i. Internal controls are inadequate.

ii. The transactions run in large numbers.

iii. The management is interested in getting statements of accounts audited periodically for enabling better management of resources.

10.26.3 The Advantages of Continuous Audit

i. **Early location of errors and frauds:** It helps in detecting errors and frauds immediately on their occurrence, and not at the year end when it would become difficult to install corrective control mechanisms.

ii. **Quick rectification**: rectification of errors at an early stage is possible.

iii. Continuous guidance to client.

iv. **Finalizations of accounts completion in time:** Just at the end of the accounting period.

v. **Moral check:** Make employees of the client alert and more efficient in conducting their work.

vi. **Improves statutory auditor's focus**: It relieves statutory auditors of routine testing and allows them to focus efforts on more valuable activities.

10.26.4 Some Apparent Demerits of Continuous Audit

i. The records and figures in the books of accounts, which have already been checked by the auditor, may be altered after the audit is over.

ii. Frequent visits made by the auditor may cause inconvenience at times.

iii. The client may suffer due to the clash of duties between his staff and that of the auditor.

iv. It is more expensive because the auditor has to devote more time to this audit.

v. The work of audit becomes too mechanical and repetitive.

10.27 INFORMATION SYSTEMS AUDIT

According to Ron Weber, "Information systems auditing is an organizational function that evaluates asset safeguarding, data integrity, system effectiveness, and system efficiency in computer based information systems. It has arisen for seven major reasons:

i. The consequences of losing the data resource;

ii. The possibility of misallocating resources because of decision based on incorrect data or decision rules;

iii. The possibility of computer abuse if computer systems are not controlled;

iv. The high value of computer hardware, software, and personnel;

v. The high costs of computer error;

vi. The need to maintain the privacy of individual persons; and

vii. The need to control the evolutionary use of computers."

10.28 ANNUAL AUDIT

Meaning: Annual Audit is conducted at the end of the accounting year, after the books of accounts have been closed.

10.28.1 Procedure

It does not interrupt with the regular functioning of the client's accounting or operations functions and ensures completion of work in one session due to continuity. The auditor may use statistical sampling methods and techniques which lead to time effectiveness. The possibility of tampering with the books of accounts during the audit is considerably reduced as the audit work starts only after the books are closed.

10.28.2 Limitations and precautions

A major disadvantage of annual audit is that all the errors and frauds are found at the end of the accounting year, which makes it very difficult to fix responsibility for defalcations. It delays the presentation of Audited Financial Statements to the shareholders and to prevent the delay, the auditor uses sample testing, which also reduces the possibility of detection of frauds and errors.

10.29 INTERIM AUDIT

Meaning and concept: Interim audit is an audit conducted between two annual audits. It may be conducted for a specific period, such as a quarter or half year, with an interim object of declaration of interim dividend or valuation of shares on a certain date, in case of mergers.

It is carried out by professionals, but has no legal status as the figures may be altered subsequently.

Use of Interim Audit

It is useful for:

i. Early detection and rectification of errors & frauds

ii. Publishing of interim results in some cases

iii. Timely completion of records and final audit

iv. Moral checks on employees

10.30 BALANCE SHEET AUDIT

Meaning: Balance sheet audit is generally synonymous with statutory audit. In a balance sheet audit, the auditor reviews and critically examines the Financial Statements, which include the Balance Sheet and Profit & Loss Account prepared by the management. He verifies each assertion in the Financial Statements, working backwards and checking through original entries made in the books of accounts and evidences to support the entries recorded.

3.30.1 Objective

While conducting a balance sheet audit, the auditor can rely upon the system of internal controls and internal checks and also on the reports of the internal auditor. Wherever internal controls and checks are sound, he can reduce the extent of routine checking of vouching, posting, casting and other routine tests. However, he should increase the extent of checking to obtain audit assurance if he finds that there are weaknesses in the internal control systems.

3.30.2 Need

With the development of industries and computerization of accounts, the need for balance sheet audit has increased. Now, the statutory auditor can reduce the extent of routine checking and concentrate more on critical examination of the Balance Sheet due to the computerized recording of large number of transactions and adoption of EDP system controls in data processing.

3.30.3 Procedure

As per the guidelines of national and international accounting bodies, the auditor should follow carefully planned audit procedures:

i. For identification of areas where sample testing is sufficient.

ii. For performance of certain compliance procedures and substantive procedures in some areas.

iii. For analytical review of Financial Statements.

iv. For verification of assets and liabilities stated in the Financial Statements.

v. For scrutiny of books of accounts to check whether Financial Statements are in conformity with the records.

vi. For evaluation of the internal control system and critical examination of the assertions made in the Financial Statements.

vii. For ensuring the compliance of all legal requirements relating to adequate disclosure of material facts in the Financial Statements.

3.30.4 Advantages of Balance Sheet Audit

i. Balance sheet audit commences after the completion of books of accounts. The management prepares the Balance Sheet, therefore changes in the accounts is not possible once the verification process is started.

ii. No interruption from the accounts department. Checking can be done smoothly without any breaks in between.

iii. No loose links because audit is conducted in a continuous flow, which reduces the chances of missing the verification of any aspect.

iv. Sample tests reduce the time involved for routine checking. The saving on account of time results in cost effectiveness.

10.31 DIFFERENCE BETWEEN BALANCE SHEET AUDIT AND ANNUAL AUDIT

Balance sheet audit and annual audit both commence after the financial period and are carried on until they are completed. Both are generally taken to be the same but balance sheet audit is a recent concept, where the efforts are concentrated on verification of balance sheet items. The main distinction is given as under:

S.No.	Balance Sheet Audit	Annual Audit
i.	Balance Sheet audit are more suitable for large Organisations where branches are wide spread and internal control systems are centralized and large numbers of small transactions are recorded at different places.	Annual audits are suitable in small organizations and where internal control system is reviewed by annual auditor, whether statutory or voluntary.
ii.	Balance sheet audit is limited to: Verification of balance sheet items and their comparison with previous year figures. Examination of items of profit & Loss Accounts with direct relation to Balance Sheet items. Concentrated efforts are made for verification of Balance Sheet and examination of Profit & Loss Account, but not for internal control systems.	Annual audit is to: Review the internal control systems and internal checks, and adherence to management policies. Critical examination of Financial statements and checking whether they are in conformity with the books of accounts maintained.

S.No.	Balance Sheet Audit	Annual Audit
iii.	The concept of balance sheet audit has its origin in the USA and is more popular in companies working globally.	Generally, annual audit is treated as balance sheet audit in India. However, because of computerization and EDP accounting, it is gaining popularity in India as a separate concept.

10.32 DIFFERENCE BETWEEN BALANCE SHEET AUDIT AND CONTINUOUS AUDIT

S.No.	Balance sheet Audit	Continuous Audit
i.	Balance sheet audit is taken up at the end of the financial period, when Financial Statement are drawn from completed books of accounts and other records.	Continuous audit is examination of records continuously throughout the year, at regular or irregular intervals.
ii.	Mandatory, and prescribed by different statutes.	Not mandatory/ Optional. It is conducted at the discretion of the management.
iii.	Statutory audit is conducted with the objective 0f ensuring truthfulness and fairness of the Financial statements of an entity.	Continuous audit is conducted with the objective of review of internal controls. Checks and financial or non financial operations of the organization.
iv.	Its scope is prescribed by the governing law.	Its scope is decided by the management and auditor through the Letter of Engagement.
v.	The auditor is an independent person and is appointed by the shareholders, on whose behalf the audit is conducted.	Continuous audit can be conducted by any independent agency or by the employees of the enterprise. It is conducted on behalf of the management.
vi.	A qualified CA can be a statutory auditor.	No qualification is prescribed.
vii.	The auditor's term ends at every AGM. However, he can be re appointed if he is not qualified.	The auditor's term may continue at the will of the management.
viii.	Report to shareholders/ owners in a format prescribed under law.	Report to the management in no prescribed formate.
	(a) As no routine checking is done so check on employees is lost. (b) Reliance on internal control is assumed and no efforts are made for review of internal controls or checks. (c) No timely detection of errors and frauds as it commences at the end of the financial year and works like a postmortem analysis. (d) In this era of computerization, the quantum of errors has reduced, but blunders may occur due to programming errors in the system of recording of transactions and preparation of Financial Statements.	(a) Very costly as more time is spent on continuous check. (b) Figures can be altered once the audit is over for a certain period. (c) Frequent visits by the auditor or his team may create inconvenience to the accounts department. (d) There are chances of collusion between the client' staff and auditor's staff because of frequent visits and distribution of duties among them.

10.33 COMPLETE, PARTIAL AND DETAILED (IN DEPTH) AUDIT

A complete audit is an audit where the scope of audit is not confined to specific limits, which may be set by the management or any other authority. The auditor is required to check all the possible aspects of a business, including manufacturing operations, data flow processes, accounting records and procedures, etc. In general business practices, it is not feasible to get a complete audit conducted.

A partial audit is a non statutory audit, which restricts the scope of the auditor to checking of certain specific aspects only. The auditor's powers to enquiry are restricted by his terms of engagement. He may not be allowed to obtain information which falls outside the purview of the scope defined for him. E.g. an auditor may be appointed to check the accuracy of recording of transactions relating to cash sales, or he may be appointed to conduct an audit for the month of Diwali only.

Detailed audit is also known as audit-in-depth. It involves checking of transactions from the time of their recording till their final effect on the Financial Statements. Every stage that a transaction goes through in the accounting process is closely examined by the auditor using various audit evidences.

10.34 STATUTORY REPORT

Statutory Audit of a public company implies the audit of the transactions of the company which are the subject-matter of the report under section 143. The auditor, however, has to certify as correct only as much of the Statutory Report as relates to the shares allotted by the company, cash received in respect of such shares and other receipts and payments of the company. The auditor, therefore, must:

(a) Examine the internal check with regard to the control over amounts collected. And

(b) Study the Memorandum, articles of Association and the Prospectus for ascertaining the amount of authorized capital, its composition, terms of issue, particulars of any underwriting contract entered in to, the rate of underwriting commission, shares agreed to be issued for consideration other than cash and particulars of important agreements entered into by the company.

In addition he should carry out an audit of the issue of shares. The under mentioned steps are also necessary:

i. Vouch the payment of the underwriting commission.

ii. Vouch the brokerage paid on issue of share by examining the application and confirming that they bear the stamps of the brokers or agents to whom brokerage has been paid. Refer to minutes of the Directors authorizing the payment of such broker age. Also see that the provisions of section 40 have not been contravened.

iii. Vouch the payment of preliminary Expenses and see that the amount paid does not exceed the amount fixed by the Articles or the prospectus.

iv. Vouch all other receipts and payments of the company up to date within seven days of the report; pay special attention to receipts and payments on capital account, e.g., sale proceeds of assets acquired from the vendor of the business, payments made to him, purchase of fixed assets, etc.

v. Check in detail amounts deposited in the bank and withdrawals thereof with the entries in the bank Pass Book. Obtain a certificate from the Bank as to the bank balance as at the date up to which the statutory report has been prepared.

vi. Verify that the amounts receivable and payable which have been adjusted in the books of account but have been excluded from the balance of receipts and payments.

The statutory audit culminates in the preparation of the statutory report. Its main content, with which the audit is concerned, is the abstract of Receipts and payments made up to a date within 7 days of the report, exhibiting under distinctive heads, receipts of the company from shares, debentures and other sources, payment made and balance left in hand. The Statutory Report is required to be certified by the auditors of the company, in so far as the report relates to shares allotted by the company, cash received in respect of which the checking of accounts, as per details given above, has been carried out.

Study Note - 11

AUDIT PLANNING, PROGRAMME AND PROCEDURES

This Study Note includes

11.1 Introduction
11.2. Audit Planning
11.3 Continuous Audit
11.4 Final Audit
11.5 Audit Working Papers
11.6. Audit Note Book
11.7 Quality Control for Audit Work
11.8 Audit Sampling
11.9 Audit Risk
11.10 Surprise Checks

11.1 INTRODUCTION

In any audit, the auditor examines the evidence available to him and gives his opinion on the basis of such examination. Further, he has to carry out the audit with the framework of standard auditing practices and that too with ethical conduct. Thus, the question involved is how the auditor should proceed to collect the necessary purposeful evidence, i.e. how he should prepare himself for an audit. The auditor has to move in a systematic manner so that he would be in a position to collect and review the purposeful evidence and also satisfy himself of the correctness of the financial operations of the business. In general, the whole audit process involves the following:

(i) Defining the scope of the audit work, i.e. preparation of the audit engagement letter.

(ii) Obtaining the knowledge of the client's business and formulating the audit programme.

(iii) Evaluation of the accounting and internal control system existing in the auditee enterprise.

(iv) Determining the nature, timing and extent of audit procedures keeping in mind the audit risk and materiality involved.

(v) Adequate documentation is also necessary, i.e. preparation of audit note book and working papers.

(vi) Formulation of opinion about the financial statements.

(vii) Issuance of audit report.

The auditor uses the following techniques to collect the necessary evidence:

(i) vouching.

(ii) Confirmations.

(iii) Physical examination and observation.

(iv) Analytical procedures.

(v) Test checking.

(vi) Inquiry.

(vii) Electronic data processing.

(viii) Preparation of reconciliation statements.

(ix) Flow charting.

(x) Scanning.

Further, the auditor has to see that various provisions of the law governing the enterprise are complied with. He has to examine the accounting principles followed and disclose the deficiencies and limitation on the scope, if any, observed by him. It is be noted that the auditor is concerned not only with the true and fair presentation of the affairs of the enterprise but also with the system of maintenance of accounts to bring real benefits of efficiency in working. At the same time, it is also a fact that the selection of the appropriate audit procedures is a matter of experience and judgment.

11.2. AUDIT PLANNING

SA 200 on 'Basic Principles Governing an Audit' issued by ICAI, mentions Audit Planning as one of the basic principles. It states that the auditor should obtain the knowledge about client's business to determine the nature, timing and the extent of the audit procedures. The audit plans should cover among other things, obtaining knowledge about the client's accounting systems, policies and the internal control procedures and coordinating the work to be performed. Further plans should be flexible one so that these could be developed or revised as and when considered necessary.

SA 300 on audit planning further expounds the concept laid down in SA 200. SA 300 applies to the planning process of the audit of financial statements as well as to other financial information in context of recurring audits.

Adequate planning helps to:

(a) ensure that appropriate attention is devoted to important areas of audit;

(b) ensure that potential problems are promptly identified;

(c) ensure that the work is completed properly and in time;

(d) utilize the assistants properly; and

(e) Coordinate the work performed by others.

The auditor should consider the factors such as the complexity of audit, the environment in which the entity operates his previous experience with the client and knowledge of client's business, while planning his audit work.

(A) Knowledge of the client's business

It will enable the auditor to identify the events, transactions and practices that in his judgment may have a significant effect on the financial information. The auditor can obtain such knowledge from:

(i) the client's annual report to its shareholders;

(ii) minutes of meetings of shareholders, Board of Directors etc;

(iii) internal financial management reports;

(iv) previous year's audit working papers;

(v) discussion with client;

(vi) the client's policy and procedures manual;

(vii) consideration to the state of economy and its affect on client's business; and

(viii) visit of the client's premises and plant facilities.

SA 310 on 'Knowledge of Business' issued by ICAI, establish standards on what is the knowledge of the business, why it is important to the auditor and to members of the audit staff working on an engagement, why it is relevant to all phases of an audit, and how the auditor obtains and uses this knowledge.

(B) Development of an overall plan

The overall plan should cover the following:

(a) terms of audit engagement and statutory responsibilities;

(b) nature and timing of reports or other communication;

(c) nature and timing of reports or other communication;

(d) relevant legal and statutory requirements;

(e) accounting policies of client and changes therein;

(f) effect of new accounting or auditing pronouncements on the audit;

(g) identification of critical audit areas;

(h) conditions requiring special attention;

(i) degree of reliance as regards accounting system and internal control;

(j) possible rotation of emphasis on specific audit areas;

(k) nature and extent of audit evidence to be obtained;

(l) work of internal auditors and reliance to be placed on them;

(m) consideration to branch auditor's report;

(n) allocation of work between joint auditors and the procedures for its control and review; and

(o) establishing and coordin*ating the staff requirements*

(C) Audit Programme

An audit programme is a detailed plan of the auditing work to be performed, specifying the procedures to be followed in verification of each item and the financial statements and the estimated time required. To be more comprehensive, an audit programme is written plan containing exact details with regard to the conduct of a particular audit. It is a description or memorandum of the work to be done during an audit. Audit programme serves as a guide in arranging and distributing the audit work as well as checking against the possibility of the omissions.

As per SA 300, the auditor should prepare a written audit programme setting forth the procedures that are needed to be implemented while carrying out the audit plan. He may take into account the reliance to be placed on internal controls. The auditor has some flexibility in deciding when to perform audit procedures. But, sometimes he may have no discretion as to timing, such as, observing the stock taking by the client's personnel. The audit programme should consider previous year's audit programmes and these may be modified, if necessary.

An audit programme may be classified into two categories:

i. Programme common to all types of audit. For example, checking of books of accounts; and

ii. Special programme containing the work relating to a particular audit. For example, the audit programme for a partnership firm would be different from that of a company.

(a) Advantages of audit programme

(i) The main advantages of an audit programme are as follows:

(ii) It serves as a ready check list of audit procedures to be performed.

(iii) The audit work can be properly allocated to the audit assistants or the article clerks.

(iv) The auditor may easily know the extent of work done at any point of time. Thus, the progress of work done can be under the supervision and control of the auditor.

(v) Audit programme would not only be useful for the audit assistants in carrying the audit work but for the principal too as he would be in a position to account for the individual responsibilities.

(vi) A uniformity of the work can be attained as the same programme would be followed from time to time.

(vii) It is a useful basis for planning the programme for the following year.

(viii) It may be used as evidence by the auditor in the event when any charge is brought against him. He can prove that there has no negligence on his part and he exercised reasonable care and skill while performing the task.

(b) Disadvantages of Audit Programme

The main disadvantages of an audit programme are as follows:

(i) The auditor's task becomes mechanical and the auditors may lose interest and initiative.

(ii) Drawing up of an audit programme may be unnecessary for a small concern.

(iii) Though audit programme helps in fixing responsibilities but inefficient staff may defend themselves by stating that the matter was not contained in the audit programme.

(iv) Rigid programmes cannot be laid down for each type of business.

Though an audit programme may suffer from the above disadvantages but these can be removed by taking some initiatives such as consulting the audit assistants, modifying the programme on the basis of experience gained during audit, etc.

11.3 CONTINUOUS AUDIT

Continuous audit involves the detailed examination of all the transactioas by the auditor continuously throughout the year or at regular intervals, say fortnightly or monthly. A continuous audit is one which is commenced and carried on before the close of the financial year to which it relates. It involves the constant engagement of auditor's staff at the client office throughout the period under review. Continuous audit is suitable in cases where the final accounts are desired to be presented soon after the close of the financial year or there is great volume of transactions or the system of internal check is weak.

(a) Advantages

(i) A close and extensive examination of accounts is possible as the auditor gets full year for the purpose.

(ii) The errors and frauds can be detected and rectified soon.

(iii) A regular supervision by the auditor brings increased efficiency and accuracy in the accounts of the enterprise.

(iv) Better MIS system because of availability of updated and accurate accounts.

(v) Continuous audit create more check on the client's staff.

(vi) The auditor can have much better understanding of the client's business and thus he can suggest the client the ways to improve operational efficiency.

(vii) The final accounts can be prepared and reported upon soon after the end of the financial year.

(viii) It also facilitates auditor to schedule his work in convenient manner and avoid the pressure that may mount at the close of financial year.

(b) Disadvantages

(i) The auditor checks the books of accounts in several visits. The items or figures or books of accounts may be tampered by the client's staff after the auditor has checked them during previous visits.

(ii) The technique of continuous audit is not suitable for small concerns.

(iii) Auditor's frequent visits may cause inconvenience to the client's staff.

(iv) Further, friendly ties may develop between client's staff and the auditor' staff. This may lead to collusion among them.

(v) The work become too mechanical as it continues throughout the year.

These disadvantages can be avoided by taking the following measures:

(i) An audit programme should be prepared in a systematic manner.

(ii) The auditor should use secret ticks and use different colours to denote the specific ticks during the course of checking the different entries.

(iii) Specific instructions should be given to the client's staff not to alter or correct the audited figures.

(iv) The visits should be at irregular intervals so that the staff of the client may not be able to prepare in advance against the possible queries.

(v) Adequate documentation, i.e., working papers should be maintained so that the thread of work is not lost.

11.4 FINAL AUDIT

A final audit is also called as Completed Audit or Periodical Audit. Final audit is done after the close of the financial year, i.e. after the books of accounts have been closed and the final accounts are drawn up. In this type of audit, the client gives the possession of books of accounts to the auditor for audit and routine checking and other audit procedures begin only after that.

(a) Advantages

i. The work can be carried on at a stretch. Thus the thread of work is not lost.

ii. As the audit work commences only after the year end, there is no dislocation of client's work.

iii. Collusion among audit staff and client's staff can be avoided.

iv. Periodical audit is also suitable for small size concerns.

(b) Disadvantages

i. Accounts cannot be subjected to detailed checking. Some of the errors or frauds may remain undetected.

ii. Periodical audit is not advisable for large concerns because they have voluminous transactions.

iii. There is a delay in presentation of final accounts.

11.5 AUDIT WORKING PAPERS

Audit working papers are the record of the planning and execution of the audit engagement. Auditors retain a set of working papers for each audit engagement for each year. The audit working papers for the current year are referred to as the current working papers. Working papers that are relevant to more than one audit engagement are often kept separately in a file referred to as permanent working papers. The audit working papers (current and permanent) for a client audit engagement are sufficiently detailed to enable another appropriately experienced and competent auditor that is not familiar with the client to obtain an overall understanding of the engagement.

SA 230 on 'Documentation' issued by ICAI deals with the 'working papers'. As per this SA, documentation refers to the working papers prepared or obtained and retained by the auditors for his audit work. Working papers (or documentation) serve three purposes (i) aid in planning and performance of the audit; (ii) aid in supervision and review of the audit work; and (iii) these papers serve as an evidence of the audit work performed by the auditor to support his opinion.

Further, as per SA 230, working papers are the momentous records of the auditor which help in establishing that the reasonably logical and verifiable conclusions were reached on the basis of relevant audit evidence. These working papers also facilitate audit planning and supervision of the audit work. The form and content of working papers vary from audits to audits, but they are affected by the following matters:

(a) nature if engagement;

(b) form of audit report;

(c) nature and complexity of client's business;

(d) nature and condition of client's records

(e) degree of reliance of internal controls;

(f) supervision of work performed by assistants.

Types of working paper files

In case of recurring audits, some working papers files may be classified into permanent audit files and current audit files: while the former is updated with the Information of continuing importance, the latter contains information relating to audit of a single period. The contents of these files are given below:

Permanent Audit File	Current Audit File
(a) Legal and organizational structure of the entity, e.g. MOA and AOA in case of a company.	(a) Correspondence relating to acceptance of annual reappointment.
(b) Extracts or copies of legal documents, agreements and minutes relevant to the audit.	(b) Extracts of important matters in the minutes of Board Meetings and General Meetings relevant to the audit.
(c) A record if study and evaluation of internal controls.	(c) Copies of management letters.
(d) Analysis of significant ratios & trends.	(d) Analysis of transactions and balances.
(e) Copies of the audited financial statements of previous year(s).	(e) Copies of communication with other auditors, experts and third parties.
(f) Notes regarding significant accounting policies.	(f) Audit programme.
(g) Significant audit observations of the earlier years.	(g) Conclusions reached on significant aspects of audit.

Working papers are the property of the auditor, the portions or extracts of which can be had at his discretion. These working papers should kept in safe custody and in confidential manner for such time as is sufficient to meet the requirements of his practice or to satisfy any related legal or professional requirement of record retention. However, if required by some legislation, the auditor has to make working papers available to the regulatory authority(s). In case of Chantery Martin & Co, it was held that the audit working papers are the property of the auditor and he is entitled to retain them.

ICAI has prescribed that the members have to retain the working papers for a period of 7 years (as per SQC 1). Otherwise, the member is guilty of professional misconduct.

11.6. AUDIT NOTE BOOK

An audit book is usually a bound book in which a large variety of maters observed during the course of audit are recorded. The audit note book is a permanent record of the auditor. For each individual audit, the auditor usually maintains a separate audit note book. The audit note book should be maintained clearly, completely and systematically. An audit note book is a great evidential tool available as a defence with the auditors in the event of any charge is brought against them. In case of City Equitable Fire Insurance Company, the auditors were relieved because they have maintained record of the audit work performed at each stage.

i. Contents of Audit Note Book

ii. Name of the business enterprise.

iii. Organisation structure.

iv. Important provisions of Memorandum and Articles of Association.

v. Communication with the previous auditor, if any.

vi. Management representations and instructions.

vii. List of books of accounts maintained by the enterprise.

viii. Accounting methods, internal control systems followed by the enterprise, applicable laws etc.

ix. Key management personnel.

x. Errors and fraud discovered.

xi. Matters requiring explanations or clarifications.

xii. Special points that need attention in the audit report and for subsequent audits.

11.7 QUALITY CONTROL FOR AUDIT WORK

ICAI has issued SA 220 in this regard. The objective of this standard is to establish standards on quality control as to the policies and procedures of an audit firm for audit work generally, and procedures regarding the work delegated to assistants on an individual audit. It defines 'Auditor' as the person with final responsibility for the audit; 'Audit firm' as a partnership firm or sole practitioner providing audit service; 'Personnel' as all partners and professional staff engaged in the audit practice of the firm; 'Assistants' as personnel involved in an individual audit other than auditor.

(1) Factors to be considered for incorporating quality control in audit work

The audit firm should implement quality control policies to ensure all audits are conducted in accordance with Auditing and Assurance Standards. The following essential factors should be considered for incorporating quality control in audit work-

(a) Professional Requirements.-Adherence to basic principles such as independence, integrity, objectivity, confidentiality, etc.

(b) Skills and competence -Audit personnel should have required degree of skill and competence.

(c) Assignment - Audit work should be assigned only to competent personnel.

(d) Delegation -There is to be sufficient direction, supervision and review of work at all levels.

(e) Consultation -Whenever necessary, consultancy within and outside the firm with experts.

(f) Acceptance and Retention of clients.-Evaluation of prospective client and review of existing client should be done on an ongoing basis.

(g) Monitoring -Continued adequacy and operational effectiveness of quality control policies and procedures should be monitored.

(h) The firm's quality control policies and procedures should be effectively communicated to its personnel.

(2) Levels for Audit Work-Audit Firm and Individual Audit

Quality control policies and procedures should be implemented at 9oth the level of audit firm and on individual audits (SA 220). The quality control policies applicable to firm should be implemented for individual audits to the extent applicable. The audit work should be delegated to assistants with professional competence and should be appropriately directed and supervised. The work of assistants should also be reviewed.

Direction

Audit assistants should be informed of the nature of business and possible accounting or auditing problems. They should be explained of what is expected of them and how to achieve it. They should be informed about the importance of audit programme, time budgets and overall audit plan.

Supervision

(i) Persons carrying out supervisory responsibilities should

(ii) monitor the progress of audit;

(iii) become informed of and address significant accounting and auditing questions raised during the audit;

(iv) resolve the differences of professional judgment and consider the level of consultation as appropriate.

Review

(i) Review of work of audit staff should be carried out to ensure that the

(ii) work has been performed as per the audit programme;

(iii) work performed has been adequately documented;

(iv) all significant matters have been resolved or are reflected in audit conclusions;

(v) objectives of the audit procedures have been achieved; and

(vi) conclusions expressed are consistent with the work performed.

The following matters need to be reviewed on a timely basis

(i) overall audit plan and the audit programme;

(ii) assessment of inherent and control risks as well as any modifications made to the overall audit plan and programme;

(iii) documentation of the audit evidence obtained from substantive procedures and the conclusions drawn there from;

(iv) any proposed adjustments to the financial statements arising out of auditor's examination and observations.

Delegation and Supervision of Audit Work

Except for the smallest of audit engagements, it is not possible for an auditor to perform the entire audit himself. This is because the audit would take too long to complete and the cost of performing the audit would be prohibitive. This means that it is usually necessary for the auditor to delegate significant work (or authority to further delegate work) to other staff members within the audit firm. Delegation is only possible if there is appropriate supervision and review of the work performed. The person that supervises and reviews work performed by others is a person who is at least as equally experienced and competent as the person to whom the work/authority has been delegated, and is usually the person that delegated the work/ authority.

Delegation

An auditor only delegates work/authority to persons (i.e. delegatees) with the appropriate experience and competence. This applies to all levels of organization within the audit firm. Thus, a senior staff member to whom work/authority has been delegated only further delegates work/authority to other staff members that have the appropriate experience and competence.

An auditor or staff member delegating work/authority ensures that the person to whom the work/ authority has been delegated (i.e. the delegatee) completely understands the nature of the work that the person is required to perform as well as the limits of any delegated authority.

Supervision

Auditors and audit staff members supervise the work delegated by them to others so as to minimize the risk of a lessening of the standard of care. The more complex the nature of the work delegated and the less experienced or competent the staff member to whom the work has been delegated, then the greater the degree of supervision.

Auditors supervise work while it is being performed by the delegatee. This contrasts with the review of work which auditors carry out after the delegatee has performed the work.

The purpose of supervision is to provide the supervisor with a degree of assurance that the work of the delegatee is being performed (as opposed to was performed) in accordance with the instructions given and with the appropriate standard of care.

Review

Work performed by the auditor and his audit staff is reviewed. Work performed by the auditor (the engagement partner) is reviewed by a person not personally involved with the client (the review partner and/or personnel from quality control). Work performed by the auditor's staff members is usually reviewed by the person that delegated the work to those staff members.

The purpose of this quality review is to ensure that the work was performed in accordance with instructions given, with the appropriate standard of care, and in accordance with any delegated authority. In relation to work performed in the control testing, substantive testing and opinion formulation stages, the reviewer ensures that audit procedures performed conform with the audit programs, that audit procedures required to be performed have been properly performed, that the evidence obtained has been properly documented and that conclusions reached are consistent with the evidence obtained.

11.8 AUDIT SAMPLING

The main objective of an audit is to formulate an overall opinion on the financial statements being examined by the auditor. The accounts of a large size enterprise have a large number of transactions. So it may be physically impossible for the auditor to check each and every transaction. For example, the total number of payments made by a large Bank in a year may be so large that the auditor cannot verify all of them. If he attempts to do so, it would probably take him many years to complete the audit and that to at great costs. Therefore, an auditor has top undertake selective verification or in other words audit sampling.

(1) Meaning

As per SA 530 on "Audit Sampling", it means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population.

It is important to recognise that certain testing procedures do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise, applying audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount) does not qualify as audit sampling with respect to the portion of the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population but would not necessarily be the basis for a valid conclusion about the remaining portion of the population.

(2) Test Checking

Test checking is concerned with selecting and examining a representative sample from a large number of similar items. There is no hard and fast rule of selecting item for the test checking. The justification for the test checking lies in the theory of probability which states that a sample selected from a series of items will tend to exhibit the same characteristics as present in the population, i.e. full series of items. While test checking the following aspects need to be considered:

i. Presentation and disclosure.

ii. Adherence to the generally accepted accounting practices.

iii. Compliance with the statutory requirements.

iv. Existence of errors and frauds.

v. Arithmetical accuracy.

vi. Materiality of the items involved.

(3) Precautions before applying test checking

The auditor must take the following precautions before he applies test checking for auditing:

i) The auditor must review the system of internal controls existing in the enterprise. Test checking should be avoided in case the internal control system is weak or ineffective.

ii) The sample selected for test checking should be representative in character and the transactions should be of homogeneous nature.

iii) The number of transactions to be selected for test checking should be predetermined depending upon the extent to which the reliance can be placed on the results of test checking.

iv) The auditor should identify those areas where test checking is not suitable, for example, opening and closing entries, bank reconciliation statement, non-recurring items, transactions of a seasonal industry, other areas where the compliance with the applicable law is required such as managerial remuneration under Companies Act, etc.

v) No element of bias should be present in selecting a sample.

vi) The system of test checking should be reviewed from time to time so that necessary improvements, if any, can be made.

(4) Methods of statistical sampling

There are two main methods for determining the size of sample viz. Judgmental Sampling and Statistical Sampling. Each one of these methods is discussed below:

Judgmental Sampling - In this method, the sample size is determined on the basis of the personal experience and the knowledge of the auditor. It is one of the simple methods of sampling. It may be noted that this method, though simple in its applicability, is neither scientific nor objective. The risk of personal bias in selection of sample is always present. Thus, an element of subjectivity does prevail in this method.

Statistical Sampling: - This method is more scientific in its approach than the method of judgmental sampling. It involves application of mathematical techniques like theory of probability, use of random number tables etc. But it may also be noted that the auditor need not require having an in depth understanding of the statistical techniques because published statistical tables are available which indicate the sample size based on predetermined criteria.

The advantages of statistical techniques, properly applied, over judgement sampling are:

i. Conclusions about the total population can be stated with a know confidence and precision;

ii. Sample size is objectively determined;

iii. Time and money may be saved by limiting sample size to that required to achieve a given result.

For these reasons, whenever the size and homogeneity of the group to be checked permits, statistical sampling is generally to be preferred to judgement sampling. Statistical sampling is most likely to be successful when the following conditions are present:

i. A large population to be checked;

ii. The population consists of similar items;

iii. Items for checking easily selected and located;

iv. The error rate is reasonable low (e.g. good system of internal control in force).

(5) Selection of the sample

Auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

While there are a number of selection methods, three methods commonly used are:

(a) Random selection, which ensures that all items in the population have an equal chance of selection, for example, by use of random number tables.

(b) Interval sampling or Systematic selection, which involves selecting items using a constant interval between selections, the first interval having a random start. The interval might be based on a certain number of items (e.g. every 20th voucher number) or on monetary totals (e.g. every 1,000 increase in the cumulative value of the population). When using systematic selection, the auditor would need to determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For example, if in a population of branch sales, a particular branch's sales occur only as every 100th item and the sampling interval selected is 50, the result would be that the auditor would have selected all, or none, of the sales of that particular branch.

(c) Haphazard selection, which may be an acceptable alternative to random selection, provided that the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units. When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, toward items which are easily located, as they may not be representative.

One another method which is used is Stratified Sampling. This method involves dividing the whole population into separate groups. These groups are called strata. The sample is taken from these strata. Each stratum is treated as if it was a separate population and the proportionate of items is selected from this stratum. This method is based on the logic that in case of highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each stratum. In a way, this method is an extension of random sampling. For example, debtors' balances may be divided into following strata:

- balances in excess of ₹ 1,00,000;
- balances in the range of ₹ 75,000 - ₹ 1,00,000;
- balances in the range of ₹ 25,000 - ₹ 75,000; and
- balances below ₹ 25,000

(6) Sampling risk

While determining the sample size, the auditor should consider sampling risk, the tolerable error, and the expected error.

Sampling Risk: Sampling risk arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure. The auditor is faced with sampling risk in both tests of control and substantive procedures as follows:

(a) Tests of Control:

i. Risk of Under Reliance: The risk that, although the sample result does not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.

ii. Risk of Over Reliance: The risk that, although the sample result supports the auditor's assessment of control risk, the actual compliance rate would not support such an assessment

(b) Substantive Procedures:

i. *Risk of Incorrect Rejection: The risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is materially misstated, in fact it is not materially misstated.*

ii. *Risk of Incorrect Acceptance: The risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is not materially misstated, in fact it is materially misstated.*

The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial

Statements than either the risk of under reliance or the risk of incorrect rejection. Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Tolerable Error: Tolerable error is the maximum error in the population that the auditor would be willing to accept and still concludes that the result from the sample has achieved the audit objective. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be. In tests of control, the tolerable error is the maximum rate of deviation from a prescribed control procedure that the auditor would be willing to accept, based on the preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the auditor would be willing to accept so that when the results of all audit procedures are considered, the auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

Expected Error: If the auditor expects error to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is expected to be error free. In determining the expected error in a population, the auditor would consider such matters as error levels identified in previous audits, changes in the entity's procedures, and evidence available from other procedures.

11.9 AUDIT RISK

In very broad terms, audit risk is the risk of a material misstatement of a financial statement item that is or should be included in the audited financial statements of an entity. In theory, audit risk ranges anywhere from zero, where there is complete certainty of no material misstatement, to one, where there is complete certainty of a material misstatement. In practice, however, audit risk is always greater than zero. There is always some risk of material misstatement as it is not possible, (except for the audit of the simplest of financial statements), due to the limitations inherent in both accounting and auditing, to be absolutely certain that a material misstatement will not exist.

i. "Audit risk" is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Such misstatements can result from either fraud or error. SA 400 on "Risk Assessments and Internal Controls" identifies the following three components of audit risk:

ii. Inherent risk. – it is the susceptibility of a account balance or class of transaction to misstatements that could be material, either individually or when taken together with misstatements in other balance or classes, assuming that there were no internal controls.

iii. Control risk.-it is the risk that misstatement, that could occur in an account balance or class of transactions and that could be material, either individually or when taken together with misstatements in other balances or classes, will not be prevented/detected/corrected on timely basis by the accounting and internal control systems

Detection risk.-it is the risk that an auditor's substantive procedures (the procedures designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system) will not detect a misstatement that exists in account balance or class of transactions that could be material, either individually or when taken together with misstatements in other balances or classes

11. 10 SURPRISE CHECKS

Auditor and his staff have to visit the client's place for carrying out the audit. Normally, the visit is given to understand the accounting system, to evaluate the system of internal controls, stock taking etc. It is well accepted that the audit constitutes a moral check on the employees of the client and thus have a deterrent effect. But at the same time, if the auditor or his staff visits at regular intervals, the client or his staff may get time to be well prepared in advance for the audit queries. This may impair the deterrent effect. Thus, there is a need of element of surprise.

An element of surprise can significantly improve the effectiveness of an audit and therefore, wherever practicable, an element of surprise should be incorporated into the audit programme. The Council of ICAI has made the following recommendations in this regard:

i) Surprise checks should be considered as a desirable part of each audit.

ii) The areas over which surprise checks should be employed would depend upon the circumstances of each audit but should normally include:

- Verification of cash and investments.
- Test verification of stores and stocks and the records relating thereto.

- Verification of books of prime entry and statutory registers normally required to be examined for the purposes of audit.

iii. The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.

iv. The results of the surprise checks should be communicated to the management if they reveal weakness in the internal control system or the existence of fraud or error.

v. The auditor should satisfy himself that adequate action is taken by the management on the matters communicated by him.

vi. The results of surprise checks should be included in the audit report if they are material and affect the true and fair view of the accounts on which the reporting is done.

Study Note - 12

INTERNAL CONTROL, INTERNAL CHECK AND INTERNAL AUDIT

This Study Note includes

12.1 Internal Control
12.2 Internal Check
12.3 Difference between a Checklist and an Internal Control Questionnaire
12.4 Distinction between Internal Check, Internal Audit and Internal Control
12.5 Brief Difference between Internal Audit, Internal Control and Internal Check
12.6 Surprise Check
12.7 Cut off Procedures
12.8 Examination in Depth/Auditing In Depth: ''Walk Through Test"
12.9 Difference between Test Checking and Statistical Sampling
12.10 Internal Audit
12.11 Organisational Independence
12.12 Standards on Internal Audit (SIA)

12.1 INTERNAL CONTROL

The internal control system comprises all the methods and procedures adopted to assist in achieving the objective of efficient conduct of business, ensure adherence to management policies, safeguarding of assets, prevention and detection of frauds and errors, and checking the accuracy and completeness of the accounting records. Internal checks and internal audit are integral parts of the overall internal control system.

Internal control refers to a process that is designed for helping the organization to accomplish goals and objectives through people of the organization and IT systems, whereas internal check is a part of internal control. It refers to the accounting procedure that acts as a safeguard against frauds and losses. On the other hand, internal auditing is an activity that devises ways for organizations for better achievement of objectives.

12.1.1 Essentials of An Internal Control System

An efficient internal control system should provide:

i. For proper division of functional responsibilities.

ii. For proper authorization and assignment of duties to perform and record the transactions.

iii. For adoption of proper practices for adherence with management policies.

iv. For proper review and authorization of all transactions before they are recorded in the books and safeguard all business assets.

v. Proper internal checks

vi. Proper internal audit system.

12.3 Objectives of Internal Control

Each organization must have a system of internal control in place for achieving the preset goals. Other than accomplishing the desired goals and objectives of the organization, this system plays a very important role in any organization. The main objectives of internal control are as follows:

i) **Compliance:** To have compliance with law and the accounting practices generally accepted and followed in the country. The accounting process also needs to be in compliance with these.

ii) **Reliance:** To increase the reliance on the internal systems, people and accounting practices followed by the organization, so that the chances of frauds are reduced.

iii) **Safeguarding:** To safeguard the organization's accounts, employees and assets by formation of fool-proof policies, rules and regulations.

iv) **Security:** To provide security to customers, employees and property of the organization. Physical security systems like security guards, locks and anti-theft devices are used for providing protection.

v) **Increased efficiency:** To assist in human resource and performance management, and to keep proper control over business activities to achieve maximum levels of efficiency.

vi) **Evaluation:** To evaluate the accounting system for proper authorization of transactions.

vii) **Review and correction:** To review the working of the business, locate weak points in operations and to take corrective measures for proper working.

viii) **Authorization:** To provide proper authority for purchase, sale, valuation, verification and possession of assets.

ix) **Delegation:** To provide for division of duties among the employees where all staff members work cohesively.

x) **Accurate planning:** To ensure that the auditors and the accountants of the organization make all the financial reports correctly and to ensure that financial planning is done accurately.

xi) **Conformity with accounting principles:** To conform to the basic accounting concepts, and principles and lc1.ws governing the organization.

xii) **Resource utilization:** To ensure that all the resources: man, material, money and machines of the organization are optimally used.

xiii) **Safeguarding of resources:** To protect the resources of the organization against mismanagement or fraud and to ensure that the company's activities are in accordance with laws and regulations.

xiv) **Setting future Corporate Goals:** An efficient system of internal control helps the organization in goal setting. However, the organization should have certain policies, rules and regulations in place to achieve the preset goals.

12.1.3 Advantages of Internal Controls

Efficiency, effectiveness and economy: A good internal control system ensures that the resources are utilized only for their intended purposes and helps to overcome the risk associated with the misuse of organization's funds and other resources.

Prevention of errors and irregularities: It prevents errors and irregularities by detecting them in a timely manner, thereby promoting reliable and accurate accounting records.

Safeguard from irregularities or misappropriations.

Employees' satisfaction: It protects the interests of employees by segregation of duties and delegation of responsibilities.

12.1.4 Types of Internal Control Systems

The type of internal control system to be employed in an organization depends upon the requirements and nature of the business. Generally, there are two types of Internal Control in an Organisation: preventive and detective controls. Both types of controls are essential to an effective internal control system. From a quality standpoint, preventive controls are essential because they are proactive and emphasize quality. However, detective controls play a critical role by providing evidence that the preventive controls are functioning as intended.

i) **Preventive Controls** are designed to discourage errors or irregularities from occurring. They are proactive controls that help to ensure departmental objectives are being met. Examples of preventive controls are:

- **Segregation of Duties:** Duties are segregated among different people to reduce the risk of error or inappropriate action. Normally, responsibilities for authorizing transactions (approval), recording transactions (accounting) and handling the related asset (custody) are divided.
- **Approvals, Authorizations, and Verifications:** Management authorizes employees to perform certain activities and to execute certain transactions within limited parameters. In addition, management specifies those activities or transactions that need supervisory approval before they are performed or executed by employees. A supervisor's approval (manual or electronic) implies that he or she has verified and validated that the activity or transaction conforms to established policies and procedures.
- **Security of Assets (Preventive and Detective):** Access to equipment, inventories, securities, cash and other assets is restricted; assets are periodically counted and compared to amounts shown on control records.

ii) **Detective Controls** are designed to find errors or irregularities after they have occurred. Examples of detective controls are:

- Reviews of Performance: Management compares information about current performance to budgets, forecasts, prior periods, or other benchmarks to measure the extent to which goals and objectives are being achieved and to identify unexpected results or unusual conditions that require follow-up.
- Reconciliations: An employee relates different sets of data to one another, identifies and investigates differences, and takes corrective action, when necessary.
- Physical Inventories
- Audits

iii) **Corrective Controls** target at the correction of errors and irregularities as soon as they are detected.

12.1.5 Steps In Internal Control

An effective internal control system consists of certain important steps:

Control Environment: Establish Integrity & ethical value.

Assessment of Risk: Establishment of plan to prevent risks.

Control Activities: Formulating policies & procedures.

Information & communication: Evaluation of employee performance.

Monitoring: Assessing overall performance of the Organisation.

12.1.6 Nature and Scope of Internal Control

(i) **Nature:** Internal control is an essential prerequisite for efficient and effective management of any organization. It is, thus a primary responsibility of every management to establish and maintain an adequate system of internal control appropriate to the size and nature of the business of the entity.

SA 265 defines the system of internal control as "all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information".

(ii) Scope: SA 265 defines 'accounting system' as "series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records". The system of internal control "extends beyond those matters which relate directly to the functions of the accounting system" and comprises control environment and control procedures.

'Control' represents the overall attitude, awareness and actions of directors and management regarding the internal control system of the entity. For example, in a strong control environment, there would be tight budgetary controls and an effective internal audit function. The control environment in an enterprise depends largely on the following factors:

i. The entity's organizational structure and methods of assigning authority and responsibility (including segregation of duties and supervisory functions).

ii. The function of the board of directors or the corresponding governing body and its committees, e.g. how strong is the audit committee of the board of directors.

iii. Management's philosophy and operating style. Does the management believe in having a strong control environment (which implies that the management itself would also be subjected to the discipline of controls)?

iv. Management's control system including the internal audit function, personnel policies and procedures.

'Control procedures' are the policies and procedures that the management has established to achieve the entity's specific objectives, e.g. physical verification of assets, periodical review and reconciliation of accounts, specific controls on computer generated data.

The scope of internal control, as per the above definition, extends beyond mere accounting controls. Thus operational controls such as quality control, work standards, budgetary control, periodic reporting, policy appraisals, quantitative controls, etc. are all parts of the internal control system.

In an independent financial audit, the auditor is primarily concerned with those policies and procedures within the accounting and internal control systems which are relevant to the assertions underlying the financial statements. These comprise primarily controls relating to safeguarding of assets, prevention and detection of fraud and error, accuracy and completeness of accounting records and timely preparation of reliable financial information. On the other hand, in an operational audit, the auditor reviews all controls including administrative and managerial controls concerned with the decision-making process. An example of administrative controls is the maintenance of records giving details of customers contacted by the salesman or the procedure of getting the production manager's approval of the samples of a manufactured product.

12.1.7 Basic Elements of Internal Control

An effective system of internal control should have the following basic elements:

1. **Financial and other Organizational Plans:** This may take the form of manual suitably classified by flow charts. It should specify the various duties and responsibilities of both management and staff, stating the powers of authorisation that reside with various members. This is important as in the event of staff absence or otherwise the correct flow of work and the internal control system could be vitiated by any wrong implementation of procedures by staff either unintentionally or willfully.

2. **Competent Personnel:** In any internal control system, personnel are the most important element. When the employees are competent and efficient in their assigned work, the internal control system can be worked and operated efficiently and effectively even if some of the other elements of the internal control system are absent.

3. **Division of Work:** this refers to the procedure of division of work properly among the employees of the organization. Each and every work of the organization. Each and every work of the organization should be divided in different stages and should be allocated to the employees in accordance with quality and skill.

4. **Separation of operational responsibility from record keeping:** If each department of an organization is being assigned to prepare its own records and reports, there may be a tendency to manipulate results for showing better performance. So in order to ensure reliable records and information, record-keeping function is separated from the operational responsibility of the concerned department.

5. **Separation of the custody of assets from accounting:** To protect against misuse of assets and their misappropriation, it is required that the custody of assets and their accounting should be done by separate persons. When a particular person performs both the functions, there is a chance of utilizing the organisation's assets for his personal interest and adjusting the records to relieve himself from the responsibility of the assets.

6. **Authorization:** In a internal control system, all the activities must be authorized by a proper authority. The individual or group which can grant either specific or general authority for transaction s should hold a position commensurate with the nature and significance of the transactions and the policy for such authority should be established by the top management.

7. **Managerial supervision and review:** The internal control system should be implemented and maintained in conformity with the environmental and elemental changes of the concern. By adapting any specific control system permanently, the extent to which the procedures of flexible controls have been followed in real practice should be observed and re-examined.

Importance: Good internal control is essential for assuring the accomplishment of goals and objectives. It provides reliable financial information for management decisions. It ensures compliance with applicable laws and regulations to avoid the risk of public scandals. Poor or excessive internal control reduces productivity, increases the complexity of processing transactions, increases the time required to process transactions and add no value to the activities. Good internal control helps ensure efficient and effective operations that accomplish the goals of the organisation and protects employees and assets. It helps in bringing to light any misuse or misappropriation of the company's assets and takes corrective measures in safeguarding assets. It creates appropriate climate for efficient organizational functioning. It prevents and detects frauds and errors and ensures timely preparation of financial statements and report for decision making.

12.1.8 Limitations of Internal Control

i. **Organizational Structure:** Deficiencies in organizational structure make internal control ineffective.

ii. **Size of the Organization:** Small organizations have very low levels of internal control, which are almost negligible due to more interference by owners and management.

iii. **Unusual Transactions:** The internal control procedures normally fail to keep a check on unusual transactions.

iv. **Costly:** The implementation of internal control procedures and processes involves incurring costs in terms of time, effort and resources.

v. **Abuse of Power:** Members at the top-level management may override/interfere with control.

vi. **Collusion of two or more People:** It may lead to internal controls being over- ridden.

vii. **Obsolescence:** Control system may become redundant with passage of time if not updated with change in the size and nature of business.

viii. Potential for human error.

ix. **Frequent follow-up measures:** Follow-up procedures need to be frequent to ensure its effectiveness, which is extremely time-consuming.

12.1.9 Responsibilities of Management Vis-A-Vis Auditors

(a) Primary Responsibility of Management: The prime responsibility for maintaining an adequate accounting system and incorporating various internal controls rests with the management. The responsibility of closely monitoring the system to ensure that it is in place, so as to facilitate the basic objectives of installing it, also rests with the management.

(b) Auditor's Responsibility: To safeguard his own interests, the auditor might resort to examination and evaluation of the internal controls that exist in the organization. He formulates an audit programme only after satisfying himself that such internal control systems are adequate and in consonance with the requirements of the business. The auditor should bring the weaknesses of the internal control system, if any, to the management's notice through a "letter of weakness" or "management letter".

12.1.10 Evaluation of Internal Control By The Auditor

A. Understanding the System

This can be done in the following ways:

i. Discussions with personnel at various levels of the organization.

ii. Reference to organization charts, procedure manuals, information flow channels, etc.

iii. Inquiries using a brief, but complete questionnaire

B. Testing of internal control

This can be done in the following ways:

i. Procedural tests:

These tests deal with checking the compliance of the procedures laid down by the management in respect of transactional flow at each stage. They provide reasonable assurance about the proper implementation and effectiveness of internal controls.

ii. Examination in depth:

This involves examination of a few selected transactions from the beginning till the end. Recording of transactions at various stages, documentation of the same, and authenticity of authorizations is checked in detail.

The Auditor forms a conclusion, based on his examination of the internal control system, which incorporates the following points:

a. The degree and nature of weaknesses in the system.

b. The extent to which audit reliance may be placed.

c. The nature, timing and extent of substantive procedures that need to be applied.

12.1.11 Techniques For Evaluation of Internal Control System

i. Narrative Record: It is a complete and exhaustive description of the system. It is appropriate in circumstances where a formal control system is lacking, like in the case of small businesses. Gaps in the control system are difficult to identify using a narrative record.

ii. Check List: It is a series of instructions that a member of the audit staff is required to follow. They have to be signed/ initialed by the audit assistant as proof for having followed the instructions given. A specific statement is required for every weakness area.

iii. Flow Chart: It is a pictorial representation of the internal control system depicting its various elements such as operations, processes and controls, which help in giving a concise and comprehensive view of the organization's working to the auditor. A complete flow chart would depict the process of raising documents, personnel involved in doing so, the flow of documents through various departments, maintenance of records, flow of goods and consideration, and dealing with results.

The internal control evaluation process becomes easier through a flow chart as a broad picture of all the controls involved can be gauged in a glimpse.

iv. Internal Control Questionnaire: This is the most widely used method for collecting information regarding the internal control system and involves asking questions to various people at different levels in the organization. The questionnaire is in a pre-designed format to ensure collection of complete and all relevant information. The questions are formed in a manner that would facilitate obtaining full information through answers in "Yes" or "No''.

12.2 INTERNAL CHECK

The accounting of transactions has a number of steps such as posting to the concerned books of accounts, recording receipts and payments of cash etc. These processes involve a various number of staffs. Thus in an internal check system, practically a continuous internal audit is carried on by the staff itself. The work of one individual is checked by the other in the staff. Internal check is a valuable part of the internal control. According to Spicer and Pegler, internal check is an arrangement of staff duties where none is allowed to carry through and record every aspect of a transaction so that, without collusion between any two or more persons, fraud is prevented and at the same time the possibilities of errors and frauds are reduced to the minimum.

For example, at the time of cashing a cheque at any bank, the cheque is produced at the counter from where customers get a token. The token number is entered into the token book as well as at the back of the cheque by the attending clerk. The cheque is then passed on to the ledger clerk who verifies the credit balance in the customer's account and makes a debit entry. The cheque is then sent for verifying the signature of the customer and then it is passed for payment to the cashier. The cashier makes the payment to the cashier. The cashier makes the payment against the token and records it in the cash register.

12.2.1 Auditor's Duty In Regard to Internal Check System

In the case of a big concern where there is a good internal check system the auditor may, to a great extent, presume the accuracy of the accounting. But he must not be negligent. He should apply a few test checks, i.e. he should check a few transactions here and there at random or check fully the accounts for a few months, and carry out a through check of the whole of a certain class of transactions taking place during that particular period, e.g. cash sales, or cash received or credit purchases during that period. In selecting certain transactions are representative and true specimens the auditor should see that such sample transactions are representative and true specimens of such entries throughout the year.

If he finds that there is no mistake and there is nothing to arouse his suspicion, he may presume that the accounts are correct. It must be remembered that in such a case, the auditor is not relieved of his responsibility. Therefore, it would be better for him to probe the matter thoroughly if there is the slightest suspicion. If later on, it is found that a fraud had been committed which the auditor failed to detect as he had not checked all the transactions, he would be held liable. The existence of a good internal check system reduces to a great extent the work of the auditor but does not reduce his liability. To what extent an auditor should depend upon the internal check system will depend upon his tact, skill, experience and judgement.

The internal check is said to have the following fundamental aims:

i. To pin down to definite persons responsibility for particular acts, default or omission, by the segregation of tasks.

ii. To obtain confirmation of facts and entries, physical and financial, by the creation and preservation of necessary records.

iii. To facilitate the "breakdown" of routine procedures so as to avoid bottlenecks and to establish an even flow of work.

iv. To reduce to a minimum the possibility of fraud and error.

Check list is usually a questionnaire set, designed to draw attention to important aspects of the system of internal check. The question should be phased in such a way that an affirmative answer would normally reveal a satisfactory position. If the answer is negative, enquiry should be made to see if there is a satisfactory substitute for the procedure referred to in the questionnaire. A negative answer always merits further examination. All the items on the questionnaire cannot be of the same importance and an unhealthy position might be revealed either by a single negative answer or by a number of such answers.

No questionnaire for the appraisal of a system of internal check can ever be considered to be complete. Although every effort should be made to make such a questionnaire as comprehensive as possible, it is primarily a stimulation to thinking along recognized channels.

12.2.2 Internal Control Questionnaires

The evaluation of internal check system in an organization is of great concern both to the statutory auditor as well as to the internal auditor. The guiding factor for audit operation by the statutory auditor depends to a great extent on the soundness or otherwise of the internal controls in business. Due to the limitation of time a statutory auditor can spend on a company's audit, he has to decide the extent of in-depth audit of many areas, particularly the checking and verification of routine aspects of financial transactions.

The evaluation of the internal check system including internal accounting control gives an opportunity to the statutory auditor to have a clearer insight into the operational systems and an overall view of the organization Workings to spot weakness in the systems and procedure both in respect of financial and operational areas of the business The internal check system questionnaire is a list of systematically and logically prepared questions designed to find out and evaluate the effectiveness of the internal check system regarding various aspects and accounting transactions of an organization. The questionnaire are to be as comprehensive as possible in nature to make sure that all aspects and accounting transactions are covered which are to be replied by the official of the department or division concerned.

During the course of the audit statutory auditor will submit to the organization a complete questionnaire for reply by concerned official which will help the former to form an opinion as to the adequacy and reasonableness of the internal check system.

The statutory auditor during the course of his audit may make test checks or in-depth checking depending on the circumstances to make sure that the replies to the questionnaire are accurate and complete. In respect of many of the replies, the statutory auditor may have to make sure that the internal check system are really in operation through proper verification. In respect of negative replies, he may have to qualify his audit report depending on the seriousness of the situation.

The internal auditor in their pre-audit i.e. before taking up real internal audit operations may require the officials concerned to reply to the questionnaire. This will help the internal auditor in shaping his programming.

The department or divisional heads should also make use of such questionnaire, solely on their own initiative, by directing the personnel to prepare replies to such a questionnaire for the benefit of the department itself. This procedure will enable the department head to evaluate the existing internal control system and thereby to suggest management to review the said systems to further strengthen the organizational controls.

(A) Internal Control Questionnaire For Cash And Bank Receipts

Is inward mail opened by persons not connected with handling cash or the Accounts Department?

1. Is the inward mail date stamped?
2. Is there a detailed record of receipts prepared?
3. Are all cheques specially crossed by employees opening mail?

4. Are bank deposits prepared and made by someone other than those responsible for cash receipts and/or personal ledger. Are duplicate (or counterfoils of) receipted deposit slips received from the bank?
5. Is there any comparison of items listed on the duplicate (or counterfoils of) deposit slips with the amounts of cheques recorded in the cash receipts records?
6. Are receipts given for over-the counter collections?
7. Is there reconciliation of such proofs of collection with amounts banked?
8. Are collections of branch offices and sales offices deposited in special bank accounts subject to withdrawal only by the head office?
9. If collections are made by representatives of the company in cash, have serially numbered been issued to them?
10. Is there a system of issuing permanent receipts in lieu of the temporary/provisional receipts issued by bill collections etc.
11. Are such collections promptly received and banked? Are the receipts forms :
    a. Serially numbered?
    b. Kept in safe custody?
    c. Controlled by register?
    d. Unused stocks checked regularly?
    e. Made out by one employee and dispatched by another?
    f. Accounted for, including those cancelled in respect of partially used receipts, books not intended to be used, cancelled. Are cancelled receipts preserved?
12. Is the opening of bank accounts authorized by the Board of Directors?
13. Are sundry items, such as, dividends, interest, rent, commissions etc. regularly checked by responsible official to satisfy that correct amount are received?
14. Is there a procedure to ensure that Hundi borrowing as only by cheques crossed "Account Payee"?
15. Is the cash balance verified frequently (incoming money orders. VPP receipts etc.).
16. Are they listed immediately?
17. Are such lists compared with the Cash Book regularly?
18. Is there an arrangement with the postal authorities to receive cheques instead of cash?
19. Are the cashier's duties taken over for a few days, by someone else, occasionally?
20. If rough cash book is maintained:
    (a) Is a fair cash book written up promptly?
    (b) Is the fair cash book checked with the rough cash book, by a person other than the cashier?

(B) Internal Control Questionnaire for Purchase And Creditors

1. Is purchasing centralized in the Purchase Department?
2. Are purchases made only from approved supplier?
3. Is a list of approved suppliers maintained for this purpose?
4. Does the master list contain more that one source of supply for all important materials?
5. Are the purchase orders based on valid purchase requisitions duly signed by persons authorized in this behalf?

6. Are purchases made on behalf of employees?
7. If so, is the same procedure followed as for other purchases?
8. If special approval required for purchases from employees, Directors and Companies in which Directors are interested?
9. Purchase of capital goods?
10. Are purchases based on competitive quotations from two or more suppliers?
11. Is comparative quotation analysis sheet is drawn before purchases are authorized?
12. If the lowest quotation is not accepted, is the purchase approved by a senior official?
13. If the price variation clause is included, is it approved by a Senior official?
14. Are purchase orders pre-numbered and strict control exercised over unused forms?
15. Are purchase orders signed only by employees authorized I this behalf?
16. Do purchase orders contain the following minimum information :
    a. Name of the supplier?
    b. Delivery terms?
    c. Quantity?
    d. Price?
    e. Freight terms?
    f. Payment terms?
    g. Any extra applicable?
17. Is revision of terms of purchase orders duly authorized?
18. Are copies of purchases orders and revisions forwarded to Accounts and Receiving Department?
19. If “yes” do the copies show the quantities ordered?
20. If “no”, is there an adequate procedure orders complied by Receiving Department to be notified to accept deliveries?
21. Is a List of pending purchase orders complied by purchase department at least office every quarter?
22. Are all materials, supplies, etc. received only in the Receiving Department?
23. If they are received directly by User Department/Processors/ Customers, is there a procedure of obtaining acknowledgements for quantity received and the conditions of the goods?
24. Are persons connected with receipt of materials and the keeping of receiving records denied authority, to issue purchase orders or to approve invoices.
25. Are materials, supplies etc. inspected and counted, weighted or measured in the Receiving Department?
26. Are quantities and description checked against purchase order (or other form of notification) and goods inspected for condition?
27. Does the Receiving Department deliver or supervise the delivery of each item received to the proper Stores or Department location.
28. Are acknowledgements obtained from suppliers for goods/containers returned to them?
29. Are all receipts of materials evidenced by pre-numbered Goods Received Notes?

30. Are copies of Goods Received Notes forwarded to Accounts Department and a list of goods received to Purchase Department?
31. Are all cases of materials returned, shortages and rejections advised to the Accounts Department, for raising Debit Memos on suppliers or claim bill on carriers/insurance companies as the case may be?
32. Are all debit notes :
    a. Pre numbered?
    b. Numerically controlled?
33. Properly recorded in the financial accounting or in memorandum registers?
34. Are all suppliers invoices routed direct to the Accounts Department?
35. Are they entered in a Bill Register before submitting them to other department for check and/or approval?
36. Are advance and partial payments entered on the invoices before they are submitted to other departments?
37. Does the system ensure that all invoices and credit notes received are duly processed?
38. In respect of raw materials and suppliers, are reconciliation made of quantities and or values received, as shown by purchase invoices, with receipts into stock records?
39. Are duplicate invoices marked immediately on receipts to avoid payment against them?
40. If payments are made against duplicate invoices even occasionally are adequate precautions take to avoid duplicate payments?
41. Does the Accounts Department match the invoices of suppliers with Goods Received Notes or acknowledgements received as per Q.17 and purchase orders? Are Goods Received Notes and receiving records regularly reviewed for items for which no invoices have been received?
42. Are all such items, investigated and is provisions made for the liability in respect of such items?
43. Is such review/investigation done by a person independent of those responsible for the receipts and control of goods?
44. Do all invoices bear evidence of being checked for prices, freight terms extensions and additions?
45. Is the relative purchase order attached to the invoice for payment?
46. Where the client both buys from and sell to a person regularly, is a periodic review made of all amounts due from him to determine whether any set off is necessary?
47. Is a special request used for making payments in advance or against documents through Bank?
48. Thereafter, are the invoices processed in the normal course?
49. Are all advance payments duly authorized by persons competent of authorize such payment?
50. Is a list of pending advances made at least every quarter and is a proper follow up maintained?
51. Are all adjustments to creditor's accounts duly approved by those authorized in this behalf?
52. Is a list of employees by designation with limits of authority in respect of several matters referred to in this section maintained.
53. Are all suppliers statements compared with ledger accounts?
54. Is there any follow up action to investigate differences, if any between the supplier's statements and the ledger accounts?

55. Is a list of unpaid creditors prepared and reconciled periodically with the General Ledger Control accounts?
56. Is there a system of ensuring that cash discounts are availed of, whenever offered?

(c) Internal Control Questionnaire for Sales And Debtors Section

1. Are standard price lists maintained?
2. Are prices which are not based on standard price lists, required to be approved by senior executive outside the Sales Department?
3. Are written orders from customers received in all cases?
4. If oral/telephonic orders are received, are they recorded immediately in the client's standard forms?
5. Is there a numerical control of all customers' orders?
6. Are credit limits fixed in respect of individual customers?
7. Are credit limits approved by an official independent of the Sales Department?
8. Are credit limits reviewed periodically? Are customers' credit limits checked before orders accepted?
9. Is this done by a person independent of Sales Department?
10. If sales to employees are made at concessional prices?
11. Is there a limit to the value of such sales?
12. Is there an adequate procedure to see that these limits are not exceeded?
13. Are the amounts recovered in accordance with the term of sales?
14. Are dispatches of good authorized only by Despatch Notes/Gate passes or similar documents?
15. Do such Despatch Notes/Gate passes or similar documents bear preprinted numbers?
16. Are they under numerical control?
17. Are they prepared by a person independent of : the Sales Department?
18. The processing of invoices?
19. Except when all documents are prepared in one operation, are the Despatch Notes/Gate passes matches with :
    a. Excise Duty Records?
    b. Sales invoices (applicable)?
20. Are the goods actual dispatched checked independently with the Despatch Notes/Gate passes and Customer's Orders?
21. Are acknowledgements obtained from customer for the goods delivered?
22. Are the Customer's orders marked for goods delivered?
23. Are shortages in goods delivered to the customer investigated?
24. Are credits to customers for shortage, breakages and losses in transit matched with claims lodged against carriers/insurers?
25. Are all invoices pre-numbered?
26. Are sales invoice numbers accounted for?
27. Are invoices checked for price?
28. Calculations including

29. Excise Duty and sales tax?
30. Terms of payment?
31. Are "no charge" invoices authorized by a person independent of the custody of goods or cash?
32. Are invoices mailed direct to the customer promptly?
33. Are credits to customer for remittances posted only from the entries in the cash book (or equivalent record)?
34. Does cashier notify immediately –
    a. Sales Department
    b. Debtors' Ledger Section and

    Credit Controller –
    a. Of all dishonoured cheques or
    b. Other negotiable instruments of all documents sent through bank but not retired by the customers?
35. Is immediate follow up action taken on such notification?
36. Are bills of exchange etc. as per such record periodically verified with the bills on hand?
37. Is record of customers' claims maintained?
38. Are such claims properly dealt with in the accounts?
39. Does the Receiving Department count, weigh or measure the goods returned by customers?
40. Does the Receiving Department record them on a Sales Returns Note?
41. Are copies of Sales Returns Notes sent to
    a. Customer?
    b. Sales Department?
    c. Debtors Ledger Section?
42. Are the returned goods taken into stock immediately?
43. Is a Credit Notes issued to the customer for the goods returned?
44. Are all Credit Notes pre-numbered?
45. Are Credit Notes numerically controlled?
46. Are Credit Notes authorized by a person independent of :
    a. Custody of goods?
    b. Cash receipts?
    c. Debtors' Ledger?

    Are Credit Notes –
47. Compared with Sales Returned Notes or other substantiating evidence?
48. Checked for price?
49. Checked for calculations?
50. Are corresponding recoveries of sales commissions made, when Credit Notes are issued to customers?

51. Are units of sales (as per sales invoices)s correlated and reconciled with the purchases (or production) and stocks on hand?
52. Is the Sales Ledger balanced periodically and tallied with the General Ledger control account?
53. Are ageing schedules prepared periodically?
54. Are they reviewed by a responsible person?
55. Are statements of accounts regularly sent to all customers?
56. Are the statements checked with the Debtors' Ledger before they are issued?
57. Are the statements mailed by a person independent of the ledger keeper?
58. Are confirmation of balances obtained periodically?
59. Are the confirmation verified by a person independent of the ledger keeper and the persons preparing the statement?
60. Is special approval required for payment of customers?
61. Writing off Bad Debts?
62. Is any accounting control kept for bad debts written off?
63. Is any follow up action taken for recovering amounts written off?

In the case of export sales, is a record maintained of import entitlements due?

Does the record cover the utilization/disposal of such entitlement?

Are sales of scrap and wastage subject to the same procedures and controls as sales of finished goods?

12.3 DIFFERENCE BETWEEN A CHECKLIST AND AN INTERNAL CONTROL QUESTIONNAIRE

S. No	Basis	Check List	Internal Control Questionnaire
i.	Point of Time	It is issued at the commencement of audit and reported back after completion of audit.	It can be issued at any point of time and reported back immediately.
ii.	Issued To	It is issued to the audit staff to be followed by them during audit and reported back at completion.	It is issued to various people at different levels in the organization.
iii.	Contents	It contains instructions to be followed by audit assistants.	It contains questions to be answered by the employees of the organization.
iv.	Objective	It works as a guideline for audit staff so that no area remains unchecked	This is used to collect the information to know about the internal control system and evaluate the weaknesses therein.

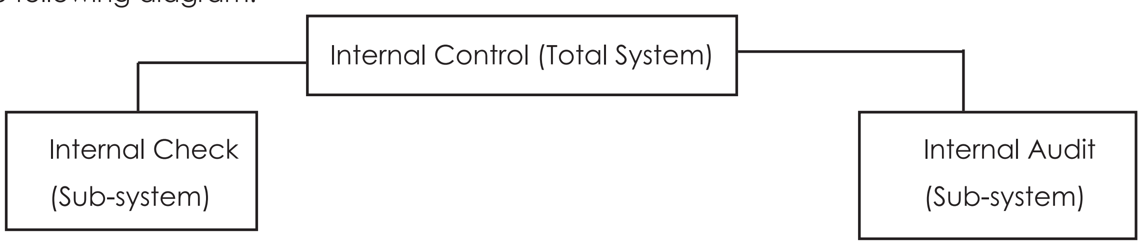
12.4 DISTINCTION BETWEEN INTERNAL CHECK, INTERNAL AUDIT AND INTERNAL CONTROL

Internal check has been defined by the Institute of Chartered Accountants in England and Wales, as the "checks on day-to-day transactions which operates continuously as part of the routine system whereby the work of one person is proved independently or complementary to the work of another, the object being the prevention or earlier detection of error or fraud." The internal check in accounting system implies that the maintenance of the system of book keeping and arrangement of staff duties in such a manner that no person can completely carry through a transaction, and record every aspect thereof.

Internal audit has been defined by the Institute of Internal Auditors, recently of as an "independent, objective assurance and consulting activity designed to add value and improve an organisations, operations. It helps an organisation accomplish its objectives by bringing a systematic disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process." Traditionally internal audit was considered to be restricted to the examination of the books of accounts of the organisation with a view to ascertaining whether they correctly record the transactions. In fact, a good internal control system should have internal audit as an integral part. The modern concept of internal auditing as given in the aforesaid definition shows that internal auditing has moved ahead significantly by showing greater responsibilities to become one of the important management control devices.

It can be seen from the above two definitions that both of the internal check and internal audit that they are the parts of the overall control system. Internal check operates as a built-in device as far as the staff organisation and job allocation aspects of the control system are concerned. On the other hand, the adequacy and operations of internal control on a regular basis is to be reviewed by the management through internal audit system to ensure that all significant controls are operating effectively. Thus internal check is merely an arrangement of book keeping and clerical duties, but internal audit involves evaluating the quality and operation of the various controls.

Inter-relationship between internal control, internal check and internal audit can be described with the help of the following diagram:



12.5 BRIEF DIFFERENCE BETWEEN INTERNAL AUDIT, INTERNAL CONTROL AND INTERNAL CHECK

S No.	Basis	Internal Audit	Internal Control	Internal Check
i.	Meaning	It is a continuous critical review of financial and operating activities by a staff member of the auditor.	It consists of all the methods and procedures adopted to assist in achieving the objective of efficient conduct of business. It Includes internal checks and internal audit	A system of allocation of responsibility, division of work, and methods of recording transactions, whereby the work of an employee is checked continuously by another.
ii.	Way of Checking	In an internal audit system, each component of work is checked .	In internal controls systems, work of one person is automatically checked by another.	It operates in routine to doubly check every part of a transaction at the time of occurrence and recording of the same

S No.	Basis	Internal Audit	Internal Control	Internal Check
iii.	Objective	Its objective is to evaluate the internal control system and to detect frauds and errors.	Its objective is to ensure adherence to management policies, safeguarding of assets, prevention and detection of frauds and errors, accuracy and completeness of accounting records.	Its objective is to ensure that no one employee has exclusive control over any transaction or group of transactions and their recording in the books
iv.	Point of Time	In an internal audit system, work is checked after it is done.	In an internal control system, checking is done simultaneously with the conduct of work. Every transaction is checked as soon as it is entered.	Methods of recording transactions are devised where work of an employee is checked continuously by correlating it with the work of others.
v.	Thrust of system	The thrust of internal system is to detect errors and frauds.	The thrust of internal check system is to prevent errors.	The thrust of internal control lies in fixing of responsibility and division of work to avoid duplication.
vi.	Cost Involvement	In an internal audit system, work is checked specially; therefore cost is involved in addition to accounting	The system proves to be costly in case of small businesses because more number of employees are engaged	It is a part of internal control and a method of division of work, therefore does not add to the cost.
vii.	Report	The internal auditor submits his report to the management	Internal Controls provide for built in MIS reports	The summary of day to day transactions work as report for the senior.

12.6 SURPRISE CHECK

All the audit procedures which are applied as not in the general routine of conducting an audit but are spontaneous in nature for surprise checks. They are performed without giving a prior notice to the client.

Features of Surprise Check:

- It is spontaneous in nature i.e. unplanned.

Random selection of items to be checked.

- Helps in assuring maintenance of up-to-date accounts.

Performed in situations facing weak internal controls.

- Helps in testing effectiveness of internal controls.
- The frequency of occurrence depends on the auditor's professional judgment.
- Ensures communication of weaknesses in the controls to the management.

Importance: It reduces the routine work of the auditor so that he can devote more time to important aspects.

12.7 CUT OFF PROCEDURES

i) **Definition:** Periods usually coincide with calendar months, which lead to the need for specific demarcation between transactions forming the part of one period from those included in the following period. Thus, cut-off procedures are adopted to allocate revenues and costs to the proper accounting period.

ii) **Areas of concern:** Close attention should be paid to the accounts payable and accounts receivable functions. These two functions are the most susceptible to recording of transactions in the wrong accounting period.

iii) **Cut-of points:** Serially numbered documents like invoice for sales or purchase bills are allocated to the respective accounting periods by establishing cut-off points based on the serial numbers.

iv) **Importance:** Cut-off procedures require detailed testing by the auditor so as to ensure proper accounting of assets and liabilities, which may arise without the corresponding physical delivery of goods taking place.

v) **Example:** The purchase procedure involves a number of steps, like issuing purchase requisitions, inviting quotations, selecting sellers and defining the terms of purchase, entering agreement, receipt of goods, storage of goods, payment, etc. All the documents and vouchers that substantiate the proof of authentication of these transactions are serially numbered. It is the auditor's duty to examine the cut-off points and ensure that the transaction has been recorded in the period in which the title in goods is transferred, irrespective of the period of physical delivery of goods and to ensure compliance to the Accounting Standards and the relevant Statute.

12.8 EXAMINATION IN DEPTH/AUDITING IN DEPTH: ''WALK THROUGH TEST"

The process of examination in depth explains its meaning and importance. It is stated as under:

i. Fixation of the maximum tolerable error limit/desired confidence level.

ii. Selecting a few transactions in each area of audit to be checked.

iii. Verification of those selected transactions- 100% by verifying the accounting aspects, internal control aspects, documentation and audit trail.

iv. Audit trail refers to the documents, records, books and files, which enable an auditor to trace a transaction from its source till it is summed up, recorded and presented in an accounting report.

v. Analysis of the results with the maximum tolerable error limit.

12.9 DIFFERENCE BETWEEN TEST CHECKING AND STATISTICAL SAMPLING

S.No.	Basis	Test Checking	Statistical Sampling
i.	Selection	Selective transactions are verified.	Drawing a sample from a large number of transactions.
ii.	Technique	No specific technique is used.	Statistical technique used is: selection on random basis.
iii.	Subjective	It is subjective and depends upon the choice of the auditor.	It depends upon the statistical technique applied.
iv.	Risk& Method	It involves more risk as there are no specific methods for test check.	It carries lesser risk and various statistical methods can be used at different times.

12.10 INTERNAL AUDIT

Internal audit is an independent appraisal activity within the organization by the staff of the entity or by an independent professional appointed for that purpose, for review of accounting, financial and other operations and controls established within an organization as a service to the organization. The objective of internal audit is to furnish the analysis, appraisals, suggestions and information concerning the activities reviewed to the management for promoting effective control at reasonable cost.

According to the Institute of Internal Auditors New York, "Internal audit is an independent appraisal activity within the organization for the review of financial, accounting and other operations done as a basis of service to the management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls".

According to Prof. Walter B. Meigs, "Internal auditing consists of a continuous, critical review of financial and operating activities by a staff of auditors functioning as full time salaried employees."

Internal Audit under section 138 of Companies Act, 2013:

Internal Audit is required by –

(1) Such class or classes of companies as may be prescribed shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company.

(2) The Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

According to the Institute of Internal Auditors, internal audit involves five areas of operations:

i. Reliability and integrity of financial and operating information: Internal auditors should review the reliability and integrity of financial and operating information and the means used to identify, measures, classify and report such information.

ii. Compliance with laws, policies, plans, procedures and regulations: Internal auditor should review the systems established to ensure compliance with those policies, plan and procedures, law and regulations which could have a significant impact on operations and reports and should determine whether the organization is in compliance thereof.

iii. Safeguarding of Assets: Internal auditors should verify the existence of assets and should review the means of safeguarding assets.

iv. Economic and efficient use of resources: Internal auditor should ensure the economic and efficient use of resources available.

v. Accomplishing of established objectives and goals for operations: Internal auditor should review operation or programmes to ascertain whether results are consistent with established objectives and goals and whether the operations or programmes are being carried out as planned.

12.10.1 Features of Internal Audit

1. It is an independent appraisal activity within the organization.

ii. It can be conducted by the staff of the entity or by an independent professional appointed for that purpose.

iii. It is conducted for review of accounting, financial and other operations and controls established within an organization.

iv. It is conducted as a service to the organization and is not a part of the organization.

v. It intends to furnish the analysis, appraisals, suggestions and information concerning the activities reviewed to the management.

vi. Internal auditing functions as a continuous effort for promoting effective control at cost reasonable cost.

12.10.2 Functions of Internal Audit

Very large organizations and some small and medium size organizations also have found the need for internal audit in addition to the external audit. Internal auditors are employees of the organization and work exclusively for the organization. Their functions partly overlap those of the external auditors and in part are quite different.

The functions of internal auditors can be described as follows:

1. **An appraisal function:** The internal auditor's job is to appraise the activity of others, not to perform a specific part of data processing. For example, a person who spends his time checking employee expense claims is not performing an internal audit function. But an employee who spends some times reviewing the system of checking employee expense claims may be performing an internal audit function.

2. **As a service to the organization:** the management requires that the auditor ensures the following:

   - That its policies are fulfilled.
   - That the information it requires to manage effectively is reliable and complete; this information is not only that which is provided by the accounting system.
   - That the organisation's assets are safeguarded.
   - That the internal control system is well designed.
   - That the internal control system works in practice.

   The internal auditor's activities will be directed to ensure that these requirements are met. The internal auditor can be seen as the notice of the board within the enterprise.

3. **Other duties:** other duties may include the following events:

   - Being concerned with the implementation of social responsibility policies adopted by top management.
   - Being concerned with the response of the internal control system to errors and required changes to prevent errors.
   - Being concerned with the response of the internal control system to external stimuli. The internal control system must continually upgrade itself to deal with change.
   - Acting as a training officer in internal control matters.
   - Auditing the information given to management particularly interim accounts and management accounting reports.
   - Taking a share of the external auditor's responsibility in relation to the figures in the annual accounts and
   - Being concerned with the compliance with external regulations such as those on the environment, financial services, related parties etc.

12.10.3 Scope

The Institute of Internal Auditors defines scope of internal auditing as 'examination and evaluation of the adequacy and effectiveness of organisation's system of internal control and the quality of actual performance'. Therefore, internal auditing is concerned with an evaluation of both internal control as well as the quality of actual performance. According to the Institute, the scope of internal audit involves the following:

- Review the reliability and integrity of financial and operating information and the means to locate, identify, measure, classify and report such information.

- Appraise the economy and efficiency with which resources are employed.
- Review the systems established to ensure compliance with those policies, plans, procedures, laws and regulations which could have a significant effect and impact on operations and report, and should determine whether the organization is in compliance.
- Review the means of safeguarding assets and as appropriate verify the existence of such assets.
- Review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.
- Internal auditing, therefore, is a function distinct from authorization and recording. It is concerned not only with examination of the transaction as recorded in the books of accounts but also with appraisal or procedure with a view to effecting change for better efficiency, where possible.

12.10.4 Need of Internal Audit

The need for internal audit has becoming in demand due to the following reasons:

I. Increased size and complexity of businesses.

II. Enhanced compliance requirements.

III. Focus on risk management and internal controls to manage them.

IV. Unconventional business models.

V. Intensive use of information technology.

VI. Stringent norms mandated by regulators to protect investors.

VII. An increasingly competitive environment.

Internal audit is an important management tool for the following reasons:

a. Internal audit ensures compliance of Companies (Auditors Report) Order,2003.

b. It ensures compliance of accounting standards and policies.

c. It ensures reliability of MIS through internal audit's independent appraisal and review.

d. It looks into the standard of efficiency of business operation.

e. It can evaluate various problems independently and suggest improvement.

f. This system makes the internal control system effective.

g. It ensures the adequacy, reliability, accuracy and understandability of financial and operational data.

h. It performs as an integral part of 'Management by system'.

i. It can add valuable assistance to management in acquiring new business, promoting new products and expansion or diversification of business etc.

12.10.5 Advantages of Internal Audit

(A) To the management in specific:

i. It gives a review of overall internal control system established by the management.

ii. It furnishes the deviations in following the procedures adopted for safeguarding assets.

iii. It appraises the organizational structure and management information system.

iv. It establishes that the policies, plans and strategies implemented are well in place and gives suggestions on management information systems reports for promoting effective control at reasonable cost.

(B) To the statutory auditor in specific

i. It evaluates the internal control system, so the statutory auditor can reduce the number of tests that he may have had to conduct in case there was no internal audit

ii. It carries out physical stock taking procedures, so reliance on stock valuation is increased.

iii. It helps in timely completion of accounts and accuracy of records.

iv. It evaluates the contingent liability existing at the year end.

v. It ensures correctness of financial statements through a system of pre-audit or continuous audit.

(C) To the organization as a whole and other stakeholders in general

I. The regular audit and checks result in accurate and efficient accounting system.

II. It is a critical review of the business' performance and management.

III. It provides strict supervision and direction to have effective controls.

IV. It provides safeguard to the business assets and prevents misuse and misappropriation of all business assets.

V. The auditor can suggest ways and means to improve performance of the business.

VI. It prevents occurrence of errors and frauds.

VII. It enhances the performance of the business by division of duties and responsibilities as per the capability of the employees.

VIII. It keeps a check on proper utilization of resources, which leads to reduction in costs.

12.10.6 Distinction Between Internal Audit And External Audit:

On accounting matters, the internal and external auditors operate mainly in the same field and they have a common interest in ascertaining that there is an effective system of internal control for presentation and detection of errors and frauds and to ensure that it is operating satisfactorily and that an adequate accounting system exists to provide the information necessary for preparing true and fair financial statements. There are some fundamental differences between the work of an internal auditor and that of an external auditor regarding the following:

a. **Appointment:** The internal auditor is appointed by the management, generally the Directors and is responsible to them.

The external or the statutory auditor is appointed according to the concerned statute. Generally, in case of company form of organization, the auditors are appointed by the shareholders in the annual general meeting.

b. **Scope:** The extent of the work undertaken by the internal auditor is determined the management.

The external auditor undertakes the area of the work which arises from the responsibilities placed on him by the governing statute.

c. **Approach:** The internal auditor's approach is with a view to ensure that the accounting system is efficient, so that the accounting information presented to management throughout the period is accurate and discloses material facts.

The external auditor's approach is governed by his responsibility to satisfy himself that the accounts to be presented to the shareholders show a true and fair view of the profit or loss for the financial period and of the company's state of affairs at the end of that period.

d. **Responsibility:** The internal auditor's responsibility is to the management. It follows that the internal auditors, being a servant of the company, does not have independence of status.

The external auditors, however, is responsible directly to the shareholders. Unlike the internal auditors, he is a representative of the shareholders and has independence of status.

e. Objective: The main objective of internal audit is to ensure that the laid down policies, procedures and other internal control functions are functioning as designed.

Whereas the objective of the external auditor is to express opinion and view to on financial statements whether those statements are showing true and fair view of the organisation.

f. Independence: External auditor is more independent than internal auditor in the field of reporting.

Except these important differences, the work of both the internal auditor and the external auditor, on matters of accounting, is carried out largely by similar means, such as:

- Examination of the system of internal check, for both soundness and principle and effectiveness in operation.
- Examination and checking of accounting records and statements.
- Verification of assets and liabilities.
- Observations, inquiry, making of statistical comparisons and such other measures as may be judged necessary.

The wide experience of the external auditor may be of assistance to the internal auditor: while on the other side the latter's intimate acquaintance with business concern may be of help to the external auditors. Co-operation in planning of the respective auditors may save unnecessary works, although the external auditors must always satisfy himself as to the work carried out by the internal auditors.

12.10.7 Relying Upon the Work of an Internal Auditor

The statutory auditor can rely upon the work of the internal auditor in deciding the extent of checking and planning the audit work. However, the statutory auditor will be solely responsible for his report and for determination of the nature, timing and extent of the auditing procedures and adoption of audit techniques.

Thus:

i. Not mandatory: It is not mandatory for the statutory auditor to compulsorily rely on work of internal audit.

ii. Not protected from liability: Even if he relies on the work of internal audit, he is still not protected from his liability.

iii. Required to comment on internal audit: In the case of companies having Share Capital + Reserves at a minimum level of ₹ 50 lacs, or having minimum Average Annual Turnover of ₹ 5 crores for last 3 financial years, CARO 2003 requires a statutory auditor to mention in his report whether the internal audit system is commensurate with the size and nature of the business.

12.10.8 Importance of Internal Audit Function to Statutory Auditor

The internal auditor, depending on the size and structure of the enterprise and as per the requirements of its management, performs the following functions:

i. Reviews the accounting systems and internal controls prevailing in the organization.

ii. Examination of management information system reports on financial and operational performance of the organization, to check the efficiency and effectiveness of the operations and the management policies laid down for the purpose.

iii. Collection of third party evidences and physical verification of stocks and other assets at the year end.

iv. Collection of evidence and estimation of contingent liabilities.

12.10.9 Criteria for Placing Reliance on the Work of Internal Auditor

S. No.	Points of Consideration
i.	**Independence** Who is responsible for reporting and to whom? Is there interference by other managers in the internal audit department? What is the position of an internal auditor in the organization?
ii.	**Skill and Competence** What are the qualifications and experience of the internal auditor? Is a trained team from the staff conducting the internal audit? Is the internal audit staff updated with changes in law?
iii.	**Audit Planning** What is the composition of qualified and unqualified staff in the internal audit team? How long has the experience of the internal audit staff been in the same organization? How is the internal audit staff trained?
iv.	**Use of Documentation** Is the internal control system evaluated by the use of questionnaires, flow charts and checklists? Are such questionnaires and checklists considered?
v.	**Audit Procedure** Is there an internal audit manual in existence? Is the internal audit work done as per an audit programme and whether the audit programme is frequently amended? Is there a consultation with the statutory auditor regarding the audit programme? Is there a system of rotating the functions among internal audit staff? Is there a system of maintaining working papers by internal audit staff? Is the work of internal auditor subjected to supervision by managers?
vi.	**Audit Scope & purview** Does the internal auditor cover only financial areas or also operational areas? Does the defined scope of internal audit cover investigations, statutory compliance and year end stock taking procedures?
Vii.	**Audit Report** To whom is the internal audit report submitted? Does it contain recommendations in addition to observations? Is there a follow up of earlier recommendations? What is the management's attitude towards internal audit recommendations? What is the periodicity of audit report?

12.10.10 Difference between Internal Audit and Operational Audit:

	INTERNAL AUDIT	OPERATIONAL AUDIT
i.	Compliance objective	Risk identification, process improvement objective
ii.	Financial accounts focus	Business focus
iii.	Audit focus	Efficiency & improvement focus
iv.	Transaction-based	Process-based
v.	Policies and procedures focus	Risk management focus
vi.	Cost Centre wise budget monitoring	Accountability for performance improvement Results
vii.	Focus on policies, transactions and compliance	Focus on goals, strategies and risk management Processes

12.11 ORGANISATIONAL INDEPENDENCE

Another concept related to internal check is known as Organisational Independence. It exists where no person in an organization is in a position to both perpetrate and conceal, in the nominal course of their duties, a misstatement. It is achieved and possible through the segregation of incompatible functions. Functions are incompatible if their combination may permit the commitment and concealment of intentional or unintentional misstatements or where the duties of one function can bypass, the controls which should exist on the other. The following are some examples of incompatible functions:

- One of the accounts receivable personnel is also responsible for opening the mail. Such a person may misappropriate cash and conceal the deficiency by altering the accounts receivable records.
- The employee that authorizes cheques to be paid to suppliers is also responsible for signing the cheques. The employee may misappropriate funds by authorizing a cheque to be paid to an accomplice.
- The employee responsible for, say, the marketing department is also responsible for accounting for the profitability of that centre. The employee may incorrectly treat as a prepayment, for example, current expenditure on advertising, in order to improve the performance of the department.

Functions that are typically segregated are access to assets, execution of related transactions and the recording of related transactions. Thus, a person having custody of an asset, such as cash, should not also be responsible for accounting for transactions affecting that asset otherwise the person may create and/or conceal shortages in the asset by incorrectly accounting for the asset. Similarly, a person who has custody of an asset, such as cash should not be responsible for authorizing transactions affecting that asset otherwise the person may create and/or conceal shortages in the asset through the incorrect authorization of a transaction. Finally, a person responsible for the operations of, for example, a cost/ profit centre, should not be responsible for accounting for that centre otherwise the person may be tempted to bias results to improve reported performance. Additionally, organizational independence requires that there be segregation.

12.12 STANDARDS ON INTERNAL AUDIT (SIA)

Internal Audit – India

i. Clause 49 of Listing Agreement - Responsibility of audit committee to review adequacy of internal audit function and internal audit reports.

ii. Section 138 of Companies Act, 2013 specify Such class or classes of companies as may be prescribed shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company. The Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

iii. Clause 4 (vii) of CARO, 2003 requires auditors to report: “in the case of:

   1. listed companies; and/or

   2. other companies having:

      - a paid-up capital and reserves greater than ₹ 50 lakhs as at the commencement of the financial year concerned, or

      - an average annual turnover greater than ₹ 5 crores for a period of three consecutive financial years immediately preceding the financial year concerned,

   The internal auditor is required to attend and participate at the meeting of such Audit Committees.

iv. Section 465 of the Companies Act, 2013 requires that every Producer Company shall have internal audit of its accounts carried out by a chartered accountant, at such interval and in such manner as may be specified in articles.

v. The Securities and Exchange Board of India has mandated complete internal audit on a half-yearly basis for stock brokers/trading members/clearing members.

vi. IRDA (Investment) (Fourth Amendment) Regulations, 2008 has introduced requirements o quarterly internal audit for insurers.

vii. Companies going in for tapping the international capital market, especially, those seeking listing in US stock exchanges, NASDAQ, NYSE, etc., also need a strong internal audit function to meet the stringent corporate governance and internal control requirements of those stock exchanges. In this context, the US companies, having US public as investor also needs to comply with the requirements of Sections 302 and 404 of the Sarbanes Oxley Act of 2002.

12.12.1 Framework of SIA

The Framework for Standards on Internal Audit comprises four components viz., the Code of Conduct, the Competence Framework, the Body of Standards and the Technical Guidance.

Internal audit is conducted in variant economic, legal, cultural and business environments. The organisations in which internal audit is performed differ widely in size, structure, nature of business, scale, purpose, objectives and geographical spread. Further, the internal audit activity may be performed by an entity’s employees or by some external agency. Thus, the Framework for Standards on Internal Audit applies to all the persons performing internal audit activity, irrespective of whether the function is performed in-house or by an external agency.

12.12.2 Purpose of SIA

- To provide standards for quality of services during an internal audit
- To codify the best practices in internal audit services

12.12.3 Scope of SIA

The SIA shall apply whenever an internal audit is carried out. The SIA(s) are mandatory from the respective date(s) mentioned in the SIA(s). However, any limitation in the applicability of a specific Standard shall be made clear in the Standard. The mandatory status of a Standard on Internal Audit implies that while carrying out an internal audit, it shall be the duty of the members of the Institute to ensure that the SIAs are followed. If, for any reason, a member has not been able to perform all or any of such activities, as mentioned in accordance with the SIAs, his report should draw attention to the material departures therefrom.

12.12.4 Summary of Standards on Internal Audit ('SIA') Issued By ICAI

SIA 1: Planning an Internal Audit

i. Planning involves developing an overall plan for the expected scope and conduct of audit and developing an audit programme showing the nature, timing and extent of audit procedures.

ii. Develop and document a plan in consultation with those charged with governance, including the audit committee for each internal audit engagement.

iii. Objectives of internal audit engagement as well as time and resources required for conducting the engagement be considered. Internal audit plan should also reflect risk management strategy of the entity.

iv. Internal audit plan should cover areas such as obtaining knowledge of legal and regulatory framework within which the entity operates, obtaining knowledge of the entity's accounting and internal control systems and policies, determining the effectiveness of internal control procedures adopted by the entity, determining the nature, timing and extent of procedures to be performed, identifying activities warranting special focus based on materiality and criticality of such activities, and their overall effect on operations of the entity, identifying and allocating staff to different activities to be undertaken.

v. Planning process includes obtaining knowledge of business, establishing the audit universe, establishing the objectives of engagement, establishing scope of the engagement, deciding resource allocation, preparation of audit programme.

vi. Plan to be finalised in consultation with the appropriate authority before commencement of the work

SIA 2: Basic Principles Governing Internal audit

i. Internal auditor should adhere to the basic principles governing an internal audit.

ii. These principles are integrity, objectivity and independence, confidentiality, skills and competence, work performed by others, documentation, planning, internal audit evidence, accounting system and internal control, and internal audit conclusions and reporting.

SIA 3: Internal Audit Documentation

i. Internal audit documentation should be designed and properly organized to meet the requirements and circumstances of each audit. To formulate policies for standardization of internal audit documentation.

ii. It should be sufficiently complete and detailed for an internal auditor to obtain an overall understanding of the audit.

iii. All significant matters which require exercise of judgment, together with internal auditor's conclusion thereon should be included in the internal audit documentation. Documentation prepared by internal auditor should enable reviewer to understand:

- the nature, timing and extent of audit procedures performed to comply with SIAs and applicable legal and regulatory requirements;
- the results of audit procedures and audit evidence obtained;
- significant matters arising during the audit and conclusions reached thereon; and
- terms and conditions of an internal audit engagement/requirements of internal audit charter, scope of work, reporting requirements, any other special conditions, affecting the internal audit.

iv. It should cover all the important aspects of an engagement viz., engagement acceptance, engagement planning, risk assessment and assessment of internal controls, evidence obtained and examination/evaluation carried out, review of the findings, communication and reporting and follow up.

v. The internal audit file should be assembled within sixty days after the signing of the internal audit report.

vi. To formulate policies as to the custody and retention of the internal audit documentation within the framework of the overall policy of the entity in relation to the retention of documents.

SIA 4: Reporting

i. To review and assess the analysis drawn from internal audit evidence obtained as the basis for his conclusion on the efficiency and effectiveness of systems, processes and controls including items of financial statements.

ii. Report clearly expressing significant observations, suggestions/recommendations based on the policies, processes, risks, controls and transaction processing taken as a whole and managements' responses.

iii. Report includes basic elements such as title, addressee, report distribution list, period of coverage of the report, opening or introductory paragraph, objectives paragraph, scope paragraph (describing the nature of an internal audit), executive summary (highlighting key material issues, observations, control weaknesses and exceptions), observations, findings and recommendations made by the internal auditor, comments from the local management, action taken report – action taken/not taken pursuant to the observations made in the previous internal audit reports, date of the report, place of signature and Internal auditor's signature with membership number.

iv. To facilitate communication and ensure that recommendations presented in final report are practical from the point of view of implementation, the internal auditor should discuss the draft with the entity's management prior to issuing the final report. The different stages of communication and discussion should be discussion of draft, Exit meeting, formal draft, submission of final report.

v. When there is a limitation on the scope of internal auditor's work, the internal auditor's report should describe the limitation.

vi. To state in the report that the same is to be used for the intended purpose only as agreed upon and the circulation of the report should be limited to the recipients mentioned in the report distribution list.

SIA 5: Sampling

i. Design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence to meet the objectives of internal audit engagement unless otherwise specified by the client.

ii. When designing an audit sample, internal auditor should consider specific audit objectives, the population from which internal auditor wishes to sample, and the sample size.

iii. When determining the sample size, internal auditor should consider sampling risk, tolerable error and the expected error.

iv. To select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items or sampling units in the population have an opportunity of being selected.

v. Having carried out, on each sample item, those audit procedures that are appropriate to the particular audit objective, the internal auditor should:

  - analyse the nature and cause of any errors detected in the sample;
  - project the errors found in the sample to the population;
  - reassess the sampling risk; and

- consider their possible effect on the particular internal audit objective and on other areas of internal audit engagement

vi. To evaluate the sample results to determine whether the assessment of relevant characteristics of the population is confirmed or whether it needs to be revised.

SIA 6: Analytical Procedure

i. To apply analytical procedures as the risk assessment procedures at the planning and overall review stages of internal audit.

ii. Analytical procedures are analysis of significant ratios and trends including resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.

iii. Factors to be considered for analytical procedures are significance of the area being examined, adequacy of the system of internal control, availability and reliability of financial and non–financial information, the precision with which results of analytical procedures can be predicted, availability and comparability of information regarding the industry in which the organization operates, the extent to which other auditing procedures provide support for audit results. After evaluating the aforementioned factors, internal auditor should consider and use additional auditing procedures, as necessary, to achieve the audit objective.

iv. To apply analytical procedures at or near the end of internal audit when forming an overall conclusion as to whether the systems, processes and controls as a whole are robust, operating effectively and are consistent with the internal auditor's knowledge of the business.

v. When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative evidence.

SIA 7: Quality Assurance in Internal Audit

i. A system for assuring quality in internal audit should provide reasonable assurance that the internal auditors comply with professional Standards, regulatory and legal requirements, so that the reports issued by them are appropriate in the circumstance. In order to ensure compliance with the professional standards, regulatory and legal requirements, and to achieve the desired objective of internal audit, a person within the organization should be entrusted with the responsibility for the quality in the internal audit, whether done in–house or by an external agency.

ii. In case of in–house internal audit or a firm carrying out internal audit, the person entrusted with the responsibility for the quality in internal audit should ensure that the system of quality assurance includes policies and procedures addressing leadership responsibilities for quality in internal audit, ethical requirements, acceptance and continuance of client relationship and specific engagement, as may be applicable, human resources, engagement performance, monitoring The quality assurance framework should cover all the elements of internal audit activity.

iii. The internal quality review framework should be designed with a view to provide reasonable assurance that the internal audit is able to efficiently and effectively achieve its objectives of adding value and strengthening the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system.

iv. The internal quality reviews should be undertaken on an ongoing basis. The person entrusted with the responsibility for quality in internal audit should ensure that recommendations resulting from the quality reviews for improvements in the internal audit activity are promptly implemented.

v. Internal quality reviews are also communicated to appropriate levels of management and those charged with governance on a timely basis along with the proposed plan of action to address issues and concerns raised in the review report.

External quality review is a critical factor in ensuring and enhancing the quality of internal audit

SIA 8: Terms of Internal Audit Engagement

i. Internal auditor and the auditee should agree on the terms of engagement before commencement. Terms should be approved by the Board of Directors or a relevant Committee thereof such as the Audit Committee or such other person(s) as may be authorised by the Board in this regard.

ii. It should contain a statement in respect of the scope of internal audit engagement.

iii. It should clearly mention that internal auditor would not be involved in the preparation of auditee's financial statements. It should also be made clear that the internal audit would not result in the expression of an opinion or any other form of assurance on the auditee's financial statements or any part thereof.

iv. The terms of engagement should clearly mention the responsibility of the auditee vis-a-vis the internal auditor.

v. It should provide the internal auditor with requisite authority, including unrestricted access to all departments, records, property and personnel and authority to call for information from concerned personnel in the organization.

vi. The internal auditor should have full authority on his technologies and other properties like hardware and audit tools he may use in course of performing internal audit.

vii. It should be clear that the ownership of working papers rests with internal auditor and not the auditee.

viii. The engagement letter should contain a condition that the report of internal auditor should not be distributed or circulated by the auditee or the internal auditor to any party other than that mutually agreed between the internal auditor and auditee unless there is a statutory or a regulatory requirement to do so.

ix. There should be a clear understanding among internal auditor and auditee as to the basis on which the internal auditor would be compensated, including any out of pocket expense, taxes etc, for the services performed by him.

x. It should contain a statement that the internal audit engagement would be carried out in accordance with the professional Standards applicable to such engagement as on the date of audit.

SIA 9: Communication with Management

i. Internal auditor while performing audit should communicate clearly the responsibilities of internal auditor and an overview of the planned scope and timing of audit with the management.

ii. Communication regarding the planned scope and timing of internal audit may assist the management to understand better the objectives of internal auditor's work, to discuss issues of risk and materiality with internal auditor and to identify any areas in which they may request the internal auditor to undertake additional procedures, assist the internal auditor to understand the entity and its environment better.

iii. Different stages of communication and discussion should be: discussion of draft; exit meeting; formal draft; and final report.

iv. Clear communication of internal auditor's responsibilities, planned scope and timing of internal audit and expected general content of communications helps establishing the basis for effective two–way communication.

v. Appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include significance and nature of the matter, and the action expected to be taken by management.

vi. Where matters required by this SIA to be communicated, are orally communicated, internal auditor shall document them and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of internal audit documentation.

SIA 10: Internal Audit Evidence

i. To obtain sufficient appropriate evidence to enable him to draw reasonable conclusions therefrom on which to base his opinion or findings.

ii. Scope of an internal audit is much broader in comparison to that of statutory audit. The depth of coverage of internal audit, being a management function, would also be much wider. An internal audit function normally is spread beyond checking of financial transactions and is expected to cover comments on internal control systems, risk management, propriety aspect of transactions.

iii. To evaluate sufficiency of appropriate audit evidence before conclusions therefrom. The internal audit evidence should enable internal auditor to form a opinion on the scope of the terms of engagement.

iv. The reliability of internal audit evidence depends on its source – internal or external and on its type.

v. When internal audit evidence obtained from one source is inconsistent with that obtained from another, or the internal auditor has doubts over the reliability of information to be used as internal audit evidence, the internal auditor shall determine what modifications to or additional audit procedures are necessary to resolve the matter.

vi. Various methods for obtaining audit evidence include inspection, observation, inquiry and confirmation, computation and analytical review.

SIA 11: Consideration of Fraud in an Internal Audit

i. An internal auditor is not expected to possess skills and knowledge of a person expert in detecting and investigating frauds, he should, however, have reasonable knowledge of factors that might increase the risk of opportunities for frauds in an entity and exercise reasonable care and professional skepticism while carrying out internal audit.

ii. A system of internal control comprise of following five elements namely control environment, entity's risk assessment process, information system and communication, control activities and monitoring of controls. It is essential for internal auditor to gain an understanding of the components of system of internal control.

iii. The primary responsibility for prevention and detection of frauds is that of the management of the entity. The internal auditor should, however, help the management fulfill its responsibilities relating to fraud prevention and detection.

iv. To obtain an understanding of the various aspects of control environment and evaluate the same as to the operating effectiveness.

v. To evaluate the mechanism in place for supervision and assessment of internal controls to identify instances of any actual or possible breaches therein and to take corrective action on a timely basis.

vi. To carefully review and assess conclusions drawn from audit evidence obtained. Actual or suspected fraud or any other misappropriation of assets should be immediately reported to management.

vii. To document fraud risk factors identified as being present during internal auditor's assessment process and document internal auditor's response to any other factors.

SIA 12: Internal Control Evaluation

i. The system of internal control must be under continuous supervision by management to determine that it is functioning as prescribed and is modified, as appropriate, for changes in environment. Internal control system extends beyond those matters which relate directly to the functions of accounting system and comprises of control environment and control activities.

ii. To examine the continued effectiveness of internal control system through evaluation and make recommendations, if any, for improving that effectiveness. To focus towards improving internal control structure and promoting better corporate governance.

iii. To obtain an understanding of significant processes and internal control systems sufficient to plan the internal audit engagement and develop an effective audit approach, assess and evaluate the maturity of entity's internal control, assess management's attitudes, awareness and actions regarding internal controls and their importance in the entity.

iv. To evaluate internal control system in an entity, based on various criteria x To ensure segregation of duties between various functions.

v. Tests of control are performed to obtain audit evidence about the effectiveness of design of internal control systems.

vi. Based on the results of tests of control, internal auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. To consider whether internal controls were in use throughout the period.

vii. To identify internal control weaknesses that has not been corrected and make recommendations to correct those weaknesses.

viii. When internal controls are found to contain continuing weaknesses, internal auditor should consider whether management has increased supervision and monitoring, additional or compensating controls have been instituted and/or management accepts the risk inherent with control weakness

ix. To evaluate identified control deficiencies and then determine whether those deficiencies, individually or in combination, are significant deficiencies or material weaknesses

x. Report to the management should provide a description of significant deficiency or material weakness in internal control. His opinion on possible effect of such weakness on entity's control environment

SIA 13: Enterprise Risk Management

i. Risk is an event which can prevent, hinder, fail to further or otherwise obstruct the enterprise in achieving its objectives. Risk may be broadly classified into Strategic, Operational, Financial and Knowledge.

ii. ERM is a structured, consistent and continuous process of measuring or assessing risk and developing strategies to manage risk within the risk appetite. It involves identification, assessment, mitigation, planning and implementation of risk and developing an appropriate risk response policy. Management is responsible for establishing and operating the risk management framework.

iii. ERM process consists of Risk identification, prioritization and reporting, Risk mitigation, Risk monitoring and assurance. The corporate risk function establishes the policies and procedures, and the assurance phase is accomplished by internal audit. The role of internal auditor is to provide assurance to management on the effectiveness of risk management.

iv. Nature of internal auditor's responsibilities should be adequately documented and approved by those charged with governance.

v. To review the maturity of an ERM structure by considering whether the framework so developed, inter alia protects the enterprise against surprises, stabilizes overall performance with less volatile earnings, operates within established risk appetite, protects ability of the enterprise to attend to its core business and creates a system to proactively manage risks.

vi. To review whether the ERM coordinators in the entity report on the results of assessment of key risks at appropriate levels, which are, inter alia risk Management Committee, Enterprise Business and Unit Heads, Audit Committee.

vii. To submit his report to the Board or its relevant Committee, delineating the following information Assurance rating (segregated into High, Medium or Low) as a result of the review, Tests conducted, Samples covered and Observations and recommendations.

SIA 14: Internal Audit in an Information Technology Environment

i. The overall objective and scope of an internal audit does not change in an IT environment. However, the use of a computer changes the processing, storage, retrieval and communication of financial information and the interplay of processes, systems and control procedures. This may affect the internal control systems employed by the entity. Accordingly, an IT environment may affect the procedures followed by the internal auditor in obtaining a sufficient understanding of the processes, systems and internal control system and the auditor's review of the entity's risk management and continuity systems.

ii. To consider the effect of an IT environment on internal audit engagement, inter alia the extent to which IT environment is used to record, compile, process and analyse information and the system of internal control in existence in the entity with regard to flow of authorised, correct and complete data to the processing centre, the processing, analysis and reporting tasks undertaken in the installation and the impact of computer–based accounting system on the audit trail that could otherwise be expected to exist in an entirely manual system.

iii. To have sufficient knowledge of information technology systems to plan, direct, supervise, control and review the work performed. The sufficiency of knowledge would depend on the nature and extent of the IT environment. The internal auditor should consider whether any specialised IT skills are needed in the conduct of audit, for example, the operating knowledge of a specialised ERP system.

iv. If specialized skills are needed, the internal auditor should seek the assistance of a technical expert possessing such skills, who may either be the internal auditor's staff or an outside professional. If the use of such a professional is planned, the internal auditor should obtain sufficient appropriate evidence that the work performed by the expert is adequate for the purposes of the internal audit.

v. To obtain an understanding of the systems, processes, control environment, risk– response activities and internal control systems sufficient to plan the internal audit and to determine the nature, timing and extent of the audit procedures.

vi. When the information technology systems are significant, the internal auditor should also obtain an understanding of IT environment and whether it influences the assessment of inherent and control risks. The nature of risks and internal control characteristics in IT environments include the Lack of transaction trails, Uniform processing of transactions, Lack of segregation of functions, Potential for errors and irregularities, Initiation or execution of transactions, Dependence of other controls over computer processing, Potential for increased management supervision, Potential for the use of computer–assisted audit techniques.

vii. To review whether the information technology system in the entity considers the confidentiality, effectiveness, integrity, availability, compliance and validity of data and information processed. To review the effectiveness and safeguarding of IT resources, including – people, applications, facilities and data.

SIA 15: Knowledge of the Entity and its Environment

i. To obtain knowledge of the economy, entity's business and its operating environment, including its regulatory environment and the industry in which it operates, sufficient to enable him to review the key risks and entity–wide processes, systems, procedures and controls. To identify sufficient, appropriate, reliable and useful information to achieve the objectives of the engagement.

ii. Prior to accepting an engagement, the internal auditor should obtain a preliminary knowledge of the industry and of the nature of ownership, management, regulatory environment and operations of the entity subjected to internal audit, and should consider whether a level of knowledge of the entity's business adequate to perform the internal audit can be obtained.

iii. Following the acceptance of the engagement, further and more detailed information should be obtained. To the extent practicable, the internal auditor should obtain the required knowledge at the commencement of the engagement. As the internal audit progresses, that information should be assessed, enhanced, updated, refined and validated as the internal auditor and the engagement team obtain more knowledge about the entity's business.

iv. In case of continuing engagements, internal auditor should update and re– evaluate information gathered previously, including information in the prior year's working papers. The internal auditor should also perform procedures designed to identify significant changes that have taken place in the operations, control environment, technology and strategic processes since the last internal audit.

v. To obtain sufficient, appropriate information about the entity. An understanding of business risks facing the entity increases the likelihood of identifying risks of material misstatement in the information subject to internal audit.

vi. Knowledge of the entity's business is a frame of reference within which the internal auditor exercises professional judgment in reviewing the processes, controls and risk management procedures of the entity.

vii. To ensure that the internal audit engagement team assigned to an internal audit engagement obtains sufficient knowledge of the business to enable them to carry out internal audit work delegated to them. The internal auditor should also ensure that the audit team appreciates and understands the need tobe alert for additional information and the need to share that information with the internal auditor and other members of internal audit team.

viii. To make effective use of knowledge about the business, internal auditor should consider how this knowledge acquired, affects his review of internal controls and systems taken as a whole and whether his overall entity–wide assessment of systems, procedures, controls and risk management principles are consistent with his knowledge of the entity's business.

ix. The information and knowledge obtained by the internal auditor on the entity and its environment should be adequately documented in the engagement working papers.

SIA 16: Using the Work of an Expert

i. To obtain technical advice and assistance from competent experts if the internal audit team does not possess necessary knowledge, skills, expertise or experience needed to perform all or part of the internal audit engagement.

ii. When the internal auditor uses the work of an expert, he should satisfy himself about the competence, objectivity and independence of such expert and consider the impact of such assistance or advice on the overall result of internal audit engagement, specially in cases where the outside expert is engaged by senior management or those charged with governance.

iii. When determining whether to use the work of an expert or not, internal auditor should consider the materiality of the item being examined, the nature and complexity of the item including the risk of error therein, the other internal audit evidence available with respect to the item.

iv. When the internal auditor plans to use the expert's work, he should satisfy himself as to the expert's skills and competence. To consider the objectivity of the expert. To satisfy himself that the expert has no personal, financial or organizational interests that will prevent him from rendering unbiased and impartial judgments and opinion.

v. When the internal auditor intends to use the work of an expert, he should gain knowledge regarding the terms of the expert's engagement. To seek reasonable assurance that the expert's work constitutes appropriate evidence in support of the overall conclusions formed during the internal audit engagement. To consider whether the expert has used source data which are appropriate in the circumstances.

vi. In exceptional cases where the work of an expert does not support related representations in the overall systems, procedures and controls of the entity, the internal auditor should attempt to resolve the inconsistency by discussions with the auditee and the expert.

vii. The internal auditor should not, normally, refer to the work of an expert in the internal audit report.

SIA 17: Consideration of Laws and Regulations in an Internal Audit

i. It is the primary responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

ii. The objectives of the internal auditor are to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements, to perform specified audit procedures to help identify instances of noncompliance with other laws and regulations that may have a significant impact on the functioning of the entity and to respond appropriately to non–compliance or suspected non–compliance with laws and regulations identified during the internal audit.

iii. Since the role of an internal auditor is to carry out a continuous and critical appraisal of the functioning of an entity and suggest improvements thereto, the identification of non–compliance with laws and regulations is also an inherent part of his responsibilities.

iv. Internal auditor should obtain an Understanding of the Legal and Regulatory Framework. The internal auditor shall inquire from the management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and Inspecting correspondence, if any, with the relevant licensing or regulatory authorities to help identify instances of non–compliance with other laws and regulations that may have a significant impact on the entity's functioning.

v. The internal auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non–compliance or suspected non–compliance with laws and regulations which impact the functioning of the entity, including the reporting framework, have been disclosed to the internal auditor.

vi. If the internal auditor becomes aware of information concerning an instance of non–compliance or suspected non–compliance with laws and regulations, the internal auditor shall obtain an understanding of the nature of the act and circumstances in which it has occurred and further information to evaluate the possible effect on the functioning of the entity. The internal auditor may discuss the findings with those charged with governance where they may be able to provide additional audit evidence.

vii. The internal auditor shall evaluate implications of non–compliance in relation to other aspects of internal audit, including the internal auditor's risk assessment and the reliability of written representations, and take appropriate action.

viii. If the internal auditor concludes that non–compliance has a significant impact on the functioning of an entity and has not been adequately dealt with by the management, the internal auditor shall report the same in accordance with SIA 4, "Reporting". If the internal auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non–compliance that may be significant to the functioning of the entity has, or is likely to have, occurred, the internal auditor should report the same.

Study Note - 13

VOUCHING AND VERIFICATION

This Study Note includes

13.1 Voucher: Meaning and Object
13.2 Vouching
13.3 Cash Vouching Procedure
13.4 Teaming & Leading / Lapping
13.5 Audit of Payments
13.6 Verification of Assets and Liabilities

13.1 VOUCHER : MEANING AND OBJECT

13.1.1 Meaning and Object

A voucher is a piece of substantiating evidence, in the form of a written record of expenditure, disbursement, or completed transaction.

Examples of types of vouchers: Cash Memo, Sale Invoice, Purchase Requisition Slip, Purchase Invoice, Gate Keeper's Note, Bank Paying Slip, Bank Statements, Minutes Book, etc.

13.1.2 Types of Vouchers

i. **Original and Collateral Vouchers:**

Original vouchers are called primary vouchers, and their copies or supporting documents are called collateral vouchers.

ii. **Internal and External Vouchers:**

Vouchers may generate inside the company (internal vouchers) or outside the company (external vouchers).

iii. **Missing Vouchers:**

(a) A missing voucher can be any of the following: missing Cash Memo, missing page in a Cash Collection Statement, missing inward challan for goods received, missing Inspection Report for material, missing TDS Certificate for tax deductions at source, missing Resolution to authorize increase in borrowing power by the company, missing Bank Statement for a day or a month, etc.

(b) A voucher could become missing due to:

i. Wrong or careless filing of document. E.g., missing Bank Statement for a day or a month, missing TDS Certificate.

ii. Unintentional non-awareness of statutory requirements. E.g., missing Resolution to authorize increase in borrowing power by the company, or accidental fire, or lost otherwise.

iii. Intention to hide the misappropriation by a person. E.g., non-recording of Purchas Invoices received later for goods received and taken in stocks, missing Cash Memo, etc.

(c) The auditor should be careful and should carry out cross verification processes from other sources and documents to be able to form a firm opinion in the case of missing vouchers.

(d) The auditor should qualify his report or give a Disclaimer of Opinion in this case, or may give an adverse report with reasoning on a particular issue depending upon the materiality of the missing voucher as necessary evidence on the issue.

13.1.3 Disqualification of a Voucher

The following stated defects would disqualify a voucher from being appropriate evidence:

i. If the date of voucher does not correspond with the date of payment entered in the Cash Book, the auditor may refuse to accept it as an old voucher may have been used to conceal misappropriation.

ii. If the voucher is not passed by the authorized personnel in the organization.

iii. The amount of the voucher differs in words and figures.

iv. The nature of payment in the voucher does not relate to the business.

v. The amount of voucher does not tally with the amount entered in the Cash Book.

vi. The voucher is in the name of an employee/director, and not in the name of the client's company.

13.2 VOUCHING

"Vouching is the examination by the auditor of all documentary evidences, which are available to support the authenticity of the transaction entered in the client's record." - Spicer and Pegler.

The act of examining all documentary evidences (vouchers) is referred to as vouching. Its basic objective is to establish the authenticity of the transactions recorded in the primary books of account.

Vouching is said to be "the essence of auditing" *or may* be termed as the "backbone of auditing"

13.2.1 Importance of Vouching

"Vouching is the foundation over which the structure of auditing is erected"

i. **Serves as evidence:** Vouching being an important auditing procedure helps in obtaining evidence with respect to transactions recorded, which ultimately ensures the completeness, accuracy, genuineness and validity of the transactions.

ii. **Assurance:** With the help of vouching, the auditor is ensured about recording of transaction, proper allocation to accounting period, occurrence of transaction, and further classification and disclosure of transactions as per the standard accounting principles and policies.

iii. **Preliminary for Verification:** Vouching serves as a basis of verification of assets and liabilities. Examination of the source documents justifying the amount of assets and liabilities stated in the Balance Sheet can be done by vouching.

iv. **Establishes Authenticity:** It facilitates authenticity of the transactions recorded in the primary books of accounts.

13.2.2 Special Considerations During Vouching

(A) It is important to note that in vouching of payments, the auditor does not merely seek proof that money has been paid away, but keeps into consideration the following relevant points:

i. **Checking the relevant documentary evidence:** It helps in assuring the genuineness of the transaction and accuracy in its recording.

ii. **Checking the authority on the basis of which the entry has been made:** It helps in assuring that the transaction has actually occurred.

iii. **Confirming that the amount mentioned in the voucher has been posted to the appropriate account:** It helps in assuring the proper classification according to accounting policies and practices.

iv. Checking that complete disclosure regarding the nature of the transaction is made.

(B) Thus, the general principles of vouching as well as auditing can be listed as under:

i. Genuineness

ii. Accuracy

iii. Authenticity

iv. Authorization

v. Classification

vi. Disclosure

13.2.3 Vouching Of Cash Transactions

A. "There are two main objects of a system of cash control. The first is to ensure that all receipts of the business from all sources are accounted for; and therefore, every precaution should be taken by all means of internal check to make it as difficult as possible for the receipts to be misappropriated. The second is to ensure that every payment has been properly recorded in the books of account and that the payee has actually received the amount."- De Paula

B. Weaknesses in the internal control system cause a number of risks to arise relating to cash transactions. The auditor should be careful in evaluating the internal checks and controls to detect the possible cash misappropriations such as:

i. Excessive cash balances in the cash book could be fictitious.

ii. Understatement of receipts by preparing duplicate receipts for sums less than original.

iii. Duplicate copy of sales invoice may be altered so that the party's account is debited with an amount that is lower than the actual sale and the amount of difference may be misappropriated.

iv. Incorrect totaling or balancing of the Cash Statements/Day Book/Cash Book.

v. **Suspense A/c:** Cheques from customers may be credited to suspense account and cash may be withdrawn later to square up the account.

vi. **Dummy workers:** Salary payments to non-existing workers.

vii. False bank confirmations may be prepared.

viii. False bank statements and duplicate FDRs get issued by the top management at the banks (as in the case of Satyam Computers).

ix. Receipts not entered in the cash book, particularly casual or non-recurring transactions such as:

- Bad debts recovered
- Overpayment to suppliers
- Sale of assets

x. Bad debt written off in earlier years but cash recovered later may be misappropriated.

xi. Discounts allowed may be overstated and the excess amount may be misappropriated from cash received.

xii. Cheques deposited in the bank may not be recorded in the Cash Book/Bank ledger and an equivalent amount of cash may be withdrawn later on.

xiii. Bank balance "kited", i.e. in the case of money transfer from one bank account to another, the receipt in a Bank A is shown prior to the balance date and the payment after it.

xiv. Teeming and leading: Part cash received may be held up and lapped up against subsequent receipts.

xv. Cash sales treated as credit sales.

xvi. Bank pay-in-slips with false particulars.

C. The auditor should take the following steps of action in case of occurrence of such risks:

S. No.	Risky Elements	Auditor's Action
i.	Opening Balance	It should be compared with the closing balance of the last year's Cash Book and as per audited Balance Sheet of the previous year.
ii.	Accounting Manual	To ensure written guidelines and set procedures to be followed in the company and its effective adherence.
iii.	Review of compliance Procedure	He should select a few representative transactions and entries, and follow them from the beginning to the end, to ensure that they are properly authorized, processed and substantiated.
iv.	Sample Transactions checked in depth	He may select a few representative transactions and entries, and follow them from the beginning to the end, to ensure that they are properly authorized, processed and substantiated.
v.	Numbering	There should be pre-numbered Cash Memos, Invoices, money receipts, Credit Notes, etc. and their copies should be properly maintained.
vi.	Cashier's Control	The cashier should not have full control on Sales Ledger, Creditor's Ledger, Invoices, Bank Reconciliation, Credit Notes, etc.
vii.	Incoming Mail	It should not be opened by the cashier or the clerk maintaining the Debtors' Ledger.
viii.	Cheques/ Postal Orders	It should be crossed 'Account payee only", and should be promptly dispatched to the parties concerned.
ix.	Daily Reconciliation	Of cash credited to debtors and the collection/receipts issued.
x.	Daily deposit of Collection	Cash collections should be deposited in the bank on the same day (net of payments authorized, if any, out of that).
xi.	Bank Reconciliation Statement	it should be prepared regularly by the cashier and also by some other person not involved with cash receipts or records
xii.	Petty Cash Imprest System	Petty cash should be maintained as per the impress system.
xiii.	Petty Cash Register	It should be under proper supervision and all payments through the register should be authorized with a maximum amount fixed for individual payments.
xiv.	Authorized Payments	All payments other than petty cash should be made by cheques which are prepared only against authorization of a senior executive.
xv.	Mark as "Paid" vouchers	Vouchers, against which cheques have been issued, should be marked as "Paid" so as to prevent their production in support of further cheques.

S. No.	Risky Elements	Auditor's Action
xvi.	Wrong Payee Name	E.g. A cheque received in the name of MCD could be fraudulently deposited by the cashier in the name of "M. C. Dey" by fradulantly adding the two dots and ''ey''. E.g. A cheque issued similarly in the name of ''D. R. Khanna'' could be encashed by ''Des Raj Khanna'' or his tenant/ brother on the other floor ''dev Ram Khanna''.
xvii.	Issue of Cheques	A double sided carbon paper may be used while issuing a cheque so that the cheque's details are noted not only on the sheet placed under the cheque (for the issuer's record), but also behind the cheque, to prevent unauthorized changes being made on the face of the cheque, that may go undetected. A transparent tape may be stuck on the name of the payee and the amount of the cheque to prevent manipulations.
xviii.	Bank Dealings	Insistence on payments and receipts by Payees A/c Cheques or Drafts as far as possible. The nature of imprest payments should be such that they could ordinarily be made by cheques.

13.3 CASH VOUCHING PROCEDURE

Cash sales are generally open to a wide scope for commission of frauds and these may be prevented only by an effective system of internal checks and controls.

After ascertaining the efficiency of the internal check system of cash controls as detailed above, the auditor should vouch cash sales as follows:

S. No.	Evidences Relevant	Audit Procedures
i.	Compliance of Accounting Manual or laid down Control Systems	To evaluate that the system laid down is proper and the same is being adhered to.
ii.	Separate authority to deliver goods and collect cash	To ensure that the salesmen have no authority to deliver the goods to, or receive cash from, the customers.
iii.	Three copies of Cash Memo	To verify that there should be at least three copies, preferably in different colors and clearly marked on it the purpose"Original for Customer" and the second copy for the Delivery Counter" are to be delivered to the customer. The third (book copy) remains with the respective salesman.
iv.	Stamp – marking by cashier as "paid"	To ensure that the customers present both the copies to the cashier who, upon receiving the payment and stamp-marking the copies as `Paid'; returns the same to the customer.
v.	One copy retained by Delivery Counter	To verify that the second copy with "Paid" stamp is handed over to, and retained by the delivery clerk for his own record of outgo.

S. No.	Evidences Relevant	Audit Procedures
vi.	Daily Cash Sales Summary for Reconciliation	To verify that the pre-numbered Cash Memos are reconciled with the Daily Cash Summary and that any missing number is vouched for to be recorded in it.
vii.	• Bank pay-in-slips • Cash Book Bank Book Bank Statement	To check daily deposit of cash as per Cash Sales Summary.
viii.	Till Rolls, in case of Automatic Cash Registers	To verify that the daily totals entered in the Cash Book are checked with the Till Rolls.
ix.	Stocks Register	The entries in the Stock Register should be reconciled with Daily Cash Sales Summary.
x.	Originals of cancelled Cash Memos	These must be available in original, duly cancelled.
xi.	Reconciliations of Cash Sales with: • VAT/Sales Tax returns • Excise Returns • General ledger Sales Ledger Accounts	The cross verifications may be checked to ensure accuracy

13.4 TEEMING & LEADING/ LAPPING

Teeming & Leading is a commonly followed method of misappropriation of cash by concealing cash shortages and covering them through recoveries from another customer. It is not uncommon in case of cash collections if the internal check and internal control on cash transactions are not proper. E.g., a salesman recovers ₹ 10,000 from customer C and misappropriates the same, but to conceal the misappropriation, he declares ₹ 10,000 received later from another customer D as received from C so that the balance of C confirms to the client's debtor list, and so on for recovery from E of same amount declared as from D.

Teeming and leading may not amount to fraud, but negligence on the part of the management and weaknesses in internal checks or controls may lead to substantial amounts being misappropriated by the cashier. This may result in a huge loss if he is not in a position to clear the debts when caught.

The auditor has to follow the following procedure for timely detection of teeming and leading:

i. Ascertain if the Cash Memos are consecutively numbered, and the dates, name and amount as per the Daily Summary reconcile with relevant cash receipt records.

ii. Reconcile individual cash amounts as per receipts with records in the Rough Cash Book.

iii. Reconcile the receipts as recorded in the Rough Cash Book, main Cash Book, pre-numbered Cash Memos, with counterfoils of the pay-in-slips.

iv. Ensure whether cash receipts are deposited in the bank on a timely basis.

v. Examine the Debtors Ledger, especially entries showing part payments, to satisfy that the debtors concerned have indeed made part payments.

vi. Confirmations may be obtained from the debtors from time to time.

13.5 AUDIT OF PAYMENTS

(1) Transactions with Directors

i. Check that any contract entered into by the director or his relatives etc. with the company is in accordance with the provisions of section 188 of the Companies Act, 2013.

ii. Every director of a company who is directly or indirectly, concerned or interested in a contract or agreement entered or proposed to be entered into with the company, must disclose his interest to the company at the Board meeting (Section 184).

iii. Further, for making purchase of goods and materials and sale of goods, materials and services to certain parties in which directors are interested, it is necessary to ensure that the prices are reasonable vide CARO, 2003.

iv. The remuneration paid to the directors of public companies or the private companies which are the subsidiaries of public companies should be in accordance with the provisions of section 197 of the Companies Act, 2013.

(2) Payment for Acquisition of Assets

i. The payment for acquisition of assets should be made under proper authorization and be duly supported by receipt for amount paid.

ii. Check the title deeds in case of purchase of immovable properties. Also ensure that the ownership in case of the moveable asset has been registered in the name the purchaser.

iii. The auditor should also verify the existence, value and the title of the assets acquired.

iv. In case of a company, ensure that the provisions of section 179 of the Companies Act, 2013 have been complied with.

v. Check that the cost of the asset purchased has been properly capitalized in the books of account. Thus, the amounts paid to bring the asset to their present condition or location and incurred upto the asset being put into use should be capitalized. Further such taxes (e.g. CENVAT) which are recoverable from the authorities shall not form the part of cost of the asset.

(3) Payments controlled by the Companies Act, 2013- As per section 179 & 180, the Board of Directors of a public company or of a private company which is a subsidiary of a public company, shall not, except with the consent of such public company or subsidiary in general meeting, exercise the following powers:

i. Sell, lease or otherwise dispose of the whole or substantially the whole of the undertaking or undertakings of the company.

ii. Remit or give time for repayment of any debt due by director(s), except in case of renewal or continuance of an advance made b' a banking company in the ordinary course of its business.

iii. Invest, otherwise than in trust securities, the amount of compensation received by the company in respect of the compulsory acquisition, after the commencement of this Act, of any such undertaking referred in (i) above, or of any premises or properties used for any such undertaking and without which it cannot be carried on or an be carried on only with difficulty or only after a considerable time.

iv. Borrow monies where the amount borrowed together with monies already borrowed by the company apart from the temporary loans obtained from the company's bankers in the ordinary course of business, exceeds the aggregate of the paid up capital of the company and its free reserves; and

v. Contribute amounts to charitable and other funds, not related to the business of the company or the welfare of the employees, the aggregate whereof exceeds in a financial year ₹ 50,000 or 5% of the average net profit, during the three financial years immediately preceding, whichever is greater.

(4) Assets acquired on Hire Purchase Basis

i. A movable asset, acquired on a hire purchase basis, should preferably be adjusted in accounts at its cash value by raising a liability for the amount payable to the financing company.

ii. The amount of interest payable along with each installment, whether separately or included therein should be debited to the interest account.

iii. Payments under a hire purchase agreement should be vouched having regard to the conditions contained therein.

iv. The amount, if any, paid as a penalty for late payment of installments should be debited as an expense instead of being added to the cost of the assets.

(5) Payment of Expenses

i. Every item of expenditure should be written off in the year in which it is incurred, except where its benefit is likely to extend over a number of years. In such case, only a part of it may be written off in the year in which it is incurred and the balance carried forward as deferred revenue expenditure, to be written off in subsequent years.

ii. The amount of expenses should be written off as soon as practicable, on taking into account the nature of the expenditure and the period over which the benefit is expected to extend.

iii. Further, the auditor should be careful to see that Deferred Revenue Expenditure be distinguished from losses of an extraordinary character which sometimes also are carried forward, when it is not possible to write them off, in the year in which these are suffered either on account of inadequacy of profits or on account of the desire of the directors not to burden unduly the profits of a year.

iv. If the provision for outstanding expenses made in a past year turns out to be insufficient and the amount is material, proper disclosure of such a fact should be made in the accounts of the year in which any further amount is charged on that account.

v. Only expenses incurred for the purpose or for the benefit of business are chargeable to it. The auditor therefore, should make certain, as far as practicable, that no personal expenses are charged to the business. In the case of a company, as per section 143, personal expenses, if charged to revenue, have to be reported, particularly those which are not covered by commercial practices or contractual obligation.

vi. It should be verified that all expenses incurred, whether paid or payable, have been included in the accounts and that where any part of an item of expenses relates to the period that extends beyond the close of the year, a proportionate amount thereof has been adjusted as prepaid expense.

vii. Where some of the expenses are found to have been adjusted in a lump-sum specially at the close of the year, these might be fictitious items introduced merely to reduce profits. These, therefore, should receive special attention of the auditor.

(6) Payment of Taxes

i. Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the receipted challan.

ii. Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid.

iii. The interest allowed on advance payments of income tax should be included as income and penal interest charged for non-payment should be debited to the interest account.

(7) Customs and Excise Duties

(a) Custom Duty

i. Check the bills of clearing agents duly supported by receipted Bills of Entry, where the custom duty has been paid by the Custom Agents. If a payment has been made directly, the Bill of Entry relevant thereto together with the receipt should be inspected.

ii. In the event of dispute where a provisional payment has been made, the amount determined as payable finally should be ascertained and any additional duty payable or refund of the amount paid in excess which is recoverable should be brought into account.

iii. In certain cases, drawback of customs duty is allowed if goods (imported or containing imported materials) are exported. The auditor should see that on export the refund of duty has been claimed.

(b) Excise Duty - Excise duty is a levy on manufacture. The liability for the duty arises at the point of time at which manufacture is completed. The point of time at which duty is collected may be determined by consideration of administrative convenience. Normally, excise duty is paid before the issue of excisable goods from the factory. The amount thereof is deposited with the State Bank or any other bank notified by the excise authorities, to the credit of the Controller of Excise and the duplicate copy of the challan is forwarded to him for obtaining the permit.

i. The following points should be considered to verify such payments:

ii. The amount of duty paid must be checked with quantity of goods in respect of which the issue permits for the goods have been received.

iii. Check the triplicate copy of the TR-6IGAR-7 challan, if available in the file in respect of such payments_ It will serve as an additional evidence of the duty having been paid.

iv. Certain entities maintain a current account with the excise authorities. In such a case, permits are issued in advance and duty is paid according to the quantity of excisable goods issued during each month or a shorter period.

(8) Travelling Expenses - Travelling expenses are normally payable to staff according to rules approved by directors or partners. Where no rules exist, the auditor should recommend that these be framed for controlling the expenditure. In the absence of T.A. Rules, the expenditure should be vouched on the basis of actual expenditure incurred. A voucher should be demanded for all items of expenses incurred, except those which are capable of independent verification.

As regards travelling expenses claimed by directors the auditor should satisfy himself that these were incurred by them in the interest of the business and that the directors were entitled to receive the amount from the business.

The voucher for travelling expenses should normally contain the undermentioned information:

- Name and designation of the person claiming the amount.
- Particulars of the journey.
- Amount of railway or air fare.
- Amount of boarding or lodging expenses or daily allowance along with the dates and times of arrival and departure from each station.
- Other expenses claimed, e.g., porterage, tips, conveyance, etc.

If the journey was undertaken by air, the counterfoil of the air ticket should be attached to the voucher, this should be inspected. For travel by rail or road, the amount of the fare claimed should be checked from some independent source. Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified. The evidence in regard to sundry expenses claimed is generally not attached to T.A. bills. So long as the amount appears to be reasonable it is usually not questioned. All vouchers for travelling expenses should be authorised by some responsible official. In the case of foreign travel or any extraordinary travel, the expenses, before being paid, should be sanctioned by the Board.

Unless the Articles specifically provide or their payment has been authorised by a resolution of shareholders, directors are not entitled to charge travelling expenses for attending Board Meetings.

(9) Repairs to Assets -Since the line demarcating repairs from renewals is slender. usually it is not a simple matter to determine the amount of the expenditure, if any, included as charges for repairs, which should be considered as that incurred for renewal of an asset and added to its cost. It may sometimes be possible to determine this on a consideration of the nature of repairs carried out.

- The proportion of the charges which had the effect of increasing the value of an asset or enhancing its capacity or life, should be treated as capital expenditure.
- If it is not possible to form an opinion accurately on the basis of evidence as regards the nature of repairs, a certificate from the engineer under whose supervision the repairs were carried out, confirming the classification of expenditure should be obtained.

(10) Preliminary Expenses -The expenditure incidental to the creation and floating of a company includes stamp duties, registration fees, legal costs, accountant's fees, cost of printing, etc.

i. Check the contracts relating to preliminary expenses.

ii. If preliminary expenses incurred by promoters have been reimbursed to them by the company, the resolution of the Board of Directors and the power *in* the Articles to make such reimbursement should be seen.

iii. Examine the bills and statements supporting each item of preliminary expenses.

iv. It should be seen that no expenses other than those which constitutes preliminary expenses are booked under this head. The auditor can cross check the amount of preliminary expenses with that disclosed in the prospectus, statutory report and the balance sheet.

v. Check that any amount which is paid in excess of the amount disclosed in the prospectus should have been approved by the shareholders.

vi. Expenditure in connection with the preliminary expenses so far it has not been written-off should be separately disclosed under the head miscellaneous expenditure.

vii. Further, see that Underwriting commission and brokerage paid for shares and debentures should not be included under the head preliminary expenses.

(11) Salaries and Wages.-The auditor should take into consideration the following points:

(i) Internal Control: See that an adequate system of internal control exist as to the appointment, promotion, transfer and discharge of' employees, recording attendance of workers engaged on the time basis, as well as particulars of' jobs performed by piece workers, arrangement for the preparation of wages and salaries bills and their analysis, and sanctioning the disbursement of wages and salaries. The system of internal check should be operational one and that too in an effective manner.

(ii) Other matters:

a. Salary and Wage Bill: Check the salary and wage bill in detail by reference to the record of attendance, schedule of rates, sanctioned by the management for different classes of workers and employees and the sanction for their payment.

b. **Dummy Workers:** Examine that the salary and wage sheet contains no names of dummy workers. Also see that the employee or worker who has received the salary or wage has put his initials for the amount received against his name in the sheet.

c. **Statutory Deductions:** Check the computation of wages and salaries payable to different workers and employees on taking into account the deduction and other factors such as leave pay, PF, ESI, TDS etc.. into consideration.

d. **Mode of Payment:** Check whether the amount has been paid in cash or through cheque or through bank arrangements. Now a days, the companies are also giving the salary in the form of ESOPs etc.

e. **Undisbursed Payments:** Ensure that all payments to workers and other employees have been acknowledged and amounts which have remained undisbursed have been deposited back in the bank and credited to the Unpaid Wages and Salaries Accounts.

f. Computation: Test the correctness of the amount paid by reference to the Annual Return of Salaries, etc., submitted to the Income-tax Authorities and that of wages with Employee's State Insurance Cards.

g. Loans and Advances to employees or workers: Where loans have been granted to employees or workers, the auditor should trace recoveries out of loans and advances, outstanding against employees into the Employees Loans and Advances Register.

h. Arrangement with Banks: Where the enterprise has made arrangements with bank as to the deposit of salary and wages in say, `Salary and Wage Account - XYZ Limited' with the bank, the auditor should prepare a reconciliation statement as to the amount withdrawn and not withdrawn by the employees or workers.

(12) Petty Cash

i. Trace the amounts advanced to the petty cashier for meeting petty office expenses from the Cash Book in the Petty Book.

ii. Vouch payments with docket vouchers which must be supported, wherever possible, by external evidence e.g., payee's receipted bill or invoices, cash memo, etc.

iii. Trace payments made for the purchase of postage stamps recorded in the Postage Book. The totals of the Postage Book should be test checked.

iv. Confirm that the postage expenses for the year are reasonable as compared with that in the postage expenses from month to month.

v. Where a columnar Petty Cash Book is maintained, check that the extension have been carried forward into appropriate amount columns.

vii. Check the column totals and cross totals. Trace posting of the various columns in which payments are classified to the respective ledger accounts.

vii. Verify the cash balance in hand.

(13) Research and Development Expenditure

i. Ascertain the nature of research and development work to be carried out or that have already been carried out.

ii. If the expenses are routine development expenses, it should be seen that they are written off to the profit and loss account.

iii. Check whether the concerned research activity is authorised by the Board and has relevance to the objectives of the company.

iv. If any machinery and equipment have been bought specially for the purpose of research activity, the cost thereof, less the residual value should be appropriately debited to the Research and Development Account over the year of research.

v. Ensure that the stipulations of AS-26 on Intangible Assets have been adhered to.

vi. Tax benefit arising on the research and development expenses should be taken into account in creating tax provision.

vii. No expense unrelated to the research and development programme should be allowed to be debited to Research & Development Account.

(14) Advertisement Expenses

i. Ascertain the nature of advertisement expenses to ensure that the same have been allocated properly, i.e. capital, deferred revenue or revenue.

ii. Obtain the complete list of media of advertisement i.e., newspapers, hoardings, magazines, television, radio etc. showing the dates, exact location, timings, etc., along with the amounts paid in respect of each category.

iii. See that advertisement expenses relate to the clients business.

iv. Ascertain whether there is a regular contract with an advertising agency.

v. Discounts, if any, should be properly adjusted and disclosed in the bills.

vi. Checks the receipts for amounts paid for the advertising expenses incurred.

vii. See that outstanding advertising expenses have been properly disclosed on the liabilities side of the balance sheet.

(15) Retirement Gratuity to Employees

i. Check the basis on which the gratuity payable to employees is worked out. The liability for gratuity may either be worked out on actuarial rules or agreement or on the presumption that all employees retire on the balance sheet date.

ii. Ensure that the basis of computing gratuity is valid.

iii. Verify computation of liability of gratuity on the aggregate basis.

iv. Check the amount of gratuity paid to employees who retired during the year with reference to number of years of service rendered by them.

v. See that the annual premium has been charged to Profit and Loss Account in case the concern has taken a policy from LIC.

vi. Ensure that the accounting treatment is in accordance with AS-l5.

13.6 VERIFICATION OF ASSETS AND LIABILITIES

Only the vouching to ascertain the arithmetical accuracy is not enough, the auditor is supposed to go beyond that while doing audit. In all types of transactions vouching is must, but in case of capital items the auditor is required to go beyond that and verify the physical existence and evaluate the assets and liabilities to arrive at true and fair view of the state of affairs of business. Now a day it is statutory liability of the auditor to verify assets & liabilities and if he fails he is held liable for negligence. e.g. in London Oil Storage Co. Ltd., Vs Seear Husluck and Co., (1904), Acct. L.R. 30-93, it was held that an auditor, who fails to verify the existence of assets as shown in the balance sheet of the company, is liable. In another case, Arthur E. Green & Company Vs. The Controller, Advances & Discount Corporation (1920) Act, LR xiii, it was held that an auditor is guilty of negligence, if he fails to detect time barred debts within the schedule of debts.

Verification, as defined by Spicer and Pegler, is "An enquiry into the Value, Ownership, Title, Existence, possession and presence of any charge on the assets", while according to Lan Caster, "The verification of assets is a process by which the auditor substantiates the accuracy of the right hand side of the balance sheet, and must be considered as having three distinct objects –

(a) the verification of the existence of assets

(b) the valuation of assets and

(c) the authority of their acquisition.

Meaning – Verification means **"Proving the truth".** An auditor has not only to see the arithmetical accuracy and bonafides of the transactions in the books of accounts by vouching only, but has also to see that the assets as recorded in the balance sheet actually exist. The fact that there is an entry regarding purchases of an asset and has been found to be currently recorded, is not a proof that the asset is in the possession of the concern at the date of balance sheet. It is possible that after the asset had been acquired and the necessary entries made in the books of accounts, the asset might have been disposed of or pledged or mortgaged and no entry had been made regarding these facts in the books of accounts before the closing of the financial year. He has also to see whether a particular asset as appearing in the balance sheet exists or not. Verification of liabilities is also as important as the verification and assets. If the liabilities are overstated or understated, the balance sheet will not represent a true and fair view of the state of affairs of the Company.

In short, verification is a function of examining assets & liabilities to check (i) Value (ii) Ownership (iii) Title (iv) Existence (v) Possession and (vi) to see whether the assets are free from any charge or encumbrance etc.

Importance of Verification – Verification is very important function from view point of both, the auditor and the client as it gives clear idea as to true and fair view of balance sheet. The importance of verification may be described as under –

(a) True and fair view of Balance Sheet – verification of assets and liabilities enables the auditor to comment on true and fair state of affairs of the business.

(b) Valuation – verification enables the auditor to determine whether the assets or liabilities are overstated or under stated.

(c) Omissions – verification facilitates the act of confirming the omission of any asset or liability in the balance sheet.

Scope of Verification – verification includes confirming of whether the assets were in existence on the date of balance sheet, whether assets had been acquired for the purpose of business only, whether the assets had been acquired under a proper authority, whether the right of ownership of the assets vested in the enterprise, whether the assets were free from any charge and whether, the assets were properly valued and disclosed in the balance sheet.

Objects of Verification – verification of assets and liabilities is done with the following objects

i. To know whether the Balance-Sheet exhibits a true and fair view of the State of affairs of the business.

ii. To find out whether the assets were in existence

iii. To find out the ownership and title of the assets

iv. To show correct valuation of assets and liabilities

v. To verify the arithmetical accuracy of the books of accounts

vi. To ensure that the assets have been recorded properly

vii. To detect frauds & errors, if any

viii. To find out whether there is an adequate internal control regarding acquisition, utilization and disposal of assets.

Advantages of Verification – Careful verification of assets fetches the following advantages to the client –

(a) It avoids manipulation of accounts

(b) It guards against improper use of assets

(c) It ensures Proper recording and valuation of assets.

(d) It exhibits true and fair view of the state of affairs of the Company.

Technique of Verification – Auditor may adopt the following techniques for verification of assets & liabilities.

(i) Inspection – This means physical inspection of the assets like counting cash in hand, measuring inventory, inspection of securities, share certificate etc.,

(ii) Observation – The auditor may observe or witness the inspection of assets done by others.

(iii) Confirmation – This means obtaining written evidence from outside parties regarding existence of assets like, confirmation from Debtors and Creditors about the balance outstanding etc.,

How to conduct the verification work

i) Examine the documentary evidence and see that the assets are properly recorded in the books of accounts.

ii) Verify the opening balance from the schedule of fixed assets, ledger or register.

iii) Verify acquisition on the basis of orders, invoices, title deeds etc.,

iv) Verify the self constructed assets on the basis of contractors bill, work order etc.,

v) Ensure that the fully written off fixed assets are properly recorded.

vi) See the authority of disposal of fixed assets.

vii) Follow a proper procedure to ascertain the omissions, if any.

viii) Verify ownership of the fixed assets on the basis of title deeds.

ix) Verify existence of assets by physical verification. He should ensure that the physical verification of assets is carried out by the management.

x) Test check the records of fixed assets with physical verification reports and see that discrepancies, if any, are properly dealt with.

xi) See whether the assets are charged. He should verify the Loan Agreements, Register of charge, Board Resolution, Share Holders Resolution etc.,

xii) He should keep in mind the following points while verifying the assets & liabilities –

   a. Whether the assets and liabilities are properly traced from ledger to Balance Sheet

   b. Whether the assets are acquired for the business and liabilities got created for the purpose of business and are clearly stated in the Balance Sheet.

   c. Whether the assets and liabilities are properly grouped under specified heads in the balance Sheet.

   d. Whether the assets & liabilities are in actual existence on Balance Sheet date.

   e. Whether along with ownership the possession of assets lies with the client.

   f. Whether the assets are properly valued in the Balance Sheet

   g. Whether the liabilities stated in the Balance Sheet tallies with the confirmation certificate

(A) Plant & Machinery :

As in case of industrial concern out of total assets 20% to 50% cost is that of Plant & Machinery and hence the auditor is required to take much more precaution while verifying the Plant and Machinery and for this he should give attention to following points-

i. He should get the detailed list of all Plant and Machineries and asset wise accumulated depreciation.

ii. He should trace the opening balance in the Plant & Machinery register with the help of last year's audited balance sheet.

iii. He should verify quotations, invoices, cost etc., in connection with Purchase of Plant & Machinery. If there are sales of Plant & Machinery in audit period he should verify the invoice to that effect. He should check the Board Resolution authorizing Purchases of Plant & Machinery.

iv. If any machinery is disposed off and sold as scrap during the audit period, he should check the authorization and values report in that connection.

v. He should check the rates and calculation of depreciation and ensure these are according to the provision of Section 123 of the Companies Act, 2013.

vi. He should check whether related expenses incurred on purchases of machinery are duly capitalized.

vii. He should check whether proper accounting of profit earned or loss suffered on Sale of Machinery, during the audit period, is done.

viii. If any machine is manufactured by the client it self, auditor should verify that capitalization of material, labor and other expenses is properly done.

ix. He should obtain from the Company management certificate about the verification of all items as required under CARO. [Section 143]

x. He should scan the Plant register and physically inspect some of the major plants by visiting to the works.

xi. He should, finally, ensure appropriate disclosure of all information on the balance sheet as required by the Companies Act.

xii. He should obtain a certificate from the local auditor to that effect, if Plant and Machinery is kept abroad at a distant place.

(B) Freehold Land and Building:

i. He should see that Freehold Land and Buildings are shown separately and not mixed with lease hold or other assets.

ii. He should see that separate accounts for land and for buildings are mentioned because on land usually no depreciation is provided.

iii. He should see that the balance shown on Balance Sheet is directly traceable from respective ledger account.

iv. He should examine the title deeds of the property and see that the asset is in the name of the client and in the free and fair possession of the client.

v. He should examine that the title deed is genuine.

vi. The Purchases during the year be examined with the related correspondence, broker's note, auctioneer's note.

vii. In case of construction of the building auditor should examine the various certificates such as Builder's certificate, Contractor's certificates, Architect's certificate, Local authority certificate where needed.

viii. He should verify the sale, if a part of property has been sold during the period under audit.

ix. He should obtain a certificate from mortgagee if the property has been mortgaged and the deeds are with the mortgagee to verify the property.

x. Land is not subject to depreciation but see that proper depreciation is provided on building as per the provision of Section 123 of the Companies Act, 2013.

xi. See that the fluctuation in the value is not to be considered on Balance Sheet but if it has been considered then see that this is properly disclosed on Balance Sheet.

xii. Auditor should physically verify the existence of asset.

(C) Imported Plant & Machinery:

i. The Auditor should examine the directors Minute Book for the resolution passed authorizing the purchases.

ii. The Auditor should check the RBI's permission and the import License.

iii. The Auditor should examine the agreement with the foreign supplier, particularly check the terms of payment, interest rates and the basis of deferred Payment.

iv. The Auditor should vouch the bills & receipts relating to purchases, customs duty payment, clearing & shipping charge, insurance premium etc.,

v. The Auditor should check the entries made in the books of account.

(D) Revaluation of Fixed Assets

A revaluation means a revision of the book value of capital assets in accordance with a proper appraisal of such assets. Such appraisal includes establishment of proper values by a systematic procedure that encompasses:

i. Physical examination of each unit of the plant.

ii. Engineering estimates of future working.

iii. Possibility of obsolescence

If a company revalues its assets and shows the same in the Balance Sheet at their replacement cost, depreciation in respect of such assets is to be provided on the basis of the revalued costs.

Any reserve created out of revaluation should not be used for distribution as dividend because revaluation by itself does not create any funds. Only provision of increased depreciation on the revalued cost will result in creation of funds to be utilized for replacement of the assets concerned.

(E) Furniture & Fixtures :

i. Generally, furniture, fixtures and fittings are shown as one asset in the Balance Sheet, but auditor should remember that there is a distinction between them. Furniture, is movable e.g. chairs, fixture is tightly fixed to the ground e.g. science laboratory, while fittings are fitted on the walls e.g. electric wiring.

ii. See that furniture, fixture & fittings register is properly maintained.

iii. Verify that the balance from the register is correctly posted on the Balance Sheet.

iv. See that proper depreciation is charged in each class as per the provision of section 123 of the Companies Act, 2013.

v. Check the invoices, quotations, orders and authorizations in regard to new purchases of furniture during the years.

vi. Verify the sale of furniture and authorization for sale.

vii. Check whether proper accounting is done for any profit earned or loss suffered on sale. Physically verify the existence of the furniture, fixture & fittings.

viii. If acquired on lease, examine the conditions of lease and see whether these are followed duly or otherwise the lease will be forfeited.

(F) Motor Vehicles :

i. Ensure whether the concern is maintaining proper and separate register giving full particulars of vehicles.

ii. Check up whether opening balances have been properly traced in the register or not.

iii. Check up whether the entries regarding new purchases and sales of old vehicles have been properly recorded or not.

iv. Check up various documents such as agreement, invoices, bills, orders, authorizations etc., relevant to purchases & sales.

v. Check the auctioneer's statement, valuer's report etc., in case of sale of vehicle as scrap.

vi. See profit earned or loss suffered on sale is properly accounted.

vii. Verify whether fair depreciation on vehicles is provided or not.

viii. Verify registration & license to see all the vehicles are in the name of the auditee or not.

ix. Verify physically all the vehicles by inspecting their registration numbers.

x. Check the certificate from lender in case R/C book of any vehicle is lying with the lender.

xi. See whether proper insurance on vehicles are paid or not.

(G) Goodwill :

Goodwill is intangible but not a fictitious asset and as such has value so long it remains with the business. Therefore its value depends upon the earning capacity of the business and fluctuates accordingly. Auditor, while verifying the goodwill, will take into consideration the following points –

i. Auditor should see how the goodwill gets created, if there was no opening balance, verify the value from the agreement of purchasers of business, minute books etc.,

ii. Opening balance be verified from last year's audited Balance Sheet.

iii. He should check the accounts and compare goodwill account with the Balance Sheet to ensure that goodwill account is clearly stated in the Balance Sheet and no other asset is mixed with it.

iv. Satisfy himself by making a reference to the Articles of Association or Partnership Deed, as the case may be, if value of goodwill is enhanced or reduced during the year under audit.

v. Since goodwill is an intangible asset, verification of charge on it doesn't arise.

vi. As goodwill is always valued at cost, a question of providing depreciation on it doesn't arise.

(H) Investments:

i. Insist on a schedule of investments, when number of investments held by the auditee is very large.

ii. Examine the investment schedule with reference to the relevant ledger accounts.

iii. See that the investments have been shown properly in the Balance Sheet

iv. He should verify the existence of investments by inspecting the certificate, deposit receipts etc.,

v. Obtain a certificate from bank of certain securities given to the bank for safe custody.

vi. Examine the transfer deed, broker's contract note if certificate of investments is not received upto the date of audit of the securities purchased during the year under audit.

vii. Examine the trust deed if securities are held by a trust on behalf of the client.

viii. Verify the Sales proceeds from pass book of the sale of any securities made after the date of Balance Sheet but before the audit.

ix. Verify relevant vouchers and certificates whether securities are free from any charge or not

x. See whether investments are properly valued or not giving consideration to the provisions of the Articles of Association in case of trust companies as they are valued at cost but in case of finance companies they are valued, being traded as current assets, at cost price or market price, whichever is less.

xi. See that regarding the investments in subsidiaries, disclosure requirements of section 133 are complied with.

xii. Check the balance in the schedule of investments in the name of the client and compare it with the general ledger and Balance Sheet. See that the investments are in the name of the client.

xiii. See that investments made by the company are not contrary to the provisions of section 186 of the Indian Companies Act, 2013.

xvi. In case of application money paid for shares which are still to be allotted, the fact is to be specifically disclosed in Balance Sheet.

xvii. Confirm that uncalled amount on partly paid shares held as investment is shown as contingent liability in Balance sheet.

xviii. The auditor has to report, as per section 143 of the Companies Act, whether any shares, debenture sold at price lower than their cost, in the case of finance company, whether proper records of investments are kept.

xix While auditing the investments the auditor should keep in mind the provisions of AS 13.

(I) Patents

i. Examine the patents and verify them with the help of the certificate from the party granting the patents.

ii. Ensure that the patents are duly registered in the name of the auditor.

iii. Verify the voucher, pass book, agreement, authorization etc., in case of outright purchases of patents and see that the cost is fully capitalized.

iv. Check the renewal fees, if any, paid is debited to Profit and Loss Account.

v. In case of patents developed by the client, expenditure incurred on its development, should be capitalized.

vi. Call for schedule in case the number of patents is large and examine the dates and acquisition, description and expiry date etc.,

vii. Question of charge on patents does not arise as it itself is a right in use.

viii. See that proper depreciation is provided on patents as per the provision of the Companies Act.

(J) Trade Marks

i. See that the trade Marks are registered in the name of the auditee.

ii. See whether it is shown distinctively in the Balance Sheet.

iii. Check the Assignment Deed to ascertain the Terms and Conditions of the acquisition of Trade Marks to see whether the terms are followed properly.

iv. Obtain a schedule of Trade Marks if those are in large numbers.

v. See that the renewal fee is regularly paid.

vi. Verify the valuation of Trade Marks to see whether it is properly done or not.

(K) Copy Rights

i. Verify copyrights with agreements.

ii. See whether revaluation of copyrights is made properly and profit or loss is properly accounted.

iii. Obtain the certificate of approved valuer to that effect.

iv. See that the balance exhibited on balance sheet can be traced from ledger account.

v. Verify the opening balance from last year's audited balance sheet.

(L) Sundry Debtors

i. Trace the opening balance from last year's audited Balance Sheet.

ii. Obtain Sundry Debtors' schedule from the management and compare it with ledger accounts.

iii. See the debtors are shown properly on Balance Sheet.

iv. See that the provision for bad debts, discounts etc., is properly made.

v. Examine the relevant vouchers, minute book for verifying whether bad debts written off are correct or not.

vi. See that the legal requirements of schedule of the Companies Act, 2013 are duly complied with. For this purpose the debtors are to be classified as –

  a. Debtors outstanding for a period exceeding six months and

  b. Other Debtors also, particulars to be given separately of –

  c. Debts considered good and in respect of which the Company is fully secured.

  d. Debts considered good for which the Company holds no security other than the debtors' personal security.

  e. Debts considered doubtful or bad. Over and above these requirements, Debts due by directors or other officers of the Company or any of them either severally or jointly with any other person or debts due by firms or Private Companies respectively in which any director is a partner or a director or a member to be disclosed separately. Debts due from other Companies under the same management to be disclosed with the name of the Companies. The maximum amount due by directors or other officers of the Company at any time during the year to be shown by way of a note.

vii. If the customers have purchased the goods on hire purchase basis and some of the installments are not due, the same is not to be shown as debtors, instead they are to be shown on "Stock out on "hire purchase" at cost.

viii. If the goods are sold on Sale or approval basis, such customers cannot be shown as debtors unless they have agreed to purchase the same before the date of the Balance Sheet.

ix. Whenever there are credit balance in debtors accounts, the same should not be deducted from other debtors' debit balance. Such credit balance is to be shown on the liability side separately.

x. Enquire whether there is any dispute regarding any balance included in debtors. The auditor should verify the document regarding any dispute.

xi. The auditor should ascertain that there are no unrecorded debtors and for he has to examine the cut off transactions. He should examine the cut off procedures to ensure separation of transactions of the current year from the next year. Sale of the current year should be separated from the sale of next year. He shall ensure that sales bills are prepared for goods dispatched. No sales bills are raised unless the goods are actually dispatched and sold during the accounting year.

xii. The auditor shall check collection from debtors in the next year to decide whether the year end balances are good or not. If debtor has become insolvent, after the date of Balance Sheet, such debtors should be provided for.

xiii. The auditor should arrange to send the letters of confirmation balance by the client as per clients record and see that the reply of confirmation is forwarded to his office directly, usually this should be sent within 15 or 20 days of year ending date under the supervision of audit staff. After the reply is received, the same should be tallied with the balance shown in the debtors ledger and differences, if any, be reconciled.

(M) Stock in Trade

This is an important asset and may be used to fabricate profit and give misleading Balance Sheet and hence an auditor is required to take lot of care and caution while verifying stock in trade and for following points be considered –

i. Verify whether an efficient internal check system regarding stock is in operation or not.

ii. Compare the stock register with purchases and sales book, in regard to question

iii. Check the gate keepers' outward register to find out whether any fictitious sale has been entered in Sales Book.

iv. Check the Stock sheets and Calculations, additions, costing etc., there in.

v. See that goods sold but not delivered are not included in Closing Stock.

vi. See that goods purchased, invoices received but delivery yet to be received are included in the Closing Stock.

vii. See that goods received from others to be sold on their behalf are not included in Closing Stock.

viii. See that furniture, tools etc., are not included in Closing Stock.

ix. Compare the balances of Stock Register with the Stock sheets.

x. Method of stock taking may be enquired into, to find out possibilities of frauds and errors.

xi. Examine the principle followed in the valuation of stock to ensure that those were followed in previous years.

xii. Check whether stocks are valued on the basis of "Cost price" or "Market price" whichever is less or not.

xiii. Compare the Gross Profit rate of current year with that of previous years, if considerable variation is found, that should be enquired into in detail.

xiv Determine the obsolete, slow moving, non-moving and damaged item and ascertain their treatment in accounts.

xv Obtain a certificate from the management to the effect that the stock sheets are accurate and confirming that they have been signed by responsible person.

xvi In case of the manufacturing concern the goods may be of following categories and should be valued and verified after taking above points into considerations and checking the relevant cost recorded like purchases requisitions, material requisitions, goods received notes, bin card and stores ledger etc.,

a) Raw materials b) Work in Progress c) Finished goods d) Stores & Spare parts.

xvii Ensure that the various components of Stock have been separately disclosed in the Balance Sheet with their mode of valuation.

(N) Loose Tools:

Loose tools at the end of the year should be checked by the auditor as follows:

i. The auditor should see that the cost of loose tools is properly determined and certified by the Chief Engineer.

ii. If the loose tools are manufactured by the organization, the authorized officer shall certify the value of such tools.

iii. He should physically verify these tools or obtain a list of tools duly certified by the responsible officer. Any discrepancies shall be investigated.

iv. Ensure that the closing stock of tools is valued at cost. See that the valuation is done on the basis, which is consistent taking in to consideration obsolescence, damage, brokerage etc.,

v. See that the loose tools are disclosed in the Balance Sheet on asset side under the head "Current Assets".

(O) Live Stock

i. See the live Stock Register and note down carefully the particulars like breed, year of purchases, purchase price, depreciation etc., for various categories of animals.

ii. See that some identification number is given to identify the animals.

iii. Examine the basic of valuation of animals. In case the animals are purchased at the age of maturity the cost will include Purchase Price plus freight. If the animal is reared from its conception and then brought to Maturity the cost includes cost of calving, cost of fodder etc., consumed till maturity and the suitable share of overheads.

iv. See that the cost up to the maturity stage of animal has been written off once the earning capacity of the animals starts declining over the remaining life.

v. Ensure that disposal value at the end of the life of the assets has been adjusted properly.

(P) Bills Receivables

i. Get the schedule of bills receivables from the management.

ii. Check the total of the Schedule with the ledger.

iii. Check each bill to ascertain whether it is properly drawn, signed by the drawee and properly stamped or not.

iv. Verify the Cash received on the matured bills after Balance Sheet date.

v. Check the bills discounted with the B.R. Book and Cash Book.

vi. See that relevant foot note by way of contingent liabilities regarding bills discounted but yet not matured, properly appears on Balance Sheet.

vii. Verify the bills deposited with bank for safe custody or for collection or for securities of loans, with the bank certificate to that effect.

viii. Check the cash book and rebate / discount in connection with the proceeds received from retired bills before maturity.

ix. Trace the balance shown in Balance Sheet from the ledger account. Check the opening balance from last year's audited Balance Sheet.

(Q) Cash in Hand

i. Visit the auditee's premises and physically count, whole of the cash at a time and compare it with the balance shown on Cash Book.

ii. He should not accept IOU's as cash.

iii. If cash could not be counted on last day of the year he may visit as per his convenience and count the cash and check the cash book from the end of the last year to the date as and when cash is counted to verify the correctness of each balance at the end of last year.

iv. If actual cash counting is not possible ask the auditee to deposit whole of the cash in hand at the close of the year into bank, then the Closing Cash Balance gets automatically checked.

v. Whatever it may be, auditor should pay surprise visit to auditee and count the cash to prevent the cashier to borrow money and make up the deficiency which was due to embezzlement in the past.

vi. Get certificates from the auditors of the branches about the cash balance in hand and their correctness.

vii. Check the documentary evidences in reference to the cash in transit.

viii. See that the cash in hand is properly shown on the Balance Sheet.

ix. See if the large number of post dated cheques is found in hand on the date of balance sheet, the same are not treated as realised/collected during the audit period.

x. see the form and quantum of mutilated notes/coins is not large enough considering the size and nature of the business. Also see that such mutilated coins/notes are exchanged at the earliest.

(R) Cash at Bank

i. Compare the balance as shown in the Pass Book with balance of Cash shown in the bank column of Cash Book.

ii. Prepare Bank Reconciliation Statement to ascertain the reasons behind the difference between Pass book balance and Cash book balance.

iii. Obtain a balance certificate from the bank in case of suspicion of presentation of fictitious pass book and compare the balance with Cash book.

iv. Obtain separate certificates for different accounts or deposits with the bank for proper verification of different balances.

v. See that "The charges not yet collected" are genuine and not made up in order to conceal the deficiency.

(S) Loans and Advances

Loans and advances may be of different types like –

(a) Loans against the security of Land & Building.

(b) Loans against the security of goods.

(c) Loans against the security of stocks & shares

(d) Loans against the security of Insurance Policies

(e) Loans against the personal Security of the borrower.

Therefore, in each case the duty of auditor in general is as under:

i. Examine whether a proper loan ledger has been maintained upto date or not.

ii. Examination of the Security ledger against each loan.

iii. Examine the loan agreement and find out the rate of interest, due dates of installments, penalty, interest etc.,

iv. Ascertain whether any loan is doubtful of recovery. In case it is doubtful, a provision for the expected loss is to be made.

v. Verify that loans have got proper sanction from the authority.

vi. Obtain a letter of confirmation from the parties to whom loans are advanced.

In case of loans to directors, prior approval of the Central Government is obtained.

(a) Loans Against The Security of Land & Buildings

(ii) Examine the mortgage deed in depth and to confirm that the mortgage has been properly executed in favour of the lender.

(iii) Examine the title deeds deposited.

(iv) Examine the Valuer's certificate, in order to verify the value and see that the value is adequate.

(V) Confirm that the property is properly insured and insurance premium has been paid in time.

(Vi) Examine the title of the borrower in connection with property etc.,

(vii) Take the acknowledgement of title deeds from the first mortgage in the case of second mortgage.

(Viii) Confirm that the mortgage is properly registered.

(ix) The amount of loan should not be more than two thirds of the value of property.

(x) The auditor should enquire the rated interest and the date on which it is payable; if the loan has been outstanding for a long time, he should make an enquiry when the interest has not been paid.

(xi) In the case of loan on mortgage of lease hold land, the auditor should see that the ground rent has been paid regularly by the borrower on the due date.

(xii) In the case of part repayment of loan, the auditor should get the loan confirmed.

(b) Loans Against The Security of Goods

(i) Examine the nature of the goods and confirm that the goods are belonging to the borrower.

(ii) Verify whether loan is granted against railway receipts, lorry receipt, dock warrant, godown keeper's receipt etc.,

(iii) See that the rent of godown is paid in full and the goods are fully insured if the goods are stored in godown.

(iv) Examine the value of goods by comparing them to the present market value. He may rely on the inspector's report regarding quantity and quality.

(v) Examine the turnover of the client if the goods are perishable.

(c) Loans Against Security of Stocks & Shares

(i) Call for a statement of stocks and shares given as security.

(ii) Confirm that all shares are fully paid up

(iii) See that an instrument of transfer, properly stamped is available for his checking.

(iv) See that the value is properly disclosed as per the market rates.

(v) Ensure that there is a sufficient margin for the loans advanced.

(vi) Ensure that the charge is properly registered.

(d) Loans Against The Security of Insurance Policies

(i) See that the policy has completed at least two years from the date of the first premium.

(ii) Confirm that all the premiums have been properly paid and policy is in force.

(iii) Ascertain that the due notice has been given to the insurance company.

(iv) See that loan has been advanced on the basis of surrender value of the policy as certified by the insurance company.

(v) Confirm that the premium, if any, paid by the lender to keep the policy in force is debited to loan account of the borrower.

Trade Creditors

i. Ask for a schedule of creditors and check the same with purchase ledger already examined by him.

ii. Verify posting in the purchase ledger

iii. Ensure that all purchases made during the year especially at the end of the year are included in the accounts of the creditors.

iv. In case of suspicion, ask for the statement of account to be sent and verify the same along with scrutiny of ledger account and reconcile the differences, if any,

v. See the various debits given for discount, goods return etc., are genuine

vi. Enquire into the reason for non payment of overdue creditors. It is possible that amount might have been misappropriated.

vii. Examine some purchase invoices and confirm that they are relating to the year under audit.

viii. Test check returns and see that they are supported by credit notes of the suppliers.

ix. Obtain confirmation from the parties.

x, Also, the auditor should keep in mind the following guidelines about audit of creditors.

Internal control – The auditor should review the following aspects of internal control relating to creditors –

a) Proper recording of transactions and linking of payment with outstanding.

b) Periodical schedule of creditors.

c) Follow up action on overdue accounts

d) Payment to creditors as per the approved policies.

e) Statement of accounts obtained from creditors.

f) Proper adjustments in creditors accounts regarding purchase returns, cash discount, trade discount etc.,

g) Cut off Procedure regarding creditors.

Verification – The auditor should employ the following procedures **Examination of Records –**

a) Carryout appropriate procedure to judge the adequacy of cut off procedure. Ensure that documents relating to receipt of goods before the year end are recorded.

b) Look into the difference between total of creditors balance and the control account balance

c) Examine relevant correspondence for verification of validity, accuracy and completeness of creditors.

d) Pay attention to outstanding items claims for short supply, poor quality, discount etc., Examine correctness of transfer from one account to another.

e) Examine any unusual payments at the end of the year.

f) Confirm material liabilities at the end of the year.

Confirmation

The direct confirmation for creditors is similar to that adopted for debtors.

Disclosure

The auditor should examine whether creditors are disclosed properly in the financial statements.

Certificate from the Management

Obtain a certificate from the management that all the known liabilities have been recorded in the books of accounts.

Working Papers

The auditor should verify all the working papers relating to creditor.

Provision for Taxation

i. See that the provision for taxation made in the current year is adequate taking into account the profit made, deductions and any other allowances as per Income Tax Act. The auditor should see that suitable adjustment is made in respect of additional demand or refund as the case may be. Material Tax liability for which no provision is made should be disclosed in the report.

ii. Get a Statement of Income.

iii. Vouch advance payment of Income tax referring to the challans and bank statements.

iv. Ensure that Provision for taxation for the current year is shown separately in the Profit and Loss account and in the Balance Sheet.

v. In case the tax liability determined is more than that provided for against which the company might prefer an appeal before the high authority, a reference to this effect should be made in the accounts. Where an application for rectification of mistakes u/s 154 of the Income Tax Act, has been made the amount of tax decided is considered or disputed. As per AS4, the disputed tax liability may require a provision and suitable disclosure. The auditor should enquire from the management, review minute of the meeting of the BOD and correspondence with the lawyers for determination of the Provisions.

vi. Examine the assessment completed, revised or rectified during the year.

Provision for Proposed Dividend

i. See that there is an adequate Profit for declaration of dividend.

ii. Check the minute books recommending dividend to ascertain the rate of dividend recommended.

iii. Verify the calculation of proposed dividend and see whether it is provided on the paid up share capital only, excluding the calls in arrears and forfeited shares.

iv. See that it is properly exhibited in the final accounts.

Provision for Expenses Not Allowable Under Income Tax Act

i. The expenses not deductible in the calculation of tax liability can be debited to profit and Loss account, hence auditor should verify if any of such expenses appear in Profit and Loss accounts.

ii. Verify the correctness of the amount.

iii. See whether those 'not allowable expenses' are re-added in the profit of the year to calculate the expected tax liability and the provision for taxation is made accordingly or not.

Secret Reserve:

Any reserve not appearing on the Balance Sheet is called as a Secret Reserve. The existence of the reserve may be inferred from an intelligent verification of the accounts by the auditor even though the amount cannot be ascertained. Generally such type of reserve appears in financial institutions and insurance companies. Secret reserve may be created by –

i. Writing down the assets much below their cost

ii. Providing excessive depreciation

iii. Providing more reserve for doubtful debts etc.,

iv. Writing down the goodwill considerably

v. Omitting certain assets from Balance Sheet

vi. Charging capital expenditure to revenue account

vii. Over valuing the liability.

viii. Showing contingent liabilities as real liabilities etc., According to the Provisions of Companies Act, 2013, creation of Secret Reserve is prohibited except in the case of banking, financial, insurance and electricity companies.

To verify the secret reserve, if any, the auditor should keep in mind the following points :

i. Carefully enquire into the necessity of creating such reserve.

ii. Don't qualify audit report if it is found that the intention of the company is honest and the amount is reasonable.

iii. May pass a remark in audit report that the assets are understated,

iv. Discuss the fact, if found, that the director's intention behind creating secret reserve was not honest and only to facilitate improper dealing in shares.

Contingent Liabilities :

The liability which depends on happening or not happening something is called as contingent liability. This liability may involve payment of revenue nature incurring losses or involves the acquisition of asset.

Examples

(i) Disputed claims by workers for compensation

(ii) Bills Discounted

(iii) Guarantees given in favour of others

(iv) Amount on incomplete contracts

(v) Calls unpaid on partly paid shares

(vi) Payment of gratuity under Industrial Dispute Act,

(vii) Preference dividend in arrears.

Verification –

Auditor should carefully verify contingent liabilities as it may become actual liability on happening or not happening certain events and while verifying keep in mind following points.

i. Obtain certificate about the contingent liabilities disclosed in the Balance Sheet, from a responsible officer.

ii. Carefully examine whether such liabilities are in existence or not.

iii. Check relevant documents to confirm the existence of contingent liability.

iv. Verify the certified list given by responsible officer to ascertain whether there exists any contingent liability which may turn to be an actual liability.

vi. Verify whether proper provision is made or not for the contingent liability turned out to be an actual liability.

vii. Verify bill discounting register, investment register, minute book and other relevant records to establish the amount of contingent liability.

viii. See whether contingent liability is properly disclosed in the Balance Sheet.

Capital Reserve:

It is not defined by the Companies Act, 2013. It may be defined as any profit or reserve earned on sale or purchase of capital asset and / or business and which cannot legally be distributed among share holders. It is created out of abnormal and non-trading profits like premium received on issue of shares, balance remaining after reissues of forfeitured shares on share forfeited account, profit earned on amalgamation, absorption or reconstruction of companies, Capital Redemption reserve, Profit prior to incorporation etc. While verifying this reserve an auditor should keep in mind, following points –

i. See whether the capital profits transferred to this reserve are really surpluses of capital nature or not.

ii. See whether the Capital Reserve is utilized according to the provisions of Articles of Association or not.

iii. See whether it is properly exhibited on Balance Sheet or not.

Gratuity:

i. Auditor should see that proper provision is made for the gratuity and if not whether the auditee has disclosed the amount not provided for

ii. As provided in the Companies Act, amended in 1988, the auditor should qualify his report if the company has not provided for gratuity either wholly or partly.

iii. He should check the calculation made for provision of gratuity and confirm whether it is based on the periodical actuarial valuation or not.

iv. See whether gratuity is provided for on a net of tax basis then the gross amount is properly disclosed.

v. See that the method used for calculating the provision for gratuity is disclosed and see the significance of such cost to the company.

vi. Auditor should keep in mind the provisions of AS 15 while verifying the provision made for gratuity.

Study Note - 14

AUDIT OF REGULATED AND NON-REGULATED INDUSTRIES

This Study Note includes

14.1 Audit of an Educational Institution
14.2 Audit of Hospital
14.3 Government Expenditure Audit
14.4 Audit of a Non-Governmental Organisation (NGO)
14.5 Audit of Charitable Institution
14.6 Audit of a Hotel
14.7 Audit of a Cinema Hall
14.8 Audit of a Recreation Club
14.9 Audit of a partnership firm
14.10 Audit of Small Companies
14.11 Audit of a Sole Trader
14.11 Audit from Incomplete Records
14.13 Propriety Audit in the context of Government Audit
14.14 Audit of Commercial Accounts

Regulated Industry

Meaning:

Industry that is regulated by government to a significant extent. Utility industries are excellent examples; their pricing, profits, and, sometimes, production methods are regulated by both federal and state governments.

14.1 AUDIT OF AN EDUCATIONAL INSTITUTION

The special steps involved in the audit of an educational institution are the following:

(i) Examine the Trust Deed, or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulations framed thereunder.

(ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

(iii) Check names entered in the Students' Fee Register for each month or term, with the respective class registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.

(iv) Check fees received by comparing counterfoils of receipts granted with entries in the cash book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.

(v) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.

(vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount had been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.

(vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.

(viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.

(ix) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.

(x) Verify rental income from landed property with the rent rolls, etc.

(xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

(xii) Verify any Government or local authority grant with the relevant papers of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.

(xiii) Report any old heavy arrears on account of fees, dormitory rents, etc, to the Managing Committee.

(xiv) Confirm that caution money and other deposits paid by students on admission have been shown as liability in the balance sheet and not transferred to revenue.

(xv) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.

(xvi) Verify that the Provident Fund money of the staff has been invested in appropriate securities.

(xvii) Vouch donations, if any, with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.

(xviii) Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

(xix) Vouch in the usual manner all establishment expenses and enquire into any unduly heavy expenditure under any head.

(xx) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

(xxi) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.

(xxii) Verify the inventories of furniture, stationery, clothing, provision and all equipment, etc. These should be checked by reference to Stock Register and values applied to various items should be test checked.

(xxiii) Confirm that the refund of taxes deducted from the income from investment (interest on securities, etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.

(xxiv) Verify the annual statements of accounts and while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of Staff, etc.

14.2 AUDIT OF HOSPITAL

The following points are to be considered necessary for conducting an audit of Hospital.

(i) Check the letter of appointment to ascertain the scope of responsibilities.

(ii) Study the Charter or Trust Deed under which the hospital has been set up and take a special note of the provisions affecting the accounts.

(iii) Examine, evaluate and verify the system of internal check, internal control and determine the nature, timing and the extent of the audit procedures.

(iv) Vouch the entries in the Patient's Bill Register with a copies of bill issued. Test check the selected bills to see that these have been correctly prepared taking into consideration the period of stay of each patient as recorded in the Attendance Schedule.

(v) Vouch the collection from patients with copies of bills and entries in Bills Register. Arrears of dues should be properly carried forward and where these are deemed to be irrecoverable, they should be written off under due authorizations.

(vi) Interest and/ or dividend income should be vouched with reference to the Investment Register and Interest and Dividend warrants.

(vii) In case of legacies and donations which are received for specific purposes, it should be ensured that any income therefrom is not utilized for any other purposes.

(viii) Where receipts of subscription show a significant deviations from budgeted figures, it should be thoroughly inquired into and the matter be brought to the notice of the trustees or the Managing Committee.

(ix) Government grants or grants from local bodies should be verifies with the reference to the correspondence with the concerned authorities.

(x) Clear distinction should be made between the items of capital and revenue nature.

(xi) The capital expenditure should be incurred under proper authorization by a valid resolution of the trustees or the Managing Committee.

(xii) Verify the system of internal check as regards purchases and issue of stores, medicines etc.

(xiii) Examine that the appointment of the staff, payment of salaries etc. are duly authorized.

(xiv) Physically verify the investments, fixed assets and inventories.

(xv) Check that adequate depreciation has been provided on all the depreciable assets.

14.3 GOVERNMENT EXPENDITURE AUDIT

(a) Government Expenditure Audit

Audit of government expenditure is one of the major components of government audit conducted by the office of C & AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. Briefly, these standards are explained below:

(i) **Audit against Rules & Orders:** The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority.

(ii) **Audit of Sanctions:** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorising such expenditure.

(iii) **Audit against Provision of Funds:** It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriations made.

(iv) **Propriety Audit:** It is required to be seen that the expenditure is incurred with due regard to broad and general principles of financial propriety. The auditors aims to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Audit aims to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions.

(v) **Performance Audit:** This involves that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Efficiency-cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

(b) Role of C&AG in the Audit of a Government company: The auditor of a government company is appointed by the C&AG. The C&AG have powers under section 143 of the Companies Act, 2013 as follows:

(i) to direct the manner in which the company's accounts shall be audited by the auditor and to give such auditor instructions in regard to any matter relating to the performance of his functions as such;

(ii) to conduct a supplementary or test audit of the company's accounts by such person or persons as he may authorise in this behalf; and for the purposes of such audit, to require information or additional information to be furnished to person or persons so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General may, by general or special order; direct.

In addition, the C&AG has a right to comment upon or supplement the audit report in such manner as he thinks fit.

Financial Administration of Local Bodies.

Salient Features of Financial Administration of Local Bodies

(i) **Budgetary Procedure:** The objective of local bodies budgetary procedure are financial accountability, control of expenditure, and to ensure that funds are raised and moneys are spent by the executive departments in accordance with the rules and regulations and within the limits of sanction and authorisation by the legislature or Council. Different aspects covered in budgeting are determining the level of taxation, fees, rates, and laying down the ceiling on expenditure, under revenue and capital heads.

(ii) **Expenditure Control:** At the State and Central level, there is a clear demarcation between the legislature and executive. In the local body, legislative powers are vested in the Council whereas executive powers are delegated to the officers, e.g., Commissioners. All matters of regular revenue and expenditures are generally delegated to the executive wing. For special situations like, reduction in property taxes, refund of security deposits, etc., sanction from the legislative wing is necessary.

(iii) **Accounting System:** Municipal Accounting System has been conventionally prepared under the cash system. In the recent past however, it is being changed to the accrual system of accounting. The accounting system is characterised by (a) subsidiary and statistical registers for taxes, assets, cheques etc., (b) separate vouchers for each type of transaction, (c) compulsory monthly bank reconciliation, (d) submission of summary reports on periodical basis to different authorities at regional and state level.

14.4 AUDIT OF A NON-GOVERNMENTAL ORGANISATION (NGO)

Audit Procedure for Conducting the Audit of Non-Governmental Organisation

NGO's can be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives.

Non-Governmental Organisations are generally incorporated as societies under the Societies Registration, Act, 1860 or as a trust under the India Trust Act, 1882, or under any other law corresponding to these Acts enforced in any part of India. NGO's can also be incorporated as a company under section 8 of the Companies Act, 2013. While planning the audit of a Non-Governmental Organisation (NGO), the auditor may concentrate on the following;

(i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operates.

(ii) Reviewing the legal form of the organisation and its Memorandum of Association, Articles of Association, rules and Regulations.

(iii) Reviewing the NGO's Organisation chart, Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and Formats, budgetary policies, if any.

(iv) Examination of minutes of the Board/Managing Committee/Governing Body/Management and Committees thereof to ascertain the impact of any decisions on the financial records.

(v) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.

The audit programme should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material is omitted:

(i) Corpus fund : The contributions/grants received towards corpus be vouched with reference to the letters from the donor(s). The interest income be checked with investment Register and physical investments in hand.

(ii) Reserves : Vouch transfers from projects/programmes with donors letters and board resolutions of NGO. Also check transfers and adjustments made during the year.

(iii) Ear-marked Funds : Check requirements of donors' institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.

(iv) Project/Agency Balances: Vouch dispursements and expenditures as per agreements with donors for each of the balances.

(v) Loans : Vouch loans with loan agreements receipt counter –foil issued.

(vi) Fixed Assets : Vouch all acquisitions/sale or disposal of assets including depreciation and the authorisations for the same. Also check donor's letters/agreements for the grants. For immovable property, check title, etc.

(vii) Investments : Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis-investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.

(viii) Cash in Hand : Physically verify the cash in hand and imprest balance, at the close of the year and whether it tallies with the books of accounts.

(ix) Bank Balance : Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.

(x) Stock in Hand : Verify stock in hand and obtain certificate from the management for the quantities and valuation of the same.

(xi) Programme and Project Expenses : Verify agreement with donor/contributor (s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.

(xii) Establishment Expenses : Verify that provident fund, life insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

The receipt of income of NGO may be checked on the following lines:

(i) Contribution and Grants for projects and programmes: Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.

(ii) Receipts from Fund arising programmes: Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.

(iii) Membership Fees: Check fees received with membership register, ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.

(iv) Subscription : Check with subscription register and receipts issued. Reconcile subscription received with printing and despatch of corresponding magazine/circulars/periodicals. Check the receipts with subscription rate schedule.

(v) Interest and Dividends : Check the interest and dividends received and receivable with investments held during the year.

Duties of Comptroller and Auditor General of India.

Duties of C&AG: The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C&AG as under:

(i) Compile and submit Accounts of Union and States - The C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account.

(ii) General Provisions Relating to Audit - It shall be the duty of the C&AG –

(a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

(b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;

(c) to audit and report on all trading, manufacturing profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

(iii) Audit of Receipts and Expenditure - Where any body or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

(iv) Audit of Grants or Loans - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.

(v) Audit of Receipts of Union or States - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.

(vi) Audit of Accounts of Stores and Stock - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and stock kept in any office or department of the Union or of a State.

(vii) Audit of Government Companies and Corporations - The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013.

14.5 AUDIT OF CHARITABLE INSTITUTION

When conducting the audit of a charitable institution, the auditor should consider the following matters:

(i) The auditor should study the constitution of the charitable institution, for example, whether it is set up under the Societies Registration Act or as per section 8 of the Companies Act or as a trust.

(ii) Obtain a list of members of the governing body. This will help the auditor in identifying whether any of the members of the governing body has any interest in the charitable institution.

(iii) The auditor should obtain a copy of the budget sanctioned or the financial statement. This would enable him to acquaint himself with the different heads of income and expenditures of incomes and expenditures of the institution.

(iv) Examination of the system of internal check, especially as regards the accounting of the amounts collected.

(v) Check that the amounts received towards income have been duly collected, received and deposited into the bank regularly and promptly.

(vi) These institutions receive subscriptions and donations which form the major part of their collections. Therefore the auditor should check the following:

- The amount or the rate of the annual subscription.
- Any instructions given by the donors as to the specific utilization of donation.
- Adequacy of internal controls existing as regards unused receipt books, counter foils, etc.
- Where subscriptions are received in advance these should be properly dealt with in the accounts.

(vii) Verify the amounts of legacies received by reference to correspondence with any figures and other available informations.

(viii) Where the institution has made any investments or given loans, the amount of dividend and interest should be properly vouched with reference to the counterfoils or dividend warrants received. It should be ensured that such loans or grants are given under proper authorizations.

(ix) If some property is given or taken on rent, then the auditor should check the tenancy agreement, the rent slips and the authorized person for the collection or payment, as the case may be, of the rent.

(x) Most of the organisations organize special functions such as concert etc. The auditor should be careful in such cases. All the gross receipts and outgoings are to be properly vouched by him. It should be ensured that proper internal check was maintained as regards the receipts and outgoings. For example, the person responsible for collection and disbursements should be separate persons.

(xi) The expenditure of charitable institution is also one of the major areas of concern. Thus the auditor should verify that the expenditure is made only for the charitable purpose. If the expenditure is not for the charitable purpose, then the auditor should examine the implications of applicable law and document for the same.

(xii) The auditor should physically verify the cash in hand, inventories and fixed assets.

14.6 AUDIT OF A HOTEL

The business of running a hotel is very much dissimilar to running an industrial unit for manufacturing of products. It is a service-oriented industry. The business is characterized by handling of large amounts of liquid cash, stock of foods providing a variety of services, and keeping watch on customers to ensure that they do not leave hotel without settling the dues. In view of these, the following matters require special attention by the auditor.

(i) Internal Control: Pilferage is one of the greatest problems in any hotel and it is extremely important to have a proper internal control to minimize the leakage. The following points should be checked:

(a) Effectiveness of arrangement regarding receipts and disbursements of cash.

(b) Procedure for purchase and stocking of various commodities and provisions.

(c) Procedure regarding billing of the customers in respect of room service, telephone, laundry, etc.

(d) System regarding recording and physical custody of edibles, wines, cigarettes, crockery and cutlery, linen, furniture, carpets, etc.

(e) Ensure that are trading accounts are prepared preferably weekly, for each sales point. A scrutiny of the percentage of profit should be made, and any deviation from the norms is to be investigated.

(ii) Room Sales and Cash Collections:

(a) There are various sales points scattered in a hotel and sales are both for cash and credit. The control over cash is very important. The charge for room sales is made from the guest register, and tests are to be carried out to ensure that the correct number of guests are charged for the exact period of stay. Any difference between the rate charged to the guests and standard room rent is to be investigated to see that it is properly authorized.

(b) The total sales reported with the total bills issued at each sales point have to be reconciled.

(c) Special care must be taken in respect of bills issued to customers who are staying in the hotel, because they may not be required to pay the bills immediately in cash but at a future date or by credit cards. Billing is to be done room-wise. It must be ensured that all customers pay their bills on leaving the hotel or within specified dates.

(iii) Stock: The stocks in a hotel are all saleable item like food and beverages. Therefore, following may be noted in this regard:

(a) All movement and transfer of stocks must be properly documented.

(b) Areas where stocks are kept must be kept locked and the key retained by the departmental manager.

(c) The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.

(d) Many hotels use specialized professional valuers to count and value the stocks on a continuous basis throughout the year.

(e) The auditor should ensure that all stocks are valued at the year end and that he should himself be present at the year end physical verification, to the extent practicable, having regard to materiality consideration and nature and location of inventories

(iv) **Fixed Assets:** The fixed assets should be properly depreciated, and the Fixed Assets Register should be updated.

(v) **Casual Labour:** In case the hotel employs a casual labour, the auditor should consider, whether adequate records have been maintained in this respect and there is no manipulation taking place. The wages payment of the casual labour must also be checked thoroughly.

(vi) The compliance with all statutory provisions, and compliance with the Foreign Exchange Regulations must also be verified by the auditor, especially because hotels offer facility of conversion of foreign exchange to rupees.

(vii) Other special aspects are to be verified as under:

(a) Consumption shown in various physical stock accounts must be traced to the customers' bills to ensure that all issues to the customers have been billed.

(b) All payments to the foreign collaborator, it any, are to be checked.

(c) Expenses and receipts are to be compared with figures of the previous year, having regard to the average occupancy of visitors and changes in rates.

(d) Special receipts on account of letting out of auditorium, banquet hall, spaces for shops, boutiques, and special shows should be verified with the arrangements made.

(e) In depth check should be carried out on the customers' ledgers to verify that all charges have been properly made and recovered.

(f) The occupancy rate should be worked out, and compared with other similar hotels, and with previous year. Material deviations should be investigated.

(g) Expenses for painting, decoration, renovation of building, etc. are to be properly checked.

(h) It is common that hotels get their bookings done through travel agents. The auditor should ensure that the money is recovered from the travel agents as per credit terms allowed. Commission paid to travel agents should be checked by reference to the agreement on that behalf.

(i) Apart from control over stock of edibles, control over issue and physical stock of linen crockery, cutlery, glassware, silver, toilet items, etc. should be verified.

(j) The auditor should verify the restaurant bills with reference to KOT (Kitchen order Ticket).

(k) The auditor should ensure that all taxes have been included in the client's bills.

(l) Computation and payment of salaries and wages vis-a-vis number of employees must be checked.

14.7 AUDIT OF A CINEMA HALL

Special steps involved in audit of a Cinema Hall

(i) Verify

(a) that entrance to the cinema hall is only through printed tickets;

(b) tickets are serially numbered and bound into books;

(c) that the number of tickets issues for each show and class are different;

(d) that for advance booking a separate series of tickets is issued and

(e) stock of tickets is kept in proper custody.

(ii) If tickets are issued through computer- audit the system to ensure its reliability and authenticity of data generated by it.

(iii) System should provide that at the end of each show a proper statement should be prepared and cash collected be tallied.

(iv) Cash collected is deposited in banks partly on the same day and rest on the next day – depending upon the banking facility available.

(v) Verify that proper record is kept for free passes issued and the same are issued under proper authority.

(vi) Cross check the entertainment tax deposited.

(vii) Verify the income from advertisements and slides showed before the show.

(viii) Vouch the expenditure incurred on publicity of picture, maintenance of hall, electricity expenses etc.

(ix) Vouch recoveries of advertisement expenses etc from film distributors.

(x) Vouch payment of film hire with reference to agreement with distributor or producer.

(xi) Verify the basis of other incomes earned like restaurant, car and scooter parking and display windows etc.

(xii) Confirm that depreciation on machinery and furniture has been charged at appropriate rates which are higher, as compared to those admissible in the case of other businesses, in respect of similar assets.

14.8 AUDIT OF A RECREATION CLUB

(i) Examine the constitution, powers of governing body and relevant rules relating to preparation and finalisation of accounts. In case, it is constituted as a company limited by guarantee, application of provisions of the Companies Act, 2013 should also be seen.

(ii) Vouch the receipt on account of entrance fees with member's applications, counterfoils issued to them, and minutes of the Managing Committee.

(iii) Vouch Members' subscription with the counterfoils of receipts issued to them. Trace receipts for a selected period to the Register of members; reconcile the amount of total subscription due with the amount collected and the outstanding. Check totals of various columns of the Register of Members and tally them across. See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery. The amount considered irrecoverable, if any should be written off.

(iv) Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscription received in advance have been correctly adjusted.

(v) Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests as well as with the fees chargeable for the special service rendered such as billiards, tennis, etc. Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.

(vi) Vouch purchase of sports items, furniture, crockery, etc., and trace their entries into the respective stock registers. Vouch purchases of food-stuffs, cigars, wines, etc. and test their sale price so as to confirm that the normal rates of profit have been earned on their sales.

The stock of unsold provisions and stores, at the end of the year should be verified physically and its valuation checked.

(vii) Check the stock of furniture, sports material and other assets physically with the respective stock registers or inventories prepared at the end of the year.

(viii) Inspect the share scrips and bonds in respect of investments, check their current values for disclosure in final accounts, also ascertain that the arrangements for their safe custody are satisfactory, check the accrual of income therefrom and provision of income tax thereon.

14.9 AUDIT OF A PARTNERSHIP FIRM

Special Points in Audit of a Partnership Firm: Matters which should be specially considered in the audit of accounts of a partnership firm are as under:

(i) Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.

(ii) Examine the partnership deed signed by all partners and its registration with the registrar of firms. Also ascertain from the partnership deed about capital contribution, profit sharing ratios, interest on capital contribution, powers and responsibilities of the partners, etc.

(iii) Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans, purchase of assets, extraordinary contracts entered into and other such matters which are not of a routine nature.

(iv) Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.

(v) Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.

(vi) Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreement.

(vii) Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners. Also see various requirements of legislations applicable to the partnership firm like Section 44AB of the Income-tax Act, 1961 have been complied with.

(viii) Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

14.10 AUDIT OF SMALL COMPANIES

The main objective for conducting an audit is the expression of the opinion on the financial position and the operating results of the concern. This objective does not change even in case of small companies. The things which will change are the arrangements and scope of the work. The financial position and administration of small companies would not be that much complex as that of large companies. Thus, in case of audit of small companies, the auditor should consider the following:

(i) Generally the accountancy work of such companies is also undertaken by the auditor. Thus in order to ensure objectivity and independence, the accountancy work should be kept separated from the audit work.

(ii) The auditor should submit the letter of engagement in writing to the directors of the company. This letter should spell out the management's responsibilities for the preparation of accounts and the establishment of adequate internal control system.

(iii) The auditor should also understand and evaluate the extent to which reliance can be placed on the accounting system and the internal controls operating in the company.

(iv) A management representation letter addressed to the auditor should also be obtained on the letter head of the company specifying those significant matters that affect the financial statements etc.

(v) The findings of the audit should be communicated and discussed with the appropriate authorities. Depending on the discussions of audit findings with management, the auditor should issue audit report (clean/qualified/disclaimer report).

14.11 AUDIT OF A SOLE TRADER

A sole trader is under no legal obligation to get his accounts audited. At the same time it is also to be considered that he may be so required under other acts such as Income Tax Act, 1961 but only subject to the satisfaction of certain conditions such as tax audit u/s 44AB. In other cases, it is not compulsory for him like companies to get the accounts audited.

A sole trader may, however, desire a partial audit, i.e. audit would be carried out in respect of only a part of the books of accounts or records of the part of the year. In such cases, the scope of the audit would be determined by the sole trader. Thus, it is very much desirable that the terms and conditions as well as the scope of such audit be given a form of Audit Engagement Letter. Further the report of auditor conducting the partial audit must clearly state the curtailed scope of his work so as to avoid liability of any error or fraud existing in the books and records not examined by him.

Performance Audit: The scope of audit has been extended to cover efficiency, economy and effectiveness audit or performance audit, or full scope audit. Efficiency audit looks into whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results expected of them, i.e., the relationship between goods and services produced and resources used to produce them; and examination aimed to find out the extent to which operations are carried out in an economical and efficient manner.

Economy audit looks into whether the entity has acquired the financial, human and physical resources in an economical manner, and whether the sanctioning and spending authorities have observed economy.

Effectiveness audit is an appraisal of the performance of programmes, schemes, projects with reference to the overall targeted objectives as well as efficiency of the means adopted for the attainment of the objectives. Efficiency-cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy and effectiveness. The procedure for conducting performance audit covers identification of topic, preliminary study, planning and execution of audit, and reporting. Normally speaking, the performance audit is conducted by the government in respect of various expenditure incurred. While the trend towards a comprehensive approach for conducting performance of full scope audit is visible, the coverage and depth of evaluation vary according to the statutory limitations, and the organisational constraints of C & AG.

14.11 AUDIT FROM INCOMPLETE RECORDS

The examination of records and documents is one of the most important techniques through which an auditor collects evidence. Therefore, in case the records and documents maintained by an enterprise are incomplete, it would prove to be a great handicap to the auditor.

An auditor may face the situation of incomplete records under the following circumstances:

(i) Where records are kept on single entry basis; or

(ii) Where records are kept on double entry basis, but some of the records are destroyed accidentally, or are seized by authorities, or are otherwise not available for the auditors examination due to similar reasons.

Under the second circumstance, an ideal approach for carrying out audit would be that the auditor may direct the management of the enterprise to complete or reconstruct the accounting records, e.g., if vouchers are available but the cash book, journal and the ledger are not maintained, then the cash book, journal and ledger should be written up. However, if vouchers are also not available, then cash book/journal/ledger will have to be prepared by correlating the evidence available, e.g., memoranda records, bank statements, statements from outside parties, etc. Even though such books which are prepared may not be complete, but may still contain useful information for the auditor.

On the other hand, when books are maintained on single entry basis, then the management of the enterprise would be asked to write up the books, to the extent possible, as they would have been written up under double entry system.

In any case, the following steps would be required to conduct an audit:

(i) Ascertain that the balance sheet or statement of affairs as at the beginning of the year should be prepared and all the relevant accounts should be opened in the ledger. Normally, under the single entry system, cash, bank, and personal accounts are maintained.

(ii) Confirming that all entries on receipt side of the cash book are posted in the ledger, even by opening new account(s) wherever necessary.

(iii) Check that all entries on the payment side of cash book are posted in the ledger.

(iv) Confirming that all entries appearing in bank account are posted in the ledger.

(v) Analyse personal accounts of debtors. This will provide vital information regarding credit sales, sales returns, discounts allowed, bills received, bills dishonoured, etc. It would be necessary to post such items to relevant accounts, to complete the double entry from the debtors accounts.

Similarly, it would be necessary to analyse the creditors' accounts and post entries relating to credit purchase made, discounts earned, purchases returns, bills payable issued to suppliers, bills payable dishonoured, etc., to relevant accounts.

From an auditor's view point, the supervisory controls exercised by the owners are generally less reliable and hence while auditing incomplete records, auditor will largely depend on extensive substantive procedures and obtain external evidence, physical examination/ observation, management representation and perform analytical procedures.

14.13 PROPRIETY AUDIT IN THE CONTEXT OF GOVERNMENT AUDIT

Propriety Audit: Under 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. However, some general principles have been laid down in the Audit Code, which have for long been recognized as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

1. The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

2. No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

3. Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

   (i) the amount of expenditure involved is insignificant; or

   (ii) a claim for the amount could be enforced in a Court of law; or

   (iii) the expenditure is in pursuance of a recognised policy or custom; and

   (iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

14.14 AUDIT OF COMMERCIAL ACCOUNTS

The government also engages in commercial activities and for the purpose it may incorporate following types of entities:

(i) Departmental enterprises engaged in commercial and trading operations, which are governed by the same regulations as other Government departments such as defence factories, mints, etc.

(ii) Statutory corporations created by specific statues such as LIC, Air India, etc.

(iii) Government companies, set up under the Companies Act, 2013.

All aforesaid entities are required to maintain accounts on commercial basis. The audit of departmental entities is done in the same manner as any Government department, where commercial accounts are kept. Audit of statutory corporations depends on the nature of the statute governing the corporation. In respect of government companies, the relevant provisions of Companies Act, 2013 are applicable. As per section 139 of the Companies Act, 2013 the statutory auditor of a Government company shall be appointed or re-appointed by the CAG. Such an auditor must be a chartered accountant. Further, the Companies Act, 2013, provides that the CAG shall have the powers:

(i) to direct the manner in which the company's accounts shall be audited by the auditor, and to give the auditor instructions in regard to any matter relating to the performance of his functions; and

(ii) to conduct a supplementary or test audit of the company's accounts by such person, as he may authorise in this behalf, and for the purposes of such audit to require information or additional information to be furnished to any person or persons, so authorised on such matters by such person or persons, and in such form as the CAG may direct.

   The statutory auditor shall submit a copy of his audit report to the CAG, who shall have the right to comment upon or supplement the audit report in such manner he may think fit.

   Any such comments upon or supplement to the audit report shall be placed before the company, at the same time, and in the same manner, as the audit report. Thus, it is seen that there is a two layer audit of a Government company, by the statutory auditors, being qualified chartered accountants, and by the CAG. The general standards, principles, techniques and procedures for audit adopted by the C&AG are a mixture of government audit and commercial audit as known and practiced by professional auditors. The concepts of autonomy and accountability of the institution / bodies / corporations / companies have influenced the nature and scope of audit in applying the conventional audit from the angle of economy, efficiency and effectiveness.

Study Note - 15

THE COMPANY AUDITOR

This Study Note includes

15.1 Appointment of Auditors [Section 139]
15.2 Class of Companies
15.3 Manner of Rotation of Auditors by the Companies on expiry of their term
15.4 Removal, Resignation of Auditor and Giving of Special Notice [Section 140]
15.5 Eligibility, Qualifications and Disqualifications of Auditors [Section 141]
15.6 Remuneration of Auditors [Section 142]
15.7 Powers and Duties of Auditors and Auditing Standards [Section 143]
15.8 Audit of Branch Office
15.9 Other matters to be included in Auditor's Report
15.10 Duties and powers of the Company's Auditor with reference to the audit of the branch and the Branch Auditor
15.11 Reporting of frauds by Auditor
15.12 Auditor not to render Certain Services [Section 144]
15.13 Auditor to sign Audit Reports, etc. [section 145]
15.14 Auditors to attend General Meeting [Section 146]
15.15 Punishment for Contravention [Section 147]
15.16 Role of Cost Audit
15.17 Scope of Audit Committee

Introduction

The Companies Act 2013 has made the audit of accounts of companies in India compulsory.

Section 139 to 148 provide for the qualifications, disqualifications, appointment, removal, rights, duties & liabilities of company auditors.

15.1 APPOINTMENT OF AUDITORS [SECTION 139]

(1) Subject to the provisions of this Chapter, every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting and the manner and procedure of selection of auditors by the members of the company at such meeting shall be such as may be prescribed.

Provided that the company shall place the matter relating to such appointment for ratification by members at every annual general meeting.

Provided further that before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.

Provided also that the certificate shall also indicate whether the auditor satisfies the criteria provided in section 141.

Provided also that the company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within fifteen days of the meeting in which the auditor is appointed.

Explanation.— For the purposes of this Chapter, "appointment" includes re-appointment.

(2) No listed company or a company belonging to such class or classes of companies as may be prescribed, shall appoint or re-appoint—

(a) an individual as auditor for more than one term of five consecutive years; and

(b) an audit firm as auditor for more than two terms of five consecutive years:

Provided that—

(i) an individual auditor who has completed his term under clause (a) shall not be eligible for re-appointment as auditor in the same company for five years from the completion of his term;

(ii) an audit firm which has completed its term under clause (b), shall not be eligible for re-appointment as auditor in the same company for five years from the completion of such term.

Provided further that as on the date of appointment no audit firm having a common partner or partners to the other audit firm, whose tenure has expired in a company immediately preceding the financial year, shall be appointed as auditor of the same company for a period of five years.

Provided also that every company, existing on or before the commencement of this Act which is required to comply with provisions of this sub-section, shall comply with the requirements of this sub-section within three years from the date of commencement of this Act.

Provided also that, nothing contained in this sub-section shall prejudice the right of the company to remove an auditor or the right of the auditor to resign from such office of the company.

(3) Subject to the provisions of this Act, members of a company may resolve to provide that—

(a) in the audit firm appointed by it, the auditing partner and his team shall be rotated at such intervals as may be resolved by members; or

(b) the audit shall be conducted by more than one auditor.

(4) The Central Government may, by rules, prescribe the manner in which the companies shall rotate their auditors in pursuance of sub-section (2).

Explanation.— For the purposes of this Chapter, the word "firm" shall include a limited liability partnership incorporated under the Limited Liability Partnership Act, 2008.

(5) Notwithstanding anything contained in sub-section (1), in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of one hundred and eighty days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

(6) Notwithstanding anything contained in sub-section (1), the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within thirty days from the date of registration of the company and in the case of failure of the Board to appoint such auditor, it shall inform the members of the company, who shall within ninety days at an extraordinary general meeting appoint such auditor and such auditor shall hold office till the conclusion of the first annual general meeting.

(7) Notwithstanding anything contained in sub-section (1) or sub-section (5), in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within sixty days from the date of registration of the company and in case the Comptroller and Auditor-General of India does not appoint such auditor within the said period, the Board of Directors of the company shall appoint such auditor within the next thirty days; and in the case of failure of the Board to appoint such auditor within the next thirty days, it shall inform the members of the company who shall appoint such auditor within the sixty days at an extraordinary general meeting, who shall hold office till the conclusion of the first annual general meeting.

(8) Any casual vacancy in the office of an auditor shall—

- (i) in the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within thirty days, but if such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting;
- (ii) in the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within thirty days.

Provided that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period, the Board of Directors shall fill the vacancy within next thirty days.

(9) Subject to the provisions of sub-section (1) and the rules made thereunder, a retiring auditor may be re-appointed at an annual general meeting, if—

- (a) he is not disqualified for re-appointment;
- (b) he has not given the company a notice in writing of his unwillingness to be re-appointed; and
- (c) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.

(10) Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

(11) Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

Summary at Glance

First Auditor

- First auditor of the company, other than a Government company, shall be appointed by the BOD within 30 days from the date of registration of the company;
- If BOD fails to appoint, by the member of the company within 90 days at an extraordinary general meeting appoint the first auditor;
- In case of Government company, first auditor shall be appointed by CAG within 60 days from the date of registration;
- If CAG fails to appoint, by the BOD of the company within next 30 days;
- If again BOD fails to appoint the first auditor of the company, by the member of the company within 60 days at an extraordinary general meeting;

- Tenure of the first auditor of the company in both the above cases till the conclusion of the first annual general meeting;

Sub-Sequent Auditor

- At the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting;
- Before such appointment, the written consent of the auditor to such appointment and a certificate from him shall be in accordance with the condition as may be prescribed;
- Within 15 days of the meeting the company shall file a notice of such appointment with the registrar;
- No listed company or a company belonging to such class or classes of companies as may be prescribed, shall appoint or re-appoint—
  (a) an individual as auditor for more than one term of five consecutive years; and
  (b) an audit firm as auditor for more than two terms of five consecutive years:

Cooling Period

(i) an individual auditor who has completed his term under clause (a) shall not be eligible for re-appointment as auditor in the same company for five years from the completion of his term;

(ii) an audit firm which has completed its term under clause (b), shall not be eligible for re-appointment as auditor in the same company for five years from the completion of such term.

- At the time of rotation of auditors, incoming audit firms/ auditor having common partner/s with the erstwhile audit firm shall not be eligible for appointment;
- Firm shall include a limited liability partnership incorporated under the Limited Liability Partnership Act, 2008;
- In the case of Government company, CAG in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of the company within a period of 180 days from the commencement of the financial year who shall hold the office till the conclusion of the AGM;

Re-appointment

- A retiring auditor may be re-appointed at an annual general meeting, if—
  (a) he is not disqualified for re-appointment;
  (b) he has not given the company a notice in writing of his unwillingness to be re-appointed; and
  (c) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed;
- Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company;
- Where provision of section 177 is applied, all appointments, including the filling of a casual vacancy of an auditor shall be made after taking into account the recommendations of such committee.

<u>General Circular No. 33/2014</u>

Clarification with Regard to Applicability of Provisions of Section 139(5) and 139(7) of the Companies Act, 2013

1. it is clarified that the new Act does not alter the position with regard to audit of such deemed Government companies through C&AG and thus such companies are covered under sub-section (5) and (7) of section 139 of the New Act.

2.	Clarification has also been sought about the manner in which the information about incorporation of a company subject to audit by an auditor to be appointed by the C&AG is to be communicated to the C&AG for the purpose of appointment of first auditors under section 139(7) of the New Act. It is hereby clarified that such responsibility rests with both, the Government concerned and the relevant company. To avoid any confusion it is further clarified that it will primarily be the responsibility of the company concerned to intimate to the C&AG about its incorporation along with name, location of registered office, capital structure of such a company immediately on its incorporation. It is also incumbent on such a company to share such intimation to the relevant Government so that such Government may also send a suitable request to the C&AG.

15.2 CLASS OF COMPANIES

For the purposes of sub-section (2) of section 139, the class of companies shall mean the following classes of companies excluding one person companies and small companies:-

(a) all unlisted public companies having paid up share capital of rupees ten crore or more;

(b) all private limited companies having paid up share capital of rupees twenty crore or more;

(c) all companies having paid up share capital of below threshold limit mentioned in (a) and (b) above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more.

15.3 MANNER OF ROTATION OF AUDITORS BY THE COMPANIES ON EXPIRY OF THEIR TERM

(1) The Audit Committee shall recommend to the Board, the name of an individual auditor or of an audit firm who may replace the incumbent auditor on expiry of the term of such incumbent.

(2) Where a company is required to constitute an Audit Committee, the Board shall consider the recommendation of such committee, and in other cases, the Board shall itself consider the matter of rotation of auditors and make its recommendation for appointment of the next auditor by the members in annual general meeting.

(3) For the purpose of the rotation of auditors-

   (i) in case of an auditor (whether an individual or audit firm), the period for which the individual or the firm has held office as auditor prior to the commencement of the Act shall be taken into account for calculating the period of five consecutive years or ten consecutive years, as the case may be;

   (ii) the incoming auditor or audit firm shall not be eligible if such auditor or audit firm is associated with the outgoing auditor or audit firm under the same network of audit firms.

   Explanation. I - For the purposes of these rules the term "same network" includes the firms operating or functioning, hitherto or in future, under the same brand name, trade name or common control.

   Explanation. II - For the purpose of rotation of auditors,-

   (a) a break in the term for a continuous period of five years shall be considered as fulfilling the requirement of rotation;

   (b) if a partner, who is in charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of five years.

Illustration Explaining Rotation in Case of Individual Auditor

Illustration 1:-

Number of consecutive years for which an individual auditor has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which he may be appointed in the same company (including transitional period)	Aggregate period which the auditor would complete in the same company in view of column I and II
I	II	III
5 years (or more than 5 years)	3 years	8 years or more
4 years	3 years	7 years
3 years	3 years	6 years
2 years	3 years	5 years
1 year	4 years	5 years

Note:

1. Individual auditor shall include other individuals or firms whose name or trade mark or brand is used by such individual, if any.
2. Consecutive years shall mean all the preceding financial years for which the individual auditor has been the auditor until there has been a break by five years or more.

Illustration Explaining Rotation in Case of Audit Firm

Illustration 2:-

Number of consecutive years for which an audit firm has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which the firm may be appointed in the same company (including transitional period)	Aggregate period which the firm would complete in the same company in view of column I and II
I	II	III
10 years (or more than 10 years)	3 years	13 years or more
9 years	3 years	12 years
8 years	3 years	11 years
7 years	3 years	10 years
6 years	4 years	10 years
5 years	5 years	10 years
4 years	6 years	10 years
3 years	7 years	10 years
2 years	8 years	10 years
1 year	9 years	10 years

Note:

1. Audit Firm shall include other firms whose name or trade mark or brand is used by the firm or any of its partners.
2. Consecutive years shall mean all the preceding financial years for which the firm has been the auditor until there has been a break by five years or more.

(4) Where a company has appointed two or more individuals or firms or a combination thereof as joint auditors, the company may follow the rotation of auditors in such a manner that both or all of the joint auditors, as the case may be, do not complete their term in the same year.

15.4 REMOVAL, RESIGNATION OF AUDITOR AND GIVING OF SPECIAL NOTICE [SECTION 140]

(1) The auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf in the prescribed manner.

Provided that before taking any action under this sub-section, the auditor concerned shall be given a reasonable opportunity of being heard.

(2) The auditor who has resigned from the company shall file within a period of thirty days from the date of resignation, a statement in the prescribed form with the company and the Registrar, and in case of companies referred to in sub-section (5) of section 139, the auditor shall also file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation.

(3) If the auditor does not comply with sub-section (2), he or it shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees.

(4) (i) Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or, as the case may be, ten years, as provided under sub-section (2) of section 139.

(ii) On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.

(iii) Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company (not exceeding a reasonable length) and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so,—

(a) in any notice of the resolution given to members of the company, state the fact of the representation having been made; and

(b) send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company,

and if a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting.

Provided that if a copy of representation is not sent as aforesaid, a copy thereof shall be filed with the Registrar.

Provided further that if the Tribunal is satisfied on an application either of the company or of any other aggrieved person that the rights conferred by this sub-section are being abused by the auditor, then, the copy of the representation may not be sent and the representation need not be read out at the meeting.

(5) Without prejudice to any action under the provisions of this Act or any other law for the time being in force, the Tribunal either suo motu or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors.

Provided that if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place.

Provided further that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447.

Explanation I.—It is hereby clarified that the case of a firm, the liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers.

Explanation II.—For the purposes of this Chapter the word "auditor" includes a firm of auditors.

Summary at Glance

Removal

- By a special resolution of the company and after obtaining the previous approval of the central Government, the auditor appointed under section 139 may be remove from his office before the expiry of his term;

Resignation

- The auditor shall file within 30 days from the date of resignation, a statement in prescribed form with the company and the registrar;
- In case of Government company, the auditor shall send such statement with the CAG, indicating the reason and other facts with regards to his resignation;
- If fails to comply with sub-section (2), punishable with fine not less than ₹ 50,000 but may extend to ₹ 5,00,000;

Special notice

- Special notice for resolution at an annual general meeting for appointment of auditor other than a retiring auditor;
- On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor;
- Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so,—
  - (a) in any notice of the resolution given to members of the company, state the fact of the representation having been made; and
  - (b) send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company,
- If a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may require that the representation shall be read out at the meeting.

15.5 ELIGIBILITY, QUALIFICATIONS AND DISQUALIFICATIONS OF AUDITORS [SECTION 141]

(1) A person shall be eligible for appointment as an auditor of a company only if he is a chartered accountant.

Provided that a firm whereof majority of partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company.

(2) Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

(3) The following persons shall not be eligible for appointment as an auditor of a company, namely:—

(a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;

(b) an officer or employee of the company;

(c) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(d) a person who, or his relative or partner—

(i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

Provided that the relative may hold security or interest in the company of face value not exceeding one thousand rupees or such sum as may be prescribed;

(ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of such amount as may be prescribed; or

(iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, for such amount as may be prescribed;

(e) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed;

(f) a person whose relative is a director or is in the employment of the company as a director or key managerial personnel;

(g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;

(h) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;

(i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in section 144.

(4) Where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

15.6 REMUNERATION OF AUDITORS [SECTION 142]

(1) The remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein.

Provided that the Board may fix remuneration of the first auditor appointed by it.

(2) The remuneration under sub-section (1) shall, in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company.

15.7 POWERS AND DUTIES OF AUDITORS AND AUDITING STANDARDS [SECTION 143]

(1) Every auditor of a company shall have a right of access at all times to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and shall be entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor and amongst other matters inquire into the following matters, namely:—

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(d) whether loans and advances made by the company have been shown as deposits;

(e) whether personal expenses have been charged to revenue account;

(f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Provided that the auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries in so far as it relates to the consolidation of its financial statements with that of its subsidiaries.

(2) The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made thereunder or under any order made under sub-section (11) and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

(3) The auditor's report shall also state—

(a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

(b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

(d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

(e) whether, in his opinion, the financial statements comply with the accounting standards;

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(g) whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;

(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

(j) such other matters as may be prescribed.

(4) Where any of the matters required to be included in the audit report under this section is answered in the negative or with a qualification, the report shall state the reasons therefor.

(5) In the case of a Government company, the Comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

(6) The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report under sub-section (5) have a right to,—

(a) conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorise in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and

(b) comment upon or supplement such audit report.

Provided that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub section (1) of section 136 and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

(7) Without prejudice to the provisions of this Chapter, the Comptroller and Auditor- General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

(8) Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed.

Provided that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

(9) Every auditor shall comply with the auditing standards.

(10) The Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

Provided that until any auditing standards are notified, any standard or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

(11) The Central Government may, in consultation with the National Financial Reporting Authority, by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.

(12) Notwithstanding anything contained in this section, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within such time and in such manner as may be prescribed.

(13) No duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter referred to in sub-section (12) if it is done in good faith.

(14) The provisions of this section shall mutatis mutandis apply to—

(a) the cost accountant in practice conducting cost audit under section 148; or

(b) the company secretary in practice conducting secretarial audit under section 204.

(15) If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12), he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

15.8 AUDIT OF BRANCH OFFICE

"Branch office", in relation to a company, means any establishment described as such by the company - section 2(14) of the 2013 Act.

Audit of Branch Office by company's auditor or branch auditor - Where a company has a branch office, the accounts of that office shall be audited either by the company's auditor (i.e. auditor appointed for the company in AGM) or by any other person qualified for appointment as an auditor of the company under the 2013 Act. Such 'branch auditor' shall be appointed as such under section 139 of the 2013 Act - first part of section 143(8) of the 2013 Act.

Audit of branch offices outside India - Where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country. The duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be as may be prescribed - second part of section 143(8) of the 2013 Act.

Report by Branch Auditor to company's auditor - The branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the company's auditor. The company's auditor shall deal with the report of branch auditor in his report in such manner as he considers necessary - proviso to section 143(8) of the 2013 Act.

Duties and powers of company's auditors in connection with branch audit - Duties and powers of company's auditor (main auditor) with reference audit of branch and branch auditor shall be as contained in section 143(1) to 143(4) of the 2013 Act - Rule 12(1) of Companies (Audit and Auditors) Rules, 2014. Thus, the company's auditor is responsible even if branch auditor is appointed.

Branch auditor's responsibility to report fraud - Responsibility to report fraud, as applicable to company's auditor applies to branch auditor also -Rule 12(3) of Companies (Audit and Auditors) Rules, 2014.

15.9 OTHER MATTERS TO BE INCLUDED IN AUDITOR'S REPORT

The auditor's report shall also include their views and comments on the following matters, namely:-

(a) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(b) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

(c) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

15.10 DUTIES AND POWERS OF THE COMPANY'S AUDITOR WITH REFERENCE TO THE AUDIT OF THE BRANCH AND THE BRANCH AUDITOR

(1) For the purposes of sub-section (8) of section 143, the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be as contained in sub-sections (1) to (4) of section 143.

(2) The branch auditor shall submit his report to the company's auditor.

(3) The provisions of sub-section (12) of section 143 read with rule 12 hereunder regarding reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

15.11 REPORTING OF FRAUDS BY AUDITOR

(1) For the purpose of sub-section (12) of section 143, in case the auditor has sufficient reason to believe that an offence involving fraud, is being or has been committed against the company by officers or employees of the company, he shall report the matter to the Central Government immediately but not later than sixty days of his knowledge and after following the procedure indicated herein below.

   (i) auditor shall forward his report to the Board or the Audit Committee, as the case may be, immediately after he comes to knowledge of the fraud, seeking their reply or observations within forty-five days;

   (ii) on receipt of such reply or observations the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within fifteen days of receipt of such reply or observations;

   (iii) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of forty-five days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he failed to receive any reply or observations within the stipulated time.

(2) The report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed post followed by an e-mail in confirmation of the same.

(3) The report shall be on the letter-head of the auditor containing postal address, e-mail address and contact number and be signed by the auditor with his seal and shall indicate his Membership Number.

(4) The report shall be in the form of a statement as specified in Form ADT-4.

(5) The provision of this rule shall also, mutatis mutandis, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively.

15.12 AUDITOR NOT TO RENDER CERTAIN SERVICES [SECTION 144]

An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case maybe, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company, namely:—

(a) accounting and book keeping services;

(b) internal audit;

(c) design and implementation of any financial information system;

(d) actuarial services;

(e) investment advisory services;

(f) investment banking services;

(g) rendering of outsourced financial services;

(h) management services; and

(i) any other kind of services as may be prescribed.

Provided that an auditor or audit firm who or which has been performing any non-audit services on or before the commencement of this Act shall comply with the provisions of this section before the closure of the first financial year after the date of such commencement.

Explanation.—For the purposes of this sub-section, the term "directly or indirectly" shall include rendering of services by the auditor,—

(i) in case of auditor being an individual, either himself or through his relative or any other person connected or associated with such individual or through any other entity, whatsoever, in which such individual has significant influence or control, or whose name or trade mark or brand is used by such individual;

(ii) in case of auditor being a firm, either itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity, whatsoever, in which the firm or any partner of the firm has significant influence or control, or whose name or trade mark or brand is used by the firm or any of its partners.

15.13 AUDITOR TO SIGN AUDIT REPORTS, ETC. [SECTION 145]

The person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company in accordance with the provisions of sub-section (2) of section 141, and the qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report shall be read before the company in general meeting and shall be open to inspection by any member of the company.

15.14 AUDITORS TO ATTEND GENERAL MEETING [SECTION 146]

All notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company, and the auditor shall, unless otherwise exempted by the company, attend either by himself or through his authorised representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.

15.15 PUNISHMENT FOR CONTRAVENTION [SECTION 147]

(1) If any of the provisions of sections 139 to 146 (both inclusive) is contravened, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees, or with both.

(2) If an auditor of a company contravenes any of the provisions of section 139, section 143, section 144 or section 145, the auditor shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees.

Provided that if an auditor has contravened such provisions knowingly or wilfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

(3) Where an auditor has been convicted under sub-section (2), he shall be liable to—

(i) refund the remuneration received by him to the company; and

(ii) pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.

(4) The Central Government shall, by notification, specify any statutory body or authority or an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub-section (3) and such body, authority or officer shall after payment of damages to such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.

(5) Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil or criminal as provided in this Act or in any other law for the time being in force, for such act shall be of the partner or partners concerned of the audit firm and of the firm jointly and severally.

15.16 ROLE OF COST AUDIT

Government needs authentic and reliable data of cost for various purposes like price fixation of controlled commodities. The information is also useful in various decisions like fixation of duty drawback, export incentives, amount of excise duty the product can bear, deciding whether special incentives are required to a particular industry etc.

Usefulness of Cost data to Company - The cost data is useful to company in

- Price fixation of final products
- Controlling wasteful expenditure
- Reduction of waste and scrap

- Optimum utilisation of labour, material and machinery
- Deciding proper product mix to optimise production and profitability
- To eliminate loss making products
- improving efficiency
- Supplying cost data when required by Government
- Taking 'make or buy' decision
- Making break even analysis for decision making etc.

Maintenance of Cost Records

Realising the importance of proper cost records and control, section 148(1) of the 2013 Act provides that Central Government can direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies. The direction can be issued to such class of companies engaged in the production of such goods or providing such services as may be prescribed by a notification.

In respect of companies regulated by special Act (like insurance, banking, electricity), the Central Government shall, consult the regulatory body constituted or established under such special Act before issuing such order in respect of any class of companies - provision to section 148(1) of the 2013 Act.

Cost Audit

If the Central Government is of the opinion, that it is necessary to do so, it may, by order, direct that the audit of cost records of class of companies, which are covered under section 148(1) of the 2013 Act (for maintenance of cost records) and which have a net worth of such amount as may be prescribed or a turnover of such amount as may be prescribed, shall be conducted in the manner specified in the order [section 148(2) of the 2013 Act.

The cost audit is necessary only when specific order is issued by Central Government.

Audit by Cost Accountant

Cost Audit can be done only by a 'Cost Accountant'. The Cost Accountant/ firm of cost accountants will be appointed by Board of Directors of the company. His remuneration will be fixed by members in the prescribed manner [section 148(3) of the 2013 Act].

"Cost accountant" means a cost accountant as defined in section 2(1)(b) of the Cost and Works Accountants Act, 1959 [section 2(28) of the 2013 Act].

As per government guidelines, a Cost Accountant holding certificate of practice on part time basis is not entitled to conduct cost audit. Thus, only a Cost Accountant in whole-time practice can conduct cost audit.

Appointing Cost Auditor and his Remuneration - An individual cost accountant or firm of cost accountants can be appointed as Cost Auditor. Where company has Audit Committee, appointment and remuneration will be recommended by audit committee and approved by Board. If there is no audit committee, appointment and remuneration fixation will be done by Board. Later, this remuneration shall be ratified by shareholders.

Limit on number of Cost Audit per person - Limit on number of audits per person, as are applicable to Statutory Auditors are applicable to Cost Auditor also - MCA Master Circular No. 2/2011 dated 11-11-2011.

Statutory Auditor cannot be appointed as Cost Auditor - Statutory auditor appointed under section 139 of the 2013 Act cannot be appointed to audit cost records - first proviso to section 148(3) of the 2013 Act.

Duty of Company - The company shall give all assistance and facilities to the Cost Auditor for auditing the cost records [section 148(5) of the 2013 Act.

Responsibility and rights of Cost Auditor - Responsibility, duties, rights and obligations of cost auditor are same as Financial Auditor as specified in Chapter X of the 2013 Act - Section 148(5) of the 2013 Act.

Provisions relating to of reporting fraud under section 142(12) of the 2013 Act are applicable to cost auditor also - section 142(14) of the 2013 Act.

Qualifications, Rights, duties and obligations of Cost Auditor

The qualifications, disqualifications, rights, duties and obligations of Cost Auditor /firm of cost auditors are same as applicable to statutory auditors - section 148(5) of the 2013 Act.

Submission of Cost Audit Report

The Cost Audit Report should be submitted to Board of Directors of the company - proviso to section 148(5) of the 2013 Act.

After such submission, the company shall furnish the report to Central Government within 30 days, along with full information and explanation on every reservation or qualification contained in the report - section 148(6) of the 2013 Act.

The information and explanation is required to be submitted electronically.

After considering the report of cost auditor and explanations given by the company, the Central Government can ask for further information and explanations. The company shall submit the same within prescribed time. [section 148(7) of the 2013 Act].

Penalty for Non-Compliance

In case of default, company as well as auditor is liable under section 147 of the 2013 Act [The provisions as applicable to Statutory Auditors]

Cost Accounting Standards

"Cost auditing standards" mean such standards as are issued by the Institute of Cost Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government - Explanation to section 148(3) of the 2013 Act.

Cost Accountant must follow Cost Accounting Standard - The Cost Accountant must comply with cost accounting standards - proviso to section 148(5) of the 2013 Act.

These Cost Accounting Standards have been made mandatory for being applied for preparation and certification of general purpose cost accounting statements w.e.f. 1-4-2010. If the standards are not followed while preparing of cost accounting statements, it shall be duty of Cost Accountant to make a suitable disclosure/qualification in his audit report /certificate (Council decision dated 12/13-2-2009.

Remuneration of the Cost Auditor

For the purpose of sub-section (3) of section 148,—

(a) in the case of companies which are required to constitute an audit committee—

  (i) the Board shall appoint an individual, who is a cost accountant in practice, or a firm of cost accountants in practice, as cost auditor on the recommendations of the Audit committee, which shall also recommend remuneration for such cost auditor;

  (ii) the remuneration recommended by the Audit Committee under (i) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders;

(b) in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant in practice or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.

Distinction between Financial Audit & Cost Audit

Following are distinctions between financial (statutory) audit and cost audit.

All companies must keep proper books of account, while keeping cost accounting records is compulsory only in case of specified companies.

Financial Audit is compulsory every year, while cost audit has to be carried out only when Cost Audit Order is issued by Central Government.

Financial audit is done by practising Chartered Accountant. Cost audit can be done by practising Cost accountant.

Financial Auditor is appointed in AGM, while Cost Auditor is appointed by Board of Directors.

Report of Financial Auditor has to be submitted to members, which has to be adopted in the AGM. The Cost Audit report has to be submitted to Central Government, with a copy to the Company.

Similarities between Financial Audit and Cost Audit

Following are similarities - (a) Restrictions on number of audits a person can undertake are identical (b) Powers of auditors are identical (c) Disqualifications of auditors are identical, (d) Penal provisions for non-submission of records and books of account to auditors are similar, though not identical.

15.17 SCOPE OF AUDIT COMMITTEE

An Audit Committee consists of three to five members formed to serve as communication link among various departments. Audit Committee has a fourfold relationship and therefore has to interact with management, internal auditor, statutory auditor and the public.

The Scope of Audit Committee can be discussed as follows: -

(i) Review of annual financial statements before submission to the Board of Directors.

(ii) Selection of the Statutory Auditor

(iii) Act as lies on between the Statutory Auditor and Board of Directors

(iv) Administrative control of the internal control functions through the feedback between the Internal Auditor and the Audit Committee.

(v) Over seeing internal central operation.

(vi) Over seeing internal audit operations and feedback between internal audit committee and developing the internal auditing authority through broad based internal audit programming.

(vii) Review and approval of financial information for publication

(viii) Review proposed changes in accounting system and procedures.

(viii) Help resolve differences between management, internal and statutory auditor.

(ix) Report on the audit committee acting in the Annual Reports of Board of Directors.

(x) Ensure reliability of organisation's financial statements and operational activities. To be effective and purposeful, the audit committee should maintain the following:-

(h) Audit Committee should have the independence of management, Statutory Auditor and Internal Auditor. The Board of Directors allows full freedom to the audit committee to investigate into any areas of operation.

(i) The relation between the audit committee and management should be cordial and congenial towards optimum efficiency and healthy growth of the organization.

(j) There should be a regular line of communication through occasional meetings with the management.

(k) There should be good communication relationship interwoven among management, internal auditor and statutory auditor.

Study Note - 16

THE COMPANY AUDIT

This Study Note includes

16.1 Audit of Shares
16.2 Audit of Debentures [Section 71]
16.3 Audit of Divisible Profit
16.4 Loans to Directors [Section 185]
16.5 Inter-Corporate Loans and Investment [Section 186]
16.6 Remuneration of Directors [Section 197]

16.1 AUDIT OF SHARES

16.1.1 Allotment of Securities by Company [Section 39]

"Securities" means the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956.

How to check the allotment of Securities of a Company:

- Study of the contract pursuant to which the issue is made to determine how many shares are agreed to be issued and for what value and the nature and other details of the consideration.
- Examination of the prospectus to see the substance of the contract and the relevant terms of the issue including the mode of payment of the purchase consideration in case of an issue to a vendor of the business or payability of commission to the underwriters or payability of the preliminary expenses.
- To check whether minimum amount has been subscribed or not as stated in the prospectus.
- To check whether the sums payable on application for the amount so stated have been paid to and received by the company by cheque or other instrument.
- To check whether the amount payable on application on every security shall not be less than five per cent. of the nominal amount of the security or such other percentage or amount, as may be specified by the Securities and Exchange Board by making regulations in this behalf.
- Examine the Board minute's for the purpose for which securities is issued and utilized for the same.
- Check whether the amount is refund to the applicant within prescribed time period in case of minimum amount has not been subscribed and the sum payable on application is not received within a period of thirty days from the date of issue of the prospectus.
- To check whether the company has file with the Registrar a return of allotment or not, where the Company having a share capital makes any allotment of securities**.**
- To check whether the Company has defaulted under sub-section (3) or sub-section (4). In case the company is found default under above provision then the same should be reported by the auditor in his report.

16.1.2. Alteration of Share Capital [Section 61]

- Confirm that alteration was authorised by articles.
- Verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.
- Verify that alteration had been effected in copies of Memorandum, Articles, etc.
- Obtain the reasons for which the memorandum of the company is altered.
- Check whether there is any change in the voting percentage of shareholders due to consolidate and divide all or any of its share capital into shares of a larger amount than its existing shares.
- To confirm that the alter share capital's denomination should be more than ₹1.
- Verify that proper accounting entries have been passed. Register of members may also be checked to see that the necessary alteration have been effected therein.

16.1.3. Issue of Bonus Shares [Section 63]

- Confirm that issue of Bonus Share was authorized by articles.
- Verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.
- Check that the company has issue fully paid-up bonus shares to its members only.
- Confirm that the issue of bonus shares shall not be made by capitalising reserves created by the revaluation of assets.
- Check whether the company has made any default in payment of interest or principal in respect of fixed deposits or debt securities issued by it.
- Check whether the company has made any default in payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus.
- Whether the partly paid-up shares are made fully paid-up.
- Check whether the bonus shares shall not be issued in lieu of dividend.

16.1.4. Power of company to Purchase its Own Securities [Section 68]

- Confirm that Buy-Back was authorized by articles.
- Verify the minutes of the Board meeting and special resolution passed in the general meeting in which the approval of members is obtained.
- Where the buy-back has been authorised by the Board by means of a resolution passed at its meeting then check that the buy-back is not more than ten per cent. or less of the total paid-up equity capital and free reserves of the company.
- Check that the no buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.
- To check that the buy-back shall not be more than twenty-five per cent. of the aggregate of paid-up capital and free reserves of the company. In case of buy-back of equity shares in any financial year, the reference to twenty-five per cent. in this clause shall be construed with respect to its total paid-up equity capital in that financial year.
- To check that the ratio of the aggregate of secured and unsecured debts owed by the company after buy-back is not more than twice the paid-up capital and its free reserves.

- To check that all the shares or other specified securities for buy-back should be fully paid-up.
- To check whether the buy-back is made as per SEBI regulations in case of buy-back of the shares or other specified securities listed on any recognized stock exchange.
- To check that no offer of buy-back under this sub-section shall be made within a period of one year reckoned from the date of the closure of the preceding offer of buy-back.
- To ensure that buy-back shall be completed within a period of one year from the date of passing of the special resolution, or as the case may be, the resolution passed by the Board under clause (b) of sub-section (2).
- Ensure that the buy-back has been done only out of the company's free reserves or its securities premium account or out of the proceeds of any shares or other specified securities other than out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.
- Ascertain that declaration of solvency was filed with the SEBI and/or the Registrar of Companies before making buy-back but subsequent the passing of the special resolution.
- To ensure that company shall extinguish and physically destroy the shares or securities so bought back within seven days of the last date of completion of buy-back.
- To ensure that the company shall not make a further issue of the same kind of shares or other securities including allotment of new shares or other specified securities within a period of six months except by way of a bonus issue.
- Whether the company has maintained any register of the shares or securities so bought.
- Check whether that the after the completion of the buy-back under this section the company file with the Registrar and the Securities and Exchange Board a return containing such particulars relating to the buy-back within thirty days of such completion.

16.1.5 Splitting of shares of face value from ₹ 10 to ₹ 1 per share

- Confirm that alteration was authorised by articles.
- Verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.
- Verify that alteration had been effected in copies of Memorandum, Articles, etc.
- Verify that proper accounting entries have been passed. Register of members may also be checked to see that the necessary alteration have been effected therein.

16.1.6 Share Transfer Audit:

The following aspects are required to be examined by the auditor in conducting the share transfer audit:

- Inspection of the Articles of Association regarding the prescribed form of transfer and other provisions, particularly the time limits laid down by the Articles or law.
- Notification by transferor of the lodgement made by the transferee and inspect the objections received, if any. Also see, where calls due or not paid, whether transfer can be refused under the articles and whether any transfer was so refused.
- Examining in the case of particularly partly-paid shares, where the application for registration was made by the transferor, a notice was sent to the transferee and registration was effected only on receipt of 'non-objection' received from him.

- Scrutiny of transfer forms, noting specially:
  - (a) That in every case, the application for transfer was made in the prescribed form and the prescribed authority had stamped the date on which it was presented to it; also that it was delivered to the company:
    - (i) In case of 'quoted' shares before the Register of Members were closed for the first time subsequent to the transfer within twelve months from the date of presentation of the application to the prescribed authority whichever is later.
    - (ii) In any other case within two months from the date of such presentation.
  - (b) That each transfer form is properly executed and bears the proper stamp duty.
  - (c) That the name of the company is correctly stated on the form.
  - (d) That where the consideration for transfer appears to be inadequate, an inquiry was made by the company for ascertaining the reasons therefor. (This is not necessary if the transfer form bears the seal of the Collector of Stamps.)
  - (e) That the alterations, if any, have been suitably initiated; and
  - (f) That the name and address of the transferee have been recorded completely and fully for purposes of correspondence.
- Comparison of the signatures of each transferor on the transfer form with his signature on the original application for shares or on the transfer form (if the shares were acquired on a transfer).
- Ascertaining that none of the transferees is disqualified from holding shares in the company.
- Vouching the entries in the Shares Transfer Journal by reference to the transfer forms, noting in each case:
  - (a) the name of transferor;
  - (b) the name and address of the transferee;
  - (c) the number and class of shares transferred; and
  - (d) the distinctive numbers, if any, of the shares transferred.
- Verification of postings from the Share Journal to the Register of Members.
- Inspection of each transfer as to names, addresses, occupations, form of document, description, number (in words), distinctive number of shares, stamp, date, signature, witnesses, etc.
- Check whether the transfer to firms, etc. have been rejected or not and whether notes of trust has been entered in the share register.
- Noting transferor's name, etc. and class, number and distinctive number of shares, as stated in the transfers, with old certificates and Register of Members. See that old certificates were cancelled.
- Inspection of the power of attorney and specimen signatures if transfer executed by an agent.
- Inspection of letters of indemnity for lost certificates and ensuring that duplicate certificates have been issued on proper authority.
- Where part of the shares have been transferred, the issue of balance certificates to the transferors should be seen and confirm that the distinctive number of shares have been correctly stated.
- Refer to the minutes book to ensure that all transfers recorded in the share transfer journal have been approved by the Board.
- Checking of counterfoils of new certificates.

- Reconciliation of the amount of transfer fees collected with the total number of transfers lodged and verifying that the amount of transfer fees have been accounted for.
- Reconciliation of the total number of shares of different classes issued by the company with the total amount of capital issue and its sub-divisions by extracting balances of shares held by different members from the Register of members.
- Ensuring that, in case of any share transactions by directors, corresponding entries have been made in the Register of Directors' shareholding.

16.1.7 Re-issue of forfeited shares

- The auditor should ascertain that the board of directors has the authority under the Articles of Association of the company to reissue forfeited shares. Check the relevant resolution of the Board of Directors.
- Vouch the amounts collected from persons to whom the shares have been allotted and verify the entries recorded from re-allotment. Auditor should check the total amount received on the shares including received prior to forfeiture, is not less than the par value of shares.
- Verify that computation of surplus amount arising on the reissue of shares credited to Capital Reserve Account and
- Where partly paid shares are forfeited for non-payment of call, and re-issued as fully paid, the reissue is considered as an allotment at a discount and compliance of the provisions of Section 53 is essential.

16.2 AUDIT OF DEBENTURES [SECTION 71]

"Debenture" includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not;

16.2.1 Issue of Debenture

A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. Provided that the issue of debentures with an option to convert such debentures into shares, wholly or partly, shall be approved by a special resolution passed at a general meeting. No company shall issue any debentures carrying any voting rights. Secured debentures may be issued by a company subject to such terms and conditions as may be prescribed.

Where debentures are issued by a company under this section, the company shall create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account shall not be utilised by the company except for the redemption of debentures.

Auditor's Duty:

- The auditor should verify that the prospectus had been duly filed with the registrar before the date of allotment of debentures.
- He should check the amount collected in the cash book with the counterfoils of receipts issued to the applicants and also cross check the amount into the application and allotment book.
- He should examine the debenture trust deed and note the conditions contained therein as to issue and repayment.
- If the debentures are covered by a mortgage of a charge, it should be verified that the charge has been correctly recorded in the register of mortgage and charges and it has also been registered with the registrar of the companies.

- Compliance with SEBI guidelines should also be ensured.
- Where debentures have been issued as fully paid up to vendors as a part of the purchase consideration, the contract in this regard should be checked.

16.2.2 Interest on Debentures:

A predetermined fixed rate of interest is payable on debentures irrespective of the fact that company has earned the profit or not. Debenture holders are creditors of the company, they are not the owners. They have no voting powers and cannot influence the management but their claim of interest rank ahead of the claims of the shareholders.

Auditor's Duty:

- The payment of interest should be vouched by the auditor with the acknowledgement of the debenture-holders, endorsed warrants and in case of bearer debentures with the coupons surrendered.
- The auditor should reconcile the total amount paid with the total amount due and payable with the amount of interest outstanding for payment.
- He should ensure that the interest paid on debenture like that on other fixed loans, must be disclosed as a separate item in the profit & loss account.

16.2.3 Redemption of Debentures:

A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. If debentures are redeemable it can be redeemed in any of the following way:

(i) By way of periodical drawing i.e. by creating Debenture Redemption Reserve Account.

(ii) By way of payment on fixed date.

(iii) By payment whenever the company desires to do so.

Auditor's Duty:

- The auditor should inspect the debentures or trust deed for the terms and conditions regarding redemption of debentures.
- He should see the Director's minute book authorizing the redemption of debentures.
- He should also vouch the redemption with the help of debenture bonds cancelled and the cash book.
- He should also examine the accounting treatment thoroughly.

16.3 AUDIT OF DIVISIBLE PROFIT

16.3.1 Declaration of dividend [Section 123]

Final dividend is declared in the general meeting. Board of Directors have to recommend a dividend. Declaration of dividend is 'Ordinary Business" in general meeting.

No dividend shall be declared or paid by a company for any financial year except—

(a) out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2), or out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with the provisions of that sub-section and remaining undistributed, or out of both; or

(b) out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government.

Provided that a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves of the company.

Provided further that where, owing to inadequacy or absence of profits in any financial year, any company proposes to declare dividend out of the accumulated profits earned by it in previous years and transferred by the company to the reserves, such declaration of dividend shall not be made except in accordance with such rules as may be prescribed in this behalf.

Provided also that no dividend shall be declared or paid by a company from its reserves other than free reserves.

For the purposes of clause (a) of sub-section (1), depreciation shall be provided in accordance with the provisions of Schedule II.

Interim Dividend:

The Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year in which such interim dividend is sought to be declared.

Declaration of interim dividend if company has incurred losses in current financial year:

In case the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend shall not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.

Legal Provisions applicable to interim dividend:

The amount of the dividend, including interim dividend, shall be deposited in a scheduled bank in a separate account within five days from the date of declaration of such dividend.

Entitlement of Dividend:

No dividend shall be paid by a company in respect of any share therein except to the registered shareholder of such share or to his order or to his banker and shall not be payable except in cash.

Provided that nothing in this sub-section shall be deemed to prohibit the capitalisation of profits or reserves of a company for the purpose of issuing fully paid-up bonus shares or paying up any amount for the time being unpaid on any shares held by the members of the company.

Provided further that any dividend payable in cash may be paid by cheque or warrant or in any electronic mode to the shareholder entitled to the payment of the dividend.

Consequences on non-compliance:

A company which fails to comply with the provisions of sections 73 and 74 shall not, so long as such failure continues, declare any dividend on its equity shares.

16.3.2 Unpaid Dividend Account [Section 124]

Transfer of unpaid dividend to separate account:

Where a dividend has been declared by a company but has not been paid or claimed within thirty days from the date of the declaration to any shareholder entitled to the payment of the dividend, the company shall, within seven days from the date of expiry of the said period of thirty days, transfer the total amount of dividend which remains unpaid or unclaimed to a special account to be opened by the company in that behalf in any scheduled bank to be called the Unpaid Dividend Account.

Information about unpaid dividend on Company's website:

The company shall, within a period of ninety days of making any transfer of an amount under sub-section (1) to the Unpaid Dividend Account, prepare a statement containing the names, their last known addresses and the unpaid dividend to be paid to each person and place it on the website of the company, if any, and also on any other website approved by the Central Government for this purpose, in such form, manner and other particulars as may be prescribed.

Effect of non-transfer:

If any default is made in transferring the total amount referred to in sub-section (1) or any part thereof to the Unpaid Dividend Account of the company, it shall pay, from the date of such default, interest on so much of the amount as has not been transferred to the said account, at the rate of twelve per cent. per annum and the interest accruing on such amount shall enure to the benefit of the members of the company in proportion to the amount remaining unpaid to them.

Transfer of unclaimed dividend and also shares to Investor Protection Fund:

- Any money transferred to the Unpaid Dividend Account of a company in pursuance of this section which remains unpaid or unclaimed for a period of seven years from the date of such transfer shall be transferred by the company along with interest accrued, if any, thereon to the Fund established under sub-section (1) of section 125 and the company shall send a statement in the prescribed form of the details of such transfer to the authority which administers the said Fund and that authority shall issue a receipt to the company as evidence of such transfer.
- All shares in respect of which unpaid or unclaimed dividend has been transferred under sub-section (5) shall also be transferred by the company in the name of Investor Education and Protection Fund along with a statement containing such details as may be prescribed:
- Provided that any claimant of shares transferred above shall be entitled to claim the transfer of shares from Investor Education and Protection Fund in accordance with such procedure and on submission of such documents as may be prescribed.
- If a company fails to comply with any of the requirements of this section, the company shall be punishable with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees and every officer of the company who is in default shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

16.3.3 Investor Education and Protection Fund [Section 125]

The Central Government shall establish a Fund to be called the Investor Education and Protection Fund (herein referred to as the Fund).

There shall be credited to the Fund—

(a) the amount given by the Central Government by way of grants after due appropriation made by Parliament by law in this behalf for being utilised for the purposes of the Fund;

(b) donations given to the Fund by the Central Government, State Governments, companies or any other institution for the purposes of the Fund;

(c) the amount in the Unpaid Dividend Account of companies transferred to the Fund under sub-section (5) of section 124;

(d) the amount in the general revenue account of the Central Government which had been transferred to that account under sub-section (5) of section 205A of the Companies Act, 1956, as it stood immediately before the commencement of the Companies (Amendment) Act, 1999, and remaining unpaid or unclaimed on the commencement of this Act;

(e) the amount lying in the Investor Education and Protection Fund under section 205C of the Companies Act, 1956;

(f) the interest or other income received out of investments made from the Fund;

(g) the amount received under sub-section (4) of section 38;

(h) the application money received by companies for allotment of any securities and due for refund;

(i) matured deposits with companies other than banking companies;

(j) matured debentures with companies;

(k) interest accrued on the amounts referred to in clauses (h) to (j);

(l) sale proceeds of fractional shares arising out of issuance of bonus shares, merger and amalgamation for seven or more years;

(m) redemption amount of preference shares remaining unpaid or unclaimed for seven or more years; and

(n) such other amount as may be prescribed:

Provided that no such amount referred to in clauses (h) to (j) shall form part of the Fund unless such amount has remained unclaimed and unpaid for a period of seven years from the date it became due for payment.

The Fund shall be utilised for—

(a) the refund in respect of unclaimed dividends, matured deposits, matured debentures, the application money due for refund and interest thereon;

(b) promotion of investors' education, awareness and protection;

(c) distribution of any disgorged amount among eligible and identifiable applicants for shares or debentures, shareholders, debenture-holders or depositors who have suffered losses due to wrong actions by any person, in accordance with the orders made by the Court which had ordered disgorgement;

(d) reimbursement of legal expenses incurred in pursuing class action suits under sections 37 and 245 by members, debenture-holders or depositors as may be sanctioned by the Tribunal; and

(e) any other purpose incidental thereto, in accordance with such rules as may be prescribed:

Provided that the person whose amounts referred to in clauses (a) to (d) of sub-section (2) of section 205C transferred to Investor Education and Protection Fund, after the expiry of the period of seven years as per provisions of the Companies Act, 1956, shall be entitled to get refund out of the Fund in respect of such claims in accordance with rules made under this section.

Authority to administer the fund:

- The Central Government shall constitute, by notification, an authority for administration of the Fund consisting of a chairperson and such other members, not exceeding seven and a chief executive officer, as the Central Government may appoint.
- Any person claiming to be entitled to the amount referred in sub-section (2) may apply to the authority constituted under sub-section (5) for the payment of the money claimed.

Administration and procedures of the fund:

- The manner of administration of the Fund, appointment of chairperson, members and chief executive officer, holding of meetings of the authority shall be in accordance with such rules as may be prescribed.
- The Central Government may provide to the authority such offices, officers, employees and other resources in accordance with such rules as may be prescribed.

- The authority shall administer the Fund and maintain separate accounts and other relevant records in relation to the Fund in such form as may be prescribed after consultation with the Comptroller and Auditor-General of India.
- It shall be competent for the authority constituted under sub-section (5) to spend money out of the Fund for carrying out the objects specified in sub-section (3).

Books of Accounts:

- The accounts of the Fund shall be audited by the Comptroller and Auditor- General of India at such intervals as may be specified by him and such audited accounts together with the audit report thereon shall be forwarded annually by the authority to the Central Government.
- The authority shall prepare in such form and at such time for each financial year as may be prescribed its annual report giving a full account of its activities during the financial year and forward a copy thereof to the Central Government and the Central Government shall cause the annual report and the audit report given by the Comptroller and Auditor-General of India to be laid before each House of Parliament.

16.4 LOANS TO DIRECTORS [SECTION 185]

Restrictions on Loans and Gurantees to Directors etc.

No company shall, directly or indirectly, advance any loan, including any loan represented by a book debt, to any of its directors or to any other person in whom the director is interested or give any guarantee or provide any security in connection with any loan taken by him or such other person:

Provided that nothing contained in this sub-section shall apply to—

(a) the giving of any loan to a managing or whole-time director—

(i) as a part of the conditions of service extended by the company to all its employees; or

(ii) pursuant to any scheme approved by the members by a special resolution; or

(b) a company which in the ordinary course of its business provides loans or gives guarantees or securities for the due repayment of any loan and in respect of such loans an interest is charged at a rate not less than the bank rate declared by the Reserve Bank of India.

Explanation.— For the purposes of this section, the expression "to any other person in whom director is interested" means—

(a) any director of the lending company, or of a company which is its holding company or any partner or relative of any such director;

(b) any firm in which any such director or relative is a partner;

(c) any private company of which any such director is a director or member;

(d) anybody corporate at a general meeting of which not less than twenty-five per cent. of the total voting power may be exercised or controlled by any such director, or by two or more such directors, together; or

(e) anybody corporate, the Board of directors, managing director or manager, whereof is accustomed to act in accordance with the directions or instructions of the Board, or of any director or directors, of the lending company.

Personal liability of directors for offences under the Act:

If any loan is advanced or a guarantee or security is given or provided in contravention of the provisions of sub-section (1), the company shall be punishable with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees, and the director or the other person to whom any loan is advanced or guarantee or security is given or provided in connection with any loan taken by him or the other person, shall be punishable with imprisonment which may extend to six months or with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees, or with both.

16.5 INTER-CORPORATE LOANS AND INVESTMENT [SECTION 186]

Section 2(43) of Companies Act, 2013, "free reserves" means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend.

Provided that—

(i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or

(ii) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value, shall not be treated as free reserves;

Restrictions on Investment through Investment Subsidiaries:

A company shall unless otherwise prescribed, make investment through not more than two layers of investment companies:

Provided that the provisions of this sub-section shall not affect,—

(i) a company from acquiring any other company incorporated in a country outside India if such other company has investment subsidiaries beyond two layers as per the laws of such country;

(ii) a subsidiary company from having any investment subsidiary for the purposes of meeting the requirements under any law or under any rule or regulation framed under any law for the time being in force.

Limit in respect of Investment/ Loan/Guarantee:

No company shall directly or indirectly —

(a) give any loan to any person or other body corporate;

(b) give any guarantee or provide security in connection with a loan to any other body corporate or person; and

(c) acquire by way of subscription, purchase or otherwise, the securities of any other body corporate, exceeding sixty per cent. of its paid-up share capital, free reserves and securities premium account or one hundred per cent. of its free reserves and securities premium account, whichever is more.

Where the giving of any loan or guarantee or providing any security or the acquisition under sub-section (2) exceeds the limits specified in that sub-section, prior approval by means of a special resolution passed at a general meeting shall be necessary.

The company shall disclose to the members in the financial statement the full particulars of the loans given, investment made or guarantee given or security provided and the purpose for which the loan or guarantee or security is proposed to be utilised by the recipient of the loan or guarantee or security.

Prior unanimous approval of Board in meeting:

No investment shall be made or loan or guarantee or security given by the company unless the resolution sanctioning it is passed at a meeting of the Board with the consent of all the directors present at the meeting and the prior approval of the public financial institution concerned where any term loan is subsisting, is obtained.

Provided that prior approval of a public financial institution shall not be required where the aggregate of the loans and investments so far made, the amount for which guarantee or security so far provided to or in all other bodies corporate, along with the investments, loans, guarantee or security proposed to be made or given does not exceed the limit as specified in sub-section (2), and there is no default in repayment of loan installments or payment of interest thereon as per the terms and conditions of such loan to the public financial institution.

Company registered with SEBI cannot make investment or give loans/g urantees beyond limit of 60% / 100%:

No company, which is registered under section 12 of the Securities and Exchange Board of India Act, 1992 and covered under such class or classes of companies as may be prescribed, shall take inter-corporate loan or deposits exceeding the prescribed limit and such company shall furnish in its financial statement the details of the loan or deposits.

Minimum Interest chargeable:

No loan shall be given under this section at a rate of interest lower than the prevailing yield of one year, three year, five year or ten year Government Security closest to the tenor of the loan.

No company which is in default in the repayment of any deposits accepted before or after the commencement of this Act or in payment of interest thereon, shall give any loan or give any guarantee or provide any security or make an acquisition till such default is subsisting.

Register of Investment/Loan/Gurantees/Security given/made:

Every company giving loan or giving a guarantee or providing security or making an acquisition under this section shall keep a register which shall contain such particulars and shall be maintained in such manner as may be prescribed.

The register referred above shall be kept at the registered office of the company and —

(a) shall be open to inspection at such office; and

(b) extracts may be taken therefrom by any member, and copies thereof may be furnished to any member of the company on payment of such fees as may be prescribed.

Non-applicability of restrictions on guarantees:

Nothing contained in this section, except sub-section (1), shall apply—

(a) to a loan made, guarantee given or security provided by a banking company or an insurance company or a housing finance company in the ordinary course of its business or a company engaged in the business of financing of companies or of providing infrastructural facilities;

(b) to any acquisition—

   (i) made by a non-banking financial company registered under Chapter IIIB of the Reserve Bank of India Act, 1934 and whose principal business is acquisition of securities:

   Provided that exemption to non-banking financial company shall be in respect of its investment and lending activities;

   (ii) made by a company whose principal business is the acquisition of securities;

   (iii) of shares allotted in pursuance of clause (a) of sub-section (1) of section 62.

Contravenes the provisions of this section:

The company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to two years and with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees.

16.6 REMUNERATION OF DIRECTORS

As per section 2(78) of the Companies Act, 2013 "remuneration" means any money or its equivalent given or passed to any person for services rendered by him and includes perquisites as defined under the Income-tax Act, 1961

Overall maximum managerial remuneration and managerial remuneration in case of absence or inadequacy of profits [Section 197]

Ceiling of Total Managerial Remuneration:

The total managerial remuneration payable by a public company, to its directors, including managing director and whole-time director, and its manager in respect of any financial year shall not exceed eleven per cent. of the net profits of that company for that financial year computed in the manner laid down in section 198 except that the remuneration of the directors shall not be deducted from the gross profits.

Provided that the company in general meeting may, with the approval of the Central Government, authorise the payment of remuneration exceeding eleven per cent. of the net profits of the company, subject to the provisions of Schedule V.

Provided further that, except with the approval of the company in general meeting,—

(i) the remuneration payable to any one managing director; or whole-time director or manager shall not exceed five per cent. of the net profits of the company and if there is more than one such director remuneration shall not exceed ten per cent. of the net profits to all such directors and manager taken together;

(ii) the remuneration payable to directors who are neither managing directors nor whole-time directors shall not exceed,—

  (A) one per cent. of the net profits of the company, if there is a managing or whole-time director or manager;

  (B) three per cent. of the net profits in any other case.

The percentages aforesaid shall be exclusive of any fees payable to directors under sub-section (5).

If, in any financial year, a company has no profits or its profits are inadequate, the company shall not pay to its directors, including any managing or whole-time director or manager, by way of remuneration any sum exclusive of any fees payable to directors under sub-section (5) hereunder except in accordance with the provisions of Schedule V and if it is not able to comply with such provisions, with the previous approval of the Central Government.

Remuneration to Director in Professional Capacity:

The remuneration payable to the directors of a company, including any managing or whole-time director or manager, shall be determined, in accordance with and subject to the provisions of this section, either by the articles of the company, or by a resolution or, if the articles so require, by a special resolution, passed by the company in general meeting and 5 the remuneration payable to a director determined aforesaid shall be inclusive of the remuneration payable to him for the services rendered by him in any other capacity.

Provided that any remuneration for services rendered by any such director in other capacity shall not be so included if—

(a) the services rendered are of a professional nature; and

(b) in the opinion of the Nomination and Remuneration Committee, if the company is covered under sub-section (1) of section 178, or the Board of Directors in other cases, the director possesses the requisite qualification for the practice of the profession.

A director may receive remuneration by way of fee for attending meetings of the Board or Committee thereof or for any other purpose whatsoever as may be decided by the Board.

Provided that the amount of such fees shall not exceed the amount as may be prescribed.

Provided further that different fees for different classes of companies and fees in respect of independent director may be such as may be prescribed.

Remuneration to non-executive directors based on profits:

A director or manager may be paid remuneration either by way of a monthly payment or at a specified percentage of the net profits of the company or partly by one way and partly by the other.

An independent director shall not be entitled to any stock option and may receive remuneration by way of fees provided under sub-section (5), reimbursement of expenses for participation in the Board and other meetings and profit related commission as may be approved by the members.

The net profits for the purposes of this section shall be computed in the manner referred to in section 198.

Recovery if excess remuneration drawn:

If any director draws or receives, directly or indirectly, by way of remuneration any such sums in excess of the limit prescribed by this section or without the prior sanction of the Central Government, where it is required, he shall refund such sums to the company and until such sum is refunded, hold it in trust for the company.

The company shall not waive the recovery of any sum refundable to it under sub-section (9) unless permitted by the Central Government.

Disclosure by Listed Company in Board Report:

Every listed company shall disclose in the Board’s report, the ratio of the remuneration of each director to the median employee’s remuneration and such other details as may be prescribed.

Insurance against civil liability on behalf of managerial person:

Where any insurance is taken by a company on behalf of its managing director, whole-time director, manager, Chief Executive Officer, Chief Financial Officer or Company Secretary for indemnifying any of them against any liability in respect of any negligence, default, misfeasance, breach of duty or breach of trust for which they may be guilty in relation to the company, the premium paid on such insurance shall not be treated as part of the remuneration payable to any such personnel.

Provided that if such person is proved to be guilty, the premium paid on such insurance shall be treated as part of the remuneration.

MD/WTD can receive remuneration or commission from holding or subsidiary company:

Subject to the provisions of this section, any director who is in receipt of any commission from the company and who is a managing or whole-time director of the company shall not be disqualified from receiving any remuneration or commission from any holding company or subsidiary company of such company subject to its disclosure by the company in the Board’s report.

Recovery from Director if financial statement restated due to fraud:

If any person contravenes the provisions of this section, he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

Study Note - 17

AUDIT REPORT

This Study Note includes

17.1 Scope, Basic Elements and Significance of Audit Report
17.2 Unqualified Opinion
17.3 Qualified Opinion / Report
17.4 Disclaimer of Opinion
17.5 Piecemeal Opinion
17.6 Adverse or Negative Report
17.7 Audit Report under the Companies Act, 2013
17.8 CARO-Companies (Auditor's Report) Order, 2003
17.9 Auditor's Report on Revised Accounts of Companies before circulation to Shareholders
17.10 Revision of the Audit Report
17.11 Audit of Abridged Financial Statement
17.12 Provision for Proposed Dividend
17.13 Accounts of Liquidators/Report U/S 348 of Companies Act, 2013
17.14 Section 182 of the Companies Act and the Auditor
17.15 Audit of Consolidated Financial Statements (CFS)
17.16 Corporate Governance
17.17 Audit Certificate

17.1 SCOPE, BASIC ELEMENTS AND SIGNIFICANCE OF AUDIT REPORT

17.1.1 Concept & Definitions

While conducting every audit auditor has to go through three phases

(a) Preliminary work for audit.

(b) Conduct of actual audit, and

(c) Conclusion of audit, which means submission of Audit Report.

Therefore, Audit Report is called as the ultimate and final product of every audit.

The meaning of Audit Report can be well understood from the following selected definitions

LanCester – "A Report is a statement of collected & considered facts, so drawn up as to give clear and concise information to persons who are not already in possession of the full facts of the subject matter of the report."

J.B.Ray - "The Report shall either contain as expression of opinion regarding the financial statements, taken as a whole or an assertion to the effect that an opinion cannot be expressed when an overall opinion cannot be expressed, the reason therefore should be stated. In all cases, where auditor's name is associated with financial statements the report should contain a clear cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking."

In short, the Audit Report is nothing but a statement of observation gathered & considered while proving conclusive evidence of company's financial position. It is a medium through which an auditors expresses his opinion on the financial statement under audit. It is an important part of the audit as it provides the results of the audit conducted by the auditor.

17.1.2. Importance of Audit Report

i. An Audit report is the end product of the auditing and is very important & concluding part of the audit process.

ii. Audit report gives the auditor's opinion on the accounts & record of the company, as examined by him.

iii. Audit Report reflects the work done by the auditor.

iv. Audit report is the instrument which, measures the auditors responsibility in regard to the true & fairness of the financial statement of the company.

v. Audit Report indicates the real position of the financial status of the company & which is used by different people as a reliable document.

17.1.3 The Basic Elements of the Auditors' Report are -

i. **Title:** The Auditor's Report should have an appropriate title i.e. I; "Auditor's Report". It should be distinguished from other Reports, e.g. reports of officers of the entity, Board of Directors.

ii. **Addressee:** The Auditor's Report should be appropriately addressed as required by the circumstances of the engagement and applicable laws and regulations. Ordinarily, the Auditor's Report is addressed to the authority appointing the Auditor.

iii. **Opening or Introductory Paragraph:**

(a) The Auditor's Report should identify the Financial Statements of the entity that have been audited, including the date of and period covered by the Financial Statements.

(b) The Report should include a Statement that the Financial Statements are the responsibility of the entity's management and a Statement that the responsibility of the Auditor is to express an opinion on the Financial Statements based on the audit.

iv. **Scope Paragraph:**

(a) The Auditor's Report should describe the scope of the audit by stating that the audit was conducted in accordance with auditing Standards generally accepted in India.

(b) The Report should include a statement that the audit was planned and performed to obtain reasonable assurance whether the Financial Statements are free of material misstatement.

(c) The Auditor's Report should describe the Audit as including examining, on a test basis, evidence to support the amounts and disclosures in Financial Statements, assessing the accounting principles used in the preparation of the Financial Statements, assessing significant estimates made by management, in the preparation of Financial Statements, & evaluating the overall position of Financial Statements.

(d) The Report should include a statement by the Auditor that the audit provides a reasonable basis for his opinion.

v. **Opinion Paragraph:** The Opinion paragraph of the Report should indicate the Financial Reporting framework used to prepare the Financial Statements. It should state the Auditor's opinion as to whether the Financial Statements give a true and fair view in accordance with the financial reporting framework and, where appropriate, whether the Financial Statements comply with the statutory requirements.

vi. **Date of the Report:** The date of an Auditor's Report is the date on which the Auditor signs the Report expressing an opinion on the Financial Statements. The Auditor should not date the Report earlier than the date on which the Financial Statements are signed or approved by Management.

vii. **Place of Signature:** The Report should name the specific location, which is ordinarily the city where the Audit Report is signed.

viii. **Auditor's Signature:** The Report should be signed by the Auditor in his personal name. Where a Firm is appointed as the Auditor, the Report should be signed in the personal name of the Auditor and in the name of the Audit Firm. The Partner / Proprietor signing the Report should mention his ICAI Membership Number.

Note: Where the governing statute requires the Auditor to include certain matters in his Report or prescribe the form in which the Auditor should issue his Report, such additional matters should be included in addition to the requirements of SA 700.

A. Significance of Opening Paragraph:

(a) The Opening or Introductory Paragraph identifies the Financial Statements of the entity that have been audited, including the date of and period covered by the Financial Statements.

(b) The 'Opening Paragraph' seeks to bring to the notice of the Users of Financial Statements, that preparation of the accounts is the responsibility of the Management of the enterprise, whereas the responsibility of the Auditor is to express an opinion on the said accounts based on the audit carried out by him.

(c) Through the Opening Paragraph, the Auditor communicates the basic message that the preparation of Financial Statements requires Management to make significant accounting estimates and judgements, as well as to determine the appropriate accounting principles and methods used in preparation of the said Financial Statements.

B. Significance of Scope Paragraph:

(a) The `Scope Paragraph' seeks to inform the Users about the practices and procedures followed in the conduct of audit by the Auditor.

(b) In the Scope Paragraph, the Auditor states that the audit was planned and performed in accordance with Auditing Standards generally accepted in India, and also that the audit provides a reasonable basis for his opinion.

(c) The significance of the Scope Paragraph lies in the fact that the Auditor intends to convey to the readers of his report, about the scope of audit by highlighting the nature and progress of audit. The test check approach of audit adopted by the Auditor in performing his audit work as also the significant aspect of evaluation of accounting principles and accounting estimates is also clarified.

(d) The basic objective of auditing that the Auditor provides only "reasonable assurance" is emphasized in the Scope Paragraph. Thus, this paragraph signifies the inherent limitations of audit.

17.2 UNQUALIFIED OPINION

An opinion is said to be unqualified, when the Auditor concludes that the Financial Statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the Financial Statements. Or,

The Auditor gives a Clean or Unqualified Report, when he does not have any significant reservation in respect of matters contained in the Financial Statements.

An Unqualified Opinion indicates the following -

(a) The Financial Statements have been prepared using the Generally Accepted Accounting Principles, which have been consistently applied,

(b) The Financial Statements comply with relevant statutory requirements and regulations, and

(c) There is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

(d) Any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the Financial Statements.

For issuing an Unqualified Audit Report, the Auditor has to satisfy himself that -

i. Evidence: Reasonable evidence is obtained in support of transactions recorded in the books of account.

ii. **Standards:** Accounting entries passed in the books of account are in conformity with the generally applicable accounting principles and Accounting Standards followed consistently.

iii. **True and Fair:** The Financial Statements prepared represent a true and fair summary of the transactions that took place during the year.

iv. **Classification:** The process of classification and aggregation followed in the preparation of the Financial Statements is fair and it does not hide a material fact nor does it highlight something, which may distort the real state of affairs.

v. **Format:** The form of Financial Statements is in accordance with the form prescribed by law, if any.

vi. **Free of Misstatements:** There are no material misstatements in the Financial Statements. No material transaction recorded in the books of account is illegal or beyond the legal competence of the Company.

Disclosure: All the disclosures statutorily required or otherwise relevant have been made appropriately.

17.2.1 Modified Audit Report

When the Auditor issues any Report other than unqualified, his Report is said to be modified. As per SA 750, an Auditor's Report is considered to be modified when it includes -

i. Matters That Do Not Affect the Auditor's Opinion - with Emphasis of Matter Paragraph.

ii. Matters That Do Affect the Auditor's Opinion viz:

   (a) Qualified Opinion,

   (b) Disclaimer of Opinion, and,

   (c) Adverse Opinion.

17.2.2 Emphasises Matters that do not affect the Auditor's Unqualified Opinion.

i. **Going Concern Not Resolved:** The Auditor should modify the Auditor's Report by adding a paragraph to highlight a material matter regarding a going concern problem where the going concern question is not resolved and adequate disclosures have been made in the Financial Statements.

ii. **Significant Uncertainty:** The Auditor should consider modifying his Report by adding a paragraph if there is a significant uncertainty (other than going concern problem), the resolution of which is dependent upon future events and which may affect the Financial Statements.

iii. **Multiple Uncertainties:** In extreme cases, e.g. multiple uncertainties that are significant to the Financial Statements, the Auditor may consider it appropriate to express a Disclaimer of Opinion instead of adding an emphasis of matter paragraph.

iv. **Impact of Paragraph:** The addition of an emphasis of matter paragraph does not affect the Auditor's opinion. The paragraph would preferably be included preceding the Opinion Paragraph and would ordinarily refer to the fact that the Auditor's opinion is not qualified in this respect.

Example:

"Without qualifying our opinion, we draw attention to Note X of Schedule to the Financial Statements. The entity is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The entity has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the Financial Statements.

In our opinion and to the best of our information and according to the explanations given to us, the Financial Statements give a true and fair view in conformity with the accounting principles generally accepted in India - in the case of the Balance Sheet, of the state of affairs of as at 31st March 2XXX, and • in the case of the Profit and Loss Account, of the Profit / Loss for the year ended on that date."

17.2.3 Circumstances that may Result in other than an Unqualified Opinion?

An Auditor may not be able to express an Unqualified Opinion when any of the following circumstances exist and in the Auditor's judgement, the effect of the matter is or may be material to the Financial Statements. [SA 700]

i. **Limitation on Scope:** Limitation on scope of Auditor's work may be imposed by the clients or imposed by circumstances. It may lead to situations where the Auditor may have to issue a Qualified Opinion or a Disclaimer of Opinion.

ii. **Disagreement with management:** The Auditor may disagree with the Management as to - (a) the acceptability of the accounting policies selected, or the method of their application, (b) the adequacy of disclosure in the Financial Statements, or (c) the compliance of the Financial Statements with relevant regulations and statutory requirements. In such cases, he may have to give an Adverse Opinion or a Qualified Opinion.

iii. **Significant Uncertainty:** If there is a significant uncertainty affecting the Financial Statements (other than Going Concern problem), for example, litigation involving legal claims, etc. the result of which is dependent upon the resolution of the future events, the Auditor may have to quality his opinion or disclaim an opinion. However, where such significant uncertainty is not material, the Auditor may issue an Unqualified Opinion, by adding an "Emphasis of Matter" paragraph, without qualifying his opinion.

17.2.3 Manner of Qualification / Disclaimer:

(a) Whenever the Auditor expresses an opinion other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the Financial Statements should be mentioned in the Auditor's Report.

(b) Where it is not practicable to quantify the effect of modifications made in the Audit Report accurately, the Auditor may do so on the basis of estimates made by the Management, after carrying out possible audit tests. He should clearly indicate the fact that the figures are based on Management estimates.

(c) This information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the Financial Statements.

17.3 QUALIFIED OPINION/ REPORT

i. A Qualified Audit Report is one where an Auditor gives an opinion on the truth and fairness of Financial Statements, subject to certain reservations.

ii. The Auditor's Reservation is generally stated as: "Subject to the above, we report that the Balance Sheet shows a true and fair view."

iii. The overall impact of all reservations or qualification taken together is not material enough to vitiate the overall true and fair view of Financial Statements, but it is important that such a matter(s) should be brought to the attention of the shareholders.

iv. The Report should also give detailed reasons along with quantitative impact on the qualifications on Financial Statements.

v. A Qualified Opinion should be expressed when the Auditor concludes that -

  (a) An Unqualified Opinion cannot he expressed, or

  (b) The effect of any disagreement with Management is not so material and pervasive as to require an Adverse Opinion, or

  (c) The Limitation on scope is not so material and pervasive as to require a Disclaimer of Opinion.

17.3.1 Features of a Qualified Report

The features of a Qualified Report are -

i. **Clarity:** The Auditor must express the nature of qualification, in a clear and unambiguous manner.

ii. **Explanation:** Where the Auditor answers any of the statutory affirmations in the negative or with a qualification, his Report shall state the reasons for such answer.

iii. **Placement:** All qualifications should be contained in the Auditor's Report. When there are Notes, which are subject matter of a qualification, the same should preferably he annexed to the Auditors' Report. However a reference to the Notes to Accounts in the Auditors' Report does not automatically become a qualification.

iv. **Subject to:** The words "subject to" are essential to state any qualification. The qualification should be preceded by words such as "Subject to" or "Except that" to make it clear that he is making an exception.

v. **Nature of Qualification:** Vague statements, the effect of which on accounts cannot be ascertained, like, `The debtors balances are subject to confirmation', `No provision for taxation has been made in view of the loss during the year', etc. should be avoided.

vi. **Violation of Law:** Where the Company has committed an irregularity resulting in a breach of law, the Auditor should bring the same to the notice of the shareholders by properly qualifying his report.

vii. **Quantification:** The Auditors should quantify, wherever possible, the effect of these qualifications on the Financial Statements if the same is material. Where the effect of qualification cannot be accurately quantified, the Auditor may reflect the effect on the basis of Management estimates, after carrying out necessary audit tests on such estimates.

viii. **Notes-Report Relationship:** Where notes of a qualificatory nature appear in the accounts, the Auditors should state all qualifications independently in their report so that the user can assess the significance of these qualifications.

ix. **Draft Report:** The Auditor may discuss matters of qualification with the Management of the Company to acquire their views. It is not necessary that the Auditor should accept the Management's view and modify his opinion. But it would enable the Auditor to accurately draft the qualifications in his Final Report.

17.3.2 Aspects to be Considered in Qualifying a Report

Examine whether the Auditors are in active disagreement with something which has been done by the Company, or they are merely unable to form an opinion, say, for lack of adequate information about an item.

Establish whether the matters in question are so material as to affect the presentation of a true and fair view of the whole of the affairs of the Company, or they are of such a nature as to affect on particular item disclosed in the accounts.

See whether the matters constituting the qualification involve a material contravention of any requirements of the Companies Act, which have a bearing on the accounts.

Illustrations:

Some situations calling for qualifications in Audit Reports are

i. Where the Auditors are unable to obtain all the information and explanations which they consider necessary for the purposes of their audit, e.g. -

   (a) Absence of satisfactory documentary evidence of the existence of ownership of the material assets, such as, title deeds in respect of land,

   (b) Absence of vouchers in respect of material payments made by the Company,

   (c) Destruction of books and records by fire or accident,

   (d) Non-availability of books and records owing to unavoidable circumstances, such as books and records of a foreign branch with which no communication is possible. .

ii. Where proper books of accounts have not been kept in accordance with the law.

iii. Where the Balance Sheet and P&L Account are not in agreement with the hooks of account and returns.

iv. When the information required by law is not furnished.

v. When the accounts do not disclose a true and fair view like -

   (a) Where the accounting practices followed by the Company are not considered appropriate to the circumstances and nature of the business e.g. treatment of HP Sales as outright sales,

   (b) Where there has been a change in accounting principles or procedures in relation to material items, such, valuation of stock, depreciation, treatment of by-product cost, etc. without adequate explanation and disclosure of effect of the change,

   (c) Where difference of opinion with management has arisen regarding valuation or realisability of assets, such as Stock-in-Trade, Debtors, Loans & Advances or the extent of liabilities, contingent or otherwise,

   (d) Where income or expenditure is not properly reflected so as to show a fair figure of profit for the year,

   (e) Where information is not required by law to be disclosed but the disclosure of which is considered essential by the Auditors in order to show a true and fair view,

   (f) Where there is a contravention of the provisions of the Companies Act having a bearing upon the accounts and transactions of the Company e.g. donations to political parties or for political purposes in contravention of Section 182, or contributions to charitable or other funds in excess of the limitation specified in Section 181;

   (g) Where the Company has contravened the provisions of its Memorandum and Articles of Association.

17.4 DISCLAIMER OF OPINION

A Disclaimer of Opinion Report is given when the Auditor is unable to form an overall opinion about the matters contained in the Financial Statements.

A Disclaimer of Opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the Auditor has not been able to obtain sufficient appropriate audit evidence and is, accordingly, unable to express an opinion on the Financial Statements.

It may happen in situations such as -- (a) when books of account of the Company seized by Income-Tax Authorities, (h) when it is not possible for the Auditor to obtain certain information or (c) when scope of audit work is restricted.

The Auditor will state in his Report that he is unable to term an opinion on the Financial Statements. Such Report is called as "Disclaimer of Opinion Report".

17.5 PIECEMEAL OPINION

i. The Auditor, may in some cases, find that the Financial Statements he has examined present only a partial true and fair view. In such cases, he may report that he is unable to express an opinion, limited to certain items in the statement, with which he is satisfied. Such a situation would warrant a Piecemeal Opinion.

ii. As the name suggests, the Auditor gives a divided opinion on matters with which he is satisfied and with which he is not. The Auditor should state the reasons for having given a Piecemeal Opinion.

17.6 ADVERSE OR NEGATIVE REPORT

i. An Adverse or Negative Report is given when the Auditor concludes that based on his examination, he does not agree with the affirmations made in the Financial Statements / Financial Report.

ii. The Auditor states that the Financial Statements do not present a true and fair view of the state of affairs and the working results of the organisation.

iii. The Auditor should state the reasons for issuing such a report.

iv. An Adverse Opinion should be expressed when the effect of a disagreement is so material and pervasive to the Financial Statements, that the Auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the Financial Statements.

Some Remarks which are not Qualifications.

i. Meaning: Statements or Observations which are not qualificatory in nature, may exist in the Auditor's Report. Some requirements under CARO or inquiry U/S 143 are of this non-qualificatory character.

ii. Conditions under which "Remarks' can be inserted are -

(a) The matter is of such importance in relation to the Balance Sheet as a whole that it should be brought to the notice of the members, and

(b) The point is not clearly brought out on the face of the accounts, as they stand by the note or otherwise, and

(c) The point does not affect the true and fair character of the accounts.

iii. Manner of Reporting: Where it is necessary, either statutorily or otherwise, to include a "remark" in an Audit Report which is not a qualification, the remark should be inserted as a single sentence prior to the Auditor's Opinion which should not include any reference to the remark. This remark can be put in the body of the Auditor's Report only when the Notes on Accounts do not include this information.

Example:

"The properties abroad shown in the Balance Sheet at ₹ are in the course of being but have not yet been, registered in the Company's name." (The Opinion Paragraph should not have any reference to the above remark).

Distinguish Between Explanatory Notes and Qualificatory Notes

Explanatory Notes	**Qualificatory Notes**
An Explanatory Note is meant to explain or supplement a matter contained in or related to Financial Statements.	A Qualificatory Note is intended to communicate the Auditor's reservation on the accounts.
The matter on which an Explanatory Note is given is one on which the Auditor has not taken an adverse view.	Qualificatory Notes arc notes on which the Auditor has taken an adverse view e.g. tax provision not made in the accounts.
Explanatory Notes are given by the Directors of the Company.	Qualifications are made by the Auditor in his Report to the Company's shareholders.
These are usually shown under "Notes to Accounts". All Notes, wherever shown, including those required by the Schedule III constitute an integral part of the accounting statement.	These notes are included in the Auditors' Report before the Opinion Paragraph. The reader's attention is drawn to the Qualification paragraph by use of the word "Subject to".
There is no specific reporting requirement for Notes. The Directors for	Section 129 requires the Directors to furnish full remark information on contained in every the qualification or adverse Auditors' Report.

Situation	Auditor's Duties
When the limitation of scope infringes the duties of the Auditor under the statute, e.g. inquiry Ws 143.	The Statutory Auditor should not accept the engagement.
1. When the Auditor believes that limitations in the terms of a proposed engagement is of such a nature that he would need to issue a Disclaimer of Opinion.	The Auditor should not accept such a limited engagement as an Audit Engagement.
2. Other limitations imposed by entity or by circumstances - (i) When the terms of engagement specify that the Auditor will not carry out an audit procedure which he believes necessary e.g. verification of investments, or, (ii) When the timing of the Auditor's work is such that he is unable to observe the counting of physical inventories, or, (iii) When in his opinion the accounting records are inadequate, or, (iv) When he is unable to carry out an audit procedure that he believes desirable.	(i) The Auditor should carry out reasonable alternative audit procedures to obtain sufficient audit evidence to support an Unqualified Opinion. (ii) If the Auditor is unable to carry out alternative audit procedures or is not satisfied with the evidence obtained by such alternative procedures, he should issue a Qualified Opinion or Disclaimer of Opinion. (iii) The Auditor's Report should describe the limitation and indicate the possible adjustments to the Financial Statements that might have been determined to be necessary had the limitation not existed. (iv) The Auditor cannot escape his responsibility by obtaining Management Certificates or stating that certain audit procedures were not carried out.

Distinguish Between Qualified Report and Adverse Report

Qualified Report	Adverse Report
i. A Qualified Audit Report is one an Auditor gives an opinion subject to certain reservations.	An Adverse Report is given when the concludes that based on his examination, he does not agree with the affirmations made in the Financial Statements / Financial Report.
ii. The Auditor's reservation is generally Stated as: "Subject to the above, we report that the Balance Sheet shows a true and fair view."	The Auditor states that the Financial Statements do not present a true and fair view of the state of affairs and working results of the organisation.
iii. The accounts present a true and fair view subject to certain reservations.	The accounts do not present a true and fair view on the whole.
iv. A Qualification is made in the Audit Report when the Auditor has reservation on specific item(s) of material nature.	An Adverse Report is given when the Auditor has his reservations on the true and fair view presented by the Financial Statements.

Distinguish between Clean Audit Report and Qualified Audit Report.

Clean Report	Qualified Report
The Auditor issues a Clean Report (also called as unconditional opinion) when he does not have any reservation with regard to the matters contained in the Financial Statements.	A Qualified Audit Report is one where an Auditor gives an opinion subject to certain reservations.
In a Clean Report, the Auditor states that the Financial Statements give a true and fair view of the state of affairs and results for the period.	The Auditor's reservation is generally stated as - "Subject to the above, we report that the Balance Sheet shows a true and fair view."
The Auditor is justified in issuing a clean report if- i. The accounts are prepared using generally accepted accounting principles. ii. The Auditor has examined sufficient reliable evidence in respect of transactions recorded in the books. iii. The transactions recorded represent a true recording of the events. iv. The transactions are within the legal competence of the entity. v. There are no material misstatements in the Financial Statements. vi. The Financial Statements comply with the format and disclosure requirements as per the Statute.	A Qualified Opinion should be expressed when the Auditor concludes that - i. An Unqualified Opinion cannot be expressed, ii. The effect of any disagreement with Management is not so material and pervasive as to require an Adverse Opinion, or iii. The Limitation on scope is not so material and pervasive as to require a Disclaimer of Opinion.
There is no specific duty of Management for Clean Reports.	Management is bound to give explanation & full details in respect of each qualification in the Auditors Report. [Section 134]

Date of the Audit Report.

Since significant events may take place from the date of Financial Statements, date of completing audit field work and date of Audit Report, the date of the Audit Report should be the actual date of completion of audit.

Any event coming to be known after the date of the Audit Report is not the responsibility of the Auditor even though it may have a highly significant effect on the Financial Statements reported upon.

Even though the Audit Report may be actually prepared at a date later than the date of actual completion of the audit work, it is desirable that it should be made as on the former date to limit the Auditors' responsibility.

In relation to reporting on Company Accounts, it is possible for the Auditor to report on the same day on which the Financial Statements are approved by the Board of Directors.

17.7 AUDIT REPORT UNDER THE COMPANIES ACT, 2013

The matters to be included in the Report of the Company Auditor u/s 143 are -

Powers and Duties of Auditors and Auditing Standards [Section 143]

(1) Every auditor of a company shall have a right of access at all times to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and shall be entitled to require from the officers of the company such information and

explanation as he may consider necessary for the performance of his duties as auditor and amongst other matters inquire into the following matters, namely:—

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(d) whether loans and advances made by the company have been shown as deposits;

(e) whether personal expenses have been charged to revenue account;

(f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Provided that the auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries in so far as it relates to the consolidation of its financial statements with that of its subsidiaries.

(2) The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made thereunder or under any order made under sub-section (11) and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

(3) The auditor's report shall also state—

(a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

(b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

(d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

(e) whether, in his opinion, the financial statements comply with the accounting standards;

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(g) whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;

(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

(j) such other matters as may be prescribed.

(4) Where any of the matters required to be included in the audit report under this section is answered in the negative or with a qualification, the report shall state the reasons therefor.

(5) In the case of a Government company, the Comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

(6) The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report under sub-section (5) have a right to,—

(a) conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorise in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and

(b) comment upon or supplement such audit report.

Provided that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub section (1) of section 136 and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

(7) Without prejudice to the provisions of this Chapter, the Comptroller and Auditor- General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

(8) Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed.

Provided that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

(9) Every auditor shall comply with the auditing standards.

(10) The Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section

3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

Provided that until any auditing standards are notified, any standard or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

(11) The Central Government may, in consultation with the National Financial Reporting Authority, by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.

(12) Notwithstanding anything contained in this section, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within such time and in such manner as may be prescribed.

(13) No duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter referred to in sub-section (12) if it is done in good faith.

(14) The provisions of this section shall mutatis mutandis apply to—

(a) the cost accountant in practice conducting cost audit under section 148; or

(b) the company secretary in practice conducting secretarial audit under section 204.

(15) If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12), he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

Significance of the Phrase "True and Fair" in the Auditor's Report under the Companies Act, 2013.

(i) Reporting Requirement: The Statutory Auditor of a Company has to express an opinion in his report on the true and fair view shown by the Balance Sheet and the P&L Account and Cash Flow for the year. The term "true and fair" is not defined in any legislation.

(ii) Legal Requirement as to true and fair: Section 129 of the Companies Act provides that the accounts of a Company, shall be deemed as not disclosing a true and fair view, if they do not disclose any matters which are required to be disclosed -

(a) By virtue of provisions of Schedule III to the Act, or

(b) By virtue of a notification or an order of the Central Government modifying the disclosure requirements.

As per Section 129, the Balance Sheet and P&L 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 -

Nature of Company	**Matters**
Insurance Company.	Matters which are not required to be disclosed by the Insurance Act, 1938.
Banking Company.	Matters which are not required to be disclosed by the Banking Companies Act, 1949.
Company generating / supplying Electricity.	Matters which are not required to be disclosed by the Indian Electricity Act, 1910 and Electricity (Supply) Act, 1948.
Company governed by a Special Act.	Matters which are not required to be disclosed by the Special Act.
Any Company.	Matters which are not required to be disclosed by Schedule III, or Notification or Order U/S 129.

Therefore, the Auditor should see whether the Financial Statements are drawn up in conformity with the provisions of Schedule III and that they contain all the matters required to be disclosed therein. Generally, it can be inferred that if the information required to be disclosed is properly and adequately disclosed in the manner so required, it can be considered as disclosing a "True and Fair" view.

(iii) General Requirements on true and fair: To ensure a true and fair view, an Auditor has to see the following -

- **(a) Assets:** (i) The assets are neither undervalued nor overvalued, as per the applicable accounting principles, (ii) No material asset is omitted, (iii) Charge, if any, on assets is disclosed.
- **(b) Liabilities:** (i) Liabilities are not under or overvalued and the same are properly classified, (ii) Material liabilities should not be omitted.
- **(c) Accounting aspects:** (i) Appropriate accounting principles and acceptable accounting policies have been followed consistently, and (ii) All unusual, exceptional, non-recurring items as also material deviations have been disclosed separately.

Legal Requirements: The P&L Account and the Balance Sheet discloses all the matters required to be disclosed by Schedule III of the Companies Act or any other applicable statute.

Thus, what constitutes `true and fair' view is a matter of an Auditor's judgement in the particular circumstances of the case but within the requirements of Schedule III of the Companies Act, or of any other applicable Act.

Significance of the phase ‘‘ to the best of our Information and according to the explanations given to us’’ which is generally found in the Auditors’ Reports.

i. Narrow Interpretation:

- (a) The Statement "to the best of our information and according to the explanations given to us" is an expression of opinion by the Auditors.
- (b) Such opinion is a matter of professional judgement to be exercised by the Auditors under the given situations.
- (c) Auditors will not be held responsible if they acted on information and explanations, which they be 'eve to be bonafide, but which are as a matter of fact untrue or incorrect. They have to exercise reasonable care and skill in the evaluation of information made available to them.
- (d) As a narrow interpretation of the phrase, the Auditors may state that they have acted on the basis of explanations given to them. To that extent this phrase definitely restricts the scope of enquiry to be made by an Auditor.

ii. Broad Interpretation:

- (a) The Auditors should apply professional judgement to obtain all that information and explanations, which are necessary for the performance of conducting the audit.
- (b) Under the CA Act, a CA is guilty of professional misconduct if he fails to obtain sufficient information which is necessary for the expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion.
- (c) There may be situations where - (i) the Balance Sheet shows the correct position as per books but other information indicate that the books themselves were incorrect, (ii) the Financial Statements do not reflect proper position which could have been revealed had the Auditor obtained necessary information during the course of audit.
- (d) At a wider interpretation level, the Auditor should obtain all information and explanations, which he deems necessary, for the expression of an opinion. If he does not obtain all such information, he is entitled to issue a Disclaimer of Opinion Report.

iii. **Conclusion:** Hence, the given phrase is a double-edged sword, which may be interpreted either to restrict the scope of enquiry or to stretch responsibilities beyond a limit.

Significance of Obtaining Information and Explanations from the Management.

i. **Legal Recognition:** Legal recognition is given to the process of obtaining information as part of the whole auditing process. The provisions of the Companies Act in this regard are -

   (a) Where any particulars or information is required to be given in the Balance Sheet or P&L Account of a Company or in any document required to be annexed or attached thereto, it shall he the duty of the concerned Officer of the Company to furnish without delay, to the Company, and also to the Company's Auditor, whenever he so requires, those particulars or that information in as full a manner as possible.

   (b) The Company Auditor should state whether he has obtained all the information and explanations which to the best of his knowledge and belief, were necessary for the purpose of his audit. [Section 143]

ii. **Management's Responsibility and Auditor's Limitations:**

   (a) Auditors cannot be expected to know all the technicalities and the complexities of the business deals.

   (b) Further, the relevant papers and documents to explain the transactions may not be really available to the Auditor and, even if they are available they may still need to be explained so that one can clearly understand the impact of the transactions on the accounts.

   (c) The Management, which actually enters into transactions on behalf of the Company, is expected to have thoroughly understood the implications of all material transactions, and hence Auditors are empowered to obtain explanations from the management.

iii. **Auditors' Responsibility:**

   (a) If any vital information is deliberately withheld from the Auditor in the ordinary course of audit, and he had no means to know the existence of such information, in case the accounts turn to be wrong for that reason, the Auditor should not be held guilty or negligent.

   (b) If however, the Auditor has means to know of the existence of such vita] information but he ignored it, he would be held guilty on that account.

   (c) Where the Auditor has not been able to obtain all information and explanations as required he should issue a Modified Audit Report (i.e. other than an Unqualified Report)

Branch Audit Reports be Considered by the Statutory Auditor

i. **Forwarding of Branch Audit Reports:** Where the branch audit carried out by a person other than the Statutory Auditor, the Branch Auditor shall prepare a report on the accounts of the branch office examined by him and forward the same to be Company's Auditor who shall deal with the same in such manner as he considers necessary. [Section 143]

ii. **Qualifications in Branch Audit Reports:** If the Branch Auditor's Report contains any qualification, the Statutory Auditors should normally include it in their own report unless they are satisfied that either -

   (a) Objections raised by the Branch Auditor have been met while preparing the Company's accounts or during the conduct of the Company's audit, or

   (b) The matter on which the qualification is made is not material in the context of the Company's Accounts as a whole, or

   (c) In the light of information and explanations given to them, which were not available to the Branch Auditor, they are satisfied that the qualification is not called for.

Scope of Enquiry u/s 143(1) of the Act

A. Inquiry: The company auditor of the company should inquire into the following matters, namely:—

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(d) whether loans and advances made by the company have been shown as deposits;

(e) whether personal expenses have been charged to revenue account;

(f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Provided that the auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries in so far as it relates to the consolidation of its financial statements with that of its subsidiaries.

B. Report:

(a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

(b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(e) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

(f) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

(e) whether, in his opinion, the financial statements comply with the accounting standards;

(h) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(i) whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;

(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

(j) such other matters as may be prescribed.

17.8 CARO – COMPANIES (AUDITOR'S REPORT) ORDER, 2003

CARO – COMPANIES (AUDITOR'S REPORT) ORDER, 2003 issued by the Central Government as per the power granted under section 227(4A) of the Companies Act, 1956 is applicable to an auditor report submitted after 31st December 2003.

Till date revised CARO in parallel to Companies Act, 2013 has not been come into the picture. Hence the existing CARO, 2003 is applicable as of now.

According to 143, the auditor is required to report on certain matters only if he is not satisfied after his examination of the accounts but after this new order, the auditor has to make a statement on each of the specified matters likewise in case of Govt. companies, this order is in addition to the directions of the Comptroller and Auditor General in India.

This new order is applicable to every company except,

(a) Banking Company as defined u/s 5(c) of the Banking Regulation Act, 1949,

(b) Insurance Company as defined u/s 2(21) of the Companies Act, 1956, [Insurance Company has not been defined under Companies ACT, 2013].

(c) Company licensed to operate u/s 8 of the Companies Act, 2013 and

(d) Private Limited Companies subject to the following condition

Aggregate of Paid Up Capital and Reserves should not exceed ₹ 50 Lakhs.

Loan outstanding from any Bank or Financial Institution should not exceed ₹ 25 Lakhs.

Turnover should not exceed ₹ 5 crores.

The order is applicable to foreign Companies incorporated outside India but having a place of business within India. The branches of the Companies liable to this order also come under the purview of this order.

Meaning of "Chit Fund", "Nidhi" or "Mutual Benefit" Company:

(a) These Companies - (i) manage, (ii) conduct or (iii) supervise as a foreman / agent, monetary transactions.

(b) Such transactions or arrangement is based upon an agreement between the Company and a number of people called as Subscribers.

(c) Each Subscriber shall subscribe a certain amount of money as instalment for a definite period of time.

(d) At the end of every instalment period, one subscriber shall be entitled to the prize amount. Such entitlement comes either - (i) by draw of lots, or (ii) by auction, or (iii) by tender, or (iv) in such other manner as may be provided for in the agreement.

(e) The definition also includes Companies whose principal business is accepting Fixed Deposits from and also lending to its members.

The following matters are required to be dealt in the Auditor's Report:

1. **Fixed Assets:** Auditor should comment whether the company is maintaining proper records of fixed assets, the management verified the fixed assets frequently and the material discrepancies found accounted properly, the substantial dispose of fixed assets has affected considerably the going concern.

2. **Inventory:** The auditor has to make following statements on verification and valuation of inventories.

   (a) Whether physical verification of Inventory has been conducted at reasonable intervals by the management.

(b) Are the procedures of physical verification of inventories followed by the management reasonable and adequate in relation to the size of the company and the nature of its business? If not, the inadequacies in such procedures should be reported.

(c) Whether the company is maintaining proper records of inventory and whether any material discrepancies have been noted on physical verification and if so, whether the same have been properly dealt with in the books of account.

3. Loans: In the case of loans revised, organized to firms etc. covered in the register maintained under Section 189 of the Companies Act, auditor has to make comments on the following :

(a) Has the company either granted or taken any loans, secured or unsecured to/from companies, firms or other parties covered under the register maintained under Section 189 of the Companies Act. If so, give the number of parties and amount involved in the transactions.

(b) Whether the rate of interest and other terms and conditions of loans given or taken by the company, secured or unsecured are prima facie prejudicial to the interest of the company.

(c) Whether the payment of the principal amount and interest are also regular.

(d) If over payment is more than one Lakh, whether reasonable steps have been taken by the company for recovery/payment of the principal and interest.

4. Internal Control on Purchases of Assets and Sale of goods: Is there an adequate internal control procedure commensurate with the size of the company and the nature of its business for the purchase of inventory and Fixed Assets, and the sale of goods? Whether there is a continuing failure to correct major weaknesses in internal control?

5. Transactions in which Directors are interested: Auditors statements are required on the following :

(a) Whether transactions that need to be entered into register in pursuance of Section 189 of the Companies Act, have been so entered.

(b) Whether each of these transactions have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time.

These should be commented only in the cases of transactions exceeding the value of ₹ 5 lakhs.

6. Public Deposits: In case the company has accepted deposits from the public whether the directions issued by the Reserve Bank of India and the provisions of Sections 73 and 74 of the Companies Act and the rules framed there under where applicable, have been complied with, if not, the nature of contraventions should be stated; if an order has been passed by Company Law Board, whether the same has been complied with or not.

7. Internal Audit System in certain companies: In the case of listed companies and other companies having a paid up share capital and reserves exceeding ₹ 50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding ₹ 5 crore for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business.

8. Maintenance of Cost Records: Where Maintenance of Cost Records has been prescribed by the Central Government under Section 128 of the Companies Act whether such accounts and records have been made and maintained.

9. Deposit of Statutory Dues: The Company Auditor has to report that –

(a) Is the company regular in depositing undisputed statutory dues including Provident Fund, Employees State Insurance, Income Tax, Sales Tax, Wealth Tax, Custom Duty, Excise Duty, Cess and any other statutory dues with the appropriate authorities and if not, the extent of arrears of outstanding statutory dues as at the last date of the financial year concerned for a period of more than six months from the date they seem payable, shall be indicated by the auditor.

(b) In case dues of Income Tax, Sales Tax, Wealth Tax, Custom Duty, Excise Duty, Cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending may be mentioned, but he should, while reporting, remember that a mere representation to the department should not constitute a dispute.

10. **Sickness:** Where in case of a company which has been registered for a period not less than 5 years, its accumulated losses at the end of the financial year not less than 50% of its net worth and whether it has incurred cash losses in such financial year and in the financial year immediately preceding such financial year also.

11. **Default in Repayment of Dues:** Whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported.

12. **Documents and Records for Secured Loans:** Whether adequate documents and records are maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities. If not the deficiencies to be pointed out.

13. **Compliance with Special Provisions:** Whether the provisions of any special statute applicable to chit fund have been complied with, in respect of nidhi, mutual benefit fund or societies –

    (a) Whether the net owned fund to deposit liability ratio is more than 1 : 20 as on the date of Balance Sheet.

    (b) Whether the company has complied with the prudential norms on income recognition and provisioning against sub-standard, doubtful or lost assets.

    (c) Whether the company has adequate procedures for appraisal of credit proposals/requests, assessment of credit needs and repayment capacity of the borrower.

    (d) Whether the repayment schedule of various loans granted by the nidhi is based on the payment capacity of the borrower and would be conductive to recovery of the loan amount.

14. **Records of Dealing in Securities:** If the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions and contracts and whether timely entries have been made there in, also, whether the shares, securities, debentures and other investments have been held by the company in it's own name, except to the extent of the exemption if any, granted under section 187 of the Companies Act.

15. **Guarantees for loan taken by others:** Whether the company has given any guarantee for loans taken by other from bank, or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company.

16. **Application of Term Loans:** Whether the term loans were applied for the purpose for which the loans are obtained.

17. **Financial Management:** Whether the funds raised on short term basis have been used for long term investment and vice-versa, if yes, the nature and amount is to be indicated.

18. **Preferential Allotment of Shares:** Whether the company has made any preferential allotment of shares to parties and companies covered in the Register maintained under Section 189 of the Companies Act and if so whether the price at which shares have been issued is prejudicial to the interest of the company.

19. **Creation of Security in Respect of Debentures:** Whether the securities have been created in respect of debentures issued.

20. **Disclosure of End-use of money raised from Public issue:** Whether the management has disclosed on the end use of money raised by public issue and the same has been verified.

21. **Fraud:** Whether any fraud on or by the company, has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated.

The order stipulates that if the auditor given negative qualified answer to any of the above questions on which a statement is required on his report, he should give the reasons for that and where he is unable to give any opinion he should indicate this fact with reasons. The unfavourable answers to any of the question does not mean that the opinion of auditor on the true and fairness qualified answer the auditor can give an unqualified audit report, if the qualified answer does not materially affect the financial position discussed in the Profit and Loss Account and for Balance Sheet. The Board of Directors is supposed to give comments, in its annual report, on the adverse statements made by the auditor under the order. In short, the order provides a different orientation to a company audit. Unlike traditional auditing, due to the provisional Section 143, the auditor was required to offer his comments as an expert on certain transactions of the company and to enquire whether certain transactions were prejudicial to the interest of the company. The order under Section 143, extend the scope of audit even further e.g. Auditor has to comment on the internal audit system, internal audit system, records of fixed assets etc.

17.9 AUDITOR'S REPORT ON REVISED ACCOUNTS OF COMPANIES BEFORE CIRCULATION TO SHAREHOLDERS

There may be instances, where the Management of a Company amends its audited accounts, and re-approves it and then requests the Statutory Auditors to make a Report once again on the amended accounts. The Auditors' duties in this regard are

i. **Return:** Ensure that all copies of the Original Accounts and Report are returned to the Auditor.

ii. **Disclosure:** Ensure that the fact of Revision of accounts already approved by the Board and reported upon by the Statutory Auditors, appears as a specific Note on the amended accounts.

iii. **Reporting:** Reporting requirements are as under

   (a) **Adequate Disclosure:** If the Statutory Auditor is satisfied that the disclosure made by the Company in the Notes on Accounts is adequate, there is no further need for the Auditor to refer to the revision of the Balance Sheet and/ or the Profit and Loss Account in his report.

   (b) **Inadequate Disclosure:** If the Notes on Accounts do not contain any note on the revision or if such Note is not considered as adequately comprehensive by the Auditor, the Auditor should refer to the fact of revision of the accounts in his report.

The above principles are also applicable to the audit of Government Companies. **REVISION/ RECTIFICATION OF FINANCIAL STATEMENTS**

i. **Qualified Report:** Where past accounts have been re-opened and revised on technical grounds, and the Company has asked the Auditor to give his report u/s 143 on the revised accounts, he should issue a Qualified Report only.

ii. **Format:** The Report should indicate that the Company has re-opened the accounts contrary to the opinion of ICAI` The relevant paragraph of the Report may appear as under -

''As per the opinion of the ICAI, a Company cannot re-open and revise the accounts once adopted by the Shareholders at an AGM. However, the Department of Company Affairs vide Circular dated 28.07.1987, has opined that for meeting technical requirements of taxation laws, the accounts can be re-opened. The Board of Directors of the Company, contrary to the aforesaid opinion of the ICAI, has re-opened and revised the aforesaid accounts for adjusting (the matter for meeting the technical requirements of taxation laws regarding which accounts are re-opened may be specified here).''

17.10 REVISION OF THE AUDIT REPORT

i. **Revision of Financial Statements:** The Auditor should issue a fresh report on the revised Financial Statements in accordance with - (a) Guidance Note on Auditor's Report on Revised Accounts of Companies before circulation to Shareholders, and (b) Guidance Note on Revision/Rectification of Financial Statements.

ii. **Revision of Audit Report:**

(a) Situations: Revision of Audit Report is required -

When the Auditor considers that amendment in Financial statements is not warranted, or When the Auditor advises amendment to Financial Statements, but the Management does not intend to revise the same, or

When the Management agrees for revision in the Financial Statements but is unable to do so despite its bonafide intention, but Management extends its co-operation to the Auditor and agrees to ensure that anyone in receipt of there previously issued Financial Statements together with the Audit Report thereon is informed of the situation and would be issued the revised Audit Report.

(b) Auditor's Duties: In the above situations, the Auditor should - (i) issue a Revised Report in which he should refer to the earlier report, and (ii) state the reasons for revising the report.

(c) Timing: For corporate entities, the Audit Report may be revised till the accounts are adopted at the AGM. For entities where such adoption is not required, the Auditor may consider revising the Audit Report within a reasonable time, but in any case not later than the issuance of the Audit Report for the immediately succeeding accounting period.

(d) Subsequent Financial Statements: A Continuing Auditor may consider that the revision of Financial Statements and issuance of a Revised Report is not necessary if appropriate disclosures are made in the Financial Statements of the immediately succeeding accounting period.

iii. **Preventing Reliance on Earlier Report:**

(a) If the management neither agrees to revise the Financial Statements nor agrees to circulate the proposed Revised Audit Report to the recipients of the earlier report, the Auditor should notify the persons ultimately responsible for the overall direction of the entity that action will be taken by him to prevent reliance on the Audit Report.

(b) The Auditor may take the following steps in this regard -

Notify the client that the Audit Report must no longer be associated with the Financial Statements.

Notify the regulatory agencies (ROC / Income Tax Department / SERI / RBI / IRDA etc.) having jurisdiction over the client that the Audit Report should be no longer be relied upon.

Make an appropriate statement at the ACM, if requested by the Chairman.

iv. **Withdrawal from Engagement:** When the Management neither agrees to revise the Financial Statements nor agrees to ensure that anyone in receipt of the previously issued Financial Statements and Audit Report thereon will be informed of the situation and would be issued Devised Audit Report, the Auditor may conclude that withdrawal from the further engagement with the entity is necessary.

v. **Signature:** Where a Firm is the Auditor, the Partner who signed the Original Audit Report, should also sign the Revised Report or the letter indicating preventing reliance on the Audit Report, as the case may be. In case of signing by any other Partner, the reasons thereof should be stated.

17.11 AUDIT OF ABRIDGED FINANCIAL STATEMENT

i. **Legal Requirements:** The Auditor should examine whether the requirements relating to Abridged Balance Sheet and Abridged Profit & Loss Account as laid down in Section 136 have been duly complied with.

ii. **Subsequent Events:** If the Audit Report on Abridged Financial Statements is issued on a date subsequent to the issuance of the Audit Report on Annual Accounts as per Schedule III, the Auditor's responsibility in relation to events occurring after the Balance Sheet date is limited to the events occurring up to the date of his report on the annual accounts.

iii. **Unqualified Report:** If the Auditor is satisfied that the Abridged Financial Statements are proper in all respects, he should issue an Unqualified Audit Report.

iv. **Qualified Report:** The Auditor should express a Qualified Opinion or an Adverse Opinion, as appropriate, if he has certain reservations about the Abridged Financial Statements, e.g. if a material piece of information has not been disclosed in the Abridged Financial Statements or has been disclosed in an inappropriate manner.

17.12 PROVISION FOR PROPOSED DIVIDEND

i. When a Company does not provide for an amount for Proposed Dividend, the attention of Shareholders should he drawn to the fact that no appropriation has been made.

ii. The fact that provision for Proposed Dividend has not been made should be disclosed by means of a Note in the Accounts.

iii. The Auditor should refer to the Note in his Report and make his Report subject thereto.

17.13 ACCOUNTS OF LIQUIDATORS / REPORT U/S 348 OF COMPANIES ACT, 2013

i. **Skills:** The professional skill and audit procedures to be applied for an audit u/s 328 are similar to that used during a normal audit of a Company.

ii. **Report:** There should be a fair measure of uniformity in the Reports submitted by Auditors conducting an audit u/s 348 of the Companies Act, 2013. The Auditor's Report may be on the following lines -

(a) Whether he has obtained all the information and explanations, which to the best of his knowledge and belief, were necessary for the purposes of his audit,

(b) Whether in his opinion, proper books of account as required by the Companies Act, 2013 and Companies (Court) Rules, 1959 have been kept by the Liquidator, so far as appears from his examination of these books,

(c) Whether the Liquidator's Account relating to realisations and disbursements is in agreement with the books and records produced before him,

(d) Whether in his opinion, and to the best of his information and according to the explanations given to him, the Liquidator's Account including Annexures give the information required by the Companies Act, 2013, and the Companies (Court) Rules, 1959 in the manner so required and give a true and correct view of the realisations and disbursements of the Liquidator.

iii. **CA as Liquidator:** When a Chartered Accountant acts as a Liquidator, the Statements of Accounts to be filed u/s 348 of the Companies Act, 2013, shall be audited by a Qualified Chartered Accountant, other than the Liquidator Chartered Accountant.

17.14 SECTION 182 OF THE COMPANIES ACT AND THE AUDITOR

i. Conditions for contribution to Political Party / Political Purpose:

(a) The Board should pass a resolution authorizing such contribution.

(b) The aggregate of the amount contributed in any financial year should not exceed 5% of the average net profits during three immediately preceding financial years.

ii. Payments covered under Political Contribution:

(a) Contribution made directly to a Political Party whether in cash or in other form.

(b) Expenditure incurred on printing and distribution of posters and leaflets, either directly concerned or connected with elections or otherwise for a political purpose.

(c) Contribution made directly to a political party whether in cash or in other form for running an educational institution or for undertaking philanthropic activities.

(d) Donation, Contribution, or other form of support to a Trust, Society or Association in any of the under noted circumstances -

If the Trust, Society, or Association has any political objectives either wholly or even partially.

If the Trust, Society, or Association is formed for any political purpose either wholly or even partially.

If the Trustees or Governing Council or Committee of the Trust, Society, Association have the discretion of using the funds wholly or partially for a political purpose or in furtherance of a political objective. On the other hand, the mere fact that some of the objects of a particular Trust, Society, or Association are similar to the objects of a particular political party but are not of a political nature should not act as disqualification.

(e) Expenditure incurred on remuneration (including other benefits) to employees or on other establishment where the services of the employees are made available in connection with the activities of some political party, such as elections to Legislative Assembly, Parliament etc.

(f) Making available vehicles owned by the Company to any political party or to any candidate seeking election to any local authority, assembly, Parliament, etc. either free of cost, or at less than market rate.

(g) Expenditure incurred directly or indirectly by a Company on advertisement in any publication like Souvenir, Brochure, Tract, etc by or on behalf of a Political Party or for its advantage.

(h) Donation, Subscription or payment by a Company to any person which can be regarded as likely to affect public support for a Political Party shall be deemed as contribution for a political purpose.

iii. Disclosure: Every Company should disclose in its P&L Account, the amount contributed by it during the financial year to any political party or for any political purpose, giving the particulars of the name of the recipient party or person.

iv. Auditor's Duties:

(a) The Auditor should qualify his Audit Report under the following circumstances, if he is satisfied - that the political contribution has been made in excess of the limit prescribed. (He should also indicate the amount involved.)

that facts regarding such contributions are not properly disclosed.

(b) If the Auditor is in doubt about applicability of Section 182, he should disclose this fact in his report.

(c) The Auditor should obtain a certificate from the Board stating the following

That all amounts of contributions to Political Parties have been properly recorded;

No amounts of such nature other than those so included in the books have been paid / given directly or indirectly.

(d) The Auditor need not make any special inquiry to unearth cases of unauthorized political contributions if they are not readily apparent from the examination of the accounts made in the normal course of audit.

(e) Where the Auditor fails to discover cases of contraventions of Section 182, he would be responsible only to the extent it can be established that in the conduct of the audit he acted without reasonable is care and skill.

17.15 AUDIT OF CONSOLIDATED FINANCIAL STATEMENTS (CFS)

i. **Parent Company:** The Parent Company (i.e. Holding Company) has the following responsibilities -

(a) Identifying components, and including the financial information of the components to be included in the Consolidated Financial Statements,

(b) Identifying reportable segments for segmental reporting,

(c) Identifying related parties and related party transactions for reporting,

(d) Obtaining accurate and complete financial information from components, and

(e) Making appropriate consolidation adjustments.

ii. **Objective of Audit of CFS:**

(a) To satisfy that the CFS have been prepared as per the requirements of AS - 21, 23 & 27.

(b) To enable the Auditor to express an opinion on the true and fair view presented by the CFS.

iii. **Features of CFS:**

(a) CFS arc prepared using the Separate Financial Statements of the Parent, Subsidiaries, Associates and Joint Ventures and also other financial information, which might not be covered by the Separate Financial Statements of these entities.

(b) The `other financial information' would include disclosures to be made in the CFS about the Subsidiaries, Associates and joint Ventures, proportion of items included in the CFS to which different accounting policies have been applied, adjustments made for the effects of significant transactions or other events that occur between the Financial Statements of Subsidiaries, Associates or Joint Ventures and the Parent, as the case may be, etc.

(c) The Auditor of the CFS has to use the work of other Auditors i.e. the Auditor of Financial Statements of the components, as required under SA 600.

iv. **Verification Procedures:**

Aspect	Auditors' Duties
Completeness	To ensure that all relevant Subsidiaries, Associates and Joint Ventures (JVs) have been included, the Auditor should review the following - • His working papers for the prior years for known Subsidiaries, Associates and JVs, • Parent's procedures for identification of Subsidiaries, Associates and JVs, • Investments made, to determine the shareholding in other entities, • Joint Ventures and other relevant agreements entered into by the Parent, • Statutory records maintained by the Parent, e.g. Registers u/s 190 / 186.
Control	Since control of the composition of the Board of Directors/ Governing Body of an enterprise also results in a Parent-Subsidiary Relationship, the Auditor should examine the minutes of Board Meetings, Shareholder Agreements with entities to which technology or know-how might have been provided, etc.

Aspect	Auditors' Duties
Exclution	• Where a Subsidiary' / Associate / Jointly Controlled Entity is excluded from the CFS, the Auditor should examine the reasons for the exclusion. • If it is argued that the reason for exclusion from consolidation is that the relationship of the entity with the Parent is temporary, the Auditor should examine whether the Parent had the intention to dispose of its interest at the time of making the investment.
Others	The Auditor should - • Examine the relevant law and agreements to identify long-term restrictions prohibiting transfer of funds. • Review whether the procedures and disclosure requirements laid down by the relevant AS have been followed, in preparing the CFS. • Verify that the gross amounts of Goodwill and Capital Reserve have also been disclosed, if such Goodwill arising in respect of one Subsidiary is set-off against Capital Reserve arising in respect of another. • See whether any impairment loss exists in respect of Goodwill arising on consolidation.

v. Permanent Consolidation Adjustments: The Auditor should see whether the following adjustments have been made appropriately -

(a) Capital Reserve / Goodwill: Determination of excess / deficit of the cost to the Parent of its investment in a Subsidiary over the Parent's portion of Equity of the Subsidiary, at the date on which investment in the Subsidiary is made (determination of Goodwill or Capital Reserve).

(b) Minority Interest: Determination of the amount of equity attributable to minorities at the date on which investment in Subsidiary is made.

(c) Associates: Determination of Goodwill or Capital Reserve arising on application of Equity Method to account for investments in Associates in CFS.

vi. Other Verification: The Auditor should review the Memorandum Records to verify the adjustments entries made in the preparation of CFS including the following -

(a) Intra-group interest paid and received, or management fees, etc.

(b) Unrealised intra-group profits on assets acquired from other Subsidiaries.

(c) Intra-group indebtedness.

(d) Adjustments related to harmonising the different accounting policies being followed by the Parent enterprise and its Subsidiaries.

(e) Adjustments made for the effects of significant transactions or other events that occur between the date of the Financial Statements of the Parent and one or more of the components, if the Financial Statements to be used for consolidation arc not drawn up to the same reporting date; and

(f) Determination of movement in equity attributable to the minorities since the date of acquisition of the Subsidiary.

17.16 CORPORATE GOVERNANCE

Applicability of Clause 49

The Clause 49 of the Listing Agreement shall be applicable to all companies whose equity shares are listed on a recognized stock exchange. However, compliance with the provisions of Clause 49 shall not be mandatory, for the time being, in respect of the following class of companies:

a. Companies having paid up equity share capital not exceeding ₹10 crore and Net Worth not exceeding ₹25 crore, as on the last day of the previous financial year;

Provided that where the provisions of Clause 49 becomes applicable to a company at a later date, such company shall comply with the requirements of Clause 49 within six months from the date on which the provisions became applicable to the company.

b. Companies whose equity share capital is listed exclusively on the SME and SME-ITP Platforms.

The company agrees to comply with the provisions of Clause 49 which shall be implemented in a manner so as to achieve the objectives of the principles as mentioned below. In case of any ambiguity, the said provisions shall be interpreted and applied in alignment with the principles.

A. The Rights of Shareholders

The company should seek to protect and facilitate the exercise of shareholders' rights. The company should provide adequate and timely information to shareholders. The company should ensure equitable treatment of all shareholders, including minority and foreign shareholders.

B. Role of stakeholders in Corporate Governance

The company should recognise the rights of stakeholders and encourage cooperation between company and the stakeholders.

C. Disclosure and transparency

The company should ensure timely and accurate disclosure on all material matters including the financial situation, performance, ownership, and governance of the company.

D. Responsibilities of the Board

Members of the Board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the company.

The Board and top management should conduct themselves so as to meet the expectations of operational transparency to stakeholders while at the same time maintaining confidentiality of information in order to foster a culture for good decision-making.

E. Composition of Board

The Board of Directors of the company shall have an optimum combination of executive and non-executive directors with at least one woman director and not less than fifty percent of the Board of Directors comprising non-executive directors.

Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise independent directors and in case the company does not have a regular non-executive Chairman, at least half of the Board should comprise independent directors.

Provided that where the regular non-executive Chairman is a promoter of the company or is related to any promoter or person occupying management positions at the Board level or at one level below the Board, at least one-half of the Board of the company shall consist of independent directors.

F. Independent Directors

For the purpose of the clause A, the expression 'independent director' shall mean a non-executive director, other than a nominee director of the company:

a. who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;

b. (i) who is or was not a promoter of the company or its holding, subsidiary or associate company;

   (ii) who is not related to promoters or directors in the company, its holding, subsidiary or associate company;

c. apart from receiving director's remuneration, has or had no material pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year;

d. none of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to two per cent. or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;

G. Limit on number of directorships

A person shall not serve as an independent director in more than seven listed companies. Further, any person who is serving as a whole time director in any listed company shall serve as an independent director in not more than three listed companies.

H. Maximum tenure of Independent Directors

The maximum tenure of Independent Directors shall be in accordance with the Companies Act, 2013 and clarifications/circulars issued by the Ministry of Corporate Affairs, in this regard, from time to time.

I. Non-executive Directors' compensation and disclosures

All fees / compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of shareholders in general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to non-executive directors, in any financial year and in aggregate.

Provided that the requirement of obtaining prior approval of shareholders in general meeting shall not apply to payment of sitting fees to non-executive directors, if made within the limits prescribed under the Companies Act, 2013 for payment of sitting fees without approval of the Central Government.

Provided further that independent directors shall not be entitled to any stock option.

J. Audit Committee

(i) Qualified and Independent Audit Committee

A qualified and independent audit committee shall be set up, giving the terms of reference subject to the following:

1. The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.
2. All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.
3. The Chairman of the Audit Committee shall be an independent director;
4. The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;
5. The Audit Committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;
6. The Company Secretary shall act as the secretary to the committee.

(ii) Meeting of Audit Committee

The Audit Committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.

(iii) Powers of Audit Committee

The Audit Committee shall have powers, which should include the following:

1. To investigate any activity within its terms of reference.
2. To seek information from any employee.
3. To obtain outside legal or other professional advice.
4. To secure attendance of outsiders with relevant expertise, if it considers necessary.

(iv) Role of Audit Committee

The role of the Audit Committee shall include the following:

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible;
2. Recommendation for appointment, remuneration and terms of appointment of auditors of the company;
3. Approval of payment to statutory auditors for any other services rendered by the statutory auditors;
4. Reviewing, with the management, the annual financial statements and auditor's report thereon before submission to the board for approval, with particular reference to:
    a. Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (c) of sub-section 3 of section 134 of the Companies Act, 2013
    b. Changes, if any, in accounting policies and practices and reasons for the same
    c. Major accounting entries involving estimates based on the exercise of judgment by management
    d. Significant adjustments made in the financial statements arising out of audit findings
    e. Compliance with listing and other legal requirements relating to financial statements
    f. Disclosure of any related party transactions
    g. Qualifications in the draft audit report
5. Reviewing, with the management, the quarterly financial statements before submission to the board for approval;
6. Reviewing, with the management, the statement of uses / application of funds raised through an issue (public issue, rights issue, preferential issue, etc.), the statement of funds utilized for purposes other than those stated in the offer document / prospectus / notice and the report submitted by the monitoring agency monitoring the utilisation of proceeds of a public or rights issue, and making appropriate recommendations to the Board to take up steps in this matter;

K. Nomination and Remuneration Committee

The company through its Board of Directors shall constitute the nomination and remuneration committee which shall comprise at least three directors, all of whom shall be non-executive directors and at least half shall be independent. Chairman of the committee shall be an independent director.

Provided that the chairperson of the company (whether executive or nonexecutive) may be appointed as a member of the Nomination and Remuneration Committee but shall not chair such Committee.

L. Subsidiary Companies

At least one independent director on the Board of Directors of the holding company shall be a director on the Board of Directors of a material non-listed Indian subsidiary company.

The Audit Committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.

The minutes of the Board meetings of the unlisted subsidiary company shall be placed at the Board meeting of the listed holding company. The management should periodically bring to the attention of the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

M. Related Party Transactions

A related party transaction is a transfer of resources, services or obligations between a company and a related party, regardless of whether a price is charged.

For the purpose of Clause 49 (VII), an entity shall be considered as related to the company if:

(i) such entity is a related party under Section 2(76) of the Companies Act, 2013; or

(ii) such entity is a related party under the applicable accounting standards.

N. Disclosures

Disclosure relating to –

A. Related Party Transactions

B. Disclosure of Accounting Treatment

C. Remuneration of Directors

D. Management

E. Shareholders

F. Proceeds from public issues, rights issue, preferential issues, etc.

O. CEO/CFO certification

The CEO or the Managing Director or manager or in their absence, a Whole Time Director appointed in terms of Companies Act, 2013 and the CFO shall certify to the Board that:

(i) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief :

1. these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;

2. these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.

(ii) There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.

(iii) They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of such internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.

(iv) They have indicated to the auditors and the Audit committee:

1. significant changes in internal control over financial reporting during the year;

2. significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and

3. instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system over financial reporting.

P. Report on Corporate Governance

There shall be a separate section on Corporate Governance in the Annual Reports of company, with a detailed compliance report on Corporate Governance. Non- compliance of any mandatory requirement of this clause with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The suggested list of items to be included in this report is given in Annexure - XII to the Listing Agreement and list of non-mandatory requirements is given in Annexure - XIII to the Listing Agreement.

The companies shall submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter as per the format given in Annexure – XI to the Listing Agreement. The report shall be signed either by the Compliance Officer or the Chief Executive Officer of the company.

Q. Compliance

The company shall obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated in this clause and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the annual report filed by the company.

The non-mandatory requirements given in Annexure - XIII to the Listing Agreement may be implemented as per the discretion of the company. However, the disclosures of the compliance with mandatory requirements and adoption (and compliance) / non-adoption of the non-mandatory requirements shall be made in the section on corporate governance of the Annual Report.

17.17 AUDIT CERTIFICATE

Sometimes apart from an audit report for general use, an auditor is often called upon to give a certificate for special purpose. The certificate should include the following: —

i. Auditor should see that there is a suitable declaration by the management about the subject matter.

ii. Auditor should give the certificate on his letter head or on stationary carrying his name and address to avoid misunderstanding.

iii. Auditor should clearly state his limitations and indicate the extent to which he has relied upon a technical expert if any.

iv. Auditor should indicate the specific record covered by the certificate.

v. Auditor should mention the manner in which the audit was conducted.

vi. Auditor should indicate in the certificate if he has made certain fundamental assumptions. Auditor should make a reference to the information and explanations obtained. Auditor should give clear title to it, indicating whether it is a report or a certificate.

vii. Auditor should mention whether he has used any general purpose statement like Profit & Loss Account for his investigation and also, state whether that general purpose statement has been audited by other auditors.

viii. Auditor should be careful while interpreting any law related matter, he should clearly mention that he is expressing merely his own opinion.

ix. Auditor should see that the certificate should be self contained documents. Auditor should clearly mention the responsibility assumed by him.

x. Auditor should, if he has referred the audited statements, clearly mention that the figures are used from the audited statements and relied upon.

xi. Auditor should address the certificate to the client or the Public Authority or the person requiring it as the case may be. In appropriate circumstances it may be issued by using the words as "to whom so ever it may concern".

Examples and Specimens of Auditor Certificates—

There are many more circumstance, where for, auditor is called for issuing a certificate, e.g.,

(i) "Deposits Return" Certificate.

(ii) "Ability to Refund Depositors" Certificate.

(i) Deposits Return Certificate: As provided under rule 10(1)of the Companies(Acceptance of Deposits), Rules , a non banking, non financial company has to file periodical return in prescribed form containing the information about deposits accepted and the copy of the return is required to be filed with the R.B.I. This return is to be certified by the Company Auditor.

The specimen of the Certificate may be as under:

CERTIFICATE

We certify that to the best of our knowledge and according to the information and explanation given to us and as shown by the records examined by us, the figures of deposits and interest rates under parts A, B and C of the return of the ……………… Co. Ltd. are correct.

We further certify the correctness of the particulars of the paid up capital and free reserves etc. given in the manager's certificate.

Signature & Seal of

Date: Chartered Accountant /Cost Accountant

Place: Full Address

(ii) Ability to Refund Deposits Certificate: As per the provisions of the Non Banking Financial Companies(Reserve Bank)Directions, issued from time to time every non banking financial company is required to furnish to the RBI a certificate from its auditor to the effect that, the full liabilities to the depositor of the company including interest are properly reflected in the Balance Sheet and that the company is in a position to meet the amount of such liability to the depositors. As prescribed by the RBI, the certificate shall be in following format—

CERTIFICATE

We certify that, on the basis of the checks carried out by us and the information and explanations given to us , I am of the opinion that full liabilities to the depositors of the company including interest payable thereon have been reflected in the financial statements as on 31st March of the company, as per the said financial statements and on a going concern basis and based on information and explanation given to me, is in a position to meet the liabilities to the depositors, as on that date.

Also, an auditor is required to give certificate under various provisions of the Companies Act 2013, for example, u/s 26 for matters in the prospectus, U/s 73 for public deposits, etc.

In short, Audit Certificate is a written confirmation of the accuracy of the information stated therein but does not involve any opinion.

Signature & Seal of

Date: Chartered Accountant /Cost Accountant

Place: Full Address

Difference between Audit Report and Audit Certificate

(i) Meaning: Audit Report is a statement of collected and considered information so as to give a clear picture of the state of affairs of the business to the persons who are not in possession of the full facts. While Audit Certificate is a written confirmation of the accuracy of the information stated there in.

(ii) Opinion: Audit Report contains the opinion of the auditor on the accounts, while Audit Certificate does not contain any opinion but only confirms the accuracy of the figures with the books of accounts.

(iii) Basis: Audit Report is made out on the basis of information obtained & books of account verified by the auditor, while Audit Certificate is made out on the basis of the particular data capable of verification as regards accuracy.

(iv) Guarantee: Audit Report may not guarantee correctness of financial statement in absolute terms, while Audit Certificate guarantees absolute correctness of the figures & information mentioned in the certificate.

(v) Coverage: Audit Report always covers entire accounts of the concern, while Audit Certificate covers only certain part of the accounts of the concern.

(vi) Responsibility: Audit Report does not hold auditor responsible for anything wrong in the accounts, while Audit Certificate makes an auditor responsible if anything mentioned in the certificate found as wrong later on.

(vii) Suggestion: Audit Report may provide certain suggestions for improvement while Audit certificate does not provide any such suggestion.

(viii) Nature: Audit Report is based on the vouching & verification of books of accounts, voucher, assets & liabilities, while Audit Certificate is based on checking arithmetical accuracy of the facts.

(ix) Scope: Audit Report covers all transactions done during the year, while the Audit Certificate is very specific.

(x) Characteristics: Audit Report is subjective as it is opinion oriented, while Audit certificate is objective as it is fact oriented.

(xi) Form: Audit Report is required to be presented in the prescribed format, while Audit Certificate, except in few cases, is not required to be presented in any standard format.

(xii) Address: Audit report is addressed to the members of the company at large or appointing authority, while Audit Certificate is addressed to particular person or sometimes may include the words like "To Whomsoever it may concern".

Audit report versus Audit certificate

i. Audit report is an expression of opinion on the truth and fairness of the accounts.

ii. Audit certificate is authentication of true and correctness of the data or fact certified.

iii. The existence of opinion distinguishes a report from the certificate.

iv. The example of audit report is report issued by statutory auditor of a company under Section 143 of the Companies Act, 2013.

v. The example for audit certificate is certification of consumption of imported items to be submitted to the government department for obtaining some license etc.

Study Note - 18

STANDARDS ON AUDITING (SA)

This Study Note includes

18.1 International Resources to Auditing needs
18.2 India's Response to Auditing needs
18.3 Rationale of Auditing Standards
18.4 Auditing Standards–Setting in India
18.5 International Harmonisation of Auditing Standards
18.6 Compliance with Auditing Standards
18.7 The Objectives and Functions of the Auditing and Assurance Standard Board (AASB)
18.8 Standards Issued by Auditing and Assurance Standard Board under the Authority of the Council
18.9 New/Revised Standards Issued under the Clarity Project
18.10 Comparative Statement of AS & IND AS
18.11 Standard on Auditing

Introduction

As the trade and commerce grew extensively globally, the involvement of public money therein also increased manifolds. This in turn created a demand from the investors to have the accounts of the business ventures examined by a person independent of the owners and management of the business to ensure that they were correct and reliable. Such a demand laid down the foundation for the profession of auditing. The extent of reliance placed by the public on the auditors has increased so much with time that it is, unreasonably of course, felt by the public that nothing can go wrong with an organisation which has been audited. Though the fact that an audit has been carried out is not a guarantee as to the future viability of an enterprise, it is extremely important that the auditors carry out their assignments with utmost professional care and sincerity, to uphold the faith posed by the public in them.

18.1 INTERNATIONAL RESOURCES TO AUDITING NEEDS

As a response to the above needs, the International Federation of Accountants (IFAC) was established in 1973 with the objective of "worldwide development and enhancement of the accountancy profession……. of high quality in the public interest". The International Auditing and Assurance Standards Board (IAASB), earlier known as the International Auditing Practices Committee, of the IFAC was established to "improve the quality and uniformity of practice throughout the world", by, inter alia, issuing International Standards on Auditing (ISAs) and guidance on the application of the ISAs.

18.2 INDIA'S RESPONSE TO AUDITING NEEDS

The Institute of Chartered Accountants of India was set up in 1949 to regulate the profession of chartered accountancy in India. Since its establishment, the Institute has taken numerous steps to ensure that its members discharge their duties with due professional care, competence and sincerity. One of the steps is the establishment of the Auditing Practices Committee, or the Auditing and Assurance Standards Board, as it is now known in September, 1982.

One of the main objectives of the Board is to issue auditing standards. Accordingly, the Board issues Statements on Standard Auditing Practices and Auditing and assurance Standards under the authority of the Council.

18.3 RATIONALE OF AUDITING STANDARDS

In simplest possible terms, auditing standards represent a codification of the best practices of the profession, which are already existing. Auditing standards help the members in proper and optimum discharge of their profession duties. Auditing standards also promote uniformity in practice as also comparability.

18.4 AUDITING STANDARDS–SETTING IN INDIA

As mentioned earlier, the Auditing and Assurance Standards Board of the Institute formulates the auditing standards. Broadly, following is the procedure for formulating auditing standards:

i.. The Auditing and Assurance Standards Board identifies the areas where auditing standards need to be formulated and the priority in regard to their selection.

ii. In the preparation of the auditing standards, the Board is normally, assisted by study groups comprising of a cross section of members of the Institute.

iii. On the basis of the work of the study groups, an Exposure Draft of the proposed auditing standard is prepared by the Board and issued for comments of the members.

iv. After taking into the comments received, the draft of the proposed auditing standard is finalised by the Board and submitted to the Council of the Institute.

v. The Council considers the final draft of the proposed auditing standard and, if necessary, modifies the same in consultation with the Board. The auditing standard is then issued under the authority of the Council.

While formulating the auditing standards, the Board also takes into consideration the applicable laws, customs, usages and business environment in the country.

18.5 INTERNATIONAL HARMONISATION OF AUDITING STANDARDS

The Institute of Chartered Accountants of India is a member of the International Federation of Accountants. Therefore, as a matter of policy, the auditing standards issued by the ICAI are in harmony with the International Standards on Auditing. Till date, the IAASB of the IFAC has issued thirty nine Engagement Standards, comprising one Standard on Quality control (ISQC), thirty two ISAs, two International Standards on Review Engagements (ISREs), two International Standards on Assurance Engagements (ISAEs) and two International Standards on Related Services (ISRSs). The ICAI has issued thirty five auditing standards corresponding to the Engagement Standards issued by the IAASB of the IFAC and three auditing standards are in the pipeline.

Further, the Council of the Institute of Chartered Accountants of India has also approved the following technical drafts:

i. Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services

ii. Due Process of the Auditing and Assurance Standards Board

iii. Revised Classification and Numbering Pattern of the Auditing and Assurance Standards

iv. Framework for Assurance Engagements

18.6 COMPLIANCE WITH AUDITING STANDARDS

While discharging their attest functions, it is the duty of the members of the Institute to ensure that the auditing standards are followed in the audit of financial information covered by their audit reports. If for any reason the member is unable to perform an audit in accordance with the generally accepted auditing standards, his report should draw attention to any material departures therefrom, failing which he would be held guilty of professional misconduct under clause 9 of Part 1 of the Second Schedule to the Chartered Accountants Act, 1949.

With the formation of the Auditing Practices Committee (now known as the Auditing and Assurance Standards Board) in 1982, the Council of the Institute has been issuing a series of Statements on Standard Auditing Practices (SAPs). SAPs have been renamed as Auditing and Assurance Standards (AASs). The Auditing and Assurance Standards (hitherto known as SAPs) lay down the principles of governing an audit. These principles apply whenever an independent audit is carried out.

w.e.f. 01.04.2008

Standards on

- **Quality Control (SQC) (1-99)**
- **Auditingg (SA) (100-899)**
- **Review Engagement (SRE) (2000-2699)**
- **Assurance Engagement (SAE) (3000-3699)**
- **Related Services (SRS) (4000-4699)**

18.7 THE OBJECTIVES AND FUNCTIONS OF THE AUDITING AND ASSURANCE STANDARD BOARD (AASB)

i. To review the existing and emerging auditing practices worldwide.

ii. To formulate Engagement Standards, Standards on Quality Control and Statement on Auditing.

iii. To review and revise the existing Standards and Statements on Auditing.

iv. To develop Guidance Notes on issues arising out of any Standard, auditing issues pertaining to any specific industry and revise.

v. To review and revise the existing Guidance Notes.

vi. To formulate General Clarifications, where necessary, on issues arising from Standards.

vii. To formulate and issue Technical Guides, Practice Manuals, Studies and other papers.

18.8 STANDARDS ISSUED BY AUDITING AND ASSURANCE STANDARD BOARD UNDER THE AUTHORITY OF THE COUNCIL

A. Engagement Standards:

(a) Standards on Auditing (SAs), to be applied in the audit of historical financial information.

(b) Standards on Review Engagements (SREs), to be applied in the review of historical financial information.

(c) Standards on Assurance Engagements (SAEs), to be applied in the assurance engagements, other than historical financial information.

(d) Standards on Related Services (SRSs), to be applied to engagements involving application of agreed upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

B. Quality Control standards:

Standards on Quality Control (SQCs), issued by the AASB under the authority of the Council, are to be applied for all services covered by the Engagements Standards as described above.

Illustration 1:

Mr. T. auditor of SAU Ltd. is of the opinion that "Standards on Auditing" are meant only for references and it is not necessary to follow such Standards on Auditing.

Answer:

Contention of Mr. T is totally wrong and is against the fundamental assumptions and guidelines governing auditing and assurance standards.

As per ICAI, while discharging their attest function, it will be the duty of the members of the Institute to ensure that the SAs are followed. The SAs will apply whenever an independent financial audit is carried out to express an opinion thereon.

The member of the Institute must follow the SAs. The auditors must draw attention to the material departures from SA in their audit report along with the reasons for such departure.

Auditors in their report have to mention that audit was conducted in accordance with "Generally accepted auditing standards" in Indian context.

Hence Mr. 'T' is duty bound to follow the SAs.

Illustration 2:

What is the purpose of audit?

Answer:

The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

Illustration 3:

Who are the intended users of the Financial Statement?

Answer:

The intended users of the financial statement are

i. Existing and prospective shareholder of the company,

ii. Preference shareholder of the company,

iii. Debenture holder of the company,

iv. Banker's of the company,

v. Debtor's of the company,

vi. Creditor's of the company,

vii. Government authorities- I.Tax, IDT, ROC, Ministry of corporate affairs

viii. Lender's of the company,

ix. Other authorities.

18.9 NEW/REVISED STANDARDS ISSUED UNDER THE CLARITY PROJECT

100-199	Introductory Matters
200-299	General Principles and Responsibilities: **SA 200 (Revised)** issued under the clarity project, "Overall objectives of the Independent Auditor and the conduct of an Audit in accordance with Standards on Auditing" **SA 210 (Revised)** under the clarity project, "agreeing the terms of Audit Engagements" **SA 220 (Revised)** issued under the clarity project, "Quality Control for an audit of Financial Statements" **SA 230 (Revised)** under the clarity project, "Audit Documentation" **SA 240 (Revised)** under the clarity project, "The Auditor's Responsibilities Relating to Fraud, in an Audit of Financial Statements" **SA 250 (Revised)** under the clarity project, "Consideration of Laws and Regulations in an Audit of Financial Statements" **SA 260 (Revised)** under the clarity project, "Communication with Those Charged with Governance" **SA 265** issued under the clarity project, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management" **SA 299 (AAS 12),** "Responsibility of Joint Auditors"
300-499	Risk Assessment and Response to Assessed Risks **SA 300 (Revised)** under the Clarity Project, "Planning an Audit of Financial Statements" **SA 310** under the project, 'Knowledge of the Business" **SA 315** under the Clarity Project, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment" **SA 320 (Revised)** issued under the Clarity Project, "Materiality in Planning and Performing an Audit" **SA 330** under the Clarity Project, "The Auditor's Responses to Assessed Risks" **SA 402 (Revised)** issued under the Clarity Project, "Audit Considerations Relating to an Entity Using a Service Organisation" **SA 450** issued under the Clarity Project, "Evaluation of Misstatements Identified During the Audit"
500-599	**Audit Evidence** **SA 500 (Revised)** under the Clarity Project, "Audit Evidence" **SA 501 (Revised)** issued under the Clarity Project, "Audit Evidence—Specific Considerations for Selected Items" **SA 505 (Revised)** issued under the Clarity Project, "External Confirmations" **SA 510 (Revised)** under the Clarity Project, "Initial Audit Engagements—Opening Balances" **SA 520 (Revised)** issued under the Clarity Project, "Analytical Procedures" **SA 530 (Revised)** under the Clarity Project, "Audit Sampling" **SA 540 (Revised)** under the Clarity Project, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures" **SA 550 (Revised)** under the Clarity Project, "Related Parties" **SA 560 (Revised)** under the Clarity Project, "Subsequent Events" **SA 570 (Revised)** under the Clarity Project, "Going Concern" **SA 580 (Revised)** under the Clarity Project, "Written Representations"

600-699	Using Work of Others **SA 600 (AAS 10),** "Using the Work of Another Auditor" **SA 610 (Revised)** issued under the Clarity Project, "Using the Work of Internal Auditors" **SA 620 (Revised)** issued under the Clarity Project, "Using the Work of an Auditor's Expert"
700-799	Audit Conclusions and Reporting **SA 700 (Revised)** issued under the Clarity Project, "Forming an Opinion and Reporting on Financial Statements" **SA 705** issued under the Clarity Project, "Modifications to the Opinion in the Independent Auditor's Report" **SA 706** issued under the Clarity Project, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" **SA 710 (Revised)** issued under the Clarity Project, "Comparative Information— Corresponding Figures and Comparative Financial Statements" **SA 720** under the Clarity Project, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements"
800-899	Specialized Areas **SA 800** issued under the Clarity Project, "Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks" **SA 805** issued under the Clarity Project, "Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement" **SA 810** issued under the Clarity Project, "Engagements To Report on Summary Financial Statements"
2000-2699	Standards on Review Engagements **SRE 2400 (Revised),** "Engagements to Review Financial Statements" **SRE 2410,** "Review of interim Financial Information Performed by the Independent Auditor of the Entity".

18.10 COMPARATIVE STATEMENT OF AS & IND AS

SL. No.	Accounting Standards (AS)	IND AS	Name of IND AS
			Standards on Presentation
1	AS 1	Ind AS 1	Presentation of Financial Statements
2	AS 3	Ind AS 7	Statement of Cash Flows
3	AS 5	Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
4	AS 4	Ind AS 10	Events after the Reporting Period
5	AS 25	Ind AS 34	Interim Financial Reporting
6	**No Corresponding Standard**	Ind AS 29	Financial Reporting in Hyperinflationary Economies
			Standards on Consolidation
7	AS 21	Ind AS 27	Consolidated and Separate Financial Statements
8	AS 23	Ind AS 28	Investments in Associates
9	AS 27	Ind AS 31	Interests in Joint Ventures
10	AS 14	Ind AS 103	Business Combinations
			Standards on Revenue
11	AS 2	Ind AS 2	Inventories
12	AS 7	Ind AS 11	Construction Contracts

SL. No.	Accounting Standards (AS)	IND AS	Name of IND AS
13	AS 9	Ind AS 18	Revenue
14	AS 12	Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
15	AS 11	Ind AS 21	The Effects of Changes in Foreign Exchange Rates
Standards on Liabilities and Provisions			
16	AS 15	Ind AS 19	Employee Benefits
17	AS 29	Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
18	GN	Ind AS 102	Share-based Payment
19	**No Corresponding Standard**	Ind AS 104	Insurance Contracts
Standards on Disclosures			
20	AS 18	Ind AS 24	Related Party Disclosures
21	AS 20	Ind AS 33	Earnings Per Shares
22	AS 17	Ind AS 108	Operating Segments
			Standards on Assets
23	AS 16	Ind AS 23	Borrowing Costs
24	AS 28	Ind AS 36	Impairments of Assets
25	AS 26	Ind AS 38	Intangible Assets
26	**No Corresponding Standard**	Ind AS 40	Investment Property
27	AS 10 & AS 6	Ind AS 16	Property, Plant and Equipment
28	AS 19	Ind AS 17	Leases
29	AS 24	Ind AS 105	Non-Current Assets Held for Sale and Discontinued Operations
30	GN	Ind AS 106	Exploration for and Evaluation of mineral Resources
Standards on Taxes			
31	AS 22	Ind AS 12	Income Taxes
Standards on Financial Instruments			
32	AS 31	Ind AS 32	Financial Instruments: Presentation
33	AS 30	Ind AS 39	Financial Instruments: Recognition and Measurement
34	AS 32	Ind AS 107	Financial Instruments: Disclosures
Standards on First Time Adoption			
35	**No Corresponding Standard**	Ind AS 101	First Time Adoption of Ind AS

18.11 STANDARD ON AUDITING

The Standards on Auditing are explained below in details:

18.11.1 SA 200 (Revised) — Overall objectives of the Independent Auditor and the conduct of an Audit in accordance with Standards on Auditing:

(A) Effective Date (Para 10): Audit of financial statements for periods beginning on or after 1st April,2010.

(B) Overall Objectives of the Auditor:

1. In conducting an audit of financial statements, the overall objectives of the auditor are:
   (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

   (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

2. In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the SAs require that the auditor disclaim an opinion or withdraw from the engagement, where withdrawal is legally permitted.

(C) Scope:

1. This Standard on Auditing (SA) establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs. Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the SAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the SAs. The independent auditor is referred to as "the auditor" hereafter.

2. SAs are written in the context of an audit of financial statements by an auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

   An Audit of Financial Statements:

3. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion. (Ref: Para. A1)

   [Para **A1** says that the auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. In some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.]

4. The financial statements subject to audit are those of the entity, prepared and presented by management of the entity with oversight from those charged with governance. SAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of those responsibilities. **(Ref: Para. A2-A11)**

5. As the basis for the auditor's opinion, SAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. **(Ref: Para. A28-A52)**

6. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both. The auditor's opinion deals with the financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.

7. The SAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The SAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:

   - Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
   - Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
   - Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

8. The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable laws or regulations. (Ref: Para. A12-A13) [Para12 & 13 describe below:

   A12. The opinion expressed by the auditor is on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The form of the auditor's opinion, however, will depend upon the applicable financial reporting framework and any applicable laws or regulations. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, preparation of the financial statements in accordance with the applicable financial reporting framework includes presentation.

   A13. Where the financial reporting framework is a fair presentation framework, as is generally the case for general purpose financial statements, the opinion required by the SAs is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view. Where the financial reporting framework is a compliance framework, the opinion required is on whether the financial statements are prepared, in all material respects, in accordance with the framework. Unless specifically stated otherwise, references in the SAs to the auditor's opinion cover both forms of opinion.]

9. The auditor may also have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, in relation to matters arising from the audit. These may be established by the SAs or by applicable laws or regulations.

Illustration 1:

Discuss the Basic Principles Governing an Audit (Or) what are the Basic Principles Governing an Audit as laid down is SA200?

Answer:

In conducting an audit of financial statements, the basic principles for governing an Audit is laid down below:

(a) The Auditor should obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and thereby enabling him to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework;

(b) The Auditor is liable to report on the financial statements, and communicate this to the management and where appropriate Those Charged with Governance, as required by the SAs, in accordance with the auditor's findings and opinion.

(c) The Auditor is required to obtain sufficient appropriate audit evidence about whether material misstatements exists, through designing and implementing appropriate responses to the assessed risks.

(d) When reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the SAs require that the auditor should disclaim an opinion or withdraw from the engagement, where withdrawal is legally permitted.

Illustration 2:

What are the objectives of audit?

Answer:

The objective of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the giving of an opinion by the auditor on whether the financial statements are prepared and presented, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion.

The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. In some cases, however, the applicable laws and regulations may require auditors to express opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. The Auditor shall have an understanding of the entire text of an SA, including its Application and other Explanatory Material, to understand its objectives and to apply its requirements properly.

The financial statements subject to audit are those of the entity, prepared and presented by management of the entity with oversight from those charged with governance. SAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of those responsibilities.

The mandates for audits of the financial statements of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of such an entity is conducted may include additional responsibilities, such as, the responsibility for the execution of transactions and events in accordance with legislation or proper authority.

Illustration 3:

"An Auditor is responsible for expressing opinion on financial statements in statutory Audit." — Discuss,

Answer:

The SAs require that the Auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of an Audit and among other things. By applying these skills and judgment, the auditor express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework.

An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion. It is a duty of an Auditor to form an opinion on the Financial Statements based on conclusions drawn from the audit evidence obtained. The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable laws or regulations. The auditor may also have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, in relation to matters arising from the audit. These may be established by the SAs or by applicable laws or regulations.

The opinion expressed by the auditor is on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The form of the auditor's opinion, however, will depend upon the applicable financial reporting framework and any applicable laws or regulations. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, preparation of the financial statements in accordance with the applicable financial reporting framework includes presentation.

Where the financial reporting framework is a fair presentation framework, as is generally the case for general purpose financial statements, the opinion required by the SAs is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view. Where the financial reporting framework is a compliance framework, the opinion required is on whether the financial statements are prepared, in all material respects, in accordance with the framework. Unless specifically stated otherwise, references in the SAs to the auditor's opinion cover both forms of opinion.

Illustration 4:

"The audit of financial statements relieves management of its responsibilities". Comment.

Answer: The financial statements subject to audit are those of the entity, prepared and presented by management of the entity with oversight from those charged with governance. SAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of those responsibilities.

An audit in accordance with SAs is conducted on the premise that management and, where appropriate, those harged with governance have responsibility:

(a) For the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and

(b) To provide the auditor with:

  (i) All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;

  (ii) Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and

  (iii) Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

As part of their responsibility for the preparation and presentation of the financial statements, management and, where appropriate, those charged with governance are responsible for:

- The identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.
- The preparation and presentation of the financial statements in accordance with that framework.
- An adequate description of that framework in the financial statements.

The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

Because of the significance of the premise to the conduct of an audit, the auditor is required to obtain agreement from management and, where appropriate, those charged with governance that they acknowledge and understand their responsibilities as a precondition for accepting the audit engagement. The auditor is also required to obtain written representations about whether management and, where appropriate, those charged with governance have fulfilled those responsibilities.

Illustration 5:

"Some material misstatements remain unreported by Auditors" — Comment.

Answer:

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements1. In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both. The auditor's opinion deals with the financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.

Risk of material misstatement – The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

(i) **Inherent risk –** The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

(ii) **Control risk –** The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Illustration 6:

Audit Opinion is not an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise — Comment.

Answer:

The auditor's opinion does not assure, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. The reason for this statement is that the auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. In some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

Illustration 7:

As an auditor of Escape Ltd. you have asked your audit assistant to draw the audit programme. The assistant drew up the audit programme without going through the monthly report of the Internal Auditor on the plea that he is a Chartered Accountant and have found no serious irregularities and internal control system is running perfectly.

Answer:

The contention of the audit assistant is not valid and contrary to the view and guidelines given in (SA 200).

As per (SA 200), the basic principles governing an audit are integrity, objectivity and independence. Objectivity implies that auditor's opinion should be based on facts and evidences collected through audit procedure.

Skill and competence also requires an auditor to exercise due professional care in performing the audit.

The SA also requires auditor to rely on internal control only after studying and evaluating them.

In the instant case all those basic principles have not been followed by the auditor.

Reliance based on position of the person and blindly accepting the soundness of the internal control violates the basic principles.

Only by evaluation the auditor will know whether the internal audit and related internal control is effective or not.

Illustration 8:

Explain in brief the different types of Risk (i) Inherent Risk (ii) Control Risk & (iii) Detection Risk.

Answer:

(i) Inherent Risk: The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

(ii) Control Risk: The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

(iii) Detection Risk: The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Illustration 9:

What is meant by Reasonable assurance?

Answer:

As the basis for the auditor's opinion, SAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

Illustration 10:

Whether an Auditor opinion in a financial statement is persuasive or a conclusive in nature.

Answer:

Auditors opinion in a financial statement is persuasive and not a conclusive in nature. In the financial statement, auditors gives their conclusion but based on that conclusion, user of the financial statement can't conclude the future viability of the Company or firm and took a decision on the basis of that opinion.

Illustration 11:

Who is responsible for preparation and presentation of financial statements?

Answer:

The Management and where appropriate those charged with Governance are responsible for preparation and presentation of financial statement. An audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibility:

(a) For the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and

(b) To provide the auditor with:

  (i) All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;

  (ii) Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and

  (iii) Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

18.11.2 SA 210 — Agreeing the terms of Audit Engagements:

Effective Date (Para 2): Audit of financial statements for periods beginning on or after 1st April, 2010.

Auditor's Objectives (Para 3): To accept or continue an Audit Engagement only when the basis based on which it is to be performed has been agreed, through —

(a) Establishing whether the pre-conditions for an audit are present, and

(b) Confirming that there is a common understanding between the auditor and the management (and applicable, Those Charged with Governance), of the terms of Audit Engagement.

Scope (Para 1):

This SA deals with the auditor's responsibilities in agreeing the terms of the Audit Engagement with Management and Those Charged with Governance, are present.

It includes establishing the certain pre-conditions for conducting an audit, responsibility for which rest with Management and Those Charged with Governance, are present.

18.11.3 SA 220 — Quality Control for an audit of Financial Statements:

Effective Date (Para 5): Audit of financial statements for periods beginning on or after 1st April,2010

Auditor's Objectives (Para 6): To implement quality control procedures at the engagement level, that give the Auditor with reasonable assurance which —

(a) The audit compiles with Professional Standards, and Regulatory and legal requirements

In these circumstances, the Auditor's Report which issued is appropriate.

Scope (Para 1):

1. This standard deals with specific duties of Auditor about the Quality Control Procedures for an audit of Financial Statements.
2. It also states the responsibilities of the Engagement Quality Control Reviewer.
3. This SA is to be read with relevant Ethical Requirements.

Illustration 1:

What are the duties at firm level vis a vis quality control?

Answer: Quality control systems, policies and procedures are the responsibility of the audit firm. Under SQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

(a) The firm and its personnel comply with professional standards and regulatory and legal requirements; and

(b) The reports issued by the firm or engagement partners are appropriate in the circumstances.

(c) This SA is premised on the basis that the firm is subject to SQC 1.

[SQC 1 deals with the firm's responsibilities to establish and maintain its system of quality control for audit engagements. The system of quality control includes policies and procedures that address each of the following elements:

- Leadership responsibilities for quality within the firm;
- Relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance; and
- Monitoring.]

Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence.

Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise.

Illustration 2:

List the Objectives of quality control procedures to be adopted by an audit firm.

Answer:

The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

(a) The audit complies with professional standards and regulatory and legal requirements; and

(b) The auditor's report issued is appropriate in the circumstances.

Illustration 3:

List the quality control procedures to be adopted at the individual audit level.

Answer:

The procedures of quality control are the responsibility of the audit firm. The firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance.

The system of quality control includes procedures that address each of the following elements:

- Leadership responsibilities for quality within the firm;
- Relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance; and
- Monitoring.

Illustration 4:

Mr. Black, Partner of Black & Co, Chartered Accounts died of a heart attack an 30th March, after completing the entire routing audit work of T Ltd. Mr. Lal, one of the partners of the firm therefore signed the accounts of T Ltd, without reviewing the finalization work done by the assistants. State your views with reasons.

Answer:

SA 200 "Work Performed by others" as one of the basic principles. The following principles are laid down:

a. When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information.

b. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied.

c. The auditor should carefully direct, supervise and review work delegated to assistants.

Aspects of Review: The auditor is responsible for forming and expressing his opinion on the financial statements. He should review the work performed by each assistant on the following aspects:

a. Audit Programme: Whether the work has been performed in accordance with the audit programme,

b. Documentation: Whether the work performed and the results obtained have been adequately documented,

c. Audit queries: Whether all significant audit matters have been resolved or are reflected in audit conclusions,

d. Audit procedures: Whether the objectives of the audit procedures have been achieved, and

e. Audit Opinion: Whether the conclusions expressed are consistent with the results of the work performed and support the audit opinion.

Analysis: In the present case, whether Mr. Black, the deceased partner had reviewed the work performed by assistants or not, is not clearly stated. Hence, it shall be the duty of Mr. Lal, to review the work performed by the assistants before expressing his opinion. Mr. Lal should review the working papers carefully, carry test checks and scrutinize the audit file thoroughly.

Illustration 5:

Write short notes on "Supervision of Audit work".

Answer:

Supervision of Audit work: AAS-17 on quality control for audit work requires that personnel carrying out the supervisory responsibility should perform the following functions during the audit:

(i) Monitor the progress of the audit to consider whether the assistants have the necessary skills and competence, understanding of the audit directions and are discharging their work as per audit programme,

(ii) Collect and address significant audit questions raised during the audit and based on their significance modifying the overall audit plan and programme and

(iii) Resolve any difference of professional judgment with appropriate consultation.

18.11.4 SA 230 — Audit Documentation:

Effective Date (Para 4): Audit of financial statements for periods beginning on or after 1st April,2009.

Auditor's Objectives (Para 5): To prepare documentation which provides—

(a) A sufficient and appropriate record of the basis for the Auditor's Report, and

(b) Evidence that the audit was planned and done in accordance with SAs and applicable legal and regulatory requirements.

Scope (Para 1):

1. This SA deals with the Auditor's responsibility to prepare Audit Documentation for an audit of Financial Statements. It is to be implemented as may be necessary in case of audits of other historical financial information.

2. Over and above the specific requirements of SA 230, additional documentation requirements may be established by—(a) other SAs and (b) Laws and Regulations.

Illustration 1:

What are audit working papers? Why should they be carefully preserved by the auditor?

Answer: Audit Working Papers: These refer to the documents prepared or obtained by the Auditor and retained by him in connection with the performance of his audit. Working papers should have the following features:

1. **Record of plan:** working papers should record the following:
   - Audit plan
   - Nature, timing and extent of auditing procedures performed
   - Conclusions drawn from the evidence obtained.
2. **Proper design and Organisation:**
   - Working papers should have design and properly organized to meet the condition of each audit and the Auditor's requirement in respect thereof.
   - Standardization of working papers improves the efficiency with which they are prepared and reviewed.
3. **Completeness:** it should be carefully completed and detailed for an Auditor to obtain an overall understanding of audit. The extent of documentation is based on Auditor's judgment. It is neither necessary nor practical that the Auditor should content very observation, consideration or conclusions in his working papers.
4. **Significance:** All significant matters which require the exercise of judgment together with auditor's conclusion thereon should be included in the working papers.
5. **Evidence furnished by client:** to improve the audit efficiency, the auditor generally obtains and utilizes schedules, analyses and other working papers prepared by the client. In such case, the auditor the auditor should satisfy himself that these working papers have been properly prepared.
6. **Classification:** working paper files may be classified as — (a) Permanent Audit Files, which are updated currently with information of continuing importance to succeeding audits and (b) Current Audit Files, which contain information relating primarily to the audit of a single period.

Firms to establish policies and procedures for the retention of engagement documentation.14 The retention period for audit engagements ordinarily is no shorter than ten years from the date of the auditor's report, or, if later, the date of the group auditor's report.

The Auditor need not to include in audit documentation the superceded drafts of Working Papers and Financial Statements, Notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

Illustration 2:

M/s Health Zone, a Partnership firm running a Nursing Home, has decided to discontinue you as an auditor for the next year, and requests you to handover all the relevant working papers of the previous years. Comment.

(Or)

Discuss the concept of "Lien on Working papers".

Answer:

1. **Auditor's Lien on own Working Papers:** Lien arises only in case of other person's property. Hence, the question of lien on the Working Papers does not arise since they belong to the Auditor.
2. **Client's Access to Working Papers:**

   (a) Requirement under CA Act, 1949: Under the Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he discloses information acquired in the course of his professional engagement to any person other than his Client, without the consent of his Client or otherwise than as required by any law for the time being in force.

(b) Auditors' Position:

- Unless otherwise specified by law or regulation, Audit Documentation is the property of the Auditor.
- He may at his discretion, make portions of, or extracts from, audit documentation available to Clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the Auditor or his personnel.

3. Principal Auditor's Access to Branch Auditor's Working Papers:

(a) The Statutory Auditor has to consider the report of the Branch Auditor and has a right to seek clarifications and I or to visit the Branch if he deems it necessary to do so for the performance of the duties as Auditor. The Statutory Auditor's right of access to Branch Records does not automatically extend to the Branch Auditor's Working Papers.

(b) As per SA - 600, when considered necessary, the Principal Auditor may require the Branch Auditor to answer a detailed questionnaire regarding matters on which information is required. The Branch Auditor should respond to such questionnaire. The Branch Auditor, knowing the context in which his work is to be used by the Principal Auditor, should co-ordinate with him and assists him actively.

(c) As per ICAI's Guidance Note on Auditors' Duties when Clients 1 Other Auditors seek access to his Working Papers, the Main Auditors of an enterprise do not have the right of access to the Audit Working Papers of the Branch Auditors.

(d) Hence, there is no specific requirement for the Branch Auditor to make available the photocopy of his Working Papers to the Company's Statutory Auditor.

Illustration 3. A CA Firm, Established in 1958 were the Auditors of a PSU for the Years 1984-85, 1985-86and 1986-87. They were also auditors of a few nationalized bank branches and insurance offices. They are still keeping audit working papers/files for all these years. Suggest whether there is any guideline/law or rules regarding the period for which the audit working files should be kept? Is it also relevant for other audits (i.e. Private limited companies, partnership firms, Trusts etc.)?

Answer:

(a) AAS 3/SA230: The auditor is required to retain his working papers for a period of time sufficient to:

i. Meet the needs of his practice, and

ii. Satisfy any pertinent legal or professional requirements of record retention.

b. ICAI's View: The ICAI has recommended that an auditor should maintain his records relating to audit and other work done including routine correspondence and other papers for a minimum period of 10 years.

c. Effect of pending proceedings: The limit of 10 years is only the minimum period if there are no legal or professional proceedings pending in respect of those records/Working papers.

d. Applicability for other audits: The requirements as to the period of retention of the audit working papers would be applicable for other audits also i.e., audits of private companies, partnership firms trusts, etc.

18.11.5 SA 240 — The Auditor's Responsibilities Relating to Fraud, in an Audit of Financial Statements:

Effective Date (Para 9): Audits of financial statements for periods beginning on or after 1st April,2009.

Auditor's Objectives (Para 10):

(a) To identify and assess the risks of material mis-statement in the Financial Statements for the reason of fraud,

(b) To obtain sufficient appropriate audit evidence about the assessed risks of material mis-statement due to fraud, through designing and implementing appropriate response, and

(c) To respond appropriately to identified or suspected fraud.

Scope (Para 1): This Standard deals with Auditor's responsibilities relating to fraud in an audit of Financial Statements. It expands on how SA-315 is to be applied in the case of risks arising out of material mis-statement due to fraud.

18.11.6 SA 250 (Revised) — Consideration of Laws and Regulations in an Audit of Financial Statements:

Effective Date (Para 9): Audits of financial statements for periods beginning on or after 1st April,2009.

Auditor's Objectives (Para 10):

1. To collect sufficient appropriate audit evidence regarding compliance with the provisions of laws and regulations which generally recognized to have a direct effect on the determination of material amounts and disclosures in the Financial Statements,
2. To perform specified audit procedures to identify non-compliance with other laws and regulations that may have a material effect on the Financial Statements, and
3. To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

Scope (Para 1):

1. This SA deals with the Auditor's duties to consider laws and regulations when performing an audit of Financial Statements.
2. This SA does not applicable to other assurance engagements, in which the auditor is specifically engaged to test and report separately on compliance with specific laws and regulations.

Illustration 1:

List the auditor's duties under SA250 in consideration of laws and regulations in his audit.

Answer:

This SA distinguishes the auditor's duties in relation to compliance with two different categories of laws and regulations as follows:

(a) The provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws. and

(b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements

In this SA, differing requirements are specified for each of the above categories of laws and regulations. For the category referred to in paragraph

(a) Above, the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations. For the category referred to in paragraph

(b) The auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

As part of obtaining an understanding of the entity and its environment in accordance with SA 315 the auditor shall obtain a general understanding of:

(a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and

(b) How the entity is complying with that framework.

The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements.

Illustration 2:

Discuss briefly the role of a statutory auditor in relation to unlawful acts or defaults by the clients.

Or,

What should the auditor do when noncompliance is discovered?

Answer:

Reporting Non-Compliance to Those Charged with Governance:

Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor, the auditor shall communicate with those charged with governance matters involving noncompliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

If, in the auditor's judgment, the non-compliance is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

Reporting Non-Compliance in the Auditor's Report on the Financial Statements:

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, express a qualified or adverse opinion on the financial statements.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit.

If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion.

Reporting Non-Compliance to Regulatory and Enforcement Authorities:

If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

Documentation:

The auditor shall document identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.

18.11.7 SA 260 (Revised) — Communication with Those Charged with Governance:

Effective Date (Para 4): Audits of financial statements for periods beginning on or after 1st April,2009.

Auditor's Objectives w.r.t. Those Charged with Governance (Para 5):

1. Communicate clearly with Those Charged with Governance, the responsibilities of the Auditor in relation to the Financial Statement Audit and a checking of the planned scope and timing of the audit.
2. Collect from Those Charged with Governance, the information related to the audit.
3. Provide Those Charged with Governance, with timely observations coming out from the audit that are significant and relevant to their responsibility to overview the financial reporting process, and
4. Promote two-way communication effectively between the Auditor and Those Charged with Governance.

Scope (Para 1):

1. This Standard deals with the Auditor's responsibility to communicate with Those Charged Governance, in case of an audit financial statements.
2. Applies irrespective of an Entity's Governance Structure or Size. However, special considerations apply where all Those Charged with Governance are involved in controlling an entity, and for listed entities.
3. This SA does not provide requirements regarding the Auditor's communication with an entity's Management or Owners, unless they are also Charged with a Governance role.

18.11.8 SA 265 — Communicating Deficiencies in Internal Control to Those Charged with Governance and Management:

Effective Date (Para 4): Audits of financial statements for periods beginning on or after 1st April,2010.

Objective: The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

Scope of this SA:

1. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements. This SA does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of SA 315 and SA 330. SA 260 (Revised) establishes further requirements and provides guidance regarding the auditor's responsibility to communicate with Those Charged with governance in relation to the audit.
2. The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. This SA specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.
3. Nothing in this SA precludes the auditor from communicating to those charged with governance and management other internal control matters that the auditor has identified during the audit.

18.11.9 SA 299 (AAS 12) —Responsibility of Joint Auditors:

Effective Date: This Standard on Auditing becomes operative in respect of all audits relating to accounting periods beginning on or after April 1, 1996.

Objectives:

1. Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors.
2. The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.
3. Where, in the course of his work, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgment by, other joint auditors, he should communicate the same to all the other joint auditors in writing. This should be done by the submission of a report or note prior to the finalization of the audit.

Scope: Normally, the joint auditors are able to arrive at an agreed report. However, where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible –

(a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

(c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(e) for ensuring that the audit report complies with the requirements of the relevant statute.

Illustration 1:

Highlight the principles in SA 299 on Division of work among joint auditors.

Answer:

Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors.

The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

Illustration 2:

Bring out the nature of responsibility of joint auditors.

(Or)

The responsibilities of joint auditors are joint and several. Discuss.

Answer:

In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible –

(a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

(c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(e) for ensuring that the audit report complies with the requirements of the relevant statute.

Illustration 4:

If there is difference of opinion among the joint auditors with respect to any matter, majority joint auditor's opinion will prevail while reporting. Comment

Or,

One of the three joint auditors of a company differs from the views of the other two auditors with regard to certain matters to be covered by the report. Discuss his rights and duties in this regard.

Answer:

Joint Report: Normally, the joint auditors are able to arrive at an agreed report. In such circumstances, only one Audit Report shall be given and it should signed by the all joint auditors.

Disagreement in Views: It is the duties and rights of those Auditors among the Joint Auditors where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report.

Majority rule not applicable: A joint auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

So, it can be said that if there is any difference of opinion among the joint auditors with respect to any matter, majority joint auditor's opinion will not prevail while reporting.

18.11.10 SA 300(REVISED) — Planning an Audit of Financial Statements:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after 1st April 2008.

Objectives: The objective of the auditor is to plan the audit so that it will be performed in an effective manner. For conducting this, key requirements are:

1. **Involvement of Key Engagement Team Members:**

   The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members. **(Ref: Para. A5)**

2. **Preliminary Engagement Activities:**

   The auditor shall undertake the following activities at the beginning of the current audit engagement:

   (a) Performing procedures required by SA 220, "Quality Control for Audit Work" regarding the continuance of the client relationship and the specific audit engagement;

   (b) Evaluating compliance with ethical requirements, including independence, as required by SA 220; and

   (c) Establishing an understanding of the terms of the engagement, as required by SA 210, "Terms of Audit Engagements". **(Ref: Para. A6-A8)**

3. **Planning Activities:**

   (i) The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

   (ii) In establishing the overall audit strategy, the auditor shall:

   (a) Identify the characteristics of the engagement that define its scope;

   (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;

   (c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;

   (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

   (e) Ascertain the nature, timing and extent of resources necessary to perform the engagement. **(Ref: Para. A9-A12)**

   (iii) The auditor shall develop an audit plan that shall include a description of:

   (a) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

   (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 "The Auditor's Responses to Assessed Risks".

   (c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs. (Ref: Para. A13)

   (iv) The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A14)

   (v) The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A15-A16)

Scope: This Standard on Auditing (SA) deals with the auditor's responsibility to plan an audit of financial statements. This SA is framed in the context of recurring audits. Additional considerations in initial audit engagements are separately identified. (Ref: Para. A1-A4).

Illustration 1:

The overall audit strategy and audit plan is subject to updates and changes during the course of audit. Comment

Answer:

The auditor shall update and change the overall audit strategy and the audit plan as and when necessary during the course of the audit.

As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

Illustration 2:

What is the objective of Audit Programme?

Or,

What is meant by Audit Programme?

Answer:

The auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan. The programme may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.

In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. The auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit. However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence. The auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistants, and the involvement of other auditors or experts.

The auditor normally has flexibility in deciding when to perform audit procedures. However, in some cases, the auditor may have no discretion as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.

The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related programme, it should be considered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

Illustration 3:

Mr. Ananda pursuing CA and doing articleship from a reputed firm in Kolkata, Chakraborty & Co. One of the partners of the firm assigned him a job for drafting Audit Programme of a manufacturing company. What are the basic sources of documents to be considered for drafting audit programme?

Answer:

The following basic documents for drafting Audit Programme may be considered by Ananda:

i. Internal Audit Report,

ii. Financial Statement of previous years,

iii. Tax audit report,

iv. Manual of the company, if any,

v. System file or Permanent file,

vi. Working paper of last year,

vii. By understanding the accounting package of the company

viii. Ledger of the company

ix. Type of report required by management of the company

x. Interaction with the client

xi. By understanding the working procedure and internal control of the company, etc.

18.11.11 SA 315 — Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

Objective: The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

Scope of this SA: This Standard on Auditing (SA) deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.

18.11.12 SA 320(REVISED) — Materiality in Planning and Performing an Audit:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective: The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

Scope of this SA:

This Standard on Auditing (SA) deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. SA 450, explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

Materiality in the Context of an Audit:

Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph 2 provides the auditor with such a frame of reference.

The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

(a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;

(b) Understand that financial statements are prepared, presented and audited to levels of materiality;

(c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

(d) Make reasonable economic decisions on the basis of the information in the financial statements.

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. (Ref: Para. A1)

[**Para A1:** In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

(a) Identifying and assessing the risks of material misstatement;

(b) Determining the nature, timing and extent of further audit procedures; and

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.]

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

(a) Determining the nature, timing and extent of risk assessment procedures;

(b) Identifying and assessing the risks of material misstatement; and

(c) Determining the nature, timing and extent of further audit procedures.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although, it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.

Determining Materiality and Performance Materiality when Planning the Audit:

When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A2-A11)

[Para A2 – A11 described below:

A2. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

A3. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

A4. In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

A5. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period.

A6. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in different circumstances.

Considerations Specific to Small Entities:

A7. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.

A8. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the financial statements of those entities may therefore be influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public utility programs/projects, such as, Accelerated Irrigation Benefit Programme (AIBP), Pradhan Mantri Gram Sadak Yojana (PMGSY) undertaken by the Central/State governments or related government entities.

A9. In an audit of the entities doing public utility programs/projects, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures (Ref: Para. 10)

A10. Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

- Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, and the remuneration of management and those charged with governance).
- The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).

A11. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)]

[Para **A12** says that Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.]

Illustration 1:

How does an auditor determine whether a particular item is material or not?

Answer: Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;

- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

(a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;

(b) Understand that financial statements are prepared, presented and audited to levels of materiality;

(c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

(d) Make reasonable economic decisions on the basis of the information in the financial statements.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although, it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.

When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole:

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

Illustration 2:

"Auditor's assessment of materiality may be different of the time of planning the engagement than at the time of evaluating the results of his audit procedures". Comment

Answer:

Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

Illustration 3:

An assistant of RZ & Co, Chartered Accounts, detected an error of ₹ 6 per interest payment, which recurred a number of times. The General Manager (Finance) of Empty Ltd advised him not to request for passing any adjustment entry as individually the errors were of very small amounts. The Company had 2,000 deposit accounts and interest was paid quarterly. State your views in this issue, with reasons.

Answer:

Principle: Mis-statements including omissions are considered to be material, if they either individually or in aggregate, could reasonably be expected to influence the economic decisions of the users, using the Financial Statements.

Analysis: In the above case, an error of ₹ 6 per interest payment, even if small individually, will have a material effect due to the large number of transactions (2,000 deposit accounts).

Conclusions: Hence, RZ & Co, need not to pay any attention to the advise given by the General Manager (Finance) of Empty Ltd. The necessary adjustment should therefore be carried out in the accounts of the company.

Illustration 4:

On the audit of Dreamlight Ltd. the audit partner of the engagement set the preliminary level of audit materiality at ₹1,200,000. After, the partner reviewed the audit of senior's assessment of inherent risk, he decided that the materiality level should be increased to ₹1,800,000. Required:

A. What is the relationship between materiality and audit risk?

B. How will this new level of materiality affect the nature and extent of auditing procedures?

Answer:

A. The relationship between materiality and audit risk:

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

(a) Determining the nature, timing and extent of risk assessment procedures;

(b) Identifying and assessing the risks of material misstatement; and

(c) Determining the nature, timing and extent of further audit procedures.

In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

(a) Identifying and assessing the risks of material misstatement;

(b) Determining the nature, timing and extent of further audit procedures; and

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

B. The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially (Initially ₹ 1,200,000 and revised at ₹ 1,800,000).

If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

18.11.13 SA 330 — The Auditor's Responses to Assessed Risks:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

Objective: The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

Scope of this SA: This Standard on Auditing (SA) deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315, "Identifying and Assessing Risks of Material Misstatement Through Understanding the Entity and Its Environment" in a financial statement audit.

18.11.14 SA 402(REVISED) — Audit Considerations Relating to an Entity Using a Service Organisation:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives: The objectives of the user auditor, when the user entity uses the services of a service organisation, are:

(a) To obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement; and

(b) To design and perform audit procedures responsive to those risks.

Scope of this SA:

1. This Standard on Auditing (SA) deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations. Specifically, it expands on how the user auditor applies SA 315 and SA 330 in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

2. Many entities outsource aspects of their business to organisations that provide services ranging from performing a specific task under the direction of an entity to replacing an entity's entire business units or functions, such as the tax compliance function. Many of the services provided by such organisations are integral to the entity's business operations; however, not all those services are relevant to the audit.

3. Services provided by a service organisation are relevant to the audit of an user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organisation are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets. A service organisation's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:

   (a) The classes of transactions in the user entity's operations those are significant to the user entity's financial statements;

   (b) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

   (c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements that are used to initiate, record, process and report the user entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger;

   (d) How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;

   (e) The financial reporting process used to prepare the user entity's financial statements, including significant accounting estimates and disclosures; and

   (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

4. The nature and extent of work to be performed by the user auditor regarding the services provided by a service organisation depend on the nature and significance of those services to the user entity and the relevance of those services to the audit.

5. This SA does not apply to services provided by financial institutions that are limited to processing, for an entity's account held at the financial institution, transactions that are specifically authorized by the entity, such as the processing of checking account transactions by a bank or the processing of securities transactions by a broker. In addition, this SA does not apply to the audit of transactions arising from proprietary financial interests in other entities, such as partnerships, corporations and joint ventures, when proprietary interests are accounted for and reported to interest holders.

18.11.15 SA 450 — Evaluation of Misstatements Identified During the Audit:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective: The objective of the auditor is to evaluate:

(a) The effect of identified misstatements on the audit; and

(b) The effect of uncorrected misstatements, if any, on the financial statements.

Scope of this SA:

1. This Standard on Auditing (SA) deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. SA 700 (Revised) deals with the auditor's responsibility, in forming an opinion on the financial statements, to conclude whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement. The auditor's conclusion required by SA 700 (Revised) takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with this SA. SA 320(Revised) deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

18.11.16 SA 500 (Revised) — Audit Evidence:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective: The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

Scope:

1. This Standard on Auditing (SA) explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

2. This SA is applicable to all the audit evidence obtained during the course of the audit. Other SAs deal with specific aspects of the audit (for example, SA 315), the audit evidence to be obtained in relation to a particular topic (for example, SA 570 (Revised), specific procedures to obtain audit evidence (for example, Proposed SA 520 (Revised), and the evaluation of whether sufficient appropriate audit evidence has been obtained (Proposed SA 200 (Revised) and SA 330).

Requirements:

Sufficient Appropriate Audit Evidence:

1. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. **(Ref: Para. A1-A25)**

   Information to Be Used as Audit Evidence:

2. When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence. **(Ref: Para. A26-A33)**

3. When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes,: **(Ref: Para. A34-A36)**

   (a) Evaluate the competence, capabilities and objectivity of that expert; **(Ref: Para. A37-A43)**

   (b) Obtain an understanding of the work of that expert; and **(Ref: Para. A44-A47)**

(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion. **(Ref: Para. A48)**

[Para-**A48** described — *Evaluating the Appropriateness of the Management's Expert's Work*

Considerations when evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion may include:

- The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
- If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
- If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

4. When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances:

(a) Obtaining audit evidence about the accuracy and completeness of the information; and (Ref: Para. A49-A50)

[Para A49 & A50 — *Information Produced by the Entity and Used for the Auditor's Purposes*

A49 — In order for the auditor to obtain reliable audit evidence, information produced by the entity that is used for performing audit procedures needs to be sufficiently complete and accurate. For example, the effectiveness of auditing revenue by applying standard prices to records of sales volume is affected by the accuracy of the price information and the completeness and accuracy of the sales volume data. Similarly, if the auditor intends to test a population (for example, payments) for a certain characteristic (for example, authorisation), the results of the test will be less reliable if the population from which items are selected for testing is not complete.

A50 — Obtaining audit evidence about the accuracy and completeness of such information may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the preparation and maintenance of the information. In some situations, however, the auditor may determine that additional audit procedures are needed.

(b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes. (Ref: Para. A51)

[A51— In some cases, the auditor may intend to use information produced by the entity for other audit purposes. For example, the auditor may intend to make use of the entity's performance measures for the purpose of analytical procedures, or to make use of the entity's information produced for monitoring activities, such as internal auditor's reports. In such cases, the appropriateness of the audit evidence obtained is affected by whether the information is sufficiently precise or detailed for the auditor's purposes. For example, performance measures used by management may not be precise enough to detect material misstatements.]

18.11.17 SA 501 (Revised) — Audit Evidence—Specific Considerations for Selected Items:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective: The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:

(a) Existence and condition of inventory;

(b) Completeness of litigation and claims involving the entity; and

(c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

Scope of this SA: This Standard on Auditing (SA) deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with SA 330, SA 500 (Revised) and other relevant SAs, with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements.

18.11.18 SA 505 (Revised) — External Confirmations:

Effective Date: This SA is effective for audit of financial statements for period beginning on or after April 1, 2010.

Objective: The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence. The External Confirmation Procedure to obtain Audit Evidence is described below:

SA 500 (Revised) indicates that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. That SA also includes the following generalizations applicable to audit evidence:

- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium.

Accordingly, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity. This SA is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

Other SAs recognize the importance of external confirmations as audit evidence, for example:

- SA 330 discusses the auditor's responsibility to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level, and to design and perform further audit procedures whose nature, timing and extent are based on, and are responsive to, the assessed risks of material misstatement at the assertion level. In addition, SA 330 requires that, irrespective of the assessed risks of material misstatement, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure. The auditor is also required to consider whether external confirmation procedures are to be performed as substantive audit procedures.
- SA 330 requires that the auditor obtain more persuasive audit evidence the higher the auditor's assessment of risk. To do this, the auditor may increase the quantity of the evidence or obtain evidence that is more relevant or reliable, or both. For example, the auditor may place more emphasis on obtaining evidence directly from third parties or obtaining corroborating evidence from a number of independent sources. SA 330 also indicates that external confirmation procedures may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error.
- SA 240 (Revised) indicates that the auditor may design confirmation requests to obtain additional corroborative information as a response to address the assessed risks of material misstatement, whether due to fraud at the assertion level.
- SA 500 (Revised) indicates that corroborating information obtained from a source independent of the entity, such as external confirmations, may increase the assurance the auditor obtains from evidence existing within the accounting records or from the representations made by the management.

Scope of this SA: This Standard on Auditing (SA) deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 330 and SA 500 (Revised).

It does not address inquiries regarding litigation and claims. SA 501 (Revised) deals with obtaining sufficient appropriate audit evidence from such inquiries.

18.11.19 SA 510 (Revised) — Initial Audit Engagements—Opening Balances

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective: In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

(a) Opening balances contain misstatements that materially affect the current period's financial statements; and

(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Scope of this SA: This Standard on Auditing (SA) deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement. In addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments. When the financial statements include comparative financial information, the requirements and guidance in [proposed] SA 710 (Revised) also apply. SA 300 (Revised) includes additional requirements and guidance regarding activities prior to starting an initial audit.

Illustration 1:

Outline the mode of obtaining evidence in respect of opening balances under SA510.

In an initial audit engagement, the auditor will have to satisfy about the sufficiency and appropriateness of "Opening Balances" to ensure that they are free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow in cases – (i) When the financial statements are audited for the preceding period by another auditor, and (ii) When the financial statements are audited for the first time.

Answer:

The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

(a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss4;

(b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(c) Performing one or more of the following:

  (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;

  (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

  (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance.

If the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion, the auditor shall evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements.

If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements in accordance with Proposed SA 705 and Proposed SA 710 (Revised).

Illustration 2:

Mr.SR, a chartered accountant and a partner of SR & Co., Chartered Accountants was first time appointed the auditor of Microvan Ltd. Mr. SR carried the audit procedure for verifying the opening balances only but not the previous year accounting policies as Mr. SR thinks that as per standard on auditing – 510 it is not needed. Comment

Answer: The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the accounting policies have been properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

If the auditor concludes that:

(a) the current period's accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework; or

(b) a change in accounting policies is not properly accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework, the auditor shall express a qualified opinion or an adverse opinion as appropriate in accordance with Proposed SA 705.

The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depend on various matters. One of those matters is the accounting policies followed by the entity. So it is necessary to verify the consistency of the accounting policies followed by the enterprise in the previous accounting year.

Illustration 3:

Mr. S. a Chartered Accountant, was first time appointed as the Auditor of Titan Ltd. Mr. S. carried the audit procedure for verifying the opening balances only, but not the previous year's accounting policies as it is not needed.

Answer:

Contention of Mr. S, the auditor, is not correct and contrary to the SA 510 on "Initial Engagement – opening balance". As per the said SA it is the duty of the auditor, auditing the financial statements first time, to verify and obtain appropriate audit evidence that:

(a) The closing balances of the preceding period are correctly brought forward to the current period.

(b) Whether any misstatement in opening balances is materially affecting the financial statements of the current period and

(c) Accounting policies followed in the preceding period are also being followed in current period.

Hence, in view of the above guidelines of SA 510 Mr. S should verify the accounting policies also to ensure its continuity.

18.11.20 SA 520(Revised) — Analytical Procedures:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective: The objectives of the auditor are:

(a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(b) To design and perform analytical procedures near the end of the audit that assists the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

Scope of this SA:

This Standard on Auditing (SA) deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements. The use of analytical procedures as risk assessment procedures is dealt with in SA 315. SA 330 includes requirements and guidance regarding the nature, timing and extent of audit procedures in response to assessed risks; these audit procedures may include substantive analytical procedures.

Illustration 1:

What types of analysis are covered by analytical procedures?

Or

Write short notes on analytical review procedures.

Answer:

Analytical procedures include the analysis of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Analytical procedures also include the analysis of relationships, for example:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Illustration 2:

What are the purposes of 'Analytical Procedures'?

Answer:

The purposes of 'Analytical Procedures' are:

(a) To obtain relevant and reliable audit evidence for evaluation of financial information through analysis of plausible relationships among both financial and non-financial data, when using substantive analytical procedures; and

(b) To design and perform analytical procedures near the end of the audit that assists the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

Illustration 3:

Summarize the auditor's duties in applying analytical procedures.

Or

Explain how the results of analytical review can influence the nature and extent of other audit work.

Or,

To what extent analytical procedures can be relied upon?

Or,

Write short notes on the extent of reliance on analytical procedures.

Answer:

When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall:

(a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;

(b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

(c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

(d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

If analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and

(b) Performing other audit procedures as necessary in the circumstances.

Illustration 4:

What factors should be considered while analytical procedures are performed as substantive procedures?

Answer:

This Standard on Auditing (SA) deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"). The use of analytical procedures as risk assessment procedures is dealt with in SA 315. SA 330 includes requirements and guidance regarding the nature, timing and extent of audit procedures in response to assessed risks; these audit procedures may include substantive analytical procedures.

The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

Illustration 5:

You are the auditor's of Play Limited for the first time this year. Play Limited

is a retailer of sports goods and sportswear with more than 110 retail outlets in towns throughout India. Not all the stores sell clothing. You are required to explain the purpose of analytical review and the procedures you would adopt at the planning stage of the audit.

Answer:

The purpose of analytical review include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.
- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

The procedures which may be adopted are described below:

1. **Trends:** Analyzing account and amount fluctuations by comparing current year to prior year information, and also, the information derived over several years.
2. **Checking of Reasonableness:** these checks are made by reviewing the relationship of certain account balances to other balances of reasonableness of amounts. Example of accounts that may be reasonably tested are:
   - Interest Expenses against Interest-bearing obligations
   - Rental revenues based on occupancy of premises
   - Sales Discounts and Commissions against sales volume.
   - Valuation of inventories and its turnover rate.
3. **Analysis by Computation of Ratios:** It includes the study of relationship between the amounts of the Financial Statements. The ratios which are commonly used are:
   - Gross Profit Turnover
   - Accounts Receivable Turnover
   - Inventory Turnover
   - Profitability, Leverage and Liquidity
   - Elements of income or loss as a percentage of sales.

18.11.21 SA 530 (Revised) — Audit Sampling:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective: The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

Scope of this SA:

1. This Standard on Auditing (SA) applies when the auditor has decided to use audit sampling in performing audit procedures. It deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample.

2. This SA complements SA 500 (Revised), which deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. SA 500 (Revised) provides guidance on the means available to the auditor for selecting items for testing, of which audit sampling is one means.

Definitions:

(a) **Audit sampling (sampling) –** The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

(b) **Sampling risk –** The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

(c) **Non-sampling risk –** The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. (Ref: Para A1)

[Para- **A1** — Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognize a misstatement or deviation.]

(d) **Statistical sampling –** An approach to sampling that has the following characteristics:

(i) Random selection of the sample items; and

(ii) The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling.

Requirements:

Sample Design, Size and Selection of Items for Testing:

1. When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. *(Ref: Para. A4-A9)*

2. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. *(Ref: Para. A10-A11)*

[Para A10 & A11 — *Sample Size:*

A10. The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

A11. The sample size can be determined by the application of a statistically based formula or through the exercise of professional judgment. Appendices 2 and 3 indicate the influences that various factors typically have on the determination of sample size. When circumstances are similar, the effect on sample size of factors such as those identified in Appendices 2 and 3 will be similar regardless of whether a statistical or non-statistical approach is chosen. Appendix 2 states that the sampling units might be physical items (for example, cheques listed on deposit slips, credit entries on bank statements, sales invoices or debtors' balances) or monetary units. And Appendix 3 states that when designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality, as defined in SA 320 (Revised), to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.]

3. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. (Ref: Para. A12-A13)

   [Para A12 & A13 refer that —

A12. With statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected. With non-statistical sampling, judgment is used to select sample items. Because the purpose of sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected, it is important that the auditor selects a representative sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population.

A13. The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection. Each of these methods is discussed in Appendix 4 which states that Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.]

Performing Audit Procedures:

4. The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.

5. If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. (Ref: Para. A14)

[A14 — An example of when it is necessary to perform the procedure on a replacement item is when a cancelled cheque is selected while testing for evidence of payment authorisation. If the auditor is satisfied that the cheque has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined.]

6. If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details. (Ref: Para. A15-A16)

[Para A15 & A16 refer as follow:

A15 — an example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost.

A16 — an example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.]

18.11.12 SA 540 (Revised) — Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective: The objective of the auditor is to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework:

(a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable; and

(b) related disclosures in the financial statements are adequate.

Scope of this SA:

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315 and SA 330 and other relevant SAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

   Nature of Accounting Estimates:

2. Some financial statement items cannot be measured precisely, but can only be estimated. For purposes of this SA, such financial statement items are referred to as accounting estimates. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias. **(Ref: Para. A1-A11)**

3. The measurement objective of accounting estimates can vary depending on the applicable financial reporting framework and the financial item being reported. The measurement objective for some accounting estimates is to forecast the outcome of one or more transactions, events or conditions giving rise to the need for the accounting estimate. For other accounting estimates, including many fair value accounting estimates, the measurement objective is different, and is expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability. For example, the applicable financial reporting framework may require fair value measurement based on an assumed hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as "marketplace participants" or equivalent) in an arm's length transaction, rather than the settlement of a transaction at some past or future date.

4. A difference between the outcome of an accounting estimate and the amount originally recognized or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

Illustration 1. Outline the Auditor's Duties under SA540 Vis à vis Accounting Estimates.

Answer:

The auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent reestimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements.

The auditor shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.

Based on the assessed risks of material misstatement, the auditor shall determine:

(a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and

(b) Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances.

In responding to the assessed risks of material misstatement, as required by SA 330, the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate:

(a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.

(b) Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate whether:

  (i) The method of measurement used is appropriate in the circumstances; and

  (ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework.

(c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.

(d) Develop a point estimate or a range to evaluate management's point estimate. For this purpose:

  (i) When the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate.

  (ii) When the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

In responding to the assessed risks of material misstatement, the auditor shall consider whether specialized skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence.

18.11.23 SA 550 (Revised) — Related Parties:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives: The objectives of the auditor are:

(a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related arty relationships and transactions sufficient to be able:

  (i) To recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and

  (ii) To conclude whether the financial statements, insofar as they are affected by those relationships and transactions:

    a. Achieve a true and fair presentation (for fair presentation frameworks); or

    b. Are not misleading (for compliance frameworks); and

(b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

Scope of this SA:

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it expands on how SA 315, SA 330 and SA 240 are to be applied in relation to risks of material misstatement associated with related party relationships and transactions.

   Nature of Related Party Relationships and Transactions:

2. Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. For example:

   - Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
   - Information systems may be ineffective at identifying or summarizing transactions and outstanding balances between an entity and its related parties.
   - Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

Responsibilities of the Auditor:

3. Because related parties are not independent of each other, many financial reporting frameworks establish specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and actual or potential effects on the financial statements. Where the applicable financial reporting framework establishes such requirements, the auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances in accordance with the requirements of the framework.

4. Even if the applicable financial reporting framework establishes minimal or no related party requirements, the auditor nevertheless needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions: (Ref: Para. A1)

   (a) Achieve a true and fair presentation (for fair presentation frameworks); or (Ref: Para. A2)

   (b) Are not misleading (for compliance frameworks). (Ref: Para. A3)

5. In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether one or more fraud risk factors are present as required by SA 240 because fraud may be more easily committed through related parties.

6. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

   Management may be unaware of the existence of all related party relationships and transactions, particularly if the applicable financial reporting framework does not establish related party requirements.

   Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

7. Planning and performing the audit with professional skepticism as required by SA 200 is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

18.11.24 SA 560 (Revised) — Subsequent Events

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objectives: The objectives of the auditor are to:

(a) Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements; and

(b) Respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

Scope of this SA:

1. This Standard on Auditing (SA) deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. (Ref: Para. A1)

2. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:

   (a) Those that provide evidence of conditions that existed at the date of the financial statements; and

   (b) Those that provide evidence of conditions that arose after the date of the financial statements.

   [Proposed] SA 700 (Revised) explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.

Illustration 1:

Write short note on events occurring after balance sheet date.

Answer:

Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:

(a) Those that provide evidence of conditions that existed at the date of the financial statements; and

(b) Those that provide evidence of conditions that arose after the date of the financial statements.

The date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, when, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

(a) Discuss the matter with management and, where appropriate, those charged with governance.

(b) Determine whether the financial statements need amendment

(c) Inquire how management intends to address the matter in the financial statements.

Depending on the auditor's risk assessment, the audit procedures may include procedures, necessary to obtain sufficient appropriate audit evidence, involving the review or testing of accounting records or transactions occurring between the date of the financial statements and the date of the auditor's report. The audit procedures in addition to procedures that the auditor may perform for other purposes that, nevertheless, may provide evidence about subsequent events (for example, to obtain audit evidence for account balances as at the date of the financial statements, such as cut-off procedures or procedures in relation to subsequent receipts of accounts receivable).

Illustration 2:

Explain the meaning of the term subsequent events as used in SA560. Should all types of subsequent events be considered by the auditor in his attest function?

Answer:

Subsequent events – Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report. The following types of subsequent events can be described as follows:

Events Occurring Between the Date of the Financial Statements and the Date of the Auditor's Report — The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued — The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

(a) Discuss the matter with management and, where appropriate, those charged with governance.

(b) Determine whether the financial statements need amendment and, if so, inquire how management intends to address the matter in the financial statements.

When the audited financial statements are included in other documents subsequent to the issuance of the financial statements, the auditor may have additional responsibilities relating to subsequent events that the auditor may need to consider, such as legal or regulatory requirements involving the offering of securities to the public in jurisdictions in which the securities are being offered. For example, the auditor may be required to perform additional audit procedures to the date of the final offering document. These procedures may include those performed up to a date at or near the effective date of the final offering document, and reading the offering document to assess whether the other information in the offering document is consistent with the financial information with which the auditor is associated.

The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. Depending on the auditor's risk assessment, the audit procedures required to obtain sufficient appropriate audit evidence, involving the review or testing of accounting records or transactions occurring between the date of the financial statements and the date of the auditor's report. The audit procedures required are in addition to procedures that the auditor may perform for other purposes that, nevertheless, may provide evidence about subsequent events.

Illustration 3:

Indicate briefly the procedures to identify subsequent events requiring adjustment of or disclosure in financial statements.

Or,

How are subsequent events requiring adjustment or disclosure identified?

Answer:

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following:

(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(d) Reading the entity's latest subsequent interim financial statements, if any.

When, as a result of the procedures performed, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

Illustration 4:

You are the Auditor of Manufacturing Company whose year ends on 30th June.

The following events occur after the year and before you complete the audit. The audit report issued by you is dated 20th September.

a) The Sales ledger balance at 30th June were ₹ 85,000. By 20th September, cash had been received against this amount totaling ₹ 62,000.

b) On 19th August, a Batch of goods which were shown in the stock records at 30th June at a cost of ₹ 12,000 was sold for ₹ 27,000 and another batch costing ₹ 40,000 was sold for ₹ 20,000.

c) A customer who had purchased a large consignment of goods during the accounting year claimed damages of ₹ 48,000 because the goods were faulty and unfit for use.

   The company has denied any liability.

d) A warehouse was destroyed by fire on 31st July containing stocks which were worth ₹ 1,10,000. The warehouse was valued in the company's books at worth ₹ 90,000.

State giving reasons, for your answer, how the above events would affect the account for the year ending 30th June.

Answer:

Consideration of subsequent events:

1. SA560 requires that the Auditor should consider the effect of subsequent events (a) on the financial statements, and (b) On the Auditor's Report.
2. The manner and treatment of each event depends upon its nature, i.e. (a) Adjusting event, or (b) None Adjusting Event.
3. The auditor's duties in report of each of the above situations is Described below,

Situation (a): Debtors remaining uncollected:

a. Examine the actual experience of the company in collecting due to it.

b. Examine the terms under which goods are sold and see to what extent they are being exceeded.

c. Verify whether the amount still remaining due will be collected in the immediately foreseeable future.

d. Review the correspondence with debtors since the yearend.

e. Ascertain the need, if any, to create provision for Bad Debts.

f. Discuss the necessary Bad Debts provision with the company's Directors, to make necessary adjustments in the financial statements, if required.

Situation (b): Stocks sold below cost:

a. Valuation of stock: As per prudent accounting principles and AS2. Stocks should be valued at lower of cost or net realizable value. For this purpose, stocks have to be considered on an item by item basis or in groups and not in total.

b. Goods sold above cost: in respect of items costing ₹ 12,000 and sold at ₹ 27,000 in the next period, there is further evidence as to the realisability. Hence, such items should be stated at cost and the profit should be considered only in the next accounting period.

c. Goods sold below cost: In respect of items costing ₹ 40,000 but sold for ₹ 20,000, the subsequent event provides an indication of its realizable value/market price as at the balance sheet date. Hence, such goods shall be valued at Net Realizable Value as on 31st June. The necessary adjustment should be made in the financial statements of this period.

Situation (c): Liability for Damages:

a. The Auditor should advise the company to obtain legal advice on this matter to establish –

(a) Whether there was any Legal liability, and (b) What would be the extent of the potential damages.

b. The company should identify the extent of the liability to know whether any excessive claim has been made by the claimant, which is not likely to be endorsed by the courts.

c. In case of ascertainable Liability: The company, on legal advise, should make a provision in its accounts as at 30th June, to cover the estimated amount of damages payable together with legal costs.

d. In case of unascertained liability, if the amount payable cannot be estimated it should be shown as a contingent liability in the Notes to the Accounts as at 30th June.

Situation (d): Fire subsequent to Balance Sheet Date:

a. The fire took place after the yearend, and hence its accounting effect should be reflected in the next year's accounts.

b. In case of material losses, adequate disclosure shall be made in the report of the Board of Directors.

c. The Auditor should examine the appropriateness of the going concern Assumption and report accordingly.

Illustration 5:

Sundry Debtors of a company as on 31st March include ₹12 lakhs From M/s Boston Traders, who have been declared as insolvent on 14th April. Comment.

Answer:

a. SA560: SA560 requires that the Auditor should consider the effect of Subsequent Events (i) On the financial Statements, and (ii) On the Auditor's Report.

b. AS4: AS4 requires that all significant events occurring after the balance sheet date and before the date of approval of the financial statements by the Board of Directors should be adjusted against assets/liabilities as on Balance Sheet date, if additional evidence is available in respect of conditions existed on the Balance Sheet Date.

c. Companies Act: As per schedule III Balance Sheet Disclosure Requirements, Debtors should be classified by nature into—

   (i) Fully Secured Debts,

   (ii) Debts Secured only by Debtor's Personal security, and

   (iii) Debts considered Doubtful or bad.

Analysis and Conclusion:

d. In the Given case, Debtors should be suitably adjusted in the financial statements, to show their realizable amount, since conditions existed on the balance sheet date in respect of which additional evidence has been provided by the insolvency of M/s unreliable Trades.

e. So, the Auditor should examine the Company's compliance with AS4, and report accordingly.

Illustration 6:

X ltd. was under audit for the year ended 31st March. An appeal filed by X ltd. against the demand of excise duty of ₹ 25 Crores was pending before the supreme court for which neither provision was made nor was disclosed in the notes to the financial statements. On 12th July, the Auditor came to know through paper reports that the point involved in the appeal of X Ltd was adjudicated by the supreme court in the case of some other assessee, which is in favour of the department of excise duty. The auditor insisted that provisions be made of ₹ 25 Crores in the financial statements. The Management was of the view that since its own case is still pending, no provisions is called for. It was also of the view that the event does not have any effect on the financial position of the company on the B/s date. Is the management view tenable?

Answer:

As per AS 29, a provision should be recognized if the following conditions are satisfied: Present obligation as result of past event, outflow of resources to settle the obligation is probable. Reliable estimate of the amount of excise duty demand is already made on the company. Hence present obligation exists at the Balance sheet date. Additional evidence arising after Balance Sheet date lead to the conclusion that the outflow is probable, i.e. more likely than not. ₹ 25 Crores is the amount of liability (Given).

Treatment and conclusion: Since all the conditions for recognition of a provision are satisfied, a provision should be recognized for the year ending 31st March. If the amount is material, separate disclosure is also required. The Management's contention is not tenable.

Auditor's Duties: Under SA560, the Auditor should:

i. Consider the effect of subsequent events on the financial statements & Auditor's report.

ii. Verify whether such identified events materially affect the financial statements. If so, see that they are properly accounted for in the financial statements.

iii. Express a qualified opinion or an adverse opinion as considered appropriate, when the management does not account for such events.

18.11.25 SA 570 (Revised) — Going Concern:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objectives: The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements;

(b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and

(c) To determine the implications for the auditor's report.

Scope of this SA:

1. This Standard on Auditing (SA) deals with the auditor's responsibility in the audit of financial statements with respect to management's use of the going concern assumption in the preparation and presentation of the financial statements.

Going Concern Assumption:

2. Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Special purpose financial statements may or may not be prepared in accordance with a financial reporting framework6 for which the going concern basis is relevant. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. (Ref: Para. A1)

   [A1. In some enterprises, for example, those where the funding arrangements are guaranteed by the Central Government, going concern risks may arise, but are not limited to, situations where such type of entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatization. Events or conditions that may cast significant doubt on an entity's ability to continue as a going concern may include situations where such type of entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by such an entity.]

   Responsibilities of Management:

3. Some financial reporting frameworks contain an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern, and standards regarding matters to be considered and disclosures to be made in connection with going concern. The financial reporting framework may require the management to make an assessment of the entity's ability to continue as a going concern and prepare the financial statements on a going concern basis unless the management intends to liquidate the entity or cease operations, or has no realistic alternative but to do so. In case the financial statements have not been prepared on a going concern basis, the fact would need to be appropriately disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern. The detailed requirements regarding management's responsibility to assess the entity's ability to continue as a going concern and related financial statement disclosures may also be set out in law or regulation.

4. In other financial reporting frameworks, there may be no explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. Nevertheless, since the going concern assumption is a fundamental principle in the preparation of financial statements as discussed in paragraph 2, management's responsibility for the preparation and presentation of the financial statements includes a responsibility to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so.

5. Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. The following factors are relevant to that judgment:

   - The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, financial reporting frameworks normally require an explicit management assessment specify the period for which management is required to take into account all available information.
   - The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
   - Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

   Responsibilities of the Auditor:

6. The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. This responsibility exists even if the financial Standard on Auditing (SA) 570 reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

7. However, as described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Audit Conclusions and Reporting:

1. Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for:

   (a) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or

   (b) In the case of a compliance framework, the financial statements not to be misleading. (Ref: Para. A19)

   [**A19.** The phrase "material uncertainty" means the uncertainties related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern that should be disclosed in the financial statements. In some other financial reporting frameworks the phrase "significant uncertainty" is used in similar circumstances.]

Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists:

1. When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

   (a) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business. (Ref: Para. A20)

[**A20.** The determination of the adequacy of the financial statement disclosure may involve determining whether the information explicitly draws the reader's attention to the possibility that the entity may be unable to continue realizing its assets and discharging its liabilities in the normal course of business.]

2. If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph in the auditor's report to:

   (a) Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and to

   (b) Draw attention to the note in the financial statements that discloses the matters set out in paragraph 18. (See SA 706) (Ref: Para. A21-A22)

3. If adequate disclosure is not made in the financial statements, the auditor shall express a qualified or adverse opinion, as appropriate (See SA 705). The auditor shall state in the auditor's report that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern. (Ref: Para. A23-A24)

Use of Going Concern Assumption Inappropriate:

If the financial statements have been prepared on a going concern basis but, in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate, the auditor shall express an adverse opinion. (Ref: Para. A25-A26)

Communication with Those Charged with Governance:

Unless all those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. Such communication with those charged with governance shall include the following:

(a) Whether the events or conditions constitute a material uncertainty;

(b) Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements; and

(c) The adequacy of related disclosures in the financial statements.

Illustration 1:

List the indications upon which the Auditor should assess the appropriateness of going concern assumption.

Or,

There is evidence that the public interest would be best served by the inclusion of fuller information about risks facing companies in audited financial statements. Doubts about the going concern presumption must be detected and adequately disclosed in financial statements and Auditor's Reports. You are required to list six factors, which might cause doubt on the going concern status of a company.

Or,

ZT Ltd has suffered recurring losses due to steep fall in production and has negative net worth. Its production head, an expert, has also left the company. Reply of the management is inadequate to these developments and there is no sound action plan to mitigate these situations. As an auditor, how would you deal with the situation?

Answer:

Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Special purpose financial statements may or may not be prepared in accordance with a financial reporting framework for which the going concern basis is relevant. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern.

When performing risk assessment procedures as required by SA 315, the auditor shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern.

The following are indications of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists.

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labour difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Illustration 2:

Specify additional audit procedures, which an auditor may perform while evaluating appropriateness of going concern assumption.

Answer:

When events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:

(a) When management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.

(b) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.

(c) When the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future action:

  (i) Evaluating the reliability of the underlying data generated to prepare the forecast; and

  (ii) Determining whether there is adequate support for the assumptions underlying the forecast.

(d) Considering whether any additional facts or information have become available since the date on which management made its assessment.

(e) Requesting written representations from management or, where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.

Illustration 3:

Describe the audit procedures necessary in order to gain sufficient audit evidence to be able to form an opinion on the going concern status of a company?

Answer:

Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for:

(a) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or

(b) In the case of a compliance framework, the financial statements not to be misleading.

When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

(a) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph in the auditor's report to:

(a) Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and to

(b) Draw attention to the note in the financial statements.

If adequate disclosure is not made in the financial statements, the auditor shall express a qualified or adverse opinion, as appropriate. The auditor shall state in the auditor's report that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern.

Illustration 4:

It is now an accepted fact that an auditor cannot take the "Going concern" assumption for granted. The problem has become acute in view of ever growing sickness in our industries. You are required to prepare a checklist designed to test the assumption that a particular client organization is in fact a going concern.

Ans.: SA 570 Checklist: If the answers to the following questions are "Yes", then the going concern assumption may not be appropriate, subject to other findings of the auditor.

1. **Capital structure and financial aspects:**
   a. Does the concern have a high Debt Equity Ratio?
   b. Is the concern heavily or increasingly dependent upon short term finance?
   c. Is the company utilizing the borrowing facility to the maximum or whether there is any scope for further borrowing?
   d. Are leasing arrangements preferred to capital expenditure?

2. **Working capital aspects:**
   a. Is there a gradual and significant decline in current ratio, i.e. current assets¸ Current liabilities?
   b. Are purchases being deferred, thereby reducing stocks to dangerously low levels?
   c. Is there a marked slowdown in the collection of sundry Debtors?
   d. Is there any inability to take advantage of cash discounts from creditors?
   e. Is there any increase in the time taken to pay creditors?

3. **Operational Aspects:**
   a. Are there substantial investments in R & D projects, which have not yielded any commercially exploitable products?
   b. Has there been any cancellation of capital projects for lack of funds?
   c. Is the concern substantially dependent upon a few products/patents/ production methods which may suddenly become obsolete?

d. Is the business of the concern dependent upon the growth of a handful of customers?

e. Are there substantial loans from directors, in case of small concerns? If such loans rank pari passu with other unsecured creditors, has the current ratio deteriorated?

f. Are there defaults in making statutory payments like taxes, ESI, PF etc.?

4. Profit and Loss Account Aspects:

a. Does the concern incur substantial cash losses?

b. Is there a steady decline in the rate of profitability?

c. Is there a growth beyond limits such that the company is over trading?

Illustration 5:

Where a public or private company fails to enhance the paid up capital to the statutory minimum, will the going concern assumption be considered appropriate?

Ans.

a. The minimum paid up capital of a private limited company and public limited company are ₹ 1 lakh and ₹ 5 lakhs respectively. Where a company fails to enhance the paid up capital to the statutory minimum, such company shall be deemed a defunct company within the meaning of section 248 of the companies Act, 2013 and its name shall be stuck off from the register by the ROC.

b. However, such an entity may decide not a carry on business or may decide to carry on the business in some other form of organization e.g. Partnership etc. This situation gives rise to the risk that the going concern assumption may no longer be appropriate.

c. In such situations, the auditor should perform the procedures as required by SA 570.

Unless the entity demonstrates otherwise, the auditor should consider the going concern assumption as inappropriate and report the same in accordance with Para 18 of SA 570.

18.11.26 SA 580 (Revised) — Written Representations:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after 1st April, 2009.

Objectives: The objectives of the auditor are:

(a) To obtain written representations from management that management believes that it has fulfilled the fundamental responsibilities that constitute the premise on which an audit is conducted;

(b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and

(c) To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

Scope of this SA: This Standard on Auditing (SA) deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance.

Example of acknowledgment by management of it's responsibilities i.e management representation latter:

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

This representation letter is provided in connection with your audit of the financial statements of .... for the year ended ...... for the purpose of expressing an opinion as to whether the financial statements give a true and fair view of the financial position of .... as of ...... and of the results of operations for the year then ended. We acknowledge our responsibility for preparation of financial statements in accordance with the requirements of the Companies Act, 2013 and recognised accounting policies and practices, including the Accounting Standards issued by the Institute of Chartered Accountants of India.

We confirm, to the best of our knowledge and belief, the following representations:

Accounting Policies:

The accounting policies which are material or critical in determining the results of operations for the year or financial position are set out in the financial statements and are consistent with those adopted in the financial statements for the previous year. The financial statements are prepared on accrual basis.

Assets

The company has a satisfactory title to all assets and there are no liens or encumbrances on the company's assets, except for those that are disclosed in Note X to the financial statements.

Fixed Assets

The net book values at which fixed assets are stated in the Balance Sheet are arrived at:

(a) after taking into account all capital expenditure on additions thereto, but no expenditure properly chargeable to revenue;

(b) after eliminating the cost and accumulated depreciation relating to items sold, discarded, demolished or destroyed;

(c) after providing adequate depreciation on fixed assets during the period.

Capital Commitments

At the balance sheet date, there were no outstanding commitments for capital expenditure excepting those disclosed in Note X to the financial statements.

Investments:

The current investments as appearing in the Balance Sheet consist of only such investments as are by their nature readily realisable and intended to be held for not more than one year from the respective dates on which they were made. All other investments have been shown in the Balance Sheet as 'long-term investments'.

Current investments have been valued at the lower of cost and fair value. Long-term investments have been valued at cost, except that any permanent diminution in their value has been provided for in ascertaining their carrying amount.

In respect of offers of right issues received during the year, the rights have been either been subscribed to, or renunciated, or allowed to lapse. In no case have they been renunciated in favour of third parties without consideration which has been properly accounted for in the books of account.

All the investments produced to you for physical verification belong to the entity and they do not include any investments held on behalf of any other person.

The entity has clear title to all its investments including such investments which are in the process of being registered in the name of the entity or which are not held in the name of the entity and there are no charges against the investments of the entity except those appearing in the records of the entity.

Inventories

Inventories at the year-end consisted of the following:

Raw Materials (including components)	₹…………
Work-in-Process	₹…………
Finished Goods (including by-products)	₹………....
Maintenance supplies and Stores and Spare Parts	₹…………
Loose Tools	₹…………
Others (specify each major head separately)	₹…………
Total	₹…………

All quantities were determined by actual physical count or weight or measurement that was taken under our supervision and in accordance with written instructions, on........... (date/dates of physical verification), except…………….

All goods included in the inventory are the property of the entity, none of the goods are held as consignee for others or as bailee, and, except as set out below, none of the goods are subject to any charge.

All inventories owned by the entity, wherever located, have been recorded, including goods sent on consignment.

Inventories do not include goods sold to customers for which delivery is yet to be made.

Inventories have been valued on the following basis/bases:

Raw Materials (including components)

Work-in-Process

Finished Goods (including by-products)

Maintenance supplies and Stores and Spare Parts

Loose Tools

Others (specify each major head separately)

(In describing the basis/bases of valuation, the method of ascertaining the cost (e.g. FIFO, Average Cost or LIFO) should also be stated.

Similarly, the extent to which overheads have been included in the cost should also be stated.)

The provisions have been made in respect of excess, slowmoving, damaged, or obsolete inventories and these, in our view, are adequate.

No item of inventories has a net realisable value in the ordinary course of business which is less than the amount at which it is included in inventories.

The basis/bases of valuation is/are the same as that/those used in the previous year, except as set out below:

Class of inventory	**Basis of Valuation**		**Effect of change in Basis of Valuation**
	This Year	**Last Year**	
…………….	………………	……………	………………

Debtors, Loans and Advances

The following items appearing in the books as at....... (date of the Balance Sheet) are considered good and fully recoverable with the exception of those specifically shown as “doubtful” in the Balance Sheet.

Other Current Assets

In the opinion of the Board of Directors, other current assets have a value on realisation in the ordinary course of the company's business which is atleast equal to the amount at which they are stated in the Balance Sheet, except as stated in Note X to the financial statements.

Liabilities

We have recorded all known liabilities in the financial statements.

We have disclosed in notes to the financial statements all guarantees that we have given to third parties and all other contingent liabilities.

Contingent liabilities disclosed in the notes to the financial statements do not include any contingencies which are likely to result in a loss and which, therefore, require adjustment of assets or liabilities.

Provisions for Claims and Losses

Provision has been made in the accounts for all known losses and claims of material amounts.

There have been no events subsequent to the balance sheet date which require adjustment of or disclosure in, the financial statements or notes thereto.

Profit and Loss Account.

Except as disclosed in the financial statements, the results for the year were not materially affected by:

(a) transactions of a nature not usually undertaken by the company;

(b) circumstances of an exceptional or non-recurring nature;

(c) charges or credits relating to prior years;

(d) changes in accounting policies.

General

The following have been properly recorded and, when appropriate, adequately disclosed in the financial statements:

(a) Losses arising from sale and purchase commitments.

(b) Agreements and options to buy back assets previously sold.

(c) Assets pledged as collateral.

There have been no irregularities involving management or employees who have a significant role in the system of internal control that could have a material effect on the financial statements.

The financial statements are free of material misstatements, including omissions.

The company has complied with all aspects of contractual agreements that could have a material effect on the financial statements in the event of non-compliance. There has been no non-compliance with requirements of regulatory authorities that could have a material effect on the financial statements in the event of non-compliance.

We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities reflected in the financial statements.

Illustration 1:

Explain what is meant by "Representation by management" and indicate to what extent an auditor can place reliance on such representations. Or Write short notes on Management representation Or Briefly out the salient features of SA580 Representations by Management.

Ans. SA 580 elaborate the term Written representation as below

Written representations – A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

For purposes of this SA, references to "management" should be read as "management and, where appropriate, those charged with governance." Furthermore, in the case of a fair presentation framework, management is responsible for the preparation and fair presentation of the financial statements in accordance with the financial reporting framework; or the preparation of financial statements that give a true and fair view in accordance with the financial reporting framework.

If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A26-A27)

In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A25)

If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with (Proposed) SA 7056, having regard to the requirement in paragraph 19 of this SA.

Illustration 2:

Discuss the position of an auditor in case he chooses to rely upon the certificates from the management in respect of closing stock, cash in Hand etc. List the circumstances under which he will be justified in accepting and relying upon the certificates.

Ans.

1. **Role of management representations:**
    a. Management representations are generally given for certifying the value of inventories, provision for Liabilities, Disclosure of contingent Liabilities, etc. These are intended to impress upon the Directors their responsibility for accounts.
    b. Mere Possession of such certificates does not absolve the auditor from carrying out a proper audit. These certificates can only act as second line of defense for an auditor who has carried out his work with reasonable care, skill and diligence.
    c. The auditor should not seek or accept certificates from the management when the subject matter is such that it is capable of direct verification by the auditor himself.
2. **Situations when management certificates can be justifiable:**
    a. The subject matter should not be capable of direct verification by the Auditor.
    b. The matter relates to items, which are beyond the competence of a professionally qualifies Accountant.
    c. There are proper records and reliable internal checks in the client's system that can enable the directors to prepare and issue the certificates.
    d. The certificate should be prima facie in agreement with the records maintained.
    e. The certificate should be put to commonsense tests by the auditor.
3. In case of Third party certificates e.g. Bankers, Architects, Agents etc. the following rules of reliance may be taken into account:

a. The party issuing the certificate is reputable and trustworthy,

b. The certificates relate to an item which is normally dealt with or held by such party,

c. The auditor himself is not in a position to verify the item because of its technical nature or because it would be too costly or cumbersome for him to do so,

d. The certificate prima facie is reliable and reasonable, and

e. Reference to the third party if available in the books and documents of the client as in possession of the concerned goods, property or securities belonging to the clients.

Illustration 3:

The Managing Director of a client company as returned to your draft of the letter of representation starting that the Directors Fail to see why such a letter is necessary and declaiming to issue one. How would you deal with the above situation?

Ans. SA 580

If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A26-A27)

In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A25)

If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with (Proposed) SA 7056, having regard to the requirement in paragraph 19 of this SA.

Illustration 4:

At the statutory audit of IDT limited, the physical verification of fixed assets was conducted. However, the auditor was not able to confirm the existence of valuables and important machinery. In this connection, the auditor obtained a certificate from the management to prove its existence and value and accepted the same blindly without any audit procedures. As a statutory auditor, how will you deal with the above issue? Or

An auditor of DT Ltd. was not able to get the confirmation about the existence and value of certain machineries. However, the management gave him a certificate to prove the existence and value of the machinery as appearing in the books of account. The auditor accepted the same without any further procedure and signed the audit report. Is he right in his approach?

Ans.:

1. **Management's Duties:** Physical verification of fixed assets is the primary responsibility of the management. But, the auditor should examine the verification programme adopted by the management. Through his audit procedures, the auditor must satisfy himself about the existence, ownership and valuation of fixed Assets.

2. **Auditor's Duties:**

   a. Under SA580, when a management representation relates to matters which are material to the financial information, the auditor should seek corroborative audit evidence for other sources inside or outside the entity. He should evaluate whether such representations are reasonable and consistent with other evidences and should consider whether individuals making such representations can be expected to be will informed on the matter.

b. The Auditor should also report whether he has obtained all information and explanations which are necessary for the purpose of his audit. As per the generally accepted audit principles, he is required to verify the existence of fixed assets.

c. If a representation by management is contradicted by other evidence, the auditor should examine the circumstances and, also reconsider the reliability of other representations made by management.

d. The auditor is also guilty of professional misconduct in case he expresses an opinion on financial statements without obtaining sufficient information warranting such opinion.

3. **Role of Management Representations:** Representation by Management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available.

   If the auditor is unable to obtain sufficient appropriate audit evidence regarding a matter which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination, even if he has obtained a representation from management on the matter. Therefore, the auditor's approach in the above case is not correct.

4. **Conclusion:** If the auditor expresses a clean opinion on the financial statements based on management's certificate only without any further audit procedures, he will be guilty of dereliction of duties statutorily prescribed under the companies Act. Hence, he should not express a clean opinion on the financial statements in the given case.

18.11.27 SA 600 — Using the Work of Another Auditor:

Effective Date: This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 2002.

Objectives: The purpose of this Standard on Auditing (SA) is to establish standards to be applied in situations where an auditor (referred to herein as the 'principal auditor'), reporting on the financial information of an entity, uses the work of another auditor (referred to herein as the 'other auditor') with respect to the financial information of one or more components included in the financial information of the entity. This Standard also discusses the principal auditor's responsibility in relation to his use of the work of the other auditor.

In this Standard, the term 'financial information' encompasses 'financial statements'.

Scope:

1. This SA discloses:
   - The procedure to be applied in situations,
   - Where an independent auditor, reporting on the Financial Statements of an entity.
   - Uses the work of another independent Auditor,
   - With respect to the Financial Statements of one or more divisions or branches included in the Financial Statements of the entity.

SA-600 also discusses the Principle Auditor's responsibility in respect to his use of work of the other Auditor.

2. Exclusions: The Statement does not deal with the following instances:
   - Where two or more Auditors are appointed as Joint Auditors.
   - The Auditor's relationship with a predecessor Auditor.
   - When the Principle Auditor concludes that the Financial Statements of a component are immaterial.
3. Materiality: When several components, immaterial in themselves, are together material in relation to the Financial Statements of the entity as a whole.

Illustration 1:

Discuss the principal Auditor's Procedures as enshrined in SA 600. State any six procedures to be adopted by the principal auditor in using the work of other auditors.

OR,

Rajat & Co. has been appointed as Auditors of ABC Ltd situated at Kolkata. Harsh & Co., another firm of CA's has been appointed as Auditors for a division of the same company at Shimla. What procedures should Rajat & Co. follow while using the work of Harsh & Co. with respect to the Financial information of Shimla division, included in the Financial information of ABC Ltd ?

Ans.: SA 600

i) When the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit.

ii) "Principal auditor" means the auditor with responsibility for reporting on the financial information of an entity when that financial information includes the financial information of one or more components audited by another auditor.

iii) "Other auditor" means an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component which is included in the financial information audited by the principal auditor.

iv) "Component" means a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.

Acceptance as Principal Auditor

v) The auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor. For this purpose the auditor would consider:

(a) the materiality of the portion of the financial information which the principal auditor audits;

(b) the principal auditor's degree of knowledge regarding the business of the components;

(c) the risk of material misstatements in the financial information of the components audited by the other auditor; and

(d) the performance of additional procedures as set out in this SA regarding the components audited by other auditor resulting in the principal auditor having significant participation in such audit.

The Principal Auditor's Procedures

i) In certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component.

ii) when planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.

iii) The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

(a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for coordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of inter component transactions that may require disclosure and the time-table for completion of audit; and

(b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

iv) the principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

v) the principal auditor may conclude that it is not necessary to apply procedures such as those described in paragraph 13 because sufficient appropriate audit evidence previously obtained that acceptable quality control policies and procedures are complied with in the conduct of other auditor's practice.

vi) the principal auditor should consider the significant findings of the other auditor.

vii) the principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the components. He may also decide that supplemental tests of the records or the financial statements of the component are necessary. Such tests may, depending upon the circumstances, be performed by the principal auditor or the other auditor.

Illustration 2:

Write short notes on coordination between principal auditor and other auditor.

Ans. SA 600

There should be sufficient liaison between the principal auditor and the other auditor. For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor. For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

When considered necessary by him, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties. The other auditor should respond to such questionnaire on a timely basis.

Illustration 3:

Discuss the reporting considerations of the principal auditor under SA600.

Ans.

When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

In all circumstances, if the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting that it requires a modification of the principal auditor's report. (SA 600)

18.11.28 SA 610 (Revised) — Using the Work of Internal Auditors:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives: The objectives of the external auditor, where the entity has an internal audit function that the external auditor has determined is likely to be relevant to the audit, are to determine:

(a) Whether, and to what extent, to use specific work of the internal auditors; and

(b) If so, whether such work is adequate for the purposes of the audit.

Scope:

1. This Standard on Auditing (SA) deals with the external auditor's responsibilities regarding the work of internal auditors when the external auditor has determined, in accordance with SA 315, that the internal audit function is likely to be relevant to the audit. (Ref: Para. A1-A2)

2. This SA does not deal with instances when individual internal auditors provide direct assistance to the external auditor in carrying out audit procedures or where, in terms of the applicable legal and regulatory framework, it is not permissible for the internal auditor to provide access to his working papers to the third parties.

   Relationship between the Internal Audit Function and the External Auditor

3. The role and objectives of the internal audit function are determined by management and, where applicable, those charged with governance. While the objectives of the internal audit function and the external auditor are different, some of the ways in which the internal audit function and the external auditor achieve their respective objectives may be similar. (Ref: Para. A3)

4. Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the entity as is required of the external auditor when expressing an opinion on financial statements. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal auditors.

Illustration 1:

What aspects should be considered in the evaluation of internal Audit function? Or

You have been appointed as auditor of a large industrial company which has an established internal audit department. You are required to state the main aspects you would consider to find out the effectiveness of the department. **Or**

Enumerate, in brief, the important aspects to be evaluated by the external auditor in determining the efficiency and extent of reliance to be placed on the work and function of an internal auditor. Or

The auditor needs to review the system of internal audit only when such review is required for the purpose of reporting by the auditor u/s 143 of the Act. Comment

Ans. SA 610

i) The external auditor shall determine:

   (a) Whether the work of the internal auditors is likely to be adequate for purposes of the audit; and

   (b) If so, the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures.

ii) In determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, the external auditor shall evaluate:

   (a) The objectivity of the internal audit function;

   (b) The technical competence of the internal auditors;

   (c) Whether the work of the internal auditors is likely to be carried out with due professional care; and

   (d) Whether there is likely to be effective communication between the internal auditors and the external auditor.

iii) In determining the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures, the external auditor shall consider:

(a) The nature and scope of specific work performed, or to be performed, by the internal auditors;

(b) The assessed risks of material misstatement at the assertion level for particular classes of transactions, account balances, and disclosures; and

(c) The degree of subjectivity involved in the evaluation of the audit evidence gathered by the internal auditors in support of the relevant assertions.

Illustration 2:

How far is the internal audit useful to the statutory auditor? To what extent the statutory auditor can rely on the internal audit report? **Or**

Can an auditor ignore checking of areas already checked by internal auditors?

"The statutory auditor is entitled to rely on the internal auditor". Comment **Or**

Can the statutory auditor rely upon the work of an internal auditor?

Ans. SA 610

i) The external auditor shall determine:

(a) Whether the work of the internal auditors is likely to be adequate for purposes of the audit; and

(b) If so, the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures.

ii) In determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, the external auditor shall evaluate:

(a) The objectivity of the internal audit function;

(b) The technical competence of the internal auditors;

(c) Whether the work of the internal auditors is likely to be carried out with due professional care; and

(d) Whether there is likely to be effective communication between the internal auditors and the external auditor.

iii) In determining the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures, the external auditor shall consider:

(a) The nature and scope of specific work performed, or to be performed, by the internal auditors;

(b) The assessed risks of material misstatement at the assertion level for particular classes of transactions, account balances, and disclosures; and

(c) The degree of subjectivity involved in the evaluation of the audit evidence gathered by the internal auditors in support of the relevant assertions.

iv) In order for the external auditor to use specific work of the internal auditors, the external auditor shall evaluate and perform audit procedures on that work to determine its adequacy for the external auditor's purposes.

V) To determine the adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether:

(a) The work was performed by internal auditors having adequate technical training and proficiency;

(b) The work was properly supervised, reviewed and documented;

(c) Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;

(d) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and

(e) Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

18.11.29 SA 620 (Revised) — Using the Work of an Auditor's Expert:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives: The objectives of the auditor are:

(a) To determine whether to use the work of an auditor's expert; and

(b) If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes.

Scope of this SA:

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding the use of an individual or organisation's work in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.
2. This SA does not deal with:
   (a) Situations where the engagement team includes a member with expertise in specialized area of accounting or auditing, which is dealt with in SA 220 (Revised); or
   (b) The auditor's use of the work of an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements(a management's expert), which is dealt with in SA 500 (Revised).

Illustration 1:

SA620 Applies when an auditor seeks legal opinion from an advocate. Comment

Ans. SA 620

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding the use of an individual or organization's work in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.
2. This SA does not deal with:
   (a) Situations where the engagement team includes a member with expertise in specialized area of accounting or auditing, which is dealt with in SA 220 (Revised); or
   (b) The auditor's use of the work of an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements(a management's expert), which is dealt with in SA 500 (Revised).

Illustration 2:

How does an auditor evaluate the work of an expert? What are the auditor's duties vis a vis using the work of an expert?

Ans. SA 620

If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert.

Nature, Timing and Extent of Audit Procedures

The nature, timing and extent of the auditor's procedures with respect to the requirements in paragraphs 9-13 of this SA will vary depending on the circumstances. In determining the nature, timing and extent of those procedures, the auditor shall consider matters including:

(a) The nature of the matter to which that expert's work relates;

(b) The risks of material misstatement in the matter to which that expert's work relates;

(c) The significance of that expert's work in the context of the audit;

(d) The auditor's knowledge of and experience with previous work performed by that expert; and

(e) Whether that expert is subject to the auditor's firm's quality control policies and procedures.

The Competence, Capabilities and Objectivity of the Auditor's Expert

The auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity.

Obtaining an Understanding of the Field of Expertise of the Auditor's Expert

The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to:

(a) Determine the nature, scope and objectives of that expert's work for the auditor's purposes; and

(b) Evaluate the adequacy of that work for the auditor's purposes.

Agreement with the Auditor's Expert

The auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert:

(a) The nature, scope and objectives of that expert's work;

(b) The respective roles and responsibilities of the auditor and that expert;

(c) The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert; and

(d) The need for the auditor's expert to observe confidentiality requirements.

Evaluating the Adequacy of the Auditor's Expert's Work

The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including:

(a) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence;

(b) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and

(c) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall:

(a) Agree with that expert on the nature and extent of further work to be performed by that expert; or

(b) Perform further audit procedures appropriate to the circumstances.

Reference to the Auditor's Expert in the Auditor's Report

The auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the auditor shall indicate in the auditor's report that the reference does not reduce the auditor's responsibility for the audit opinion.

Illustration 3:

The new audit trainee of your firm of auditors has asked you to advise him on the reliability of the evidence for valuation of land and buildings of ₹ 50 crores by a valuer. Describe the work you would carry out to check the independence, qualifications and experience of the valuer and the accuracy of the valuation. Or

Based upon a legal opinion of a leading advocate, DX ltd made a provision of ₹ 10 Crores towards income tax liability. The assessing authority has worked out the liability at ₹ 20 crores. It is observed that the opinion of the advocate was inconsistent with the legal position with regard to certain revenue items. Indicate the precise nature of auditor's liability in the above situation and support your views with authority, if any.

Ans.

1. **Requirement under SA620:**
   a. The auditor can seek audit evidence from an expert, either independently or in conjunction with the client.
   b. Such audit evidence may be in the form of reports, opinions, valuations and other statements like legal opinions concerning interpretations of agreements, statues, regulations, notifications, etc.
   c. Where the expert's opinion is inconsistent with the provisions of law, then the auditor should deal with such inconsistency suitably. He may do it by discussing the issue with the Auditee client or the concerned expert.
   d. However, the auditor should ensure that the expert's is prima facie dependable under the circumstances before relying upon the same.
2. **Application of SA620 to the above situation:**
   a. The auditor should see that the advocate's opinion is prima facie dependable.
   b. The situation described above clearly brings out the inconsistency of the opinion with the legal Provision with regard to certain items. Such inconsistency could have been detected and corrected if the auditor has sought assurance as to the appropriateness of the source data, assumptions involved therein and the methods adopted by the expert.
   c. The auditor could have detected the inconsistency in legal opinions if he had gone through the same carefully. This is evident having regard to the wide difference in the liability worked out by the assessing authority.
   d. Under the circumstances, the auditor should have rejected the opinion and insisted upon making proper provision.
3. **Conclusion: The opinion is basically erroneous. Therefore, the auditor is liable for negligence and lack of due professional care in performance of the audit.**

Illustration 4:

LNK Ltd's Group Gratuity Scheme valuation by an actuary shows wide variation compared to the previous year's figures. What are the statutory auditor's duties? Or

Swadesi Limited obtained an actuarial valuation for gratuity liability at this year-end. The actuary changed certain basic assumptions for working out the liability at this year-end as compared to the ones adopted by him in the preceding year. State the auditor's responsibility in this matter.

Ans. When an auditor's expert's work involves the use of significant assumptions and methods, factors relevant to the auditor's evaluation of those assumptions and methods include whether they are:

- Generally accepted within the auditor's expert's field;
- Consistent with the requirements of the applicable financial reporting framework;
- Dependent on the use of specialized models; and

- Consistent with those of management, and if not, the reason for, and effects of, the differences.

If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.

Illustration 5:

Briefly describe how an auditor can use the work of an expert.

Answer

Using the Work of an Expert: SA 620 on, "Using the Work of an Expert" discusses the auditor's responsibility in relation to, and the procedures the auditor should consider in, using the work of an expert as audit evidence. The auditor has to first determine the need to use the work of an expert considering the materiality of the item, its nature and complexity. It would be necessary in cases of valuation of certain types of assets, determining the physical condition of the assets like minerals, actuarial valuation of gratuity, determining work in progress in case of construction contracts, etc. Generally, the auditor's education and experience enable him to be knowledgeable about business matters in general, but he is not expected to have the expertise of a person trained for, or qualified to engage in, the practice of another profession or occupation, such as an actuary or engineer.

When the auditor plans to use the expert's work as audit evidence, the auditor is required to assess skill and competence of the expert, his objectivity and, finally, evaluate the work done by him. So first of all, the auditor should satisfy himself as to the expert's skills and competence by considering the expert's:

- professional qualifications, license or membership in an appropriate professional body, and
- experience and reputation in the field in which the evidence is sought.

However, when the auditor uses the work of an expert employed by him, he will not need to inquire into his skills and competence. The auditor should also consider the objectivity of the expert. Finally, when the auditor intends to use the work of an expert, he should examine evidence to gain knowledge regarding the terms of the expert's engagement and such other matters as:

- the objectives and scope of the expert's work,
- a general outline as to the specific items in the expert's report,
- confidentiality of the expert's work, including the possibility of its communication to third parties.
- the expert's relationship with the client, if any,
- confidentiality of the client's information used by the expert.

The auditor should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information, by considering:

- the source data used,
- the assumptions and methods used and, if appropriate, their consistency with the prior period,
- the results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of his audit procedures, and
- the auditor should also satisfy himself that the substance of the expert's findings is properly reflected in the financial information.

The auditor should consider whether the expert has used source data which are appropriate in the circumstances. The procedures to be applied by the auditor should include:

- making inquiries of the expert to determine how he has satisfied himself that the source data are sufficient, relevant and reliable, and
- conducting audit procedures on the data provided by the client to the expert to obtain reasonable assurance that the data are appropriate.

The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods. However, the auditor should obtain an understanding of those assumptions and methods to determine that they are reasonable based on the auditor's knowledge of the client's business and on the results of his audit procedures.

If after performing all these procedures the auditor concludes that the work of the expert is not consistent with the information in the financial statements or that it does not constitute sufficient appropriate audit evidence, the auditor should express a qualified, disclaimer or an adverse opinion. In other cases, the opinion has to be unqualified. If while giving his report the auditor considers it appropriate to disclose the identity of the expert, he should obtain his prior consent.

18.11.30 SA 700 (Revised) — Forming an Opinion and Reporting on Financial Statements:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

Objectives: The objectives of the auditor are to:

(a) Form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and

(b) Express clearly that opinion through a written report that also describes the basis for the opinion.

Scope of this SA:

1. This Standard on Auditing (SA) deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.

2. SA 705 and SA 706 deal with how the form and content of the auditor's report are affected when the auditor expresses a modified opinion or includes an Emphasis of Matter paragraph or an Other Matter paragraph in the auditor's report.

3. This SA is written in the context of a complete set of general purpose financial statements. SA 800 deals with special considerations when financial statements are prepared in accordance with a special purpose framework. SA 805 deals with special considerations relevant to an audit of a single financial statement or of a specific element, account or item of a financial statement.

4. This SA promotes consistency in the auditor's report. Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

Form of Opinion:

1. The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

2. If the auditor:

    (a) Concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

    (b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

3. If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending

on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with SA 705. (Ref: Para. A11)

[A11— there may be cases where the financial statements, although prepared in accordance with the requirements of a fair presentation framework, do not achieve fair presentation. Where this is the case, it may be possible for management to include additional disclosures in the financial statements beyond those specifically required by the framework or, in extremely rare circumstances, to depart from a requirement in the framework in order to achieve fair presentation of the financial statements.]

4. When the financial statements are prepared in accordance with a compliance framework, the auditor is not required to evaluate whether the financial statements achieve fair presentation. However, if in extremely rare circumstances the auditor concludes that such financial statements are misleading; the auditor shall discuss the matter with management and, depending on how it is resolved, shall determine whether, and how, to communicate it in the auditor's report. (Ref: Para. A12)

   [A12 — it will be extremely rare for the auditor to consider financial statements that are prepared in accordance with a compliance framework to be misleading if, in accordance with SA 210 (Revised), the auditor determined that the framework is acceptable.]

Auditor's Report:

1. The auditor's report shall be in writing. (Ref: Para. A13-A14)

   Auditor's Report for Audits Conducted in Accordance with Standards on Auditing:

   Title

2. The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor. (Ref: Para. A15)

   [A15— A title indicating the report is the report of an independent auditor, for example, "Independent Auditor's Report", affirms that the auditor has met all of the relevant ethical requirements regarding independence and, therefore, distinguishes the independent auditor's report from reports issued by others.]

   Addressee

3. The auditor's report shall be addressed as required by the circumstances of the engagement. (Ref: Para. A16)

   [A-16 — The law or regulation applicable to the entity often specifies to whom the auditor's report is to be addressed. The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.]

   Introductory Paragraph:

4. The introductory paragraph in the auditor's report shall: (Ref: Para. A17- A19)
   (a) Identify the entity whose financial statements have been audited;
   (b) State that the financial statements have been audited;
   (c) Identify the title of each statement that comprises the financial statements;
   (d) Refer to the summary of significant accounting policies and other explanatory information; and
   (e) Specify the date or period covered by each financial statement comprising the financial statements.

   Management's Responsibility for the Financial Statements:

5. This section of the auditor's report describes the responsibilities of those in the organisation that are responsible for the preparation of the financial statements. The auditor's report need not refer specifically to "management", but shall use the term that is appropriate in the context of the legal and/or regulatory framework applicable to the entity. In case of some entities, the appropriate reference may be to those charged with governance.

6. The auditor's report shall include a section with the heading "Management's [or other appropriate term] Responsibility for the Financial Statements".

7. The auditor's report shall describe management's responsibility for the preparation of the financial statements in the manner in which that responsibility is described in the terms of the audit engagement. The description shall include an explanation that management is responsible for the preparation of the financial statements in accordance with the applicable financial reporting framework; this responsibility includes the design, implementation and maintenance of internal control relevant to the preparation of financial statements that are free from material misstatement, whether due to fraud or error. (Ref: Para. A20-A22)

8. Where the financial statements are prepared in accordance with a fair presentation framework, the explanation of management's responsibility for the financial statements in the auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view", as appropriate in the circumstances. Auditor's Responsibility

9. The auditor's report shall include a section with the heading "Auditor's Responsibility".

10. The auditor's report shall state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit. (Ref: Para. A23)

    [A23— The auditor's report states that the auditor's responsibility is to express an opinion on the financial statements based on the audit in order to contrast it to management's responsibility for the preparation of the financial statements.]

11. The auditor's report shall state that the audit was conducted in accordance with Standards on Auditing issued by the Institute of Chartered Accountants of India. The auditor's report shall also explain that those Standards require that the auditor comply with ethical requirements and that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. (Ref: Para. A24-A25)

12. The auditor's report shall describe an audit by stating that:

    (a) An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements;

    (b) The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments; the auditor considers internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of internal control; and

    (c) An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of accounting estimates made by management, as well as the overall presentation of the financial statements.

13. Where the financial statements are prepared in accordance with a fair presentation framework, the description of the audit in the auditor's report shall refer to "the entity's preparation and fair presentation of the financial statements" or "the entity's preparation of financial statements that give a true and fair view", as appropriate in the circumstances.

14. The auditor's report shall state whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion. Auditor's Opinion:

15. The auditor's report shall include a section with the heading "Opinion".

16. When expressing an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent: (Ref: Para. A26-A32)
    (a) The financial statements present fairly, in all material respects, in accordance with [the applicable financial reporting framework]; or
    (b) The financial statements give a true and fair view of in accordance with [the applicable financial reporting framework].
17. When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor's opinion shall be that the financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework]. (Ref: Para. A26, A28-A32)
18. If the reference to the applicable financial reporting framework, in the auditor's opinion, is not to the Accounting Standards promulgated by the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, or the Accounting Standards for Local Bodies promulgated by the Committee on

    Accounting Standards for Local Bodies (CASLB) of the Institute of Chartered Accountants of India, as may be applicable, the auditor's opinion shall identify the jurisdiction of origin of the framework.

    The following is an illustration of a complete auditor's report incorporating the basic elements. This report illustrates the expression of an unqualified opinion.

Auditor's Report

(Appropriate Addressee)

We have audited the attached Balance Sheet of……... (Name of the entity) as at 31st March 2XXX and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion and to the best of our information and according to the explanations given to us, the financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of ……….. (Name of the entity) as at 31st March 2XXX; and

(b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date.

For PQF and Co.,
Chartered Accountants
Auditor's Signature
(Name of Member signing the Audit Report)
(Designation)
(Membership Number)

Place of Signature
Date

An illustration of auditor's report on the financial statements in the case of a company incorporated under the Companies Act, 2013 to which AS 3 is applicable.

An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor's report is as follows:

"Without qualifying our opinion, we draw attention to Note X of Schedule …… to the financial statements. The entity is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The entity has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

In our opinion…… (remaining words are the same as illustrated in the opinion paragraph- above.)

Illustration 1:

What are the different types of Opinion of an auditor in a Financial Statements? Explain briefly the different types of Opinion.

Answer:

Qualified Opinion: The auditor shall express a qualified opinion when:

(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Adverse Opinion: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Disclaimer of Opinion: The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

18.11.31 SA 705 — Modifications to the Opinion in the Independent Auditor's Report:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

Objective: The objective of the auditor is to express clearly an appropriately modified opinion on the financial statement that is necessary when:

(a) The auditor concludes based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Scope of this SA:

1. This Standard on Auditing (SA) deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

Types of Modified Opinions:

2. This SA establishes three types of modified opinions, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion. The decision regarding which type of modified opinion is appropriate depends upon: (Ref: Para A1)
   (a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
   (b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

18.11.32 SA 706 — Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

Objective: The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

(a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or

(b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Scope of this SA:

1. This Standard on Auditing (SA) deals with additional communication in the auditor's report when the auditor considers it necessary to:
   (a) Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or
   (b) Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.
2. Other Standards on Auditing (SAs) may contain specific requirements for the auditor to include Emphasis of Matter paragraphs or Other Matter paragraphs in the auditor's report. In those circumstances, the requirements in this SA regarding the form and placement of such paragraphs apply.

18.11.33 SA 710 (Revised) — Comparative Information— Corresponding Figures and Comparative Financial Statements:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

Objectives: The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and

(b) To report in accordance with the auditor's reporting responsibilities.

Scope of this SA:

1. This Standard on Auditing (SA) deals with the auditor's responsibilities regarding comparative information in an audit of financial statements. When the financial statements of the prior period have been audited

by a predecessor auditor or were not audited, the requirements and guidance in SA 510 (Revised) regarding opening balances also apply.

The Nature of Comparative Information:

2. The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.

3. The essential audit reporting differences between the approaches are:

   (a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas

   (b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented. This SA addresses separately the auditor's reporting requirements for each approach.

18.11.34 SA 720 — The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective: The objective of the auditor is to respond appropriately when documents containing audited financial statements and the auditor's report thereon include other information that could undermine the credibility of those financial statements and the auditor's report.

Scope of this SA:

1. This Standard on Auditing (SA) deals with the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion does not cover other information and the auditor has no specific responsibility for determining whether or not other information is properly stated. However, the auditor reads the other information because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. (Ref: Para. A1)

2. In this SA "documents containing audited financial statements" refers to annual reports (or similar documents), that are issued to owners (or similar stakeholders), containing audited financial statements and the auditor's report thereon. This SA may also be applied, adapted as necessary in the circumstances, to other documents containing audited financial statements. (Ref: Para. A2-A4)

18.11.35 SA 800 — Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks:

Effective Date: This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

Objective: The objective of the auditor, when applying SAs in an audit of financial statements prepared in accordance with a special purpose framework, is to address appropriately the special considerations that are relevant to:

(a) The acceptance of the engagement;

(b) The planning and performance of that engagement; and

(c) Forming an opinion and reporting on the financial statements.

Scope of this SA:

1. The Standards on Auditing (SAs) in the 100-700 series apply to an audit of financial statements. This SA deals with special considerations in the application of those SAs to an audit of financial statements prepared in accordance with a special purpose framework.

2. This SA is written in the context of a complete set of financial statements prepared in accordance with a special purpose framework. SA 805 deals with special considerations relevant to an audit of a single financial statement or of a specific element, account or item of a financial statement.

3. This SA does not override the requirements of the other SAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement.

18.11.36 SA 805 — Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement:

Effective Date: This SA is effective for audits of single financial statements or of specific elements, accounts or items for periods beginning on or after April 1, 2011. In the case of audits of single financial statements or of specific elements, accounts or items of a financial statement prepared as at a specific date, this SA is effective for audits of such information prepared as at a date on or after April 1, 2011.

Objective: The objective of the auditor, when applying SAs in an audit of a single financial statement or of a specific element, account or item of a financial statement, is to address appropriately the special considerations that are relevant to:

(a) The acceptance of the engagement;

(b) The planning and performance of that engagement; and

(c) Forming an opinion and reporting on the single financial statement or on the specific element, account or item of a financial statement.

Scope of this SA:

1. The Standards on Auditing (SAs) in the 100-700 series apply to an audit of financial statements and are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. This SA deals with special considerations in the application of those SAs to an audit of a single financial statement or of a specific element, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, SA 800 also applies to the audit. (Ref: Para. A1-A4)

2. This SA does not apply to the report of a component auditor, issued as a result of work performed on the financial information of a component at the request of a group engagement team for purposes of an audit of group financial statements (see Proposed SA 600 (Revised).

3. This SA does not override the requirements of the other SAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement.

18.11.37 SA 810 — Engagements To Report on Summary Financial Statements:

Effective Date: This SA is effective for engagements for periods beginning on or after April 1, 2011.

Objectives: The objectives of the auditor are to:

(a) Determine whether it is appropriate to accept the engagement to report on summary financial statements;

(b) Form an opinion on the summary financial statements based on an evaluation of the conclusions drawn from the evidence obtained; and

(c) Express clearly that opinion through a written report that also describes the basis for that opinion.

Scope of this SA: This Standard on Auditing (SA) deals with the auditor's responsibilities when undertaking an engagement to report on summary financial statements derived from financial statements audited in accordance with SAs by that same auditor.

Illustration of an auditor's report on summary financial statements prepared in accordance with established criteria. An unmodified opinion is expressed on the audited financial statements. The auditor's report on the summary financial statements is dated later than the date of the auditor's report on the financial statements from which summary financial statements are derived.

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS

[Appropriate Addressee]

The accompanying summary financial statements, which comprise the summary balance sheet as at December 31, 20X1, the summary income statement, summary statement of changes in equity and summary cash flow statement for the year then ended, and related notes, are derived from the audited financial statements of ABC Company for the year ended December 31, 20X1. We expressed an unmodified audit opinion on those financial statements in our report dated February 15, 20X2. Those financial statements, and the summary financial statements, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements.

The summary financial statements do not contain all the disclosures required by [describe financial reporting framework applied in the preparation of the audited financial statements of ABC Company]. Reading the summary financial statements, therefore, is not a substitute for reading the audited financial statements of ABC Company.

Management's Responsibility for the Summary Financial Statements

Management is responsible for the preparation of a summary of the audited financial statements in accordance with [established criteria].

Auditor's Responsibility

Our responsibility is to express an opinion on the summary financial statements based on our procedures, which were conducted in accordance with International Standard on Auditing (ISA) 810, Engagements to *Report on Summary Financial Statements.*

Opinion

In our opinion, the summary financial statements derived from the audited financial statements of ABC Company for the year ended December 31, 20X1 are consistent, in all material respects, with (or a *fair summary of*) those financial statements, in accordance with [established criteria].

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

18.11.38 SRE 2400 (Revised) — Engagements to Review Financial Statements:

Effective Date: This SRE is effective for reviews of financial statements for periods beginning on or after April 1, 2010.

Objective of a Review Engagement: The objective of a review of financial statements is to enable a practitioner to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the practitioner's attention that causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework (negative assurance).

Scope of a Review: The term "scope of a review" refers to the review procedures deemed necessary in the circumstances to achieve the objective of the review. The procedures required to conduct a review of financial statements should be determined by the practitioner having regard to the requirements of this SRE, relevant professional bodies, legislation, regulation and, where appropriate, the terms of the review engagement and reporting requirements.

18.11.39 SRE 2410 — Review of interim Financial Information Performed by the Independent Auditor of the Entity:

Effective Date: This SRE is effective for reviews of interim financial information for periods beginning on or after April 1, 2010.

Objectives: The objective of an engagement to review interim financial information is to enable the auditor to express a conclusion whether, on the basis of the review; anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with an applicable financial reporting framework. The auditor makes inquiries, and performs analytical and other review procedures in order to reduce to a moderate level the risk of expressing an inappropriate conclusion when the interim financial information is materially misstated.

The objective of a review of interim financial information differs significantly from that of an audit conducted in accordance with Standards on Auditing (SAs). A review of interim financial information does not provide a basis for expressing an opinion whether the financial information gives a true and fair view, or is presented fairly, in all material respects, in accordance with an applicable financial reporting framework.

A review, in contrast to an audit, is not designed to obtain reasonable assurance that the interim financial information is free from material misstatement. A review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review may bring significant matters affecting the interim financial information to the auditor's attention, but it does not provide all of the evidence that would be required in an audit.

Scope: The auditor who is engaged to perform a review of interim financial information should perform the review in accordance with this SRE. Through performing the audit of the annual financial statements, the auditor obtains an understanding of the entity and its environment, including its internal control. When the auditor is engaged to review the interim financial information, this understanding is updated through inquiries made in the course of the review, and assists the auditor in focusing the inquiries to be made and the analytical and other review procedures to be applied. A practitioner who is engaged to perform a review of interim financial information, and who is not the auditor of the entity, performs the review in accordance with SRE 2400 (Revised), "Engagements to Review Financial Statements." As the practitioner does not ordinarily have the same understanding of the entity and its environment, including its internal control, as the auditor of the entity, the practitioner needs to carry out different inquiries and procedures to meet the objective of the review.

The Institute of Cost Accountants of India
(Statutory body under an Act of Parliament)

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