SYLLABUS - 2016

INTERMEDIATE : PAPER - 12

COMPANY ACCOUNTS & AUDIT

INTERMEDIATE

STUDY NOTES

The Institute of Cost Accountants of India

CMA Bhawan, 12, Sudder Street, Kolkata - 700 016

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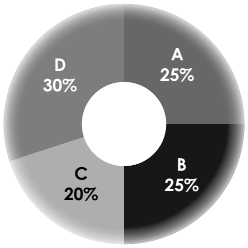
Syllabus - 2016

Syllabus Structure

A	Accounts of Joint Stock Companies	50%
B	Auditing	50%



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 : Accounts of Joint Stock Companies	
1. Accounting of Shares and Debentures	**25%**
2. Presentation of Financial Statements (as Per Schedule III)	
3. Cash Flow Statement	
4. Accounts of Banking, Electricity and Insurance Companies	**25%**
5. Accounting Standards (AS - 11, 12, 15, 16, 17, 18 and 19)	
Section B : Auditing	
6. Auditing Concepts	**20%**
7. Provision relating to Audit under Companies Act	**30%**

SECTION A: ACCOUNTS OF JOINT STOCK COMPANIES (50 MARKS)

1. **Accounting of Shares and Debentures**

   (a) Issue of shares, rights issue, bonus issue, sweat equity shares, forfeiture of share, buy-back of shares

   (b) Issue and redemption of preference shares, debentures

   (c) Under writing of shares and debentures

2. **Presentation of Financial Statements (as per Schedule III)**

   (a) Statement of Profit and Loss

   (b) Balance Sheet

3. **Cash Flow Statement (AS 3)**

4. **Accounts of Banking, Electricity and Insurance Companies**

   (a) Accounts of Banking Company

   (b) Accounts of an Electricity Company

   (c) Accounts of Insurance Company

5. **Accounting Standards (AS - 11, 12, 15, 16, 17, 18 and 19)**

SECTION B – AUDITING (50 MARKS)

6. **Auditing Concepts**

   (a) Nature, Scope and Significance of Auditing

   (b) Audit Engagement, Audit Program, Audit Working Papers, Audit Note Book, Audit Evidence and Audit Report

   (c) Internal Check, Internal Control, Internal Audit - Industry Specific.

7. **Provision relating to Audit under Companies Act**

   (a) Auditor's qualifications, disqualifications, appointment, remuneration, removal, powers and duties

   (b) Cost Audit, Secretarial Audit

   (c) Reporting Requirements under Companies Act, Report vs. Certificate, contents of the reports and qualifications in the report

   (d) Miscellaneous Audit

      (i) Branch Audit, Joint Audit

      (ii) Audit of shares and debentures

      (iii) Audit of divisible profits and dividends

      (iv) Statutory Auditors vs. Internal Auditors

      (v) Auditing and Assurance Standards relating to audit of inventories and audit of fixed assets

      (vi) Auditing of different types of undertaking – Education, Hospitals, Cooperative Societies, Banks, Trusts, Municipalities, Panchayats

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SECTION A – ACCOUNTS OF JOINT STOCK COMPANIES

Study Note 1 : Accounting of Shares and Debentures

Study Note 2 : Presentation of Financial Statements (As per Schedule III)

Study Note 3 : Cash Flow Statement

Study Note 4 : Accounts of Banking, Electiricity and Insurance Company

Study Note 5 : Accounting Standards

SECTION – B AUDITING

Study Note 6 : Auditing Concepts

Study Note 7 : Provision Relating to Audit under Companies Act

STUDY NOTE : 1
ACCOUNTING OF SHARES AND DEBENTURES

THIS STUDY NOTE INCLUDES:

1.1 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 forever. 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

- Issue of shares
  - Equity
    - Initial Public Offering (IPO)
    - Rights Issue
    - ESOS/ESOP
  - Preference
- Debenture
- Loans
- Ploughing back of profits

1.2 ISSUE OF SHARE

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 along with 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 along with 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 (Capital 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

To, 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:

$\frac{\text{Total profit on forfeiture of shares}}{\text{No. of shares forfeited}} \times \text{No. of Shares Reissued}$	= 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 To Equity Share Application A/c (Share application money on 10,00,000 equity shares @ ₹ 2 each received)	Dr.	2000	2000
Equity Share Application A/c To Equity Share Capital A/c (Share application money transferred to share capital account as per Board's resolution no. ……………. dated ………)	Dr.	2,000	2,000
Equity Share Allotment A/c To Equity Share Capital A/c (Share Allotment due on 10,00,000 shares @ ₹ 4 per share as per Board's resolution no. ……… dated……)	Dr.	4,000	4,000
Bank A/c To Equity Share Allotment A/c (Allotment money received)	Dr.	4,000	4,000
Equity Share First and Final Call A/c To Equity Share Capital A/c (Share 1st and Final Call due on 10,00,000 shares @ ₹ 4 share as per Board's resolution no. ……… dated……)	Dr.	4,000	4,000
Bank A/c To Equity Share First and Final Call A/c (For shares First and Final Call money received on 10,00,000 shares @ ₹ 4 per share)	Dr.	4,000	4,000

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.
(v) For the purchase of its own shares or other securities u/s 68.

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

Particulars		Dr. ₹ In Lakh	Cr. ₹ 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.	1,500	
To Equity Share Capital A/c			1,500
Calls in Arrear A/c	Dr.	3	
To Equity Share First Call A/c			3
Equity Share Final Call A/c	Dr.	2000	
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.

Illustration 3:

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 × ₹ 30) for 1 months @ 6% p.a.	₹ 6
On ₹ 800 (i.e. 40 × ₹ 20) for 2 months @ 6% p.a.	₹ 8
	₹ 14

Calculation of Interest on Calls-in-arrears

On ₹ 2400 (i.e. 60 × ₹ 40) for 2 months @ 5% p.a.	₹ 20
On ₹ 1800 (i.e. 60 × ₹ 30) for 1 months @ 5% p.a.	₹ 7.5
	₹ 27.5

Illustration 4:

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. To Share Application A/c [Being the issue of 2,000 shares and application money received @ ₹ 20 per share]		40,000	 40,000
Share Application A/c Dr. To Share Capital A/c [Being the transfer of application money on 2,000 shares @ ₹ 20 per share to Share Capital A/c)		40,000	 40,000
Share Allotment A/c Dr. To Share Capital A/c To Securities Premium A/c (Being the allotment money on 2,000 shares @ ₹ 50 including premium made due)		1,00,000	 60,000 40,000
Bank A/c Dr. To Share Allotment A/c (Being the allotment money on 2,000 shares @ ₹ 50 per share received)		1,00,000	 1,00,000
Share First Call A/ Dr. To Share Capital A/c (Being the first call money on 2,000 shares @ ₹ 20 per share made due)		 40,000	 40,000
Bank A/c Dr. To Share First Call A/c To Call-paid-in-advance A/c		38,900	 38,000 900

(Being the first call money on 1,900 shares @ ₹ 20 per share and share Second call money on 30 shares @ ₹30 per share received)			
Calls in Arrear A/c Dr. To, Share First Call A/c (Being the first call money for 100 shares is in arrear)		2,000	 2,000

Illustration 5:

B Ltd purchase the assets of ₹ 10,80,000 from C Ltd. The consideration 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. To C Ltd. [Being the purchase of assets from Y Ltd. as per agreement dated...)		 10,80,000	 10,80,000
Case (a) When Shares are issued at par C Ltd. Dr. To Equity Share Capital A/c (Being the issue of 10,800 shares at par to C Ltd. as per agreement dated...)		10,80,000	 10,80,000
Case (b) When Shares are issued at a premium of 20% C Ltd. Dr. To Equity Share Capital A/c To Securities Premium A/c (Being the issue of 9,000 shares at 20% premium to C Ltd. as per Board's Resolution no.......... dated..........)		 10,80,000	 9,00,000 1,80,000

Working Note: Calculation of No. of Shares to be issued 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 to be issued (A/B)	10,800	9,000

Illustration 6:

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 ₹
Goodwill A/c Dr. To Share Capital A/c (Being the issue of 2,000 shares of ₹ 100 each at par to promoters as per Board's Resolution no.......... dated..........)		2,00,000	2,00,000
Underwriting Commission A/c Dr. To Underwriter's A/c (Being the Underwriting commission due on shares)		1,00,000	1,00,000
Underwriter's A/c Dr. To Share Capital A/c (Being the issue of 1,000 shares of ₹ 100 each at par to Underwriters as per the Board's Resolution no.......... dated..........)		1,00,000	1,00,000

Illustration 7:

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. To Equity Share Capital A/c To Share Allotment A/c (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)		1,10,000	1,00,000 10,000
1.6.14	Equity Share Allotment A/c Dr. To Equity Share Capital A/c (Being allotment money due on 5000 shares @ ₹ 30 per share		1,50,000	1,50,000
1.7.14	Equity Share First Call A/c Dr. To Equity Share Capital A/c (Being 1st call money due on 5000 shares @ ₹ 20 per share		1,00,000	1,00,000
1.8.14	Calls-in-Arrear A/c Dr. To Equity Share first call A/c (Being the non receipt of 1st call money on 150 equity shares @ ₹ 20 each transferred to calls-in-Arrear A/c)		3,000	3,000
1.8.14	Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Being final call money due on 5000 shares @ ₹ 30 per share		1,50,000	1,50,000

30.8.14	Shareholders A/c Dr. To Interest on calls-in-arrear (Being the interest due on first call on ₹ 300 @ 5% for two months, assumed payment made on 30.8.12		25	25
1.09.14	Calls-in-Arrear A/c Dr. To Equity Share Final Call A/c (Being the transfer to calls-in-Arrear A/c final call money on 100 equity shares @ ₹ 30 per shares)		3,000	3,000
31.10.14	Shareholders A/c Dr. To Interest on Calls-in-Arrears A/c (Being the interest due on ₹ 3,000 @ 5% for two months)		25	25

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	01.6.14	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 Balance c/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 A/c (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, allotted and amounts adjusted			
Categories	A	B	C
(a) Applied (No. of shares)	2,500	3,000	500
(b) Allotted (No. of shares)	2,500	2,500	Nil
(c) Application money received [(a) × ₹ 20 per share]	50,000	60,000	10,000
(d) Application money required [(b) × ₹ 20 per share]	50,000	50,000 (refundable)	-
(e) Excess Application money to be adjusted with allotment [(c)-(d)]	Nil	10,000	-
(f) Allotment money due [(b) × ₹ 30 per share]	75,000	75,000	-
(g) Amount received on allotment [(f) -(e)]	75,000	65,000	-

Illustration 8:

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.A/c				60,000
(Being the purchase of machinery from Z Ltd. as per agreement dated...)				
Z Ltd.A/c	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)				
Bank A/c	Dr.		7,750	
Calls in Arrear A/c	Dr.		250	
To Share Allotment A/c				8,000
(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	
Calls in Arrear A/c	Dr.		750	
To Share First Call A/c				8,000
(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	
Calls in Arrear A/c	Dr.		2,000	8,000
To Share Second Call A/c				
(Being the second call received on 600 shares)				
Share Capital A/c	Dr.		3,750	
To Forfeited Share A/c [(50×30) + (25 ×20)]				2,000
To Calls in Arrear A/c [(50×30) + (25 ×20)]				1,750
(Being 75 shares forfeited as per Board's resolution dated...)				

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 9:

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 prorate to the applicants of 7,500 shares, the remaining 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)

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Share Capital: (₹ 2 on 9,000 shares)	18,000	By Share Application A/c	3,000
		By Balance c/d	71,750
To Share Allotment A/c (allotment money received)	26,550		
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. To Share Capital (Being Share application money transferred to Share Capital Account)		12,000	 12,000
Share Application A/c Dr. To Share Allotment A/c (Being Share application money at ₹ 2 on 1,500 shares adjusted against allotment or @ ₹0.50 on 6,000 shares issued)		3,000	 3,000
Share Allotment A/c Dr. To Share Capital A/c To Securities Premium A/c [Being the allotment money due]		30,000	 18,000 12,000
Calls –in-arrear A/c Dr. To Share Allotment A/c		450	 450
Share First Call A/c Dr. To Share Capital A/c [Being the first call money due]		18,000	 18,000
Calls –in-arrear A/c Dr. To Share First Call A/c [300×3]		900	 900
Share Capital A/c (100×8) Dr. Securities Premium A/c (100×2) Dr. To Forfeited Share A/c [100 ×(2×0.50)] To Calls in arrear A/c[100 ×5 (4.50+3)] [Being 100 shares of ₹ 10 each, ₹ 8 per Share called up, forfeited for non payment of allotment and first call]		800 200	 250 750 300
Share Second and Final Call A/c Dr. To Share Capital A/c [Being the second and final call money due on 5,900 Shares]		11,800	 11,800
Calls –in-arrear A/c Dr. To Share Second and Final Call A/c [200×2]		400	 400
Share Capital A/c (200×10) Dr. To Forfeited Share A/c [200×(2+3)] To Calls-in arrear A/c [200×(2+3)] [Being 200 shares of ₹ 10 each forfeited for non-payment of first and final call]		2,000	 1,000 1,000

Forfeited Share A/c Dr. To Share Capital A/c [Being discount on 200 shares re-issued]		300	300
Forfeited Share A/c Dr. To Capital Reserve A/c [Being the transfer of profit on re-issue]		450	450

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 × 7500/6,000)125

** Alternatively:
Ratio of allotment = 6,000:7,500 =4:5

∴Advance per share adjustable allotment = $\frac{5\times2-4\times2}{4\,\text{Shares}}$ =₹0.50 and due per share ₹4.50

So unpaid allotment money by D = 100 ×(5-0.50) = ₹450
Total amount received on allotment = (6,000 – 1,000)× ₹4.50 = ₹26,550.

** Profit on reissue:

On D's Share = 100 (2.50 – 1.50)	= ₹100
On Z's share = 100 × (5-1.50)	= ₹350
	₹450

Total money sent on application by Mr. D. (125 x 2)	₹ 250
Excess application money [₹ 250 - (100 × ₹ 2)]	₹ 50
Total amount due on allotment (100 × ₹ 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 10:
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 failure 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 transactions (including cash transactions)

Solution:

Journals

Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
Bank A/c Dr. To Share Application A/c [Being the application money received on 3,000 shares)		6,000	6,000

Share Application A/c Dr. To Share Capital A/c To Bank A/c To Share Allotment A/c (2,000@ ₹0.40) [Being the transfer and refund of application money received on 3,000 shares]		6,000	 4,000 1,200 800
Share Allotment A/c Dr. To Share Capital A/c To Securities Premium A/c [Being the allotment money due]		 10,000	 6,000 4,000
Bank A/c Dr. Calls in Arrear A/c Dr. To Share Allotment A/c [Being the remaining allotment money received on 1,960 shares]**		9,016 184	 9,200
Share First Call A/c Dr. To Share Capital A/c [Being the first call money due]		6,000	 6,000
Bank A/c Dr. Calls in Arrear A/c Dr. To Share First Call A/c [Being the first call money received on 1,900 shares @ ₹ 3 per share]**		5,700 300	 6,000
Share Capital A/c (40 × ₹8) Dr. Securities Premium A/c Dr. To Calls in Arrear A/c (184 +120) To Forfeited Share A/c [Being 40 shares forfeited for non-payment of full allotment money and the first call money]		320 80	 304 96
Share Second & Final Call A/c Dr. To Share Capital A/c [Being the second and final call due on 1,960 share]		3,920	 3,920
Bank A/c Dr. Calls in Arrear A/c Dr. To Share Second and Final Call A/c [Being the second and final call received on 1,900 shares]		3,800 120	 3,920
Share Capital A/c Dr. To Calls in Arrear A/c To Forfeited Shares A/c [Being 60 shares forfeited for non-payment on the first call and final call]		600	 300 300
Bank A/c Dr. Forfeited Shares A/c Dr. To Share Capital A/c [Being the reissued of 80 shares @ ₹ 9 as fully paid up]		720 80	 800
Forfeited Shares A/c Dr. To Capital Reserve A/c [Being the transfer of profit on re-issue] [On 40 @ ₹(2.40 - 1.00) = 56 On 40 @ ₹(5.00 – 1.00) =160 216]		216	 216

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.

****Alternative Calculation —**

Ratio of allotment = 2,000:2,400 = 5:6
Advance per share = (6×2 – 5× 2)/5 = ₹0.40
∴due on allotment = ₹5-0.40 = ₹4.60

Unpaid money or calls in arrear —	allot	Call-1	Call-2
Mohit (40) @ 4.60	184	120	-
Jagat (60)	-	180	120
	184	300	120

Illustration 11: 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 oversubscribed. 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 reduction of further sums due on shares allotted. All surplus contributions were refunded on 1st 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	**Categories**		
	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. To Equity Share Application A/c (Application money received on 56,000 shares @ ₹ 50 per share)		28,00,000	28,00,000
Feb. 01	Equity Share Application A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being application money on 10,000 shares transferred to share Capital and Securities Premium vide Board's resolution no........ dated........)		5,00,000	2,50,000 2,50,000
	Equity Share Application A/c Dr. To Bank A/c (Being excess application money refunded of vide Board's resolution no........ dated........)		16,50,000	16,50,000
	Equity Share Application A/c Dr. To Equity Share Allotment A/c To Calls in Arrear A/c (Being excess of Equity share application money adjusted with allotment)		6,50,000	5,00,000 1,50,000
	Equity Share Allotment A/c Dr. To Equity Share Capital A/c (Being allotment money due on 10,000 shares @ ₹ 50 per share vide Board's resolution no........ dated........)		5,00,000	5,00,000

	Equity Share First & Final Call A/c Dr. To Equity Share Capital A/c (Being first & final call money due on 10,000 shares @ ₹ 25 per share vide Board's resolution no........ dated........)		2,50,000	 2,50,000
Apr. 01	Bank A/c Dr. Calls in Arrear A/c Dr. Calls in Advance A/c Dr. To Equity Share First & Final Call A/c (Being amount received and adjusted, except a holder of 100 share who failed to pay the call)		97,500 2,500 1,50,000	 2,50,000
May 05	Equity Share Capital A/c Dr. To Shares Forfeited A/c To Calls in Arrear A/c (Being 100 shares held by Ramesh forfeited for non-payment of call @ ₹ 25 per share vide Board's resolution no........ dated........)		10,000	 7,500 2,500
June 10	Bank A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being 100 forfeited shares resissued at ₹ 10,500)		10,500	 10,000 500
	Share Forfeited A/c Dr. To Capital Reserve A/c (Being balance of shares forfeited transferred to capital reserve)		7,500	 7,500

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 green shoe or over-allotment option by the selling company.

1.3 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 12.

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%

Or, $\frac{2}{5} \times 100 = 40\%$

1.4 BONUS ISSUE

Capitalisation:

Capitalisation of profits is the process of converting profits or reserves into paid up capital.

Bonus Shares:

A bonus share is a free share issued without any consideration to an existing shareholder in the ratio of number of shares held by that shareholder.

Issue of Bonus share —
- decreases the Reserve & Surplus;
- Increases the issued capital but does not bring any change in cash flow and net worth.

Way to capitalize profits or reserves:

(a) by paying up amounts unpaid on existing partly paid shares so as to make them fully paid up shares, or
(b) by issuing fully paid bonus shares to the existing members.

Sources for fully paid-up bonus shares [Sec 63]

As per Sec 63(1), a company may issue fully paid-up bonus shares to its members out of-

- Its Free Reserves
- Its Secutiries Premium Account; or
- Its Capital Redemption Reserve Account

Restrictions —

- No issue of bonus shares shall be made by capitalising reserves created by the Revaluation of Assets i.e. Revaluation Reserves.

Meaning of Free Reserves: As per Sec 2(43) of the Companies Act, 2013, "Free Reserves" mean such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend.

Exclusions from Free Reserves:

- Any amount representing unrealised gains, notional gains or revaluation of assets, where shown as a reserve or otherwise, or

- 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.

Conditions for issue of fully paid-up bonus shares [SEC 63(2)]

(i) A company can issue bonus shares if its Articles expressly authorise to do so.

(ii) A resolution is required to be passed by the Board of Directors recommending its decision to issue bonus shares.

(iii) A resolution is required to be passed by the members in the general meeting to approve the Board's resolution recommending the issue of bonus shares.

Members' resolution —

- Must have an intention to capitalize the profits or reserves, and
- Must mention the amount of profits or reserves to be capitalized.

(iv) The company has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it.

(v) The Company has not defaulted in respect of payment of statutory dues of the employees such as contribution to provident fund, gratuity and bonus.

(vi) The partly-paid shares, if any, outstanding on the date of allotment are made fully paid-up.

(vii) A Company must comply with Prescribed Conditions.

(viii) The bonus shares shall not be issued in lieu of dividend.

SEBI guidelines on issue of bonus issues:

A listed company proposing to issue bonus shares shall comply with the following requirements:

1. - The articles of association of the company must contain a provision for capitalisation of reserves, etc;
   - If there is no such provision in the articles the company must pass a resolution at its general meeting making provision in the articles of association for capitalization;
2. The company has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption;
3. The company has not defaulted in payment of statutory dues of the employees such as contribution to provident fund, gratuity etc.
4. The partly-paid shares, if any, outstanding on the date of allotment are required to be made fully paid-up.
5. - No company shall, pending conversion of FCDs/PCDs, issue any by way of bonus unless similar benefit is extended to the holders of such FCDs/though reservation of shares in proportion to such convertible part of FCDs or PCDs.
   (b) The shares so reserved may be issued at the time of conversion(s) of such debentures on the same terms on which the bonus issues were made.
6. The bonus issue shall be made out of free reserves built out of the genuine profits or securities premium collected in cash.
7. Reserves created by revaluation of fixed assets shall not be capitalised.
8. The declaration of bonus issue, in lieu of dividend, shall not be made.
9. A company which announces its bonus issue after the approval of the Board of directors must implement the proposal within a period of 15 days from the date of such approval (if Shareholders' approval is not required) or 2 months (if Shareholders' approval is required).
10. Once the decision to make a bonus issue is announced, the same cannot be withdrawn.

Accounting Entries:

The various accounting entries relating to bonus issue are given below:

Particulars	L.F.	Dr. (₹)	Cr. (₹)
On issue of fully paid Bonus Shares			
1. On Declaration of such bonus			
Capital Redemption Reserve A/c Dr. Securities Premium A/c Dr. Capital Reserve A/c Dr. (realized in cash only) General Reserve A/c Dr. Profit and Loss A/c Dr. To Bonus to Shareholders A/c		XXX XXX XXX XXX XXX	 XXX
2. On issue of fully paid Bonus Shares			
Bonus to Shareholders A/c Dr. To, Share Capital A/c		XXX	 XXX

Illustration 13:

Following items appear in the Trial Balance of M Ltd. as at 31st March, 2015:

Particulars	Amount (₹)
60,000 Equity Shares of ₹ 10 each	6,00,000
Capital Redemption Reserve	45,000
Plant Revaluation Reserve	15,000
Securities Premium Account	52,500
General Reserve	1,50,000
Profit & Loss Account	75,000
Capital Reserve (including ₹ 37,500 being Profit on Sale of Machinery)	1,12,500

The company decided to issue bonus shares to its shareholders at the rate of one share for every four shares held.

Required: Pass the necessary journal entries. It is desired that there should be minimum reduction in free reserves.

Solution:

JOURNAL

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
(i)	Capital Reserve A/c Dr. Capital Redemption Reserve A/c Dr. Securities Premium A/c Dr. General Reserve A/c Dr. To Bonus to Shareholders A/c (Being the bonus declared by issuing 1 bonus share for every 4 shares held as per general body's resolution dated...)		37,500 45,000 52,500 15,000	 1,50,000
(ii)	Bonus to Shareholders A/c Dr. To Equity Share Capital A/c (Being the issue of 15,000 shares of ₹ 10 each by way of bonus)		1,50,000	 1,50,000

Notes:

(i) Plant Revaluation Reserve cannot be utilized to issue bonus shares.

(ii) Capital Reserve realised in cash can be utilized for bonus issue.

Illustration 14:

Following is the extract of the Balance Sheet of YY Ltd. as at 31st March, 2015:

		₹
Authorised Capital		
15,000 12% Preference shares of ₹ 10 each		1,50,000
1,50,000 Equity shares of ₹ 10 each		15,00,000
		16,50,000
Issued and Subscribed Capital:		
12,000 12% Preference Shares of ₹10 each fully paid 12% Preference shares of ₹ 10 each fully paid	8,000	1,20,000
1,35,000 Equity shares of ₹ 10 each, ₹ 8 paid up		10,80,000
Reserves and Surplus:		
Capital Redemption Reserve		30,000
General Reserve		1,80,000
Capital Reserve		1,12,500
Securities Premium		37,500
Profit and Loss Account		2,70,000
Secured Loans:		
12% Partly Convertible Debentures @ ₹ 100 each		7,50,000

On 1st April, 2015 the Company has made final call @ 2 each on 1,35,000 equity shares. The call money was received by 20th April, 2015. Thereafter the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held. Securities premium of ₹ 37,500 includes a premium of ₹ 7,500 for shares issued to vendors pursuant to a scheme of amalgamation. Capital reserves include ₹ 60,0000, being profit on sales of plant and machinery. 20% of 12% Debentures are convertible into equity shares of ₹ 10 each fully paid on 1st June 2015.

Required: Show necessary entries in the books of the company and prepare the extract of the Balance Sheet immediately after bonus issue but before conversion of debentures. Are the convertible debenture holders entitled to bonus shares?

Solution:

Journal of Y Y Ltd.

Date	Particulars	LF.	Dr. (₹)	Cr. (₹)
April 1	Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Being the Final call of ₹ 2 per share on 1,35,000 equity shares due as per Board's Resolution dated...)		2,70,000	 2,70,000
April 20	Bank A/c Dr. To Equity Share Final Call A/c (Being the Final Call money on 1,35,000 equity shares received)		2,70,000	 2,70,000
	Capital Redemption Reserve A/c Dr. Capital Reserve A/c [Realized in cash] Dr. Securities Premium A/c [37,500 – 7,500] Dr. General Reserve A/c Dr. Profit and Loss A/c Dr. To Bonus to Shareholders A/c (Being the Bonus issue @ one share for every four shares held by utilising various reserves as per Board's Resolution dated...)		30,000 60,000 30,000 1,80,000 37,500	 3,37,500
April 20	Bonus to Shareholders A/c To Equity Share Capital A/c (Being the Capitalisation of profits to issue 33,750 equity shares of ₹10 each, fully paid.)		3,37,500	 3,37,500

An Extract of BALANCE SHEET as at 30th April, 2015 (after bonus issue)

Particulars	Note No.	₹
EQUITY AND LIABILITIES		
(1) Shareholders' Funds		
(a) Share Capital	1	18,07,500
(b) Reserves and Surplus	2	2,92,500
(2) Non-Current Liabilities		
(a) Long-term borrowings	3	7,50,000
Total		28,50,000

Notes to Accounts:

Particulars	₹
1. Share Capital	
Authorised Share Capital	
1,87,500 Equity Shares of ₹ 10 each	18,07,500
15,000,12% Preference Shares of ₹ 10 each	1,50,000
	19,57,500
Issued, Subscribed and fully paid Share Capital	
1,68,750 Equity Shares of ₹ 10 each, fully paid	16,87,500
(Out of above, 33,750 equity shares @ ₹ 10 each were issued by way of bonus)	
12,000 12% Preference Shares of ₹ 10 each	1,20,000
Total	18,07,500
2. Reserves and Surplus	
Capital Reserves [1,12,500 - 60,000]	52,500
Securities Premium Reserves [37,500 - 30,000]	7,500
Surplus (Profit & Loss Account) [2,70,000 – 37,500]	2,32,500
Total	2,92,500
3. Long-term borrowings	
Secured	
Secured 12% Convertible Debentures @ ₹100 each	7,50,000
(out of above 1,50,000 Debentures @ ₹100 each to be converted into 15,000 Equity Shares @ ₹10 each 1st July,2015	
Total	7,50,000

Working Notes:

(i) Capital Reserve realised in cash can be utilised for issue of fully paid bonus shares.

(ii) As per SEBI guidelines, securities premium collected in cash can only be utilised for bonus issue.

(iii) As per pare (ii) of SEBI guidelines, no-company can issue bonus shares to its shareholders without extending similar benefit to convertible debentures holders. Pending such conversion, necessary number of shares should be earmarked for convertible debentures holders. Therefore, convertible debenture holders are also entitled to the bonus shares in the same ratio as the equity shareholders.

(iv) It is assumed that the company will pass necessary resolution at its general body meeting for increasing the authorised capital by ₹ 2,50,000.

Issue of Bonus Shares to equity shareholders [22,500 × ₹ 10]	2,25,000
Issue of Bonus Shares to be issued to Debenture holders after conversion	25,000
[(20% of 5,00,000)/₹ 10]× 1/4 × ₹ 10	2,50,000

1.5 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.

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.

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

800 sweat equity shares of ₹100 allotted 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)

1.6 FORFEITURE OF SHARES

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 15:

A Company invited the public to subscribe for 100,00,000 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 130,00,000 shares; applications for 20,00,000 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 3,00,000 shares which are forfeited after due notice. Later 2,00,000 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. To Equity Share Application A/c (Share application money received on 13,000,000 equity shares @ ₹ 20 each)	2,60,000	 2,60,000
Equity Share Application A/c Dr. To Bank A/c (Application for 2,000,000 rejected)	40,000	 40,000
Equity Share Application A/c Dr. To Equity Share Capital A/c To Equity Share Allotment A/c (Share application money transferred to share capital account and excess money used for share allotment.)	2,20,000	 2,00,000 20,000

Equity Share Allotment A/c To Equity Share Capital A/c To Security Premium A/c (Share Allotment due on 10,000,000 shares @ ₹ 40 per share as per the resolution of the Board of Directors)	Dr.	4,00,000	 3,00,000 1,00,000
Bank A/c To Equity Share Allotment A/c (Allotment money received)	Dr.	3,80,000	3,80,000
Equity Share first call A/c To Equity Share Capital A/c (First call money due)	Dr.	3,00,000	3,00,000
Bank A/c To Equity Share First call A/c (First call money received)	Dr.	3,00,000	3,00,000
Equity Share Final Call A/c To Equity Share Capital A/c (Share Final Call due)	Dr.	2,00,000	2,00,000
Bank A/c Calls in Arrear A/c To Equity Share Final Call A/c (Final Call money received except 300,000 Shares)	Dr. Dr.	1,94,000 6,000	2,00,000
Equity Share Capital A/c To Calls in Arrear A/c To Forfeited share A/c (300,000 shares forfeited for non payment of final call money)	Dr.	30,000	 6,000 24,000
Bank A/c Forfeited Shares A/c To Equity Share Capital A/c (200,000 shares reissued @ ₹ 85)	Dr. Dr.	17,000 3,000	20,000
Forfeited Shares A/c To Capital Reserve A/c (Being the Profit on Re-issue of 2,00,000 shares)	Dr.	13,000	13,000

Working:

1 . On 3,00,000 forfeited shares, the total amount forfeited is ₹ 24,000.

For 2,00,000 such shares the amount will be	₹ '000
(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.

**** Alternatively,** 2,00,000 × (amount forfeited – discounted on reissue)
= 2,00,000 × ₹(80-15) = ₹130,00,000

Illustration 16:

Give journal entries for the following:

a) PK Ltd. forfeited 10,000 equity shares of ₹ 10 each for nonpayment 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.

Solution:

Journal Entries

	Particulars		Dr. ₹	Cr. ₹
a)	Equity Share Capital A/c To Calls in Arrear A/c To Forfeited Share A/c (10,000 shares forfeited for non-payment of first and final call money)	Dr.	100,000	 50,000 50,000
	Bank A/c Forfeited Share A/c To Equity Share Capital Account (Reissue of 10,000 sh. @ ₹ 6.50 each)	Dr. Dr.	65,000 35,000	 100,000
	Forfeited Share A/c To Capital Reserve A/c (Balance of Forfeited share Account transferred)	Dr.	15,000	 15,000
b)	Equity Share Capital A/c To Calls in Arrear A/c To Forfeited share A/c (20,000 shares forfeited for non-payment of final call money)	Dr.	200,000	 60,000 140,000
	Bank A/c Forfeited Share A/c To Equity Share Capital A/c (Reissue of 10,000 sh. @ ₹ 6 each)	Dr. Dr.	60,000 40,000	 100,000
	Forfeited Share A/c To Capital Reserve A/c (Balance of Forfeited share A/c relating to 10,000 shares transferred) [10,000 × (7-4)]	Dr.	30,000	 30,000
c)	Equity Share Capital A/c Securities Premium A/c To Calls in Arrear A/c To Forfeited share A/c (15,000 shares forfeited for non- payment of allotment and first and final call money)	Dr. Dr.	150,000 75,000	 1,95,000 30,000
	Bank A/c To Security Premium A/c To Equity Share Capital A/c (Reissue of 10,000 sh. @ ₹ 15 each)	Dr.	140,000	 40,000 100,000
	Forfeited Share A/c To Capital Reserve A/c (Balance of Forfeited share A/c on 10,000 shares transferred) (10,000 × 2)	Dr.	20,000	 20,000

Illustration 17:

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 along with 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.

Solution:

X Ltd.

Journal Entries (without narration)

	Particulars		Dr. ₹	Cr. ₹
(1)	Application Money Received: Bank A/c To Equity Shares Application A/c (12000×3)	 Dr.	 36,000	 36,000
(2)	Refund of excess application money: Equity Share Application A/c (2000×3) To Bank A/c	 Dr.	6,000	 6,000
(3)	Transfer of share application to Share Capital: Equity Shares Application A/c (10,000 ×3) To Equity Shares Capital A/c (10000×2) To Securities Premium A/c (10,000×1)	 Dr.	 30,000	 20,000 10,000
(4)	Allotment Money Due: Equity Shares allotment A/c (10000×4) To Equity Share Capital A/c (10000×3) To Securities Premium A/c (10000×1)	 Dr.	 40,000	 30,000 10,000
(5)	Allotment Money Received: Bank A/c (9,970×4) Calls-in-Arear A/c (30×4) To Equity Share Allotment A/c	 Dr. Dr.	 39,880 120	 40,000
(6)	Bank A/c To Calls in Arrear A/c	Dr.	250	 250
(7)	Share Call Money Due: Equity Share First & Final call A/c (10,000 × 5) To Equity Share Capital A/c	 Dr.	 50,000	 50,000
(8)	Call Money Received, Adjustment of Calls-in-Advance: Bank A/c (9,920 × 5) Calls-in-Arrear A/c (30 × 5) Calls-in-Advance A/c To Equity Shares First & Final Call A/c (Received with Allotment, now adjusted)	 Dr. Dr. Dr.	 49,600 150 250	 50,000
(9)	Forfeiture of Shares: Equity Share Capital A/c (30×10) Securities Premium A/c (30×1) To Calls-in-Arrear A/c To Shares Forfeited A/c	 Dr. Dr.	 300 30	 270 60
(10)	Reissue of Forfeited Shares: Bank A/c (25×9) Share Forfeited A/c To Equity Shares Capital A/c (25×10)	 Dr. Dr.	 225 25	 250
(11)	Transfer of Profit on Reissue of Forfeited shares Shares Forfeited A/c To Capital Reserve A/c [25 × (2 - 1)]	 Dr.	 25	 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

1.7 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

$$= \frac{\text{Shareholders funds}}{\text{Buyback price}}$$

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) Transferring 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 To Bank A/c (Buying-back 2,00,000 equity shares of ₹ 10 each, at par)	Dr.	20,00,000	20,00,000
	General Reserve A/c To Capital Redemption Reserve A/c (Transfer of nominal value of shares bought back)	Dr.	20,00,000	20,00,000

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 To Equity Share Capital A/c (Final call of ₹2 per share due on 2,00,000 equity shares as per Board resolution)	Dr.	4,00,000	4,00,000
	Bank A/c To Equity Share Final Call A/c (Final call money on 2,00,000 shares received)	Dr.	4,00,000	4,00,000

	Equity Share Capital A/c Dr. To Equity Shareholders A/c (Amount due to equity shareholders transferred to their account for Buy Back)	20,00,000	20,00,000
	Equity Shareholders A/c Dr. To Bank A/c (Payment to shareholders towards buy-back)	20,00,000	20,00,000
	General Reserve A/c Dr. To Capital Redemption Reserve A/c (Transfer of nominal value of shares Bought-back.)	20,00,000	20,00,000

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. Securities Premium A/c Dr. To Equity Shareholders A/c (Amount due to equity shareholders for buying-back of 20,000 equity shares)	2,00,000 40,000	2,40,000
	Equity Shareholders A/c Dr. To Bank A/c (Payment to shareholders on account of buy-back)	2,40,000	2,40,000
	General Reserve A/c Dr. To Capital Redemption Reserve A/c (Transfer of nominal amount of equity shares Bought-back.)	2,00,000	2,00,000

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. To Equity Shareholders A/c To Capital Reserve A/c (Amount due to equity shareholders for buy-back of 20,000 shares @ ₹ 9)	2,00,000	1,80,000 20,000

	Equity Shareholders A/c Dr. To Bank A/c (Payment to equity shareholders the amount due to them)	1,80,000	1,80,000
	General Reserve A/c Dr. To Capital Redemption Reserve A/c (Transfer of nominal amount of shares bought-back)	2,00,000	2,00,000

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. To Preference Share Application A/c (Application money on 20,000 preference shares at ₹ 10 each)	2,00,000	2,00,000
	Preference Share Application A/c Dr. To Preference Share Capital A/c (Transfer of application money to preference share capital account on shares being allotted)	2,00,000	2,00,000
	Equity Share Capital A/c Dr. Securities Premium A/c Dr. To Equity Shareholders A/c (Amount due to equity shareholders consequent upon buy-back of 50,000 Shares at ₹ 15)	5,00,000 2,50,000	7,50,000
	Equity Shareholders A/c Dr. To Bank A/c (Payment to equity shareholders for amount due to them)	7,50,000	7,50,000
	General Reserve A/c Dr. To Capital Redemption Reserve A/c (Transfer of the nominal value of shares bought Back out of profit)	3,00,000	3,00,000

Illustration 23:

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	
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 Share A/c	Dr.	250	
	To Preference Shareholder A/c			2,750
	(Being redemption of preference shares)			
4.	Preference Shareholders A/c	Dr.	2,750	
	To Bank A/c			2,750
	(Being payment of amount due to preference shareholders)			
5.	Securities Premium A/c	Dr.	250	
	To Premium on Redemption of Preference Share A/c			250
	(Being use of securities premium to provide premium on redemption of preference shares)			
6.	Equity Share Capital A/c	Dr.	2,000	
	Premium on Buy-back A/c	Dr.	1,000	
	To Equity Shareholders A/c			3,000
	(being buy back of equity shares)			
7.	Securities Premium A/c	Dr.	550	
	General Reserve A/c	Dr.	450	
	To Premium on Buy-back A/c			1,000
	(being use of securities premium and general reserve to provide premium on buy-back)			
8.	General Reserves A/ c	Dr.	4,500	
	To Capital Redemption Reserve A/c (2000 + 2500)			4,500
	(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 (6,000 – 450 - 4,500)			

9.	Equity Shareholders A/c Dr. To Bank A/c (Being payment of amount due to equity shareholders). Note: Cash at Bank [1650+3150+2000-2750-3000] = ₹ 1,050		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 24:

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)	10.68	3	—
d.	Maximum number of shares for buy back - LEAST of the above	6	3	—

	Particulars	Situation I		Situation II	
		Debit	Credit	Debit	Credit
a.	Shares bought back A/c Dr. To Bank A/c [Being purchase of shares from public]	180	180	90	90
b.	Share capital A/c Dr. Security premium A/c Dr. General reserve A/c (balancing figure) Dr. To Shares bought back A/c [Being cancellation of shares bought on buy back]	60 100 20	180	30 60 —	90
c.	General reserves A/c Dr. To Capital redemption reserve A/c [Being transfer of reserves to capital redemption reserve to the extent capital is redeemed]	60	60	30	30

Note: Under situation III, the company does not qualify the debt equity ratio test. Therefore the company cannot perform the buyback 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 [270+100+50]	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	—

Alternatively: Let no. of shares bought back be x @ ₹30
Max ratio of Debt/Proprietors Fund = 2

I	II	III
$\frac{800}{720-10x-30x}=2$	$\frac{1{,}200}{720-10x-30x}=2$	$\frac{1{,}500}{720-10x-30x}=2$
or,x = 8	or, x = 3	or, x= -x, so not possible

1.8 ISSUE AND REDEMPTION OF PREFRENCE SHARES, DEBENTURES

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 cannot 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 class of 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 to be issued to members of the company.

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 25:

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
Funds Employed in :		900
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

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	Bank A/c To Equity Share Capital A/c	Dr.
(b) at a premium	Bank A/c To Equity Share Capital A/c To Securities Premium A/c	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 (i.e., out of profit)	General Reserve A/c Profit and Loss A/c To Capital Redemption Reserve A/c	Dr. Dr.
7. Issue of bonus shares	Capital Redemption Reserve A/c Securities Premium A/c (and others, if required) To Bonus to Shareholders A/c	Dr. Dr.
8. Conversion of bonus shares into equity shares	Bonus to Shareholders A/c To Equity Share Capital A/c/ To Sec. Prem. A/c (if issued at premium)	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 26:

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 27: 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 ₹ 10 each	100	Investments	40
		Stock	46
1,00,000 Redeemable Pref. shares of ₹100 each	100	Debtors	30
		Bank	30
Less: Call-in-arrears on 20,000 shares	(4)		
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

**Bonus Shares = 10,00,000 × 1/10 = 1,00,000 @ ₹10 = ₹10 Lakhs.

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 Reserve		20
Total		

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.	10	
To Bonus to Shareholders A/c			10
(Bonus declared)			
Bonus to Shareholders A/c	Dr.	10	
To Equity Share Capital A/c			10
(Conversion of Bonus Shares to Equity Shares)			

DEBENTURES – ISSUE AND REDEMPTION

"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

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 28:

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 A/c	Dr.	10,000	
	To 12% Debentures A/c			10,000
2.	Bank A/c	Dr.	9,000	
	Discount on Issue of Debentures A/c	Dr.	1,000	
	To 12% Debentures A/c			10,000
3.	Bank A/c	Dr.	11,000	
	To 12% Debentures A/c			10,000
	To Securities Premium A/c			1,000
4.	Bank A/c	Dr.	11,000	
	Loss on issue of debenture A/c	Dr.	500	
	To 12% Debentures A/c			10,000
	To Securities Premium A/c			1,000
	To Prem. on redemption of debentures A/c			500
5.	Bank A/c	Dr.	10,000	
	Loss on issue of Debentures A/c	Dr.	500	
	To 12% Debentures A/c			10,000
	To Prem. on redemption of DebenturesA/c			500
6.	Bank A/c	Dr.	9,000	
	Loss on Issue of Debentures A/c **	Dr.	1,500	
	To 12% Debentures A/c			10,000
	To Prem. on redemption of Debentures A/c			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 example of accounting entries:

Illustration 29:

(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 A/c	Dr.	230	
	Goodwill A/c	Dr.	20	
	To Liabilities A/c			30
	To PQR Company A/c			220
	(Being purchase of assets and liabilities of company)			
	PQR Company A/c		220	
	To Debentures A/c			200
	To Securities Premium A/c			20
	(Being issue of debentures at 10% premium)			

Debentures issued as Collateral Security

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, drawl 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 A/c
   (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 36th 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 12th 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 30:

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 A/c Loss on issue of debentures A/c To 15% Debentures A/c To Premium on redemption A/c	Dr. Dr.	10,000 1,500	 10,000 1,500
8th year end	15% Debentures A/c Premium on redemption A/c To Debenture Redemption A/c	Dr. Dr.	10,000 1,500	 11,500
	Debenture redemption A/c To Bank A/c	Dr.	11,500	 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 31:

A Company issued 100,000 debentures of ₹ 100 each redeemable at the end of 10^{th} year, but reserves the right to redeem earlier from the end of 5^{th} year. The company decides at the end of 5^{th} 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 To Debenture redemption A/c	Dr.	2,000	 2,000
	Debenture redemption A/c To Bank A/c	Dr.	2,000	 2,000

	Profit/ loss appropriation A/c Dr. To Debenture Redemption Reserve A/c	2,000	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 32:

On April 1, 2011 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, 2015. On April 1, 2016, debenture holders holding 10,00,000 debentures exercised their option. Pass the necessary journal entries.

Solution:

Date	Particulars	Dr ₹ in lakh	Cr ₹ in lakh
1-4-2011	Bank A/c Dr. To 12% Convertible debentures A/c (Issue of 25,00.000 convertible debentures of ₹ 100 each)	2,500	2,500
1-4-2016	12% Convertible debentures A/c Dr. To Equity share capital A/c To Security Premium A/c (Conversion of 10.00,000 deb. each, into two eq. shares of ₹ 10 at a premium of ₹ 40 each)	1,000	200 800

Illustration 33:

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.

Solution:

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 A/c	Dr.	105	
	To 13% Preference share capital A/c			100
	To Securities premium A/c			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
(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 34:

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, i.e., 2014-15 and 2017-18.

Solution:

Date	Particulars		Dr. ₹ in lakh	Cr. ₹ in lakh
14-15				
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	Dr.	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
17-18				
30-9-17	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
31-3-18	Debentures interest A/c	Dr.	56	
	To Bank A/c			56
31-3-18	Own debentures A/c	Dr.	291	
	To Bank A/c			291
	14 % Debentures A/c	Dr.	300	
	To Own debentures A/c			291
	To Capital Reserve A/c			9

	Profit and loss A/c Dr. To Debenture interest A/c		126	 126

ISSUE OF DEBENTURES AT PAR

Illustration 35:

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. To Debenture Application A/c (Being the Receipt of application money on 1,400 debentures)		2,80,000	 2,80,000
	Debentures Application A/c Dr. To 10% Debentures A/c To Debentures Allotment A/c To Bank A/c (Being the application money adjusted and surplus refunded)		2,80,000	 2,00,000 20,000 60,000
	Debentures Allotment A/c Dr. To 10% Debentures A/c (Benign the Amount due on allotment on 10,000 debentures)		4,00,000	 4,00,000
	Bank A/c Dr. To Debentures Allotment A/c (Being the Balance of the amount due on allotment received)		3,80,000	 3,80,000
	Debenture Call A/c Dr. To 10% Debentures A/c (Being the Amount due on call)		4,00,000	 4,00,000
	Bank A/c Dr. To Debenture Call A/c (Being the Amount due on call received)		4,00,000	 4,00,000

ISSUE OF DEBENTURES AT A PREMIUM

Illustration 36:

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. To Debenture Application A/c (Being application money received on 3,500		70,000	 70,000

	debentures)			
	Debentures Application A/c Dr. To 10% Debentures A/c To Debentures Allotment A/c To Bank A/c (Being the application money adjusted and the surplus refunded)		70,000	 50,000 5,000 15,000
	Debenture Allotment A/c Dr. To 10% Debentures A/c To Securities Premium A/c (Being the Amount due on allotment @ ₹ 50 on 2,500 debentures)		1,25,000	 1,00,000 25,000
	Bank A/c Dr. To Debentures Allotment A/c (Being the Balance of the amount due on allotment received)		1,20,000	 1,20,000
	Debentures Call A/c Dr. To 10% Debentures A/c (Being the Amount due on Call @ ₹ 40 on 2,500 debentures)		1,00,000	 1,00,000
	Bank A/c Dr. To Debentures Call A/c (Being the Amount due on call received)		1,00,00	 1,00,000

ISSUE OF DEBENTURES AT A DISCOUNT

Illustration 37:

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. To Debenture Application A/c (Being the Receipt of application money on 1,050 debentures)		2,10,000	 2,10,000
	Debentures Application A/c Dr. To 12% Debentures A/c To Debentures Allotment A/c To Bank A/c (Being the application money adjusted and surplus refunded)		2,10,000	 1,50,000 15,000 45,000
	Debentures Allotment A/c Dr. Discount on issue of Debentures A/c Dr. To 12% Debentures A/c (Being the amount due on allotment @ ₹ 500 on 750 debentures)		3,00,000 75,000	 3,75,000
	Bank A/c Dr. To Debentures Allotment A/c (Being the Balance of the amount due on allotment received)		2,85,000	 2,85,000

	Debentures Call A/c Dr. To 12% Debentures A/c (Being the Amount due on debentures @ ₹ 300 on 750 debentures)		2,25,000	2,25,000
	Bank A/c Dr. To Debenture Call A/c (Being the Amount due on call received)		2,25,000	2,25,000

ISSUE OF DEBENTURES FOR CONSIDERATION OTHER THAN CASH

Illustration 38: 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. Goodwill A/c Dr. To Sundry Liabilities A/c To C Ltd.A/c (Being the purchase of assets and liabilities from B Ltd. as per agreement dated...)		6,00,000 20,000	80,000 5,40,000
Case (a) If Debentures are issued at par C Ltd. A/c Dr. To 15% Debentures A/c (Being the issue of 5,400 debentures at par to B Ltd. as per Board's resolution dated....)		5,40,000	5,40,000
Case (b) If Debentures are issued at 20% premium C Ltd.A/c Dr. To 10% Debentures A/c To Securities Premium A/c (Being the issue of 4,500 debentures at a premium of 20% to B Ltd. as per Board's resolution dated...)		5,40,000	4,50,000 90,000
Case (c) If Debentures are issued at 10% discount C Ltd.A/c Dr. Discount on Issue of Debentures A/c Dr. To 10% Debentures A/c (Being the issue of 6,000 debentures at a discount of 10% to B Ltd. as per Board's resolution dated...)		5,40,000 60,000	6,00,000

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	(a) At par	(b) At 20% Premium	(c) At 10% Discount
A. Issue Price per Debenture (₹)	100	120	90
B. Purchase Consideration (₹)	5,40,000	5,40,000	5,40,000
C. No. of Debentures to be issued (B/A)	5,400	4,500	6,000

DEBENTURES ISSUED AS COLLATERAL SECURITY

Illustration 39:

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	₹
Non-Current Liabilities: Loan from Axis Bank (Secured by the issue of 1,000, 12% Debentures of ₹ 1000 each as collateral security)	8,00,000		

II. Second Method

Journal of C Ltd.

Particulars	L.F.	Dr. (₹)	Cr. (₹)
Debentures Suspense A/c Dr. To 12% Debentures A/c (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...)		10,00,000	10,00,000

An Extract of Balance Sheet of C Ltd. as at...

Liabilities	₹	Assets	₹
Non-current Liabilities: Loan from Axis Bank (Secured by the issue of 1,000, 12% debentures of ₹1,000 each as collateral security)	8,00,000		

ISSUE OF DEBENTURES UNDER DIFFERENT TERMS OF REDEMPTION

Illustration 40:

Give 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 Dentures 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 41:

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

Discount on Issue of Debenture Account

Dr. 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
Total				10	

Dr. **Discount on Issue of Debentures Account** Cr.

Date	**Particulars**	₹	**Date**	**Particulars**	₹
01.04.14	To 15% Debentures A/c	10,000	31.03.2015	By P&L A/c	4,000
				By Balance c/d	6,000
		10,000			10,000
01.04.2015	To Balance b/d	6,000	31.03.2016	By P&L A/c	3,000
				By Balance c/d	3,000
		6,000			6,000
01.04.2016	To Balance b/d	3,000	31.03.2017	By P&L A/c	2,000
				By Balance c/d	1,000
01.04.2017	To Balance b/d	1,000	31.03.2018	By P&L A/c	1,000
		1,000			1,000

REDEMPTION OUT OF PROFIT

Illustration 42:

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 calendar 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
			Total	40	

TREATMENT OF LOSS ON ISSUE OF DEBENTURES

Illustration 43:

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	₹
01.01.2015	To 10% Debentures A/c	5,000	31.12.2015	By P& L A/c	2,500
	To Premium on redemption A/c	5,000		By Balance c/d	7,500
		10,000			10,000
01.01.2016	To Balance b/d	7,500	31.12.2016	By P&L A/c	2,500
				By Balance c/d	5,000
		7,500			7,500
01.01.2017	To Balance b/d	5,000	31.12.2017	By P&L A/c	2,500
				By Balance c/d	2,500
01.01.2018	To Balance b/d	2,500	31.12.2018	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	₹
01.01.2015	To 10% Debentures A/c	5,000	31.12.2015	By P&L A/c	4,000
	To Premium on Redemption A/c	5,000		By Balance c/d	6,000
		10,000			10,000
01.012016	To Balance b/d	6,000	31.12.2016	By P&L A/c	3,000
				By Balance c/d	3,000
		6,000			6,000
01.01.2017	To Balance b/d	3,000	31.12.2017	By P&L A/c	2,000
				By Balance c/d	1,000
01.01.2018	To Balance b/d	1,000	31.12.2018	By P& L A/c	1,000
		1,000			1,000

SINKING FUND METHOD

Illustration 44:

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. Debenture Redemption Fund Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.03.2015	To Balance c/d	1,00,000	31.03.2015	By P&L App.A/c	1,00,000
31.03.2016	To Balance c/d	2,10,000	01.04.2015	By Balance b/d	1,00,000
			31.03.2016	By Interest on DRFI A/c	10,000
				By P&L App. A/c	1,00,000
		2,10,000			2,10,000
31.03.2017	To Balance c/d	3,31,000	01.04.2016	By Balance b/d	2,10,000
			31.03.2017	By Interest on DRFI A/c	21,000
			31.03.2017	By P&L App. A/c	1,00,000
		3,31,000			3,31,000
31.03.2018	To Loss on issue of Debentures/ Premium on redemption of Debentures A/c	22,100	01.04.2017	By Balance b/d	3,31,000

	To Debenture Redemption Reserve A/c	4,51,000	31.03.2018	By Interest on DRFI A/c	33,100
			31.03.2018	By P&L App. A/c	1,00,000
				By Debenture Redemption Fund Investment A/c (Profit)	
		4,73,100			4,73,100

Dr. Debentures Redemption Fund Investment (DRFI) Account Cr.

Date	Particulars	₹	Date	Particulars	₹
31.03.2015	To Bank A/c	1,00,000	31.03.2015	By Balance c/d	1,00,000
01.04.2015	To Balance b/d	1,00,000	31.03.2016	By Balance c/d	2,10,000
31.03.2016	To Bank A/c	1,10,000			
		2,10,000			2,10,000
01.04.2016	To Balance b/d	2,10,000	31.03.2017	By Balance c/d	3,31,000
31.03.2017	T Bank A/c	1,21,000			
		3,31,000			3,31,000
01.04.2017	To Balance b/d	3,31,000	31.03.2018	By Bank A/c (Sales)	3,40,000
31.03.2018	To Debenture Redemption Fund A/c (Profit)	9,000			
		3,40,000			3,40,000

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	—	—

Or, Calculate the interest on opening balance of DRFI A/c.

INSURANCE POLICY METHOD

Illustration 45:

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. Discount on Issue of Debentures A/c Dr. Loss on Issue of Debentures A/c Dr. To 15% Debenture A/c To Premium on Redemption of Deb. A/c (Being the issue of debentures at a discount of 10% and redeemable at 10% premium)		1,35,000 15,000 15,000	1,50,000 15,000
	Debentures Redemption Fund Policy A/c Dr. To Bank A/c (Being the payment of annual premium)		40,000	40,000
Dec. 31	Profit & Loss Appropriation A/c Dr. To Debenture Redemption Fund A/c (Being the transfer to profit to DRF A/c)		40,000	40,000
Dec. 31	Profit & Loss A/c Dr. To Discount on Issue of Debentures A/c (Being the discount on issue of debentures w/off)		3,750	3,750
01.01.16 Jan. 1, 16	Debenture Redemption Fund Policy A/c Dr. To Bank A/c (Being the payment of annual premium)		40,000	40,000
Dec. 31	Profit & Loss Appropriation A/c Dr. To Debenture Redemption Fund A/c (Being the transfer to profit to DRF A/c)		40,000	40,000
Dec. 31	Profit & Loss A/c Dr. To Discount on Issue of Debentures A/c (Being the discount on issue of debentures w/of		3,750	3,750
01.01.17	Debenture Redemption Fund Policy A/c Dr. To Bank A/c (Being the payment of annual premium)		40,000	40,000
Dec. 31	Profit & Loss Application A/c Dr. To Debenture Redemption Fund A/c (Being the transfer to profit to DRF A/c)		40,000	40,000
Dec. 31	Profit & Loss A/c Dr. To Discount on Issue of Debentures A/c (Being the discount on issue of debentures w/of)		3,750	3,750
01.01.18	Debenture Redemption Fund Policy A/c Dr. To Bank A/c (Being the payment of annual premium)		40,000	40,000
Dec. 31	Profit & Loss Appropriation A/c Dr. To Debenture Redemption Fund A/c (Being the transfer of profit to DRF A/c)		40,000	40,000
	Profit & Loss A/c Dr. To Discount on Issue of Debentures A/c (Being the discount on issue of debentures w/of		3,750	3,750
	Bank A/c Dr. To Debenture Redemption Fund Policy A/c (Being the receipt of policy amount on maturity)		1,65,000	1,65,000

	Debenture Redemption Fund Policy A/c Dr. To Debenture Redemption Fund A/c (Being the transfer to profit on the policy to DRF A/c)		5,000	5,000
	15% Debentures A/c Dr. Premium on Redemption of Debentures A/c Dr. To Debenture holders A/c (Being the amount due on redemption)		1,50,000 15,000	165,000
	Debenture holders' A/c Dr. To Bank A/c (Being the payment made to Debentures holders)		1,65,000	165,000
	Debenture Redemption Fund A/c Dr. To Loss on Issue of Debentures A/c (Being the loss on Issue of debentures written against the balance in DRF A/c)		15,000	15,000
	Debenture Redemption Fund A/c Dr. To Debenture Redemption Reserve A/c (Being the transfer of nominal value of debentures redeemed to Debenture Redemption Reserve A/c)		1,50,000	1,50,000

REDEMPTION BY CONVERSION

Illustration 46:

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 request and redeemed these 200 debentures by issuing him equity shares. The interest, however, on these 200 debentures was paid to the debenture holder. Pass the necessary journal entries.

Solution:

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
01.01.15	Bank A/c Dr. Discount on Issue of Debentures A/c Dr. To 10% Debentures A/c (Being the Debentures issued at 10% discount)		4,50,000 50,000	5,00,000
31.12.15	Interest on Debentures A/c Dr. To Outstanding Interest on debentures A/c (Being the Interest due on debentures)		50,000	50,000
	10% Debenture A/c Dr. To Discount on issue of Debentures A/c To Debenture holders' A/c (Being the amount due to debenture-holders)		50,000	5,000 45,000
	Debenture holders' A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being the issue of 600 Equity Shares of ₹ 50 each at a premium of 25%)		45,000	30,000 15,000
	Outstanding Interest on Debentures A/c Dr. To Bank A/c (Being the Interest paid to the Debentures holders)		50,000	50,000

Illustration 47:

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 converting 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 and 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 250 Debentures as per Board Resolution dated....)				

An Extract of Balance Sheet as at 31st December 2016

Liabilities	₹	Assets	₹
Shareholders Fund:			
Equity Shares of ₹ 100 each fully paid up	38,000		
Reserves & Surplus:**	2,000		
Non-current Liabilities:			
750, 15% Debentures of ₹ 200 each	1,50,000		

**** Note: Reserves & Surplus:**

Securities Premium	₹9,500
Discount on issue of Debentures	(₹7,500)
	₹2,000

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.

CUM INTEREST AND EX-INTEREST TRANSACTIONS

Illustration 48:

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 entries assuming (a) that the own Debentures purchased were cancelled immediately and (b) the own Debentures purchased were retained as investments till 31.12.2015 on which date they were cancelled.

Assume that the company follows English Calendar Year.

Solution:

(a) If own Debentures were cancelled immediately on date of purchase.

Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2015	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
May 01	(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	
	Interest on Own Debenture Account A/c	Dr.		1,600	
	To Bank A/c				38,800
	(Being the purchase of 400 debentures @ ₹ 97 cum-interest)				
June 30	Debentures Interest A/c	Dr.		12,000	
	To Interest on Own Debentures A/c				2,400
	To Bank A/c				9,600
	(Being the Interest paid/credited on ₹ 2,00,000 debentures held by outsiders & by the company own debentures for 2 months)				

Dec. 31	Debenture Interest A/c To Bank A/c To Interest on Own Debentures A/c (Being the interest paid/credited on ₹ 1,60,000 debentures held by outsiders and ₹ 40,000 own debentures for 6 months)	Dr.		12,000	 9,600 2,400
Dec. 31	Profit & Loss A/c To Debenture Interest A/c (Being the transfer of debenture interest to P & L A/c)	Dr.		24,000	24,000
Dec. 31	Interest on Own Debentures A/c To Profit & Loss A/c (Being the transfer of interest on own debentures to P & L A/c)	Dr.		3,200	3,200
Dec. 31	12% Debentures A/c To Own Debentures A/c To Capital Reserve A/c (Being the cancellation of 200 own debentures)	Dr.		40,000	37,200 2,800
Dec. 31	Profit & Loss Appropriation A/c To Debenture Redemption Reserve A/c (Being the transfer of an amount equivalent to the cash sum applied in redeeming the debentures)	Dr.		37,200	37,200

1.9 UNDER WRITING OF SHARES AND DEBENTURES

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)
Running Lead Manager 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 I 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:**

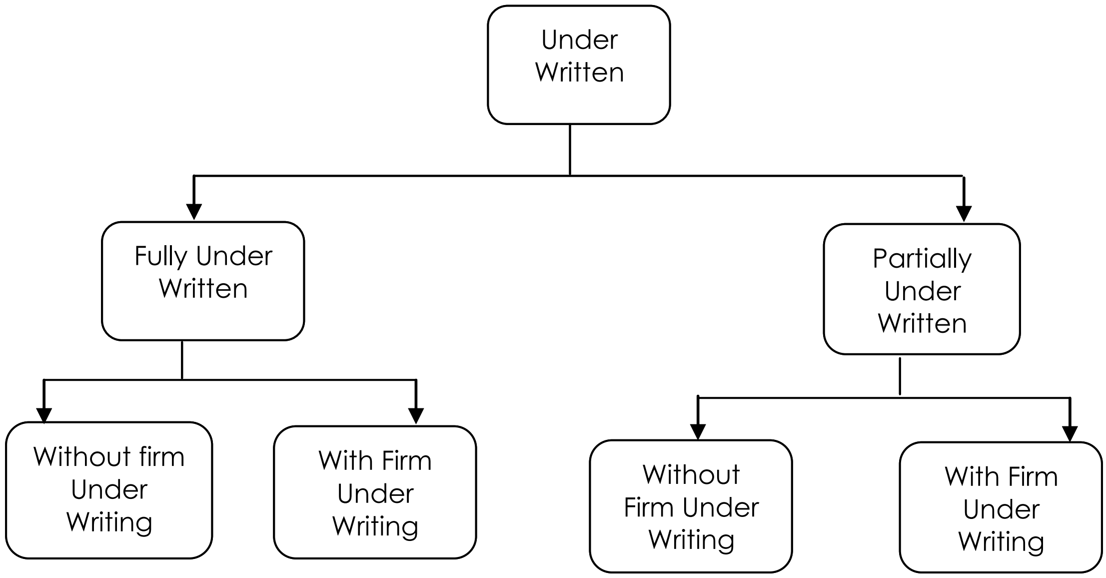
Commission/Brokerage A/c	Dr.
To Underwriter A/c	
To Broker A/c	

2. **For payment of Commission/brokerage**

Underwriter A/c	Dr.
Broker A/c	Dr.
To Bank A/c	[Cheque]
To Share Capital A/c	[Shares]
To Debentures A/c	[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 1,00,000 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 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 49:

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 the contract	22,800	-2,500	2,900	23,200
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

Alternatively:

Particulars	A	B	C	Total
Gross Liability	48,000	20,000	12,000	80,000
Firm underwriting	(6,400)	(8,000)	(2,400)	(16,800)
	41,600	12,000	9,600	6,300
Marked forms	(8,000)	(10,000)	(4,000)	(22,000)
Unmarked forms (48:20:12)	(10,800)	(4,500)	(2,700)	(18,000)
	22,800	(2,500)	2,900	23,200
Transfer of Surplus (48:12)	(2,000)	2,500	(500)	-
Net Liability	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	4,000

Working Note:

* Total Applications	40,000	Shares
Marked Applications	<u>22,000</u>	Shares
Unmarked applications	<u>18,000</u>	Shares

Illustration 50:

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 totaled 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 marked application	1,19,500	57,500	10,500	1,87,500
	4,65,500	1,67,500	79,500	7,12,500
Less: Unmarked application	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 50:

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%. 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 Maruti 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

*Alternatively, 2,25,000 unmarked applications may be distributed to all equity and thereafter, O's surplus can be transferred to A & B. Result will be the same.

(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 @ 12 each)	7,20,000	7,20,000	7,20,000
Net amount to be paid by underwriters	23,70,000	9,90,000	4,80,000

(a) The Books of Maruti Ltd.

Journal Entries

Particulars		Dr. ₹	Cr. ₹
Underwriting commission A/c	Dr.	21,60,000	
To A A/c			7,20,000
To B A/c			7,20,000
To C A/c			7,20,000
(Being underwriting commission on the shares underwritten)			

A A/c Dr. B A/c Dr. C A/c Dr. To Equity share capital A/c To Share premium A/c (Being shares including firm underwritten shares allotted to underwriters)		30,90,000 17,10,000 12,00,000	 50,00,000 10,00,000
Bank A/c Dr. To A A/c To B A/c To C A/c (Being the amount received towards shares allotted to underwriters less underwriting commission due to them)		42,00,000	 23,70,000 9,90,000 4,80,000

Illustration 51:

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)
	6,600	(350)	(450)	5,800
Adjustment: Surplus of B and C transferred to A	(800)	350	450	-
Net Liability	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 52:

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)
	(1,500)	3,500	8,000	10,000
Adjustment: Surplus of L transferred to M and N	1,500	(750)	(750)	-
Net Liability	-	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 × ₹100 × 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 53:

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)
	(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)	-
	-	(862)	-	6,345	-	(483)	5,000
Adjust: Transfer of surplus of P and SA to M	-	862	-	(1,345)	-	483	-
Net Liability	-	-	-	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 54:

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)
	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)	-
Net Liability	-	-	53,000	53,000
Add: Firm Underwriting	50,000	50,000	50,000	1,50,000
Total Liability (Shares to be subscribed)	**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 for 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. To, Equity Share Application A/c (Being application money received on Firm Applications for ₹ 2.50 per share from P,G, and K)	3,75,000	3,75,000
2	P A/c (point no. 1) Dr. G A/c (point no. 1) Dr. K A/c (point no. 1) Dr. Equity Share Application A/c Dr. To, Equity Share capital A/c (2,03,000 × ₹ 4.50) (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)	1,00,000 1,00,000 3,38,500 3,75,000	9,13,500
3	Underwriting Commission A/c Dr. To, P A/c To, G A/c To, K A/c (Being the underwriting Commission payable to P, G and K at 5% of the issue price of the shares underwritten)	7,50,000	2,50,000 2,50,000 2,50,000
4	P A/c Dr. G A/c Dr. 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)	1,50,000 1,50,000	3,00,000
5	Bank A/c Dr. To, K A/c (being the amount received from K on shares allotted Less Underwriting Commission payable to him)	88,500	88,500

Illustration 55:

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)
	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)	-
Net Liability	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 × 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 company	6,30,000 × 10x4% = 2,52,000	2,10,000 × 10 × 4% = 84,000	2,10,000 × 10 × 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
2	A A/c (5,000 × 2.50) Dr. C A/c (35,000 × 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

SELF EXAMINATION QUESTIONS:

1. Fill in the blanks:

(i) Register of Members is one of the _____________ Books maintained by a company.
(ii) ___________ ____________ is that part of the authorized capital which is offered to the public for subscription is called issued capital.
(iii) The application money to be refunded shall be credited only to the bank account from which the ______________ was remitted.
(iv) When a share is issued at a value greater than its face value it is said to be issued at a _____________.
(v) Except as provided in section 54, a company shall not issue shares at a ______________.
(vi) Issue of Bonus Share decreases the ______________________________.
(vii) ___________________ share is permissible from the existing security holders on a proportionate basis through the tender offer.
(viii) At the time of cancellation of own debentures _____________ A/c is Credited.
(ix) There are __________ types of Underwriting Agreements.
(x) A company is a distinct legal person existing _____________ of its members.

Answer:

(i) Statutory;
(ii) Issued Capital;
(iii) subscription;
(iv) Premium;
(v) Discount;
(vi) Reserves & Surplus;
(vii) Buy-back;
(viii) Own Debentures;
(ix) Two;
(x) independent.

2. State whether the following statements are 'TRUE' or 'FALSE':

(i) As per Sec 2(43) of the Companies Act, 2013, "Free Reserves" mean such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend.
(ii) 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 Forfeiture of Shares.
(iii) A Company cannot buy-back its shares from any person through a negotiated deals whether on or off the stock exchange.
(iv) A company with capital, which cannot be profitably employed, may get rid of it by resorting to buy-back, and re-structure its capital and it is a disadvantage.
(v) Issue of debentures as a collateral security means issue of debentures as a main security, that is, a security in addition to the prime security.
(vi) Debenture carries a fixed rate of dividend.
(vii) 'Unmarked' applications are those applications which bear the stamp of an underwriter.
(viii) The sum which is still to be paid to the Company for a share is known as calls in arrears.
(ix) One of the conditions for issue of sweat equity shares is — not less than one year has, at the date of such issue, elapsed since the date on which the company had commenced business.
(x) A company limited by shares shall issue any preference shares which are irredeemable.

Answer:

(i) TRUE.
(ii) FALSE.
(iii) TRUE.

(iv) FALSE.
(v) TRUE.
(vi) FALSE.
(vii) FALSE.
(viii) TRUE.
(ix) TRUE.
(x) FALSE.

STUDY NOTE: 2
PRESENTATION OF FINANCIAL STATEMENTS (AS PER SCHEDULE III):

THIS STUDY NOTE INCLUDES:
2.1 Introduction
2.2 Statement of Profit and Loss
2.3 Balance Sheet

2.1 INTRODUCTION

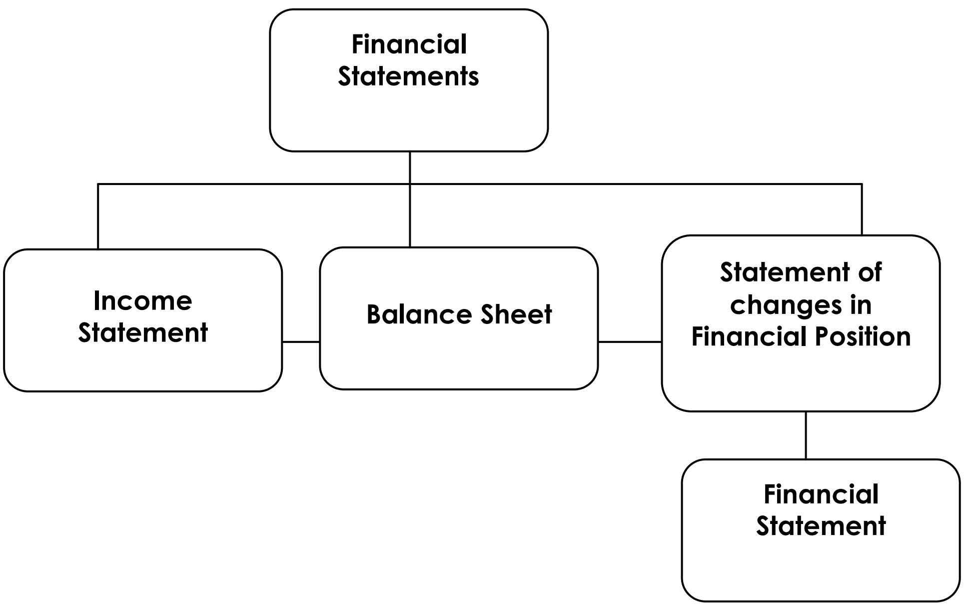
Meaning and Objective of Financial Statement
Financial statements are compilation of financial data, collected and classified in a systematic manner according to the accounting principles, to assess the financial position of an enterprise as regards to its profitability, operational efficiency, long 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 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 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.

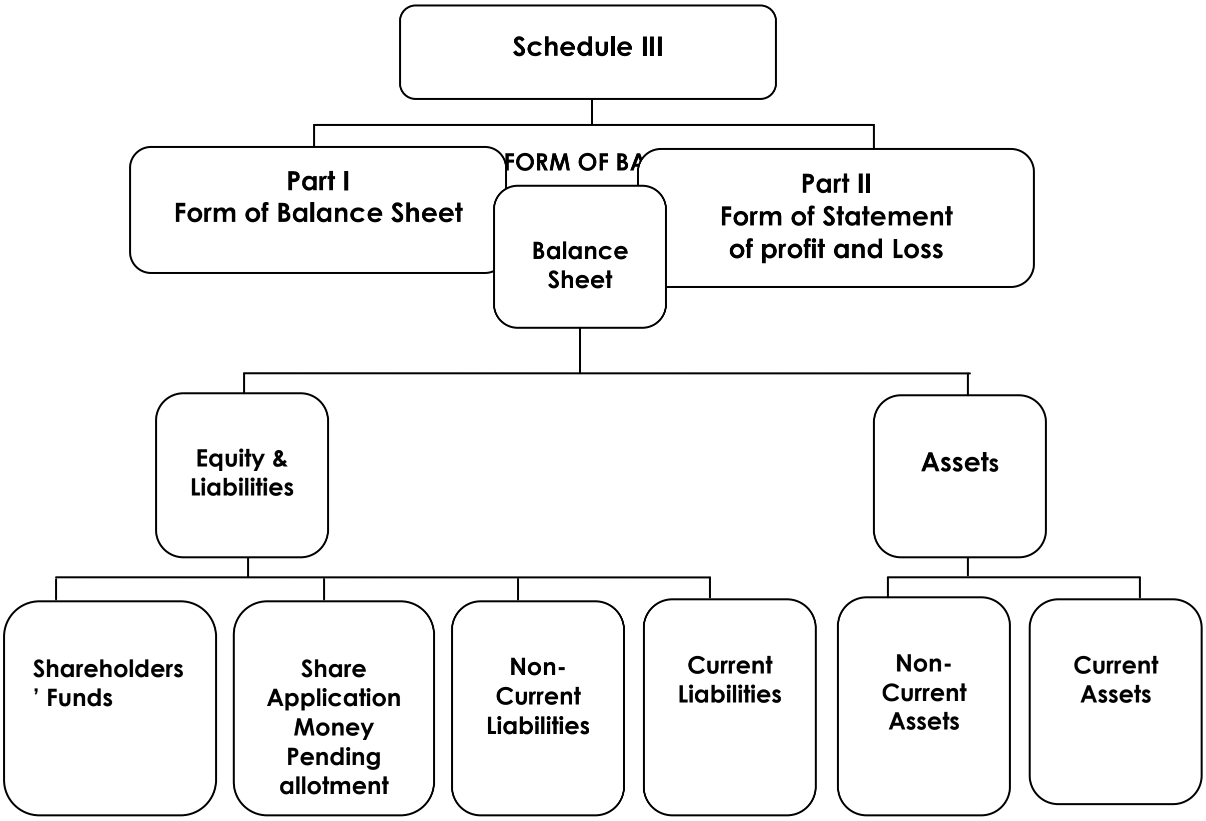
FRAME WORK

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.



Rules for Classification of Assets and Liabilities:

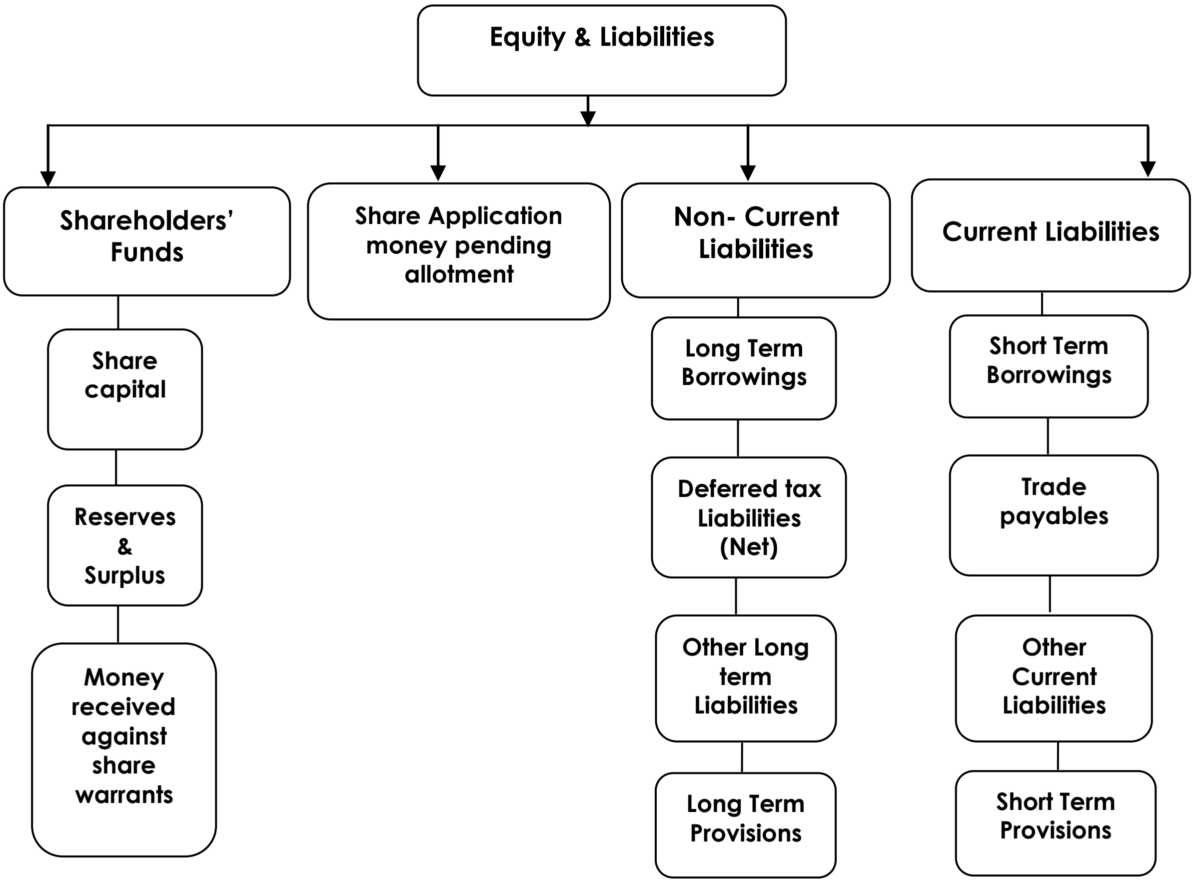
Current Liabilities —
- is expected to be settled in the company normal operating cycle; or
- is held primarily for the purpose of being traded; or
- is due to be settled within twelve months after the reporting date.

Non-Current Liabilities —
Liability other than Current liability shall be classified.

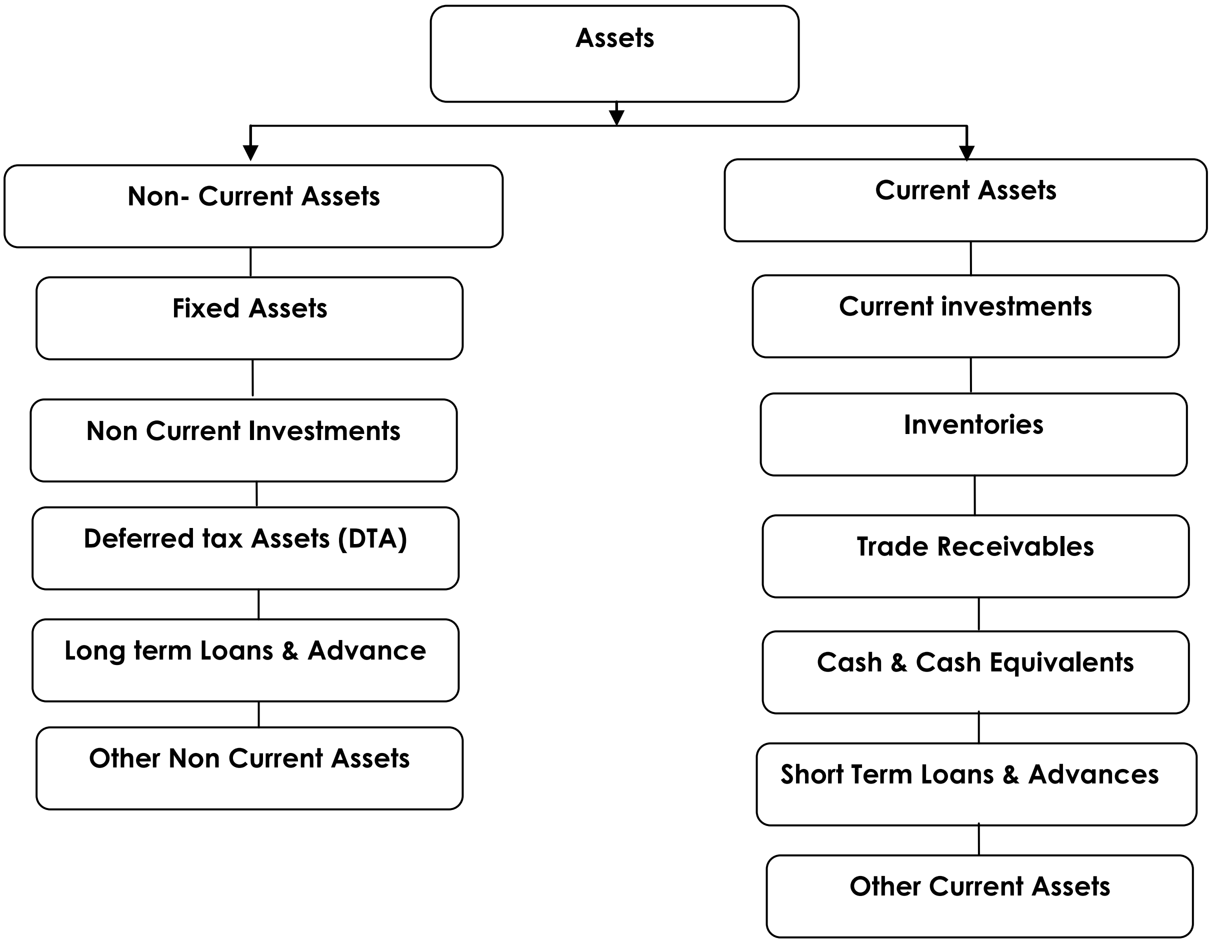
Current Assets —
- is expected to be realised, or is intended for sale or consumption, in the company's normal operating cycle; or
- is held primarily for the purpose of being traded;or
- is expected to be realised within twelve months after the reporting date; or
- is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

Non-Current Assets —
-Asset other than Current Asset shall be classified as non-current assets.

Break- up of Equity & Liabilities



Break-up of Assets



2.2 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 TAX (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

Item	Description	
1. Sec.25 Companies	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.	
2. Revenue from Operations	**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	**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.

3. Finance Costs	Finance Costs shall be classified as – (a) Interest Expenses, (b) Other Borrowing Costs, (c) Applicable Net Gain / Loss on Foreign Currency Transactions and Translation.
4. Other Income	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).
5. Additional Information:	A Company shall disclose by way of **Notes, additional information regarding** Aggregate Expenditure and Income on the following items referred below.

(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**.**

2.3 BALANCE SHEET

PART I – FROM OF BALANCE SHET
Name of the Company:………………………………………………
Balance Sheet as at: …………………………………………………… **(₹ in……)**

	Particulars	Note	Figures as at the end of Current Reporting Period	Figures as at the end of the Previous Reporting Period
			₹	₹
I.	EQUITY AND LIABILITIES			
	Shareholders' Funds			
(1)	(a) Share Capital			
	(b) Reserves & Surplus			
	(c) Money Received against Share Warrants			
	Share Application money pending allotment			
(2)	Non-Current Liabilities			
(3)	(a) Long Term Borrowings			
	(b) DTL (Net)			
	(c) Other Long Term Liabilities			
	(d) Long Term Provisions			
	Current Liabilities			
(4)	(a) Short Term Borrowings			
	(b) Trade Payables			
	(c) Other Current Liabilities			
	(d) Short Term Provisions			
	Total			
	ASSETS			
	Non-Current Assets			
II. (1)	(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			
	Current Assets			
(2)	(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 t o Contracts (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	
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,	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

Bonus Shares and Transfer to/from Reserves etc. (Additions & Deductions since last Balance Sheet to be shown under each of specified heads)	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	Other Loans should be interpreted to mean all categories listed under the heading 'Long-Term Borrowings' as per Sch VI (R).

and Other Loans shall be stated.	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 POVISIONS

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

As per Notification – G.S.R 679(E) (by Ministry of Corporate Affairs dated 4th September, 2015):

In exercise of the powers conferred by sub-section (1) of section 467 of the Companies Act,2013 (18 of 2013), the Central Government hereby makes the following further alterations in Schedule III and the details relating to Micro, Small and Medium Enterprises shall be disclosed in the notes.

Sch. III Disclosure Requirement	Points
It shall be classified as – (A) Total outstanding dues of micro enterprises and small enterprises; and (B) Total outstanding dues of creditors other than micro enterprises and small enterprises."	• 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.

Note: The following details relating to Micro, Small and Medium Enterprises shall be disclosed in the notes:

(a) The principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;

(b) The amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;

(c) The amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;

(d) The amount of interest accrued and remaining unpaid at the end of each accounting year; and

(e) The amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

(f) Explanation – the terms ‘appointed day’, ‘buyer’, ’enterprise’, ‘micro enterprise’, ‘small enterprise’ and ‘supplier’ shall have the same meaning assigned to those under (b),(d),(e),(h),(m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006.

(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,	• 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

(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).	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) LP:** 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 goods 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.

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

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 as 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	740
As on 31.3.2015		
Depreciation	260	
As on 1.4.2014		
For the year (20% on 740)	148	
	408	
Less: Deduction during the year	30	378
As on 31.3.2015		
Net block as on 31.3.2015		362
(2) Provision for taxation		540
Profit as per Profit and Loss Account		
Add back: Loss on sale of asset (short term capital loss)	20	
Depreciation	148	68
		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:

	Dr.	(₹ '000) 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 refurbishment of the premises. These are to be considered as part of the cost of leasehold premises.

(c) A review of the debtors reveals specific doubtful debts of ₹ 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.	Particulars	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.

1(a)	Administration Expenses		735
	Director's Salaries		195
	Provision for Dobtful 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		13,800
	Sales	11,025	
	Less: Manufacturing Expenses	1,365	
	Other Exp.(excluding bonus)	100	
	Depreciation	110	
	Interest		12,600
			1,200
	Pre-tax profit		120
	Bonus (10%)		
(3)	Fixed Asset:		
	Tangible Asset		
	Gross block		
	Furniture and Fixture		1,320
	Leasehold premises (210 + 200 + 190)		600
			1,920
(b)	Depreciation		
	Furniture and fixture (01.04.14) 820	820	
	For the year [15% on (1,320 – 820)]	75	895
	Cost of Leasehold Premises written of		25

	[(210+200+190) × 1/12 × ½]		
			920
(4)	Provision for taxation		1,080
	Profit as per Profit and Loss Account		
	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
	Provision for tax (@ 50%)		1,300
	(It has been assumed that depreciation calculated under income-tax act amounts for to ₹1,25,000)		650

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:		
Installment 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:		
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			

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:

(1) Net assets of Jam Ltd. taken over:

(₹ in crores)

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

Dr. Cr.

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.

SELF EXAMINATION QUESTIONS:

1. Fill in the blanks :

(i) Interest expenses are _____________ costs.

(ii) Investment of ₹45,00,000 in 40,000 12% Debenture of ₹100 each of Amrit Ltd. will come under: Assets - Non-current Assets – _______________________.

(iii) Provision for taxation of ₹88,000 will come under: Equity and Liabilities under _____________ __________ – Short-term Provision.

(iv) Short-Term Borrowings will include all Loans within a period of _____ months from the date of the loan.

(v) Stock-in-Trade (in respect of goods acquired for Trading) are classified as __________.

Answer:

(i) Finance;

(ii) Non-current Investments;

(iii) Current Liabilities;

(iv) 12;

(v) Inventories.

2. State whether the following statements are 'TRUE' or 'FALSE':

(i) Part I of Schedule III is related to preparation of Profit and Loss Statement.

(ii) Interest income in case of a Finance Company is treated as a part of revenue from Operation.

(iii) Schedule III deals only with presentation and disclosure requirements

(iv) The aggregate amount of the balance of 'Reserve and Surplus', is to be shown after adjusting negative balance of surplus/ Loss, if any.

(v) 2,00,000 8% Preference Shares of ₹100 each will come under : Equity and Liabilities – Shareholders' funds - Share Capital (Schedul III)

Answer:

(i) FALSE.

(ii) TRUE.

(iii) TRUE.

(iv) TRUE.

(v) TRUE

STUDY NOTE: 3
CASH FLOW STATEMENT

THIS STUDY NOTE INCLUDES:

3.1 Cash Flow Statement
3.2 Meaning of Cash and Cash Equivalent
3.3 Types of Cash Flow
3.4 Ind AS-7

3.1 CASH FLOW STATEMENT

Introduction

Cash flow statement is additional information to user of financial statement. This statement exhibits the flow of incoming and outgoing cash and cash equivalent. 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.

Statement of Cash Flow

"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

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.

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.

3.2 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.

3.3 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.

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.

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.

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.

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

	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		-	
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.	As at 31st March,2015	As at 31st March,2014
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	**As at 31st March,2015**	**As at 31st March,2014**
General Reserve	750	1,000
Profit & Loss A/c	100	50
Total	850	1050

7. Long Term Borrowings	As at 31st March,2015	As at 31st March,2014
Secured Loan	4,000	6,000
Total	4,000	6,000

8. Tangible Assets	As at 31st March,2015	As at 31st March,2014
Gross Block	6,000	8,000
Less: Accumulated Depreciation	1,000	1,500
	5,000	6,500

9. Long Term Loans and Advances	As at 31st March,2015	As at 31st March,2014
Advance tax	150	100
	150	100

10. Short Term Provisions	As at 31st March,2015	As at 31st March,2014
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 assets 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 lakhs, 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 activities.

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 lakhs
Purchase of fixed assets			
Purchase of fixed assets			
Increase in gross block			(2,000)
Purchase of long term investments			
	31-03-2014	31-03-2015	
	1,000	1,500	

Less: cash equivalents	100	150	
	900	1,350	(450)
			(2,450)
Income from Investments			(1,250)

Thus there were 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 financial activities	₹ In lakhs
Issure of share	1,000
Loans	2,000
Interest	(800)
Dividend	(450)
	1,750

Thus there was net cash inflows from financial activities.

Illustration 2 (c): Use the data given in Illustration 2 & 2.(a) and find out change in cash and cash equivalents:

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 for 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

7. 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:

			(₹)
Sale			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 Deferred	 6,600 1,550		
Total expenses		8,150	1,54,650
Net income			14,050

Additional information 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	
Marketable securities	
Accounts receivable	
Allowance for bad debt	
Inventory	
Prepaid insurance	
Accounts payable (for merchandise)	
Salaries payable	
Dividends payable	

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 : 31.03.2015

					(₹ 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			
		(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 (A)	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 (B)	(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 (c)	1,20,000
Net increase in Cash and Cash Equivalents (A+B+C)	1,20,000
Cash and Cash Equivalents at the beginning	6,00,000
Cash and Cash Equivalents at the end	7,20,000

Building and Equipment Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d To Cash/Bank (purchase) (Balancing figure)	36,00,000 28,80,000	By Sale of Asset By Balance c/d	7,20,000 57,60,000
	64,80,000		64,80,000

Accumulated Depreciation on
Building and Equipment Account

Dr. **Cr.**

	₹		₹
To Sale of Asset (Accumulated depreciation) To Balance c/d	4,80,000 13,20,000	By Balance b/d By Profit and Loss (Provisional)	12,00,000 6,00,000
	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:

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 after 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 thousands)**

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	1,870
Net cash from operating activities (a)		
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	

Repayments of long-term borrowings	(180)	
Interest paid	(270)	
Dividend paid	(1,200)	
Net cash used in financing activates (c)		(1,150)
Net increase in cash and cash equivalents		750
Add: Cash and cash equivalents at beginning of period		160
Cash and 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)	
Interest paid	(270)	
Dividends paid	(1,200)	
Net cash used in financing activities		(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 and 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 receipt from customers

Sales Add: Sundry debtors at the beginning of the year	30,650 1,200
Less: Sundry debtors at the end of the year	31,850 1,700
	30,150

4. Cash paid to supplies and employees

Cost of sales Administrative & selling expenses		26,000 910
		26,910
Add: Sundry creditors at the beginning of the year Inventories at the end of the year	1,890 900	2,790
		29,700
Less: Sundry creditors at the end of the year Inventories at the beginning of the year	150 1,950	2,100
		27,600

5. Income taxes paid (including tax deducted at source from dividends received)

Income tax expenses for the year (including tax) deducted at source from dividends received) Add : Income tax liability at the beginning of the year	300 1,000
Less : Income tax liability at the end of the year	1,300 400
	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 Add : Long-term borrowings made during the year	1,040 250
Less : Long-term borrowings at the end of the year	1,290 1,110
	180

7. Interest Paid

Interest expenses for the year Add : Interest payable at the beginning of the year	400 100
Less : Interest payable at the end of the year	500 230
	270

Illustration 7:

Sumangal Ltd. finds on 31st December, 2014 that it is short of funds with which to implement its branch expansion programme. On 1st January, 2014, it had a bank balance of ₹1,80,000 in its current account. From the following information, prepare a statement of Cash Flow to show how the overdraft of ₹58,750 at 31st December, 2015 has arisen:

Figures as per Balance Sheet
(as on 31st December)

	2013 (₹)	2014 (₹)
Fixed Assets	**7,50,000**	**11,00,000**
Stock and stores	**1,90,000**	**3,00,000**
Debtors	**3,80,000**	**3,65,000**
Bank Balance/(Overdraft)	**1,70,000**	**(58,750)**
Trade Creditors	**2,70,000**	**3,50,000**
Share Capital (in shares of ₹10 each)	**2,50,000**	**3,00,000**
Bills Receivable	**87,500**	**95,000**

The profit for the year ended 31st December, 2014 before charging depreciation and taxation amounted to ₹2,50,000. The 5,000 shares were issued on 1st January, 2014 at a premium of ₹5 per share. ₹1,37,500 was paid in March 2014 by way of income tax including tax on distribution of dividend. Dividend was paid as follows for 2014 (final) on the capital on 31-12-2013 @ 10% less tax 25%. For 2014 (interim) 5% on capital on 31st March, 2014 free of tax.

Solution:

Sumangal Ltd
Cash Flow Statement
For the period 1st January 2014 to 31st December 2014

Particulars	₹	₹
1. Cash Flows from Operating Activities:		
Operating profit before dep. and tax	2,50,000	
Adjustment for:		
Increase in creditors	80,000	
Decrease in debtors	15,000	
Increase in stock	(1,10,000)	
Increase in B/R	(7,500)	
Income tax paid	(1,37,500)	
Net Cash from Operating Activities (A)		90,000
2. Cash Flow from Investing Activities:		
Purchase of fixed assets	(3,50,000)	
Net Cash used in Investing Activities(2)		(3,50,000)
3. Cash Flows from Financing Activities:		
Issue of shares at premium	75,000	
Payment of final dividend(2013)	(18,750)	
Payment of interim dividend (2014)	(15,000)	
Net Cash from Financing Activities(3)		41,250
Net increase in Cash and Cash Equivalents		(2,18,750)
Cash and Cash Equivalents at the beginning		1,70,000
Cash and Cash Equivalents at the end		(48,750)

3.4 INDIAN ACCOUNTING STANDARD (IND AS) 7 — STATEMENT OF CASH FLOWS

Indian Accounting Standard (Ind AS) 7 Statement of Cash Flows

Objective

- Information about the cash flows of an entity is useful in providing users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents ,the needs of the entity to utilise those cash flows and the timing and certainty of their generation.
- The objective of this Standard is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows which classifies cash flows during the period from operating, investing and financing activities.

Definitions

The following terms are used in this Standard with the meanings specified:

- **Cash** comprises cash in hand and demand deposits.
- **Cash equivalents** are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.
- **Cash flows** are inflows and outflows of cash and cash equivalents.
- **Operating activities** are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.
- **Investing 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 contributed equity and borrowings of the entity.

Cash and cash equivalents

- Cash equivalents are held for the purpose of meeting short-term cash commitments.
- For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. An investment normally qualifies as a cash equivalent when it has a short maturity of, say, three months or less from the date of acquisition.
- Equity investments are excluded unless they are, in substance, cash equivalents.
- Bank borrowings are generally considered to be financing activities. However, where bank overdrafts which are repayable on demand form an integral part of an entity's cash management, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn.
- Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an entity rather than part of its operating, investing and financing activities.

Illustration 8:

M Ltd. had a cash balance of ₹1,50,000 as on 30.09.2015. On 15.10.2015, M Ltd. Used the cash balance to purchase a short-term bank deposit with a maturity of three months. How should this be shown in the statement of cash flow to be prepared for the quarter ended 31.12.2015?

Answer:

As per this Ind AS 7, cash flows exclude movements between items that constitute cash or cash equivalents as these components are part of cash management of an entity, rather than part of its operating, investing and financing activities.
The purchase of short-term bank deposit is therefore not shown in the statement of cash flows.

Presentation of a statement of cash flows
The statement of cash flows shall report cash flows during the period classified by operating, investing and financing activities. An entity presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business.

Operating activities

Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss.

Examples of cash flows from operating activities are:

(a) cash receipts from the sale of goods and the rendering of services;
(b) cash receipts from royalties, fees, commissions and other revenue;
(c) cash payments to suppliers for goods and services;
(d) cash payments to and on behalf of employees;
(e) cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;
(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities;
(g) cash receipts and payments from contracts held for dealing or trading purposes.

Companies in specific industries have different operating cash flows, such as cash flows from purchase and sale of dealings or trading securities. Such cash flows are classified as operating activities. Similarly, cash advances and loans made by financial institutions are classified as operating activities since they relate to the main revenue generating activity of that entity.

Investing Activities

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made from resources intended to generate future income and cash flows. Only expenditures that result from a recognized asset in the balance sheet are eligible for classification as investing activities.

Examples of cash flows arising from investing activities are:

(a) Cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment;
(b) Cash receipts from items in (a);
(c) Cash payments to acquire equity or debt instruments of other entities and interests in joints ventures excluding investments in cash equivalents instruments or held for trading purpose;
(d) Cash receipts from sales of items in (c);
(e) Cash advances and loans made to other parties;
(f) Cash receipts from the repayment of advances and loans made to other parties;
(g) Cash payments and receipts for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held trading purposes, or are classified as financing activities.

Financing Activities
These represent claims on future cash flows by providers of capital and include:

(a) Cash proceeds from issuing shares;
(b) Cash payments to owners to acquire or redeem the entity's shares;
(c) Cash proceeds from issuing debentures, loans, etc;
(d) Cash repayments of amounts borrowed; and
(e) Cash payments by a lessee for principle repayments relating to a finance lease.

Reporting cash flows from operating activities

An entity shall report cash flows from operating activities using either:

(a) **the direct method,** whereby major classes of gross cash receipts and gross cash payments are disclosed; **or**

(b) **the indirect method,** whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

Entities are encouraged to report cash flows from operating activities using the direct method. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method.

Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:

- from the accounting records of the entity; or
- by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial institution) and other items in the statement of profit and loss for:

- changes during the period in inventories and operating receivables and payables;
- other non-cash items; and
- other items for which the cash effects are investing or financing cash flows.

Under the indirect method, the net cash flow from operating activities is determined by adjusting profit or loss for the effects of:

- changes during the period in inventories and operating receivables and payables;
- non-cash items such as depreciation, provisions, deferred taxes etc.
- all other items for which the cash effects are investing or financing cash flows.

Bank Overdraft and Cash Credit

Bank overdraft facility is granted by bank for a short period to accommodate short-term fund requirement. It is linked with the operations in current account.

Cash credit is a fund-based facility granted by a bank to its customer to finance working capital requirements.

Ind AS 7 provides that bank borrowings are usually considered part of financing activities.

Bank overdrafts, repayable on demand form an integral part of an entity's cash management, and are included as a component of cash and cash equivalents.

Cash credit from bank, on a continuous basis, is considered as a part of financing activity.

Reporting cash flows on a net basis

Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

(a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity;

(b) cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

Illustration:

AMM Ltd has a foreign currency balance of USD 1,000 as on 31.3.2015. This foreign currency was purchased when the exchange rate was $1= ₹ 50. As on 31.3.2015, the exchange rate is $1= ₹ 55. How would you consider this change in the statement of cash flow for the period ended 31.3.2015?

Solution:

As per Ind AS 7, unrealised gains and losses arising from changes in foreign currency exchange rates are **not** cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and end of the period. This amount is presented separately from cash flows from operating, investing and financing activities.

AMM Ltd will prepare the cash flow statement as follows:
(Extracts of cash flow statement of AMM Ltd)

Net cash flow from operating activities (a)	XX
Net cash flow from investing activities (b)	XX
Net cash flow from financing activities (c)	XX
Increase in cash and cash equivalents during the period (d= a + b + c)	XXX
Exchange gain in respect of cash in foreign currency ($1,000 × ₹ 5) (e)	₹ 5000
Net increase in cash and cash equivalents during the period (d + e)	XXX
Add: opening balance of cash and cash equivalents	XX
Closing balance of cash and cash equivalents (including foreign currency cash balance at the closing rate $ 1 = ₹ 55)	**XXX**

Foreign currency cash flows

- Cash flows arising from transactions in a foreign currency shall be recorded in an entity's functional currency by applying to the foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow.
- The cash flows of a foreign subsidiary shall be translated at the exchange rates between the functional currency and the foreign currency at the dates of the cash flows.
- Cash flows denominated in a foreign currency are reported in a manner consistent with Ind AS 21, The Effects of Changes in Foreign Exchange Rates. However, Ind AS 21 does not permit use of the exchange rate at the end of the reporting period when translating the cash flows of a foreign subsidiary.
- Unrealised gains and losses arising from changes in foreign currency exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and the end of the period.

Interest and dividends
Cash flows from interest and dividends received and paid shall be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial institution should be classified as cash flows arising from operating activities. In the case of other entities, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.

Classification of interest and dividends, paid or received:

Particulars	Financial Institution	Others
Interest received on loans and advances	Operating activities	Investing activities
Dividends received	Operating activities	Investing activities
Interest paid	Operating activities	Financing activities
Dividends paid	Financing activities	Financing activities

Taxes on income

- Cash flows arising from taxes on income shall be separately disclosed and shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

Investments in subsidiaries, associates and joint ventures

- Between an investor entity and an associate, a joint venture or a subsidiary, only cash flows accounted for using equity or cost method such as dividends and advances are reported in the statement of cash flows.

Changes in ownership interests in subsidiaries and other businesses

The aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities.

An entity shall disclose, in aggregate, in respect of both obtaining and losing control of subsidiaries or other businesses during the period each of the following:

(a) the total consideration paid or received;
(b) the portion of the consideration consisting of cash and cash equivalents;
(c) the amount of cash and cash equivalents in the subsidiaries or other businesses over which control is obtained or lost; and
(d) the amount of the assets and liabilities other than cash or cash equivalents in the subsidiaries.

Illustration:

BB Ltd is a parent company of CC Ltd and holds 75% of the voting power of CC Ltd. During the year ended 31.3.2015, BB Ltd sold 15% of its stake in CC Ltd, thereby reducing its holding in CC Ltd to 60%.

(a) How will the proceeds received be classified in the cash flow statement of BB Ltd for the period ended 31.3.2015?
(b) Would your answer be different if CC Ltd sold 30% of its stake in CC Ltd (instead of 15%), thereby reducing its holding in CC Ltd to 45%?

Solution:

(a) As per Paras 42A and 42B of Ind AS 7, changes in the cash flows that do not result in a loss of control, such as a subsequent purchase or sale by a parent of the subsidiary's equity instruments, are accounted for as equity transactions. Accordingly, the resultant cash flows are classified in the same way as other transactions with owners as financing activities.

Hence, cash proceeds received from sale of 15% stake in subsidiary CC Ltd, not leading to loss of control, shall be classified as financing activities in the statement of cash flows prepared by BB Ltd for the period ending 31.3.2015.

(b) As per Para 39 of the Standard, the aggregate cash flows arising from obtaining or losing control of subsidiaries or other business shall be presented separately and classified as investing activities.

Hence, cash proceeds received, from sale of 30% stake in subsidiary CC Ltd leading to loss of control, shall be classified as investing activities in the statement of cash flows prepared by BB Ltd for the period ending 31.3.2015.

Non-cash transactions

Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows. Examples are acquisition of assets by assuming related liabilities, acquisition of an entity by equity issue, and conversion of debt to equity.

Components of cash and cash equivalents

An entity shall disclose the components of cash and cash equivalents and shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the balance sheet.

In view of the variety of cash management practices and banking arrangements around the world and in order to comply with Ind AS 1, Presentation of Financial Statements, an entity discloses the policy which it adopts in determining the composition of cash and cash equivalents.

The effect of any change in the policy for determining components of cash and cash equivalents, for example, a change in the classification of financial instruments previously considered to be part of an entity's investment portfolio, is reported in accordance with Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors.

Other disclosures

An entity should disclose the amount of significant cash and cash equivalent balances that are not available for use.

Disclosure of additional relevant information and its explanation may include:

(a) Undrawn borrowing facilities;
(b) Identifying cash flows that increases operating capacity separately from those required to maintain operating capacity; and
(c) Cash flows of each reportable segment.

SELF EXAMINATION QUESTIONS:

1. Fill in the blanks:

(i) For a finance company interest income it of Cash Flow from __________ __________.
(ii) Investing and financing transactions that _____ _____ require the use of cash or cash equivalents shall be excluded from a statement of cash flows.
(iii) Income from dividend and interest is a part of __________ _____________ .
(iv) For a company other than a finance company payment of interest is a ____________ activity.
(v) ________ ___________ are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Answer:

(i) Operating Activity;
(ii) do not;
(iii) Investing Activity;
(iv) Financing
(v) Cash equivalents.

STUDY NOTE: 4
ACCOUNTS OF BANKING, ELECTRICITY AND INSURANCE COMPANY

THIS STUDY NOTE INCLUDES:

4.1 Accounts of Banking Company
4.2 Accounts of Electricity Company
4.3 Accounts of Insurance Company

4.1 ACCOUNTS OF BANKING COMPANY

A bank is a commercial institution, licensed to accept deposits and acts as a safe custodian of the spendable funds of its customers. Banks are concerned mainly with the functions of banking, i.e., receiving, collecting, transferring, buying, lending, investing, dealing, exchanging and servicing (safe deposit, custodianship, agency, trusteeship) money and claims to money both domestically and internationally. The principal activities of a bank are operating current accounts, receiving deposits, taking in and paying out notes and coins, and making loans.

Banking activities undertaken by banks include personal banking (non-business customers), commercial Banking (small and medium-sized business customers) and corporate banking (large international and multinational corporations).

According to Charles J. Woelfel:

A complete banking service would comprehend a variety of functions, including any of the following:

(1) Receive demand deposits and pay customers' cheques drawn against them, and operate Automated Teller Machines (ATM);
(2) Receive time and savings deposits, issue negotiable orders of withdrawal, and pay interest thereon, as well as provide Automatic Transfer Service (ATS) for funds from serving accounts to cover cheques;
(3) Discount notes, acceptances and bills of exchange;
(4) Supply credit to business firms with or without security, issue letters of credit and accept bills drawn thereunder;
(5) Transfer money at home and abroad;
(6) Make collections and facilitate exchanges;
(7) Issue drafts, cashier's cheques, money orders, and certify cheques;
(8) Furnish safe deposit vault service;
(9) Provide custodianship for securities and other valuables;
(10) Provide personal loans, credit and services to individuals, and lend or discount customer instalment receivables of vendors;
(11) Act in a fiduciary capacity for individuals, as well as establish common trust funds;
(12) Provide corporate trust services (stock transfer agent, registrar, paying agent, escrow agent, and indenture trustee);
(13) Act as factors and engage in equipment leasing;
(14) Deal in Government securities and underwrite general obligations of state and municipal securities;
(15) Invest in government and other debt securities;
(16) Act as fiscal agent or depository for the Central Government, states and subdivisions of states;
(17) Provide miscellaneous services such as place orders in securities for customers; act as insurance agent of incidental to banking transactions; serve as finder to bring buyers and sellers together; act as travel agent and issue letters of credit and traveler's cheques; provide club accounts and other special purpose accounts; act as agent for accepting service of legal process of incidental normal banking or fiduciary transactions of the bank; act as pay role issuer; establish charitable foundations, invest in small business investment corporations and bank service corporations; deal

in foreign exchange; buy and sell gold bullion under license from the Treasury Department, and foreign coin; provide domestic and international correspondent banking services, etc.

In India, banking activities are governed by The Banking Regulation Act, 1949. As per the provisional Section 5(b) of the said Act, "banking" means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or other-wise, and withdraw able by cheque, drafts, order or otherwise.

Section 5(c) defines "Banking Companies" as any company which transacts the business of banking in India. However, any company which is engaged in the manufacture of goods or carries on any trade and which accept deposits of money from the public merely for the purpose of financing its business as such manufacturer or trader shall not be deemed to transact the business of banking within the meaning of this clause.

Business of Banking Companies

As per the provision of Section 6 of the Banking Regulation Act, 1949, a banking company may engage in any one or more of the following forms of business, in addition to the business of banking. These are:

(a) The borrowing, raising, or taking up of money; the lending or advancing of money either upon or without security; the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundis, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scrips and other instruments, and securities whether transferable or negotiable or not; the granting and issuing of letters of credit, traveler's cheques and circular notes; the buying, selling and dealing in bullion and specie; the buying and selling of foreign exchange including foreign bank notes: the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds; the purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents or others, the negotiating of loans and advances; the receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise, the providing of safe deposit vaults; the collecting and transmitting of money and securities;

(b) Acting as agents for any Government or local authority or any other person or persons; the carrying on of agency business of any description, including the clearing and forwarding of goods, giving of receipts and discharges, and otherwise acting as an attorney on behalf of customers; but excluding the business of a managing agent or secretary and treasurer of a company;

(c) Contracting for public and private loans and negotiating and issuing the same;

(d) The effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of State, municipal or other loans or of shares, stock, debentures, or debenture stock of any company, corporation or association, and the lending of money for the purpose of any such issue;

(e) Carrying on and transacting every kind of guarantee and indemnity business;

(f) Managing, selling and realizing any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims;

(g) Acquiring and holding and generally dealing with any property or any right, title or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such security;

(h) Undertaking and executing trusts;

(i) Undertaking the administration of estates as executor, trustee or otherwise;

(j) Establishing and supporting or aiding in the establishment and support of associations, institutions, funds, trusts and conveniences calculated to benefit employees or ex-employees of the company or the dependants or connections of such persons; granting pensions and allowances and making payments towards insurance; subscribing to or guaranteeing money for charitable or benevolent objects or for any exhibition or for any public, general or useful object;

(k) The acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purposes of the company;

(l) Selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account, or otherwise dealing with all or any part of the property and rights of the company;

(m) Acquiring and undertaking the whole or any part of the business of any person or company, when such business is of a nature enumerated or described in this sub-section;

(n) Doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;

(o) Any other form of business which the Central Government may, by notification in the Official Gazette, specify as a form of business in which it is lawful for a banking company to engage.

Restriction on Business of Banking Company

Section 8 of the Banking Regulation Act, 1949, imposes certain restrictions on the business of a banking company. These are as follows:

(i) No banking company shall directly or indirectly deal in the buying, selling or bartering of goods, except in connection with the realisation of security given to or held by it;

(ii) No banking company can engage in any trade, or buy, sell or barter goods for others otherwise than in connection with bills of exchange received for collection or negotiation or with such of its business or is referred to in clause (i) of sub-section (1) of section 6.

Some Important Provisions of the Banking Regulation Act, 1949

Time limit for disposal of non- banking Assets (Section – 9)

Non- banking assets must be disposed off within 7 years from the date of acquisition or period extended by RBI.

Minimum paid up capital and reserve [Section 11]

Banking Company	Minimum Aggregate value of paid up capital and reserve
1. In case of banking company Incorporated outside India:	
(a) Having a place (s) of business in the city of Mumbai or Kolkata or both	₹20 lacs
(b) Not having a place (s) of business in the city of Mumbai or Kolkata or both	₹15 lacs
2. In case of a banking company incorporated in India:	
(a) Having place of business in more than one state including place(s) business in the city of Mumbai or Kolkata or both	₹10 lacs
(b) Having all its places of business in one state and none of which is in the city of Mumbai or Kolkata.	₹1 lac + ₹10,000 for each of other places of business in the district in which it has its principal place of business + ₹25,000 for each place of business elsewhere in the state subject of maximum of rs.5 lacs

Restriction as to payment of dividend [Sections 15 (1) and (2)]

Before paying any dividend, a banking company has to write off completely all its capitalised expenses including preliminary expenses, organisation expenses, share-selling commission, brokerage, and amounts of losses incurred by tangible assets. However, a banking company may pay dividend on its shares without writing off:

1. the depreciation in the value of its investment in approved securities in any case where such depreciation has not actually been capitalised or accounted for as a loss;
2. the depreciation in the value of its investment in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company;
3. the bad debts in any case where adequate provision for such debts had been made to the satisfaction of the auditor of the banking company.

Minimum transfer of profits to reserve fund [Section 17]

Every banking company incorporated in India is required to transfer at least 25% of its profit to the reserve fund.

The profit of the year as per the profit and loss account prepared u/s 29 is to be taken as base for the purpose of such transfer and transfer to reserve fund should be made before declaration of any dividend.
If any banking company makes any appropriation from the reserve fund or securities premium account, it has to report to the Reserve Bank of India the reasons for such appropriation within 21 days.

Cash Reserve (Section 18)

Every banking company, not being a scheduled bank, has to maintain a cash reserve (CRR) of at least a percentage of the total of its demand and time liabilities in India, as on last Friday of the second preceding fortnight, as specified by R. B. I. time to time.

Cash reserve can be maintained with itself or by way of a balance in the Current account with the reserve bank or by way of net balance in current accounts or in one or more of the aforesaid ways.

Restrictions on Loans and Advances (Section 20)

No banking company shall

(a) grant any loans or advances on the security of its own shares, or

(b) enter into any commitment for granting any loan or advance to or on behalf of

  (i) Any of its directors,

  (ii) Any firm, in which any of its directors is interested as partner, manager, employee or guarantor, Or

  (iii) Any company (not being a subsidiary of the banking company or a company registered under Section 25 of the Companies Act, 1956 or a Government Company) of which any of the directors of the banking company is a director, manager, employee or guarantor or in which he holds substantial interest, or

  (iv) Any individual, in respect of whom any of its directors is a partner or guarantor.

Now-a-days, the daily transactions of bank are numerous. All these transactions are to be recorded immediately to reflect the exact position of each customer's account. Therefore, a bank has to adopt specialised system of book-keeping, which will ensure immediate entry of numerous transactions and keep an internal check on the books of account. To achieve these objectives, banks generally maintain a large number of subsidiary and memorandum books in addition to Principal Books of Account. These are as below:

Liquidity norms (Section 24)

Every banking company has to maintain in cash, gold or unencumbered approved securities, an amount at % prescribed (by RBI) of its demand and time liabilities in India.

However, this percentage is changed by the Reserve Bank of India from time to time considering the general economic conditions.

This is in addition to the average daily balance which a scheduled bank is required to maintain under Section 42 of the Reserve Bank of India Act, and in case of other banking companies, the cash reserve required to be maintained under Section 18 of the Banking Regulation Act.

Unclaimed deposits

Every banking company is required to submit a return in the prescribed form and manner to the Reserve Bank of India at the end of each calendar year of all accounts in India which could not be operated for 10 years.

This report is to be submitted within 30 days after the close of each calendar year.
In case of fixed deposit, such 10 years are to be reckoned from the date of expiry of the fixed period.

Bank's Book-Keeping System

Entering transactions in the ledger directly from vouchers Under bank's Bookkeeping system, every transaction particularly concerning the customers is entered in the personal ledger directly from vouchers as soon as it takes place.

The objective of the system is

(a) to keep up-to-date detailed ledgers,

(b) to balance the trial balance every day,

(c) to keep all control accounts in agreement with the detailed ledgers.

Main Characteristics of a Bank's Book-Keeping System

The main characteristics of a bank's system of book-keeping are as follows:

Voucher Posting	Entries in the personal ledger are made directly from vouchers instead of being posted from the books of prime entry.
Voucher Summary Sheets	The vouchers entered into different personal ledgers each day are summarised on summary sheets, totals of which are posted to the control accounts in the general ledger.
Daily Trial Balance	The general ledger trial balance is extracted and agreed every day.
Continuous Checks	All entries in the detailed personal ledgers and summary sheets are checked by persons other than those who have made the entries. A considerable force of such check is employed, with the general result that most clerical mistakes are detected before another day begins.
Control Accounts	A trial balance of the detailed personal ledgers is prepared periodically, usually every two weeks, agreed with general ledger control accounts.
Double Voucher System	Two vouchers are prepared for every transaction not involving cash-one debit voucher and another credit voucher.

Book of Accounts

1. General Ledger	The General Ledger contains: (a) Control Accounts of all personal ledgers. (b) Profit and Loss Account. (c) Assets' Accounts. (d) Contra Accounts. **Usefulness** It facilitates the preparation of Balance Sheet.
2. Profit and Loss Ledger	The Profit and Loss Ledger contains: (a) Detailed Accounts of Revenue items. (b) Detailed Accounts of Expense items. **Usefulness** It facilitates the preparation of Profit and Loss Account.

Principal Books of Accounts

Subsidiary Books

1. Personal Ledgers	(a) Current Accounts Ledger. (b) Saving Bank Accounts Ledgers. (c) Fixed Deposit (often further classified by length of period of deposit) Ledgers. (d) Loan Ledger. (e) Overdraft Ledger. (f) Cash Credit Ledger. (g) Customers' Acceptances, Endorsements and Guarantee Ledgers.
2. Bill Registers	(a) Inward Bills for Collection. (b) Outward Bills for Collection. (c) Bills Discounted and Purchased Register.

Subsidiary Registers

1. Demand Drafts, Telegraphic Transfers and Mail Transfers issued on Branches and Agencies.
2. Demand Drafts, Telegraphic Transfers and Mail Transfers received from Branches and Agencies.
3. Letters of Credit.
4. Letters of Guarantee

Memoranda Books

1. Departmental Journals	Maintain a record of all the transfer entries originated by each department
2. Cash Department's	(a) Receiving Cashiers' Cash Book (pay-in-slips are vouchers). (b) Paying Cashiers' Cash Book (Bearer Cheques/drafts etc. are vouchers). (c) Main Cash Book (by person other than cashier). (d) Cash Balance Book.
3. Clearing Department's	(a) Outward Clearing (for cheques received from customers): (i) Clearing Cheques Received Book. (ii) Bank wise List of above Cheques (one copy of which is sent to the clearing house together with cheques). (b) Inward Clearing (for cheques issued by customers received from other Banks).
4. Loans and Overdraft Departments'	(i) Registers for shares and other securities held on behalf of each customer. (ii) Summary Books of Securities giving details of Government securities, shares of individual companies etc. (iii) Godown registers maintained by the godown-keeper of the bank. (iv) Price register giving the wholesale price of the commodities pledged with the bank. (v) Overdraft Sanction register. (vi) Drawing Power book. (vii) Delivery Order books. (viii) Storage books.
5. Deposits Department	(a) Account Opening and Closing registers. (b) For Fixed Deposits, Rate register giving analysis of deposits according to rates. (c) Due Date Diary. (d) Specimen signature book.
6. Establishment department	(a) Salary and allied registers, such as attendance register, leave register, overtime register, etc. (b) Register of fixed assets, e.g. furniture's and fixtures, motor cars, vehicles, etc. (c) Stationery registers. (d) Old records register.
7. General	(a) Signature book of bank's officers. (b) Private Telegraphic Code and Cyphers.

Statistical Books

(a) To record Average Balance in Loan and Advances etc.
(b) To record Deposits received and amount paid out each month in the various departments.
(c) Number of Cheques paid.
(d) Number of Cheques, Drafts, Bills etc. collected.

THE THIRD SCHEDULE

(See Section 29)

Form 'A'

FORM OF BALANCE SHEET

Balance Sheet of .....

Balance Sheet as on 31st March.....

('000 omitted)

	Schedule No.	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
Capital and Liabilities Capital Reserves & Surplus Deposits Borrowings Other Liabilities and Provisions	 1 2 3 4 5		
Total			
Assets Cash and balances with RBI Balances with banks and money at call and short notice Investments Advances Fixed Assets Other Assets	 6 7 8 9 10		
Total			
Contingent liabilities Bills for collection	11 12		

1. **Form 'B'**

FROM OF PROFIT & LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH

	Schedule No.	Year ended 31.3 (Current Year)	Year ended 31.3 (Previous Year)
I. Income Interest earned Other Income	 13 14		
Total			
II. Expenditure Interest Expended Operating Expenses Provision and contingencies	 15 16		
Total			
III. Profit /Loss Net Profit/(Loss) (–) for the year Profit/(Loss) (–) brought forward			
Total			
Transfer to statutory reserve Transfer to other reserve Proposed Dividend Balance carried forward to Balance sheet			
Total			

Note:

1. The total income includes income of foreign branches at ₹ ____
2. The total expenditure includes expenditure of foreign branches at ₹___
3. Surplus / Deficit of foreign branches ₹________

SCHEDULES

Details of all schedules are in below:

A. Capital and Liabilities

1. **Capital**
2. **Reserve and Surplus**: It includes Statutory Reserve, Capital Reserve, Security Premium, Revenue and other Reserve and Profit and Loss Account balance.
3. **Deposits:** It includes Demand Deposits, Savings Bank Deposits and Term Deposits.
4. **Borrowings: (**i) It includes Borrowings from Reserve Bank of India, other banks, others institutions and agencies. (ii) Borrowing outside India.
5. **Other Liabilities and Provisions**: It includes Bills payable, inter-office adjustments (net), interest accrued, others (including provisions) provision for bad debts, provision for taxation.

B. Assets

6. **Cash and Balances with Reserve Bank of India**: Cash in hand (including foreign currency notes); and balances with Reserve Bank of India are shown under this item.
7. **Balances with Banks and Money at Call and Short Notice**: In India Balances with banks; money at call and short notice are shown under this item.
   Outside India — Current Account other Deposit Accounts, Money at call and short notice.
8. **Investments:** Investment in Government securities, other approved securities, shares, debentures and bonds, subsidiaries and /or joint ventures, others, gold etc., are shown under this item.
9. **Advances**: Bills purchased and discounted, cash credit, overdrafts and loans payable on demand; and term loans etc. are shown under this item.
10. **Fixed Assets**: Premises, other fixed assets (including furniture and fixtures) are shown under this item.
11. **Other Assets**: Inter-office adjustments, interest accrued, tax paid in advance, stationery and stamps, non-banking assets acquired in satisfaction of claims are shown under this item.
12. **Contingent Liabilities**: It is shown by way of a footnote. It represents liabilities not provided in the Balance Sheet.

Profit and Loss Account

Profit and Loss Account of a banking company is also prepared in vertical form. 'Form B' of the Third Schedule of the Banking Regulation Act, 1949 is to be used for preparing Profit and Loss Account. It is divided into four sections:

I. Income;
II. Expenditure;
III. Profit/Loss; and
III. Appropriations.

C. Income:
The schedules of Income are:

13. **Interest Earned**. It includes interest/discount on advances/bills, income on investments, interest on balances with RBI etc. It should be noted that according to the new form, bad debts and provision for bad debts, other provisions are not to be deducted from the interest earned. For greater transparency in accounts, these items are shown as separate items in the Profit and Loss Account.
14. **Other income**. It includes commission, exchange and brokerage, profit on sale of investments, profit on revaluation of investments, profit on sale of land, building and other assets, profit on exchange transaction, and income earned by way of dividends from subsidiaries, etc.

D. Expenditure

15. **Interest expended**. Interest paid on deposits, interest on RBI borrowings; interest on inter- bank borrowings, etc., are shown under this item.
16. **Operating expenses**. Salaries and wages of staff; rent, rates and taxes; printing and stationery; advertisement; depreciation on banks' properties; director's fees; auditor's fees; law charges; postage; repairs; insurance; etc., are shown under this item.
Third item of this section is provisions and contingencies. Provision for bad debts, provision for taxation and other provisions are shown under this item.

III. Profit/Loss

In this section, profit/loss for the current year (difference between income and expenditure explained above) and brought forward profit/loss are shown.

IV. Appropriations

In this section, amount transferred to statutory reserve as per Section 17; amount transferred to other reserve; proposed dividend, etc., are shown. The balance is transferred to the Balance Sheet.

FORM OF SCHEDULES
SCHEDULE 1 – CAPITAL

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. For Nationalised Banks Capital (Fully owned by Central Government) **II. For Banks Incorporated Outside India** Capital (i) (The amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head) (ii) Amount of deposit kept with the RBI under Section 11(2) of Banking Regulation Act, 1949		
Total		
III. For Other Banks Authorised Capital .... shares of ₹ .... each Issued Capital .... shares of ₹ .... each Subscribed Capital .... shares of ₹ .... each Called-up Capital .... shares of ₹ .... each Less: Calls unpaid		
Add: Forfeited shares		

SCHEDULE 2 - RESERVES AND SURPLUS

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Statutory Reserves Opening Balance Additions during the year Deductions during the year		
II. Capital Reserves Opening Balance Additions during the year Deductions during the year		
III. Securities Premium Opening Balance Additions during the year Deductions during the year		
IV. Revenue and other Reserves Opening Balance Additions during the year Deductions during the year		
V. Balance in Profit and Loss Account		
Total (I + II + III + IV + V)		

SCHEDULE 3 - DEPOSITS

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
A. I. Demand Deposits (i) From banks (ii) From otners II. **Savings Bank Deposits** III. **Term Deposits** (i) From banks (ii) From others		
Total (I + II + III)		
B. (i) Deposits of branches in India (ii)Deposits of branches outside India		
Total		

SCHEDULE 4 - BORROWINGS

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Borrowings in India (i) Reserve Bank of India (ii) Other Banks (iii) Other Institution and agencies **II. Borrowings Outside India**		
Total (I + II)		
Secured borrowings in I and II above. ₹…..		

SCHEDULE 5 - OTHER LIABILITIES AND PROVISIONS

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Bills Payable **II.** Inter-Office adjustments (net) **III.** Interest accrued **IV.** Others (Including Provisions)		
Total		

SCHEDULE 6 - CASH AND BALANCES WITH RESERVE BANK OF INDIA

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Cash in hand (including foreign currency notes) **II.** Balances with RBI (i) in Current Account (ii) in Other Accounts		
Total (I + II)		

SCHEDULE 7 - BALANCES WITH BANKS AND MONEY AT CALL & SHORT NOTICE

Particulars	As on 31.3. (Current Year)	As on 31.3 (Previous Year)
I. In India (i) Balances with Banks (a) In Current Accounts (b) In Other Deposit Accounts (ii) Money at Call and Short Notice (a) With Banks (b) With other institutions		
Total (i + ii)		
II. Outside India (i) in Current Accounts (ii) in Other Deposit Accounts (iii) Money at Call and Short Notice		
Total (i , ii , iii)		
Grand Total (I + II)		

SCHEDULE 8 - INVESTMENTS

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Investments in India (i) Government Securities (ii) Other Approved Securities (iii) Shares (iv) Debentures and Bonds (v) Subsidiaries and/or Joint Ventures (vi) Others (to be specified)		
Total		
II. Investments Outside India (i) Government securities (including local authorities) (ii) Subsidiaries and/or Joint Ventures abroad (iii) Other investments (to be specified)		
Total		
Grand Total (I + II)		

SCHEDULE 9 - ADVANCES

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
A. (i) Bills Purchased and Discounted (ii) Cash Credits, Overdrafts and Loans Payable on Demand (iii) Term Loans		
Total		

B. (i) Secured by Tangible Assets (ii) Covered by Bank/Government Guarantees (iii) Unsecured		
Total		
C. I. Advances in India (i) Priority Sectors (ii) Public Sector (iii) Banks (iv) Others		
Total		
II. Advances Outside India (i) Due from Banks (ii) Due from others (a) Bills Purchased and Discounted (b) Syndicated Loans (c) Others		
Total		
Grand Total (I + II)		

SCHEDULE 10 - FIXED ASSETS

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Premises At cost as on 31st March of the preceding year Additions during the year Deductions during the year Depreciation to date **II. Other Fixed Assets (including Furniture and Fixtures)** At cost as on 31st March of the preceding year Additions during the year Deductions during the year Depreciation to date		
Total (I + II)		

SCHEDULE 11 - OTHER ASSETS

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Inter-Office Adjustments (net) **II.** Interest Accrued **III.** Tax paid in Advance / Tax deducted at source **IV.** Stationery and Stamps **V.** Non-banking assets acquired in satisfaction of claims **VI.** Others		
Total		

SCHEDULE 12 - CONTINGENT LIABILITIES

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Claims against the bank not acknowledged as debts		
II. Liability for partially paid investments		
III. Liability on account of outstanding forward exchange contracts		
IV. Guarantees given on behalf of constituents		
(a) In India		
(b) Outside India		
V. Acceptances, endorsements and, other obligations		
VI. Other items for which the bank is contingently liable		
Total		

SCHEDULE 13 -INTEREST EARNED

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Interest /discount on advances /bills		
II. Income on investments		
III. Interest on balances with Reserve Bank of India and other inter-bank funds		
IV. Others		
Total		

SCHEDULE 14 - OTHER INCOME

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Commission, exchange and brokerage		
II. Profit on sale of investments		
Less: Loss on sale of investments		
iii. Profit on revaluation of investments		
Less: Loss on revaluation of investments		
IV. Profit on sale of land, buildings and other assets		
Less: Loss on sale of land, buildings and other assets		
V. Profit on exchange transactions		
Less: Loss on exchange transactions		
VI. Income earned by way of dividends etc., from subsidiaries/ companies and/or joint ventures abroad / in India		
VII. Miscellaneous Income		
Total		

SCHEDULE 15 - INTEREST EXPENDED

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Interest on deposits		
II. Interest on Reserve Bank of India /inter-bank borrowings		
III. Others		
Total		

SCHEDULE 16 - OPERATING EXPENSES

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. Payments to and provisions for employees		
II. Rent, taxes and lighting		
III. Printing and stationery		
IV. Advertisement and publicity		
V. Depreciation on Bank's property		
VI. Directors' fees, allowances and expenses		
VII. Auditors' fees and expenses (including branch auditors fees and expenses)		
VIII. Law Charges		
IX. Postages, Telegrams, Telephones, etc.		
X. Repairs and maintenance		
XI. Insurance		
XII. Other expenditure		
Total		

@ In case there is any unadjusted balance of loss, the same may be shown under this item with appropriate foot-note.

Disclosure of Accounting Policies

In order to show that the financial position of banks represent a true and fair view, the Reserve Bank of India has directed the banks to disclose the accounting policies regarding the key areas of operations along with the notes of account in their financial statements for the accounting year ending 31.3.1991 and onwards, on a regular basis. The accounting policies disclosed may contain the following aspects subject to modification by individual banks:

(1) General

The accompanying financial statements have been prepared on the historical cost and con- form to the statutory provisions and practices prevailing in the country.

(2) Transactions involving Foreign Exchange

(a) Monetary assets and liabilities have been translated at the exchange rates, prevailing at the close of the year. Non-monetary assets have been carried in the books at the historical cost.

(b) Income and expenditure items in respect of Indian branches have been translated at the exchange rates, ruling on the date of the transaction and in respect of overseas branches at the exchange rates prevailing at the close of the year.

(c) Profit or loss on pending forward contracts has been accounted for.

(3) Investments

(a) Investments in Governments and other approved securities in India are valued at the lower of cost or market value.

(b) Investments in subsidiary companies and associate companies (i.e., companies in which the bank holds at least 25 per cent of the share capital) have been accounted for on the historical cost basis.

(c) All other investments are valued at the lower of cost or market value.

(4) Advances

(a) Provisions for doubtful advances have been made to the satisfaction of the auditors:

(i) In respect of identified advances, based on a periodic review of advances and after taking into account the portion of advance guaranteed by the Deposit Insurance and Credit Guarantee Corporation, the Export Credit and Guarantee Corporation and similar statutory bodies.

(ii) In respect of general advances, as a percentage of total advances taking into account the guidelines issued by the Government of India and the Reserve Bank of India.

(b) Provisions in respect of doubtful advances have been deducted from the advances to the extent necessary and the excess have been included under "Other Liabilities and Provisions".

(c) Provisions have been made on a gross basis. Tax relief, which will be available when the advance is written-off, will be accounted for in the year of write-off.

(5) Fixed Assets

(a) Premises and other fixed assets have been accounted for at their historical cost. Premises which have been revalued are accounted for at the value determined on the basis of such revaluation made by the professional values, profit arising on revaluation has been credited to Capital Reserve.

(b) Depreciation has been provided for on the straight line/diminishing balance method.

(c) In respect of revalued assets, depreciation is provided for on the revalued figures and an amount equal to the additional depreciation consequent of revaluation is transferred annually from the Capital Reserve to the General Reserve/Profit and Loss Account.

(6) Staff Benefits

Provisions for gratuity/pension benefits to staff have been made on an accrual/casual basis. Separate funds for gratuity/pension have been created.

(7) Net Profit

(a) The net profit disclosed in the Profit and Loss Account is after:

(i) Provisions for taxes on income, in accordance with the statutory requirements.

(ii) Provisions for doubtful advances.

(iii) Adjustments to the value of "current investments" in Government and other approved securities in India, valued at lower of cost or market value.

(iv) Transfers to contingency funds.

(v) Other usual or necessary provisions.

(b) Contingency funds have been grouped in the Balance Sheet under the head "Other Liabilities and Provisions".

SOME SPECIAL TRANSACTIONS

Interest on Doubtful Debts

When a debt is found to be doubtful at the end of the accounting year, a question may arise whether the interest on that should be credited to Interest Account or not. There is no doubt that interest has accrued; but it is equally clear that the realisation of this interest is doubtful.

Therefore, as a prudent accounting policy, such interest should be transferred to Interest Suspense Account by means of the following entry:

Loan Account	Dr.
To Interest Suspense Account	

In the Balance Sheet, it should be shown on the liability side.

Next year, if a part of interest is realised and the balance becomes bad, the following entry should be passed

Interest Suspense Account	Dr. [Total interest]
To Interest Account	[Interest realised]
To Loan Account	[Interest unrealized]

It should be noted that if a debtor becomes insolvent, the bank should not take interest into account after the date of insolvency.

Illustration 1:

When closing the books of a bank on 31.12.2012 you find in the loan ledger an unsecured balance of ₹ 2,00,000 in the account of a merchant whose financial condition is reported to you as bad and doubtful. Interest on the same account amounted to ₹ 20,000 during the year.
How would you deal with this item of interest in 2012 account?
During the year 2013, the bank accepts 75 paise in the rupee on account of the total debt due up to 31.12.2012.

Show the entries and the necessary accounts showing the ultimate effect of the transactions in 2013 books of account under Interest Suspense Method.

Solution:

Under Interest Suspense Method

When preparing the 2012 accounts the sum of ₹ 20,000 due from the merchant on account of interest should not be carried to Profit and Loss Account, because its recovery was doubtful. It should, therefore, be transferred to an Interest Suspense Account which would appear as a liability in Balance Sheet on 31.12.2012.

In the Books of Bank Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
2012 Dec. 31	Merchant A/c Dr. To Interest Suspense A/c (Interest due transferred to Interest Suspense A/c)		20,000	20,000
	Interest Suspense A/c Dr. Bad Debts A/c Dr. To Merchant A/c (Interest not received and balances transferred to Bad Debts A/c)		5,000 50,000	55,000
	Cash A/c Dr. To Merchant A/c (Amount received @ 0.75 p in the rupee from the merchant.)		1,65,000	1,65,000
	Interest Suspense A/c Dr. To Profit and Loss A/c (Interest received out of Interest Suspense transferred)		15,000	15,000

In the Books of the Bank

Dr. **Merchant's Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
2012 Dec. 31	To Balance b/d Int. Suspense A/c	2,00,000 20,000	2012 Dec. 31	By Balance c/d	2,20,000
		2,20,000			2,20,000
2013 Jan. 1	To Balance b/d	2,20,000	2013 Dec. 31	By Cash (Dividend @ 75p in the rupee) " Int. Suspense A/c (amount of Int. not covered) " Bad Debts	1,65,000 5,000 50,000
		2,20,000			2,20,000

Interest Suspense Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2012 Dec. 31	To Balance c/d	20,000	2012 Dec. 31	By Merchant's A/c	20,000
		20,000			20,000
2013 Dec. 31	To Merchant's A/c " Profit & Loss A/c	5,000 15,000	2013 Jan. 1	By Balance b/d	20,000
		20,000			20,000

Notes:

1. Interest amounting to ₹20,000 due from customer has been debited to him by crediting Interest Suspense Account (and not to Interest A/c as its recovery is doubtful) and Interest Suspense A/c will appear in the liability side of the Balance Sheet.
2. Actual amount of interest which has been received in cash, i.e. ₹15,000, is transferred to P& L A/c.

Principal Accounting Policies :

(a) Foreign Exchange Transactions

(i) Monetary assets and liabilities have been translated at the exchange rate prevailing at the close of year. Non-monetary assets have been carried in the books at the historical cost.

(ii) Income and Expenditure items in respect of Indian branches need to be translated at the exchange rates on the date of transactions and in respect of foreign branches at the exchange rates prevailing at the close of the year.

(iii) Profit or Loss on foreign currency position including pending forward exchange contracts have been accounted for at the exchange rates prevailing at the closing of the year.

(b) Investment

Permanent category investments are valued at cost. Valuation of investment in current category depends on the nature of securities. While valuation of government securities held as current investments have been made on yield to maturity basis, the investments in shares of companies are valued on the basis of book value.

(c) Advances

Advances due from sick nationalised units under nursing programmes and in respect of various sticky, suit filed and decreed accounts have been considered good on the basis of–

(i) Available estimated value of existing and prospective primary and collateral securities including personal worth of the borrowers and guarantors.

(ii) The claim lodged/to be lodged under various credit guarantee schemes.

(iii) Pending settlement of claims by Govt.

Provisions to the satisfaction of auditors have been made and deducted from advances. Tax relief available when the advance is written off will be accounted for in the year of write-off.

(d) Fixed Assets

The premises and other fixed assets except for foreign branches are accounted for at their historical cost. Depreciation has been provided on written down value method at the rates specified in the Income Tax Rules, 1962. Depreciation in respect of assets of foreign branches has been provided as per the local laws.

Acceptance, Endorsement and Other Obligations

These are the liabilities of a bank which are taken by a bank on behalf of its customers and appear in the liabilities side of the Balance Sheet. For this purpose bank takes corresponding indemnities from its customers to avoid any trouble which may appear in future. In addition to that bank also takes adequate securities. These items are shown under the head Contingent Liabilities in Schedule – 12. These items include: Bills accepted by the bank on behalf of its customers, letter of credit etc.

Illustration 2:

From the following details prepare "Acceptances, Endorsements and other Obligation A/c" as would appear in the general ledger.

On 1.4.12 Acceptances not yet satisfied stood at ₹ 33,45,000. Out of which ₹ 30 lacs were subsequently paid off by clients and bank had to honour the rest. A scrutiny of the Acceptance Register revealed the following:

Client	**Acceptances/Guarantees**	**Remarks**
	(₹)	
P	15,00,000	Bank honoured on 10.6.12
Q	18,00,000	Party paid off on 30.9.12
R	7,50,000	Party failed to pay and bank had to honour on 30.11.12
S	12,00,000	Not satisfied upto 31.3.13
T	7,50,000	-do-
X	4,05,000	-do-
Total	**64,05,000**	

Acceptances, Endorsements and other Obligation Account
(in General Ledger)

(₹ '000)

Dr. **Cr.**

Date	**Particulars**	**Amount (₹)**	**Date**	**Particulars**	**Amount (₹)**
2012-13	To Constituents' liabilities for acceptances/guarantees etc. (Paid off by clients)	3,000	1.4.12	By, Balance b/d	3,345
	To Constituent's liabilities for acceptances/ guarantees etc. (Honoured by bank ₹ 33.45 lakhs less ₹ 30 lakhs)	345	2012-13	By, Constituents' liabilities for Acceptances / guarantees etc. P 1,500	6,405
10.6.12	To Constituents' liabilities for acceptances/guarantees etc. (Honoured by bank)	1,500		Q 1,800 R 750	
30.9.12	To Constituents' liabilities for acceptances/guarantees etc. (Paid off by party)	1,800		S 1,200 T 750 X 405	
30.11.12	To Constituent's liabilities for acceptances/guarantees etc. (Honoured by bank on party's failure to pay)	750			
31.3.13	To Balance c/d (Acceptances not yet satisfied)	2,355			
		9,750			**9,750**

REBATE ON BILLS DISCOUNTED

One of the major functions of a bank is to discount customers' bill. We know that when the bill is discounted by the bank Bill Discounted and Purchased Account should be debited with full amount and Customers' Current Account is credited for such discounting by the bank with net amount. In this way, total amount of discount so earned during this year is credited to Interest and Discount Account. Discount is calculated from the period of discounting the bill to the date of maturity of the bill. This is the usual transactions which are recorded in the books of bank for discounting of the bill. No problem will arise if the entire amount of discount is received during the period. In real world situation, this is not happened as the bill may not have matured for payment during the period of closing the accounts. Thus, an adjustment is required for discounting of those bills which are related to next accounting periods.

Entries

For adjustment
Interest & Discount A/c Dr.
To rebates on bill discount Account
Computation of rebates on Bills discounted

$$\text{Rebate on Bills Discounted} = \text{Amount of Bill} \times \text{Rate of Discount} \times \frac{\text{Unexpired Period}}{12}$$

Illustration 3:

In Calculate Rebate on Bills discounted as on 31 December, 2011 from the following data and show journal entries:

	Date of Bill	₹	Period	Rate of Discount
(i)	15.10.2011	50,000	5 months	8%
(ii)	10.11.2011	30,000	4 months	7%
(iii)	25.11.2011	40,000	4 months	7%
(iv)	20.12.2011	60,000	3 months	9%

Solution:

(a) Calculation of Rebate on Bills Discounted

₹	Due Date	Days after 31 December, 2013	Discount Rate	₹
50,000	18/03/2012	31+ 29 +18 = 78	8%	852.46
30,000	13/03/2012	31+29+13 = 73	7%	418.85
40,000	28/03/2012	31+29+28 = 88	7%	673.22
60,000	23/03/2012	31+29+23 = 83	9%	1,224.59
Total				3,169.12

Dec.31	Particulars	Dr. ₹	Cr. ₹
	Interest and Discount Account Dr. To, Rebate on Bills Discounted. (Being the provision for unexpired discount required at the end of the year)	3,169.12	3,169.12

Illustration 4:

On 31 March, 2011 Victory Bank Ltd. had a balance of ₹18 crores in "rebate on bill discounted" account. During the year ended 31st March, 2012, Victory Bank Ltd. discounted bills of exchange of ₹ 8,000 crores charging interest at 18% p.a., the average period of discount being for 73 days. Of these, bills of exchange of ₹ 1,200 crores were due for realization from the acceptor/customers after 31st March, 2012, the average period outstanding after 31st March, 2012 being 36.5 days.

Victory Bank Ltd. asks you to pass journal entries and show the ledger accounts pertaining to:

(i) Discounting of Bills of Exchange; and
(ii) Rebate on bill Discounted.

In the books Victory bank Ltd.
Journal

Date	Particulars	L. F.	Debit (₹) Crore	Credit (₹) Crore
2012	Rebate on Bill Discounted A/c Dr. To, Discount on Bills A/c (Being the transfer of opening balance to Rebate on Bill Discounted Account)		18.00	18.00
	Bills Purchased and Discounted A/c Dr. To, Client A/c To, Discount on bills A/c $\left[₹8{,}000 \text{ crores} \times \frac{18}{100} \times \frac{73}{365}\right]$ (Being the discounting of bills during the year)		8,000	7,712.00 288.00
	Discount on bills A/c Dr. To, Rebate on Bills Discounted A/c (Being the Provision for unexpired discount as on 31.03.2012)		21.60	21.60
	Discount on bills A/c Dr. To, Profit and Loss A/c (Being the amount of income for the year from discounting of bills of exchange transferred to Profit and Loss Account)		284.40	284.40

Ledger of Victory bank Ltd.
Rebate on Bills Discounted Account

(₹ In Crores)

Dr. Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
01.4.11	To, Discount on bills A/c	18.00	01.4.11	By balance b/d	18.00
31.03.11	To balance c/d	21.60	31.3.12	By Discount on bills A/c (Rebate required)	21.60
		39.60			39.60

Discount on Bills Account

(₹ In Crores)

Dr. Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
31.03.12	To Rebate on Bills Discount A/c	21.60	01.4.11	By rebate on Bills	18.00
,,	To Profit and Loss A/c (Transfer)	284.40	2011-12	By bills Purchased and Discount A/c	288.00
		306.00			306.00

Secured and Unsecured Advance

Secured advance means where a bank grants advance to its customers against any tangible security. Similarly, where as advance is granted by a bank to its customers without taking any tangible security, the same is called unsecured advance. It is needless to mention here that when an advance is granted by a bank to its customers against any tangible security, bank can dispose of the said security for the realization of principle and interest in case of default. The status of securities and the value of such securities must be mentioned by every bank is Schedule 9. Before granting credit every bank must compare with the market value of securities so pledged to the bank and the amount of advance granted by the bank together with the amount of interest.

Illustration 5:

The books of a bank include a loan of ₹5,00,000 advanced on 30.09.2012, interest changeable @ 16% p.a. compounded quarterly. The security for the loan being 7,000 shares of ₹100 each in a public limited company valued @ ₹90 each. There is no repayment till 31.12.2013. On 31.12.2013, the value of shares declined to ₹ 80 per share.

How would you classify the loan as secured or unsecured in the Balance Sheet?

Solution:

Date	Particulars	Amount (₹)
31.12.2013	Balance of Loan (Principal)	5,00,000
	Add: Outstanding Interest	1,08,326[1]
	Total claim	6,08,326
	Less: Value of security at that date 7,000 shares × ₹ 80	5,60,000
		48,326

∴ Classification: Secured ₹5,60,000

Unsecured ₹48,326

Workings

Calculation of Outstanding Interest

Quarters ending	Interest (₹)		Closing balance with principal (₹)
31.12.2012	20,000	$(₹5,00,000 \times \frac{16}{100} \times \frac{3}{12})$	5,20,000
31.03.2013	20,800	$(₹5,20,000 \times \frac{16}{100} \times \frac{3}{12})$	5,40,800
30.06.2013	21,632		5,62,432
30.09.2013	22,497	Do	5,84,929
31.12.2013	23,397		6,08,326
	1,08,326		

RBI's Prudential Accounting Norms

Just to control the lending activities, the recommendation of Narasimhan Committee was accepted by RBI. As per the recommendation, RBI's Prudential Accounting Norms are:

(a) Recognition of Income;
(b) Classification of Assets; and
(c) Provision for Loans and Advances

A. **Recognition of Income:**

As per RBI's norms, every bank must recognize its income
(i) Under Cash Basis (for income under non-performing asset); and
(ii) Under Accrual Basis (for income on performing assets).

Illustration 6:
Given below are details of interest on advance of a Commercial Bank as on 31.03.2013:

(₹ in Crore)

Particulars	Interest Earned (₹)	Interest Received (₹)
Performing Assets		
Term Loan	240	160
Cash Credit and Overdraft	1,500	1,240
Bills Purchased and Discounted	300	300
Non-Performing Assets		
Term Loan	150	10
Cash Credit and Overdraft	300	24
Bills Purchased and Discounted	200	40

Find out the income to be recognized for the year ended 31st March 2013.

Solution:

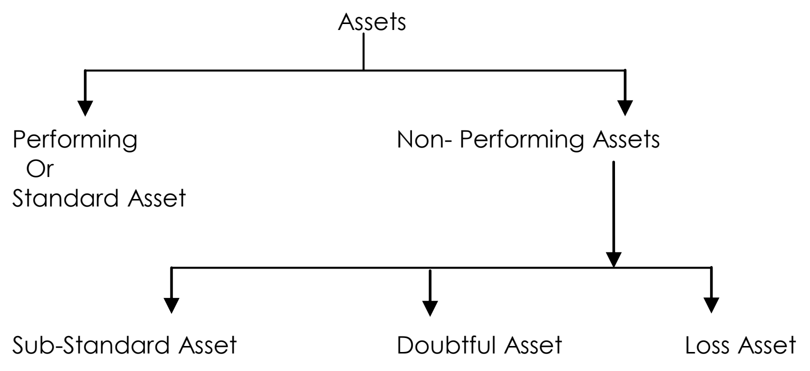
As per RBI Circular, Interest on non-performing assets are considered on Cash Basis whereas interest on performing assets are considered on Accrual Basis.

Statement Showing the Recognition of Income

(₹ in Crore)

Particulars	Amount (₹)	Amount (₹)
1. **Interest on Term Loans**		
(i) Performing Assets	240	
(ii) Non-performing Assets	10	250
2. **Interest on Cash Credit and Overdraft**		
(i) Performing Assets	1,500	
(ii) Non-performing Assets	24	1,524
3. **Interest on Bills Purchased and Discounted**		
(i) Performing Assets	300	
(ii) Non-performing Assets	40	340
Income to be Recognised		2,114

Classification of Assets
Assets are classified as:



Standard or Performing Asset

Practically, these assets bear a little amount of risk like normal risk. They do not create any trouble regarding their realization.

Provision required = **0.40%**

Restructured Advances:

- Restructured accounts classified as standard advances will attract a provision (as prescribed from time to time) in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract a provision for the period covering moratorium and two years thereafter;
- Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a provision (as prescribed from time to time) in the first year from the date of upgradation.

Banks will hold provision against the restructured advances as per the extant provisioning norms.

The above-mentioned higher provision on restructured standard advances (2.75 per cent as prescribed vide circular dated November 26, 2012) would increase to 5 per cent in respect of new restructured standard accounts (flow) with effect from June 1, 2013 and increase in a phased manner for the stock of restructured standard accounts as on May 31, 2013 as under:

- 3.50 per cent - with effect from March 31, 2014 (spread over the four quarters of 2013-14)
- 4.25 per cent - with effect from March 31, 2015 (spread over the four quarters of 2014-15)
- 5.00 per cent - with effect from March 31, 2016 (spread over the four quarters of 2015-16)

1. **Sub-Standard Advances:**

   Advances classified as "sub-standard" will attract a provision of 15 per cent as against the 10 per cent. The "unsecured exposures" classified as sub-standard assets will attract an additional provision of 10 per cent, i.e., a total of 25 per cent as against the 20 per cent. However, "unsecured exposures" in respect of Infrastructure loan accounts classified as sub-standard, in case of which certain safeguards such as escrow accounts are available, will attract an additional provision of 5 per cent only i.e. a total of 20 per cent as against 15 per cent.

2. **Doubtful Advances:**

   Doubtful Advances will continue to attract 100% provision to the extent the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis.
   However, in respect of the secured portion, following provisioning requirements will be applicable:
   The secured portion of advances which have remained in "doubtful" category up to one year will attract a provision of 25 per cent (as against 20 per cent);

   The secured portion of advances which have remained in "doubtful" category for more than one year but upto 3 years will attract a provision of 40 per cent (as against 30 per cent); and
   The secured portion of advances which have remained in "doubtful" category for more than 3 years will continue to attract a provision of 100%.

Rates of Provisioning for Non-Performing Assets and Restructured Advances

Category of Advances	Rate (%)
Standard Advances	
(a) Direct advances to agricultural and SME	0.25
(b) Advances to Commercial Real Estate (CRE) Sector	1.00
(c) All other loans	0.40
Sub-standard Advances	
Secured Exposures	15
Unsecured Exposures in respect of Infrastructure loan accounts where certain safeguards such as escrow accounts are available.	20
Unsecured other loans	25
Doubtful Advances – Unsecured Portion	100
Doubtful Advances – Secured Portion	
For Doubtful upto 1 year	25

For Doubtful > 1 year and upto 3 years	40
For Doubtful > 3 years	100

As per RBI DBOD Circular No. BP.BC 94/21.04.048/2011-12 dated 18/05/2011.
Loss Asset

The asset which are not realizable at all are known as loss assets. The entire amount should be written off or full provision should be made for the amount of outstanding provision @ 100% for such assets.

HOW TO MAKE PROVISION IN RESPECT OF ADVANCES COVERED BY THE GUARANTEES OF DICGC/ECGC

In the case of advances guaranteed by Export Credit Guarantee Corporation (ECGC) or by Deposit Insurance and Credit Guarantee Corporation (DICGC), provision is required to be made only for the balance in excess of the amount guaranteed by these corporations.
In case the bank also holds a security in respect of an advance guaranteed by ECGC/DICGC, the realizable value of the security should be deducted from the outstanding balance before the ECGC/ DICGC guarantee is off-set.
Where there is an upper limit to which the ECGC/ DICGC guarantee applies; this fact should be duly recognized in computing the amount of provision required.

Statement showing the calculation of Provision

	₹
A. Amount Outstanding	xxx
B. Less: Realizable value of Security (if any held)	(xxx)
	xxx
C. Less: ECGC/DICGC cover (% limited to ….)	(xxx)
D. Unsecured Portion [A-B-C]	xxx
E. Provision required for unsecured portion of Doubtful Asset @100%	xxx
F. Provision required for secured portion of Doubtful Asset @ 25%,/40%/100%	Xxx
G. Total Provision required [E+F]	Xxx

Illustration 7:
From the following information of details of advances of X Bank Limited calculate the amount of provisions to be made in Profit and Loss Account for the year ended 31.3.2012:

Asset classification	₹ in lakhs
Standard	6,000
Sub-standard	4,400
Doubtful:	
For one year	1,800
For two years	1,200
For three years	800
For more than three years	600
Loss assets	1,600

Solution:

Statement showing provisions on various performing and non-performing assets

Asset Classification	Amount	Provision	Amount of Provision
	₹ in Lakhs	%	₹ in lakhs
Standard	6,000	0.40	24
Sub-standard	4,400	15	660

Doubtful			
One year	1,800	25	450
2 years	1,200	40	480
3 years	800	40	320
More than 3 years	600	100	600
Loss assets	1,600	100	1,600
			4,134

Illustration 8:

From the particulars given below, ascertain the amount of provision to be made against the advances of SBI, Kolkata. (₹ in '00,000)

Particulars	**Amount (₹)**
Total amount of Loans & Advances	120
Advance fully secured	70
Advance overdue for 15 months	20
Advance overdue for more than 2½ year but less than 3 years	10
(Secured by mortgage of land & building valued ₹ 5 lakhs)	—
Unsecured Advance not recoverable	20

Solution:

Statement Showing the Ascertainment of Provisions(₹ in '00,000)

Type of Advance	**Amount** (₹ in lakh)	**Percentage of Provisions (%)**	**Amount of Provision** (₹)
Standard Asset	70	0.40%	28,000
Sub-Standard Asset	20	15%	3,00,000
Doubtful Asset	10	(Unsecured provision + 40% of secured provision)	7,00,000*
Loss Asset	20	100%	20,00,000
			30,28,000

* Unsecured Provision (₹ 10,00,000 - ₹ 5,00,000) ₹ 5,00,000 + 40% of ₹ 5,00,000

= ₹ 5,00,000 + ₹ 2,00,000

= ₹ 7,00,000

Provisions covered by Guarantee of DICG/ECGC in case of advance :

Illustration 9.

Rajatapeeta Bank Ltd. had extended the following credit lines to a Small Scale Industry, which had not paid any Interest since March, 2006:

	Term Loan	Export Loan
Balance Outstanding on 31.03.2012	₹ 35 lakhs	₹ 30 lakhs
DICGC/ECGC cover	40%	50%
Securities held	₹ 15 lakhs	₹ 10 lakhs
Realisable value of Securities	₹ 10 lakhs	₹ 08 lakhs

Compute necessary provisions to be made for the year ended 31st March, 2012.

Particulars	Term loan (₹ in lakhs)	Export credit (₹ in lakhs)
Balance outstanding on 31.3.2012	35.00	30.00
Less: Realisable value of Securities	10.00	8.00
	25.00	22.00
Less: DICGC cover @ 40%	10.00	–
ECGC cover @ 50%	-	11.00
Unsecured balance	15.00	11.00

Solution:

Required Provision:

	Term loan (₹ in lakhs)	Export credit (₹ in lakhs)
100%* for unsecured portion	15.00	11.00
100% for secured portion	10.00	8.00
Total provision required	25.00	19.00

* The above solution has been provided based on the latest NPA provisions (as per the Master Circular issued by RBI.

Illustration 10.

From the following information find out the amount of provisions required to be made in the Profit & Loss Account of a commercial bank for the year ended 31st March, 2013:

(i) Packing credit outstanding from Food Processors ₹ 90 lacs against which the bank holds securities worth ₹ 22.50 lacs. 50% of the above advance is covered by ECGC. The above advance has remained doubtful for more than 3 years.

(ii) Other advances :

Assets classification	₹ in lacs
Standard	4500
Sub-standard	3300
Doubtful :	
For one year	1350
For two years	900
For three years	600
For more than 3 years	450
Loss assets	900

Solution

(₹ in lacs)

	(₹)	(₹)
Amount outstanding (packing credit)	90.00	
Less : Realisable value of securities	22.50	
	67.50	
Less : ECGC cover (50%)	33.75	
Net Unsecured Balance	33.75	
Required provision :		
Provision for unsecured portion (100%)		33.75
Provision for secured portion (100%)*		22.50
		56.25

Other advances:

(₹ in lacs)

Assets	**Amount**	**% of**	**Provision**
	₹	**provision**	₹
Standard	4500	0.40*	18
Sub-standard	3300	15	495
Doubtful :			
For one year	1350	25	337.5
For two years	900	40	360
For three years	600	40	240
For more than three years	450	100*	450
Loss	900	100	900
Required provision	12,000		2800.5

Note : Doubtful advances have been taken as fully secured. However, in case, the students assume that no security cover is available for these advances, provision will be made for 100%.

* As per the Master Circular issued by RBI.

Preparation of Profit and Loss Account

Illustration 11.

The following are the figures extracted from the books of Y Bank Ltd. [Scheduled Commercial Bank] as on 31.3.2013.

Other information: **(Amount in ₹)**

Interest and Discount received	20,30,000	Directors' fees and allowance	12,000
Interest paid on Deposits	12,02,000	Rent and taxes paid	54,000
Issued and Subscribed Capital	5,00,000	Stationery and printing	12,000
Reserve under Section 17	3,50,000	Postage and Telegram	25,000
Commission, Exchange and Brokerage	90,000	Other expenses	12,000
Rent received	30,000	Audit fees	4,000
Profit on sale of investment	95,000	Depreciation on Bank's properties	12,500
Salaries and Allowances	1,05,000		

(i) Provision for bad and doubtful debts necessary ₹ 2,00,000.

(ii) Rebate on bills discounted as on 31.3.2013 ₹ 7,500.

(iii) Provide ₹ 3,50,000 fo income tax.

(iv) The directors desire to declare 10% dividend.

Make the necessary assumption and prepare the Profit and Loss Account in accordance with the law.

Solution:

In the books of Y Bank Ltd.
Profit and Loss Account for the year ended 31st March, 2013

		Schedule No.	Year ended 31.3.2013 (Current Year) ₹	Year ended 31.3.2012 (Previous Year) ₹
I.	**Income**			
	Interest earned	13	20,22,500	
	Other income	14	2,15,000	
	Total		22,37,500	
II.	**Expenditure**			
	Interest expended	15	12,02,000	
	Operating expenses	16	2,36,500	
	Provisions and contingencies (Note 1)		5,50,000	
	Total		19,88,500	
III.	**Profit / Loss**			
	Net Profit / Loss (–) for the year		2,49,000	
	Profit / Loss (–) brought forward		—	
	Total		2,49,000	
IV.	**Appropriations**			
	Transfer to Statutory Reserves		62,250	
	(25% of Net Profit) (Note 3)			
	Transfer to Other Reserves		—	
	Proposed dividend (10% of ₹ 5,00,000) (Note 4)		50,000	
	Balance carried over to Balance Sheet		1,36,750	
	Total		2,49,000	

Working Notes :

(1) Calculation of Provisions and Contingencies

	₹
Provision for doubtful debts :	2,00,000
Provision for Income tax	3,50,000
	5,50,000

(2) It is assumed that Rebate on Bill Discounted as on 31.3.2012 was nil.

(3) As per the provision of section 17 of the Banking Regulation Act, 1949 amount to be transferred to Statutory Reserve should not be less than 25% of Net Profit.

(4) It is assumed that the dividend has been proposed as per RBI guidelines.

(5) Corporate Dividend tax is payable when dividend is proposed / paid.

Schedule 13: Interest Earned

		₹	₹
I.	Interest and Discount received	20,30,000	
	Less: Rebate on bill discounted as on 31.3.2013	7,500	20,22,500
II.	Income on Investments		
III.	Interest on balances with RBI and other inter-bank fund		
IV.	Others		
	Total		20,22,500

Schedule 14: Other Income

		₹
I.	Commission, exchange and brokerage	90,000
II.	Rent received	30,000
III.	Net Profit on sale of investments	95,000
IV.	Net Profit on revaluation of investments	—
	Less : Net Loss on revaluation of investments	—
V.	Net Profit on sale of land, buildings & other assets	—
VI.	Net Profit on exchange transactions	—
VII.	Income earned by way of dividends etc from subsidiaries/joint ventures setpu abroad/in India	—
VIII.	Miscellaneous Income	—
	Total	2,15,000

Schedule 15: Interest Expended

		₹
I.	Interest on Deposits	12,02,000
II.	Interest on RBI / Inter-bank borrowings	—
III.	Others	—
	Total	12,02,000

Schedule 16 : Operating Expenses

		₹
I.	Payment to and provision for employees	1,05,000
II.	Rent, taxes and lighting	54,000
III.	Printing and stationery	12,000
IV.	Advertisement and publicity	—
V.	Depreciation on Bank's property	12,500
VI.	Directors' fees and allowances	12,000
VII.	Auditor's fees and expenses	4,000
VIII.	Law charges	—
IX.	Postage and telegram	25,000
X.	Repairs and maintenane	—
XI.	Insurance	—
XII.	Other expenditure	12,000
	Total	2,36,500

Preparation of Balance Sheet

Illustration 12.

From the following trial balance and the additional information, prepare a Balance Sheet of Lakshmi Bank Ltd. a Scheduled Commercial Bank as at 31st March, 2013:

Debit balance	**₹ (in Lakhs)**
Cash Credits	1,218.15
Cash in hand	240.23
Cash with Reserve Bank of India	67.82
Cash with other Banks	132.81
Money at call and short notice	315.18

Gold	82.84
Government securities	365.25
Current Accounts	42.00
Premises	133.55
Furniture	95.18
Term Loan	1,189.32
	3,882.33
Credit balance	**₹ (in Lakhs)**
Share Capital (29,70,000 equity shares of ₹ 10 each, fully paid up)	297.00
Statutory Reserve	346.50
Net Profit for the year (before appropriation)	225.00
Profit & Loss Account (Opening balance)	618.00
Fixed deposit Accounts	775.50
Savings Deposit Accounts	675.00
Current Accounts	780.18
Bills Payable	0.15
Borrowings from other Banks	165.00
	3,882.33

Additional Information :

(i) Bills for collection : ₹ 18,10,000
(ii) Acceptance and endorsements : ₹ 14,12,000
(iii) Claims against the bank not acknowledged as debts : ₹ 55,000
(iv) Depreciation charged on premises : ₹ 1,10,000 and Furniture : ₹ 78,000

Solution:

Lakshmi Bank Ltd.
Balance Sheet as on 31.3.2013

Details	**Schedule No.**	**Amount (₹ in Lakhs)**
Capital and Liabilities:		
Capital	1	297.00
Reserves and Surplus	2	1,189.50
Deposits	3	2,230.68
Borrowings	4	165.00
Other Liabilities and Provisions	5	0.15
Total		3,882.33
Assets :		
Cash and Balance with RBI	6	308.05
Balances with Banks and Money at Call and Short Notice	7	489.99
Investments	8	448.09
Advances	9	2,407.47
Fixed Assets	10	228.73
Total		3,882.33
Contingent Liabilities	12	14.67
Bills for Collection		18.10

Schedules Schedule 1 - Capital

	₹ (in lakh)
Issued, Subscribed and Called – up Capital	297.00
(29,70,000 @₹ 10)	

Schedule 2 - Reserves and Surplus

	₹ (in lakh)	₹ (in lakh)
1. Statutory Reserve		346.50
Add: 20% of ₹ 2,25,00,000		56.25
(Assumed to be an unscheduled Bank)		402.75
2. Profit & Loss A/c Opening	618.00	
Add: Current Year		
₹ (2,25,00,000 – 56,25,000)	168.75	786.75
		1,189.50

Schedule 3 – Deposit

	₹ (in lakh)
1. Demand Deposits	780.18
2. Savings Bank Deposits	675.00
3. Term Deposit	775.50
	2,230.68

Schedule 4 - Borrowings

	₹ (in lakh)
Borrowings from other Banks	165.00

Schedule 5 - Other Liabilities

	₹ (in lakh)
Bills Payable	0.15

Schedule 6 - Cash and Balances with RBI

	₹ (in lakh)
Cash in Hand	240.23
Balances with RBI	67.82
	308.05

Schedule 7 - Balances with Banks and Money at Call and Short Notice

	₹ (in lakh)
Cash with other Banks	132.81
Money at Call and short Notice	315.18
Current Accounts	42.00
	4,89.99

Schedule 8 – Investment

	₹ (in lakh)
Government securities	365.25
Gold	82.84
	4,48.09

Schedule 9 – Advances

	₹ (in lakh)
Cash Credit	1,218.15
Term Loans	1,189.32
	2,407.47

Schedule 10 - Fixed Assets

	₹ (in lakh)	₹ (in lakh)
Premises	1,34,65,000	
Less : Depreciation	(1,10,000)	133.55
Furniture	95,96,000	
Less : Depreciation	(78,000)	95.18
		228.73

Schedule 11 - Other Assets — NIL

Schedule 12 - Contingent Liabilities

	₹ (in lakh)	₹ (in lakh)
Acceptance and Endorsements	14.12	
Claims against the Bank not acknowledge as Debts	0.55	
		14.67

4.2 ACCOUNTS OF ELECTRICITY COMPANY

The Electricity Act, 2003

The Electricity Act,2003 replaced the following three existing legislations, namely:

1. The Indian Electricity Act, 1910,
2. The Electricity (Supply) Act, 1948 and
3. The Electricity Regulatory Commissions Act, 1998.

It extends to whole of India except the State of Jammu and Kashmir.

Main Features of the Electricity Act, 2003

(i) The activities like generation, transmission and distribution of power have been separately identifited.

(ii) The Act de-licenses power generation completely (except for hydro power projects, over a certain size).

(iii) 10% of the power supplied by supplers and distributors to the consumers has to be genrated using renewable and non-conventional sources of energy.

(iv) Setting up State Electricity Regulatory Commisson (SERC) made mandatory.

(v) Appellate Tribunal to hear appeals against the decision of the CERC and SERCs.

(vi) Ombudsman scheme for consumers' grievance redressal.

(vii) Provision for private licensees in transmission and entry in distribution through an independent

network.
(viii) Metering of all electiricity supplied made obligatory.
(ix) Provision relating to theft of electricity made more stricter.

Central Electricity Authority

The Central Government has the power to constitute a body called Central Electicity Authority generally to exercise prescribed functions and perform prescribed duties. The office of the CEA is an "Attached Office" of the Ministry of Power. The CEA is responsible for the technical coordination and supervision of programmes and is also entrusted with prescribed statutory functions.

Constitution: The CEA shall consist of not more than 14 Members (including its Chairperson), of whom not more than 8 shall be full-time members to be appointed by the Central Government. The Central Government appoints one of the full time members to be the chairman of the Authority.

Central Electricity Regulatory Commission (CERC)

Meaning: The Central Electricity Regulatory Commission shall be a body corporate, having perpetual succession and a common seal with power to acquire, hold and dispose of property, both movable and immovable, and to contract and shall, by the said name, sue or be sued.

Constitution: The Central Commission shall consist of the following Members namely:
(i) A chairperson and 3 Members
(ii) The Chairperson of the Authority who shall be the Member, ex-officio.

Appointment: The Chairperson and Members of the Central Commission shall be appointed by the Central Government on the recommendation of the Selection Committee.

Functions: The functions of the Central Commission include regulating the tariff of generating companies, the inter-state transmission of electricity, to issue licenses, to levy fees, to fix trading margin etc.

State Electricity Commission (SEC)

Meaning: The State Electricity Commission shall be a body corporate, having perpetual succession and a common seal with power to acquire, hold and dispose of property, both movable and immovable, and to contract and shall, by the said name, sue or be sued.

Functions: The functions of the State Commission include determining the tariff of generation, supplying, transmission and wheeling of electricity companies, wholesale, bulk or retail, regulating the inter-state transmission of electricity, to issue licenses, to levy fees, to fix trading margin etc.

How to Account for Security Deposit

Legal Provisions:
(i) The Distribution Licensee may require the consumer to deposit sufficient security against the estimated payment which may become due to him in respect of electricity supplied to the consumer.
(ii) The Distribution Licensee shall pay interest equivalent to the Bank Rate or more, as may be specified by the concerned State Commission, on the security and refund such security on the request of the person who gave such security.
(iii) Determination of Security Deposit amount for a consumer

= Load × Load Factor of the category in which the consumer falls x (Billing cycle + 45 days) × Current tariff.

Accounting of Security Deposit:

Journal of Distribution Licensee

Date	Particulars	L.F.	*Dr.* (₹)	*Cr.* (₹)
2013 April 2	**(i) On Receipt of Security Deposit** Bank A/c Dr. To Security Deposit A/c (Being the Security Deposit received)		10,00,000	 10,00,000

2014 Mar. 31	**(ii) On Making Provision for Interest Accrued on Security Deposit** Interest Expense A/c Dr. To Interest Accrued on Security Deposit A/c (Being the Provision for Interest Accrued on Security Deposit Made)		1,00,000	 1,00,000
	(iii) On Adjustment of Interest Accrued on Security Deposit in Consumer's Bill Interest Accrued on Security Deposit A/c Dr. To Sales Turnover A/c (Being the Adjustment of Interest Accrued on Security Deposit in Consumer's Bill)		1,00,000	 1,00,000

Reporting of Security Deposit In Balance Sheet of Distribution Licensee:

1. Balance of Security Deposit A/c at the end of the accounting period should be disclosed as a Non-current liability in the Balance Sheet as the same is, in substance, not repayable within a period of 12 months from the reporting date and hence does not satisfy any of the conditions of classifying a liability as current.
2. Balance of Interest Accrued on Security Deposit A/c at the end of the accounting period should be disclosed as Non-current liability in the Balance Sheet as the same is, in substance, not repayable within a period of 12 months from the reporting date and hence does not satifsty any of the conditions of classifying a liability as current.

How to Account for Service Line cum Development (SLD) Charges Received from Consumers Accounting Practices:

Following different accounting and reporting practices are noticed in published Financial Statements of some Electicity Companies:

Accounting Practice 1: SLD is accounted for as a liability and subsequently proportionate amount is transferred to Income Statement during the expected life of the Asset.

Accounting Practice 2: SLD is accounted for as Reserve as the amount is not refundable and disclosed under the head Reserves and Surplus without transferring any proportionate amount to Income Statement during the expected life of the Asset.

Accounting Practice 3: SLD is accounted for as **Capital Reserve** as the amount is not refundable and subsequently proportionate amount is transferred to Income Statement during the expected life of the Asset to match against depreciation on total cost of such asset.

Notes:

- Balance of Capital Service Line Contributions A/c at the end of the accounting period should be disclosed as Capital Reserve under the head 'Reserves and Surplus' as it is not refundable to consumers.
- Balance of Capital Service Line Contributions A/c at the end of the accounting period should be disclosed as **Capital Reserve** under the head 'Reserves and Surplus' wherein the amount transferred to Income Statement is shown as deduction. The amount transferred matches proportionately against depreciation charged on total cost of such asset in the Statement of Profit and Loss.

Accounting Practice 4: SLD is accounted for as reduction in the cost of Non-Current Asset and depreciation is provided on such reduced cost.

Accounting of Service Line Cum Development (SLD) Charges under Accounting

Practice:

Journal of Distribution Licensee

Date	Particulars	L.F.	Dr. (₹)	Dr. (₹)
2013 April 2	**(i) On Receipt of SLD Charges** Bank A/c Dr. To Capital Service Line Contributions A/c (Being the SLD Charges received)		10,00,000	10,00,000
2014 March 3	**(ii) On Transfer of Proportionate Amount to Income Statement** Capital Service Line Contributions A/c Dr. To Statement of Profit and Loss (Being the Transfer of Proportionate amount to the Income Statement)		1,00,000	1,00,000

How to Account for Grant Received under APDRP

(i) Grant received under the Accelerated Power Development and Reforms Programme (APDRP) of the Ministry of Power, Government of India towards capital expenditure is treated as capital receipt and accounted as Capital Reseve and subsequently adjusted as income (by transfer to the Statement of Profit and Loss) in the same proportion as the depreciation written off on the assets acquired out of the Grant.

(ii) The depreciation for the year to be debited to the Statement of Profit and Loss on asset acquired out of grant match against portion of grant transferred from Capital Reserve.

(iii) The unadjusted balance of capital reserve is disclosed under the head, Reseves and Surplus in the Balance Sheet.

(iv) In the Cash Flow Statement Grant received under APDRP is reported under Financing Activity.

(v) At any time if the ownership of the assets acquired, out of the grants, vest with the Government, the grants (Capital Reserve) are adjusted in the carrying cost of such assets.

(vi) The grant-in-aid assistance received by the utility under APDRP and its utilisation shown under the head Capital Expenditure made during the year is not considered for calculation of Annual Revenue Requirement (ARR) of the utility for the year.

Accounting for Depreciation

(i) As per 2009 Regulation, it has been stated in the Tariff Policy that the depreciation rates for the assets shall be specified by the Central Electricity Regulatory Commission (CERC) and these rates of depreciation shall be applicable for the purpose of trarlff as well as accounting.

(ii) The Office of the Comptroller and Auditor General of India (CAG) has expressed an opinion that power sector companies shall be governed by the rates of depreciation as notified by the CERC for providing depreciation in respect of generating assets in the account instead of the rates as per the Companies Act, 1956. Accordingly, a Company should revise its accounting policies relating to charging of depreciation w.e.f. 1st April 2009 considering the rates and methodology notified by the CERC for determination of tariff through Regulations, 2009.

(iii) As per 2009 Regulations, depreciation represents a **Cash Flow for Repayment of Loan** not by allowing Advance against Depreciation but by prescribing higher rates of depreciation for initial years of loan redemption.

(iv) The CERC prescribes following two methods of depreciation:

  (i) The Staight line Method by application of a fixed rate over the fair life of the asset.

  (ii) Optimized Depreciated Replacement cost (ODRC) based method under which the depreciation could be a method for replacement of the asset.

Calculation of Depreciation for the purpose of Tariff as per Regulation 21

(i) The value base for the purpose of depreciation shall be the historical cost of the asset.

(ii) The historical capital cost of the asset shall include additional capitalisation on accout of Foreign

Exchange Rate Variation up to 31.3.2004 already allowed by the Central Government Commission.

(iii) Land other than the land held under lease and the land for reservoir in case of hydro generating station shall not be a depreciable asset and its cost shall be excluded from the capital cost while computing depreciable value of the asset.

(iv) Depreciation shall be calculated annually, based on Straight Line Method over the useful life of the asset and at the rates prescribed in Appendix III to these regulations.

(v) The **Residual Life** of the asset shall be considered as **10 years.**

(vi) The **Salvage Value** of the Asset shall be considered as **10%.**

(vii) Depreciation shall be allowed upto maximum of **90% of the historical cost** of the asset.

(viii) On repayment of entire loan, the remaining depreciable value shall be spread over the balance useful life of the asset.

(ix) Depreciation shall be chargeable from the first year of operation. In case of operation of the asset for part of the year, depreciation shall be **charged on pro rata basis.**

APPENDIX-III DEPRECIATION SCHEDULE

Assets	SLM Depreciation Rate (Salvage Value = 10%)
1. Land under full ownership	0.00%
2. Land under Lease	3.34%
3. (a) Building & Civil Engineering Works other than Kutcha Roads	3.34%
(b) Temporary Erections such as Wooden Structures	100.00%
4. IT Equipments	15.00%
5. Self Propelled Vehicles	9.50%
6. Portable Air Conditioning Plants	9.50%
7. (a) Apparatus other than Motors let on hire	9.50%
(b) Motors let on hire	6.33%
8. Communication Equipments	6.33%
9. Office Furniture, Furnishing, Equipments, Fittings & Apparatus	6.33%
10. Any other Assets *(for example)* (a) Plants & Machinery in generating stations (b) Cooling Towers & Circulating Water Systems (c) Hydraulic Works Forming part of the Hydro-dams, etc. (d) Transformers & Switchgear (e) Lighting Arrestor, Batteries, Overhead lines including cable support (f) Meters (g) Static Air Conditioning Plants (h) Street Light Fittings (i) Vehicles other than Self Propelled Vehicles	5.28%

How to Calculate Weighted Average Rate of Depreciation

Step 1: Calculate Depreciation on Individual Assets (other than Freehold Land) at the Rates as per Appendix III.
= Cost of the Asset x Prescribed Rate of Depreciation.

Step 2: Calculate Total Depreciation on All Assets (other than Freehold Land).
i. e. is the sumassion of depreciation calculated on each asset
= Depreciation on Asset$_1$ + Depreciation on Asset$_2$ +-··········

Step 3: Calculate Total Capital Cost of All Assets (other than Freehold Land).

Step 4: Calculate Weighted Average Rate of Depreciation.

$$\frac{\text{Total Depreciation on all Assets (other than Freehold land)}}{\text{Total capital cost of All Assets (other than Freehold Land)}} \times 100$$

Illustration 13.

From the following calculate Weighted Average Rate of Depreciation considering the rates as per Appendix-III

Assets	Closing Balance at Cost
1. Land under full ownership	14,30,000
2. Land under Lease	4,30,000
3. (a) Building & Civil Engineering Works other than Kutcha Roads	33,00,000
(b) Railways Sidings	40,00,000
(c) Temporary Erections such as Wooden Structures	10,00,000
4. IT Equipments	20,00,000
5. Self Propelled Vehicles	30,00,000
6. Portable Air Conditioning Plants	25,00,000
7. (a) Apparatus other than Motors let on hire	15,00,000
(b) Motors let on hire	2,00,000
8. Communication Equipments	5,00,000
9. Office Furniture, Furnishing, Equipments ,Fittings & Apparatus	5,00,000
10. Plants & Machinery in generating stations	2,52,00,000
11. Cooling Towers & Circulating Water Systems	10,00,000
12. Hydraulic Works Forming part of the Hydro-dams, etc.	20,00,000
13. Transformers & Switchgear	2,05,00,000
14. Lighting Arrestor, Batteries, Overhead lines including cable support	42,00,000
15. Meters	20,00,000
16. Static Air Conditioning Plants	1,00,00,000
17. Street Light Fittings	47,85,000
18. Vehicles other than Self Propelled Vehicles	2,15,000

Solution:

WEIGHTED AVERAGE RATE OF DEPRECIATION

Assets	Rate	Cost	Depreciation
1. Land under full ownership	0.00%	14,30,000	0
2. Land under Lease	3.34%	4,30,000	14,362
3. (a) Building & Civil Engineering Works other than Kutcha Roads	3.34%	33,00,000	1,10,220
(b) Railways Sidings	3.34%	40,00,000	1,33,600
(c) Temporary Erections such as Wooden Structures	100.00%	10,00,000	10,00,000
4. IT Equipments	15.00%	20,00,000	3,00,000
5. Self Propelled Vehicles	9.50%	30,00,000	2,85,000
6. Portable Air Conditioning Plants	9.50%	25,00,000	2,37,500
7. (a) Apparatus other than Motors let on hire	9.50%	15,00,000	1,42,500
(b) Motors let on hire	6.33%	2,00,000	12,660
8. Communication Equipments	6.33%	5,00,000	31,650
9. Office Furniture, Furnishing, Equipments, Fittings & Apparatus	6.33%	5,00,000	31,650
10. Plants & Machinery in generating stations	5.28%	2,52,00,000	13,30,560
11. Cooling Towers & Circulating Water Systems	5.28%	10,00,000	52,800
12. Hydraulic Works Forming part of the Hydro-dams, etc.	5.28%	20,00,000	1,05,600
13. Transformers & Switchgear	5.28%	2,05,00,000	10,82,400

14. Lighting Arrestor, Batteries, Overhead lines including cable support	5.28%	42,00,000	2,21,760
15. Meters	5.28%	20,00,000	1,05,600
16. Static Air Conditioning Plants	5.28%	1,00,00,000	5,28,000
17. Street Light Fittings	5.28%	47,85,000	2,52,648
18. Vehicles other than Self Propelled Vehicles	5.28%	2,15,000	11,352
Total		9,02,60,000	59,89,862

Total Capital Cost of All Assets (other than Freehold land) = 9,02,60,000 -14,30,000
= 8,88,30,000

Weighted Average Rate of Depreciation

$$\frac{\text{Total Depreciation on all Assets (other than Freehold land)}}{\text{Total capital cost of All Assets (other than Freehold Land)}} \times 100$$

$$= \frac{59,89,862}{8,88,30,000} \times 100 = 6.4731\%$$

Illustration 14.

Calculate depreciation as per 2009 regulations from the following information of an Electricity generation project

(i) Date of commercial operation i.e. 1.9.2010.

(ii) The details of actual expenditure incurred up to the date of commercial operation i.e 1.9.2010 and projected expenditure to be incurred from the date of commercial operation up to 31.3.2014 for the assets under Transmission system.The details of apportioned approved cost as on the date of commercial operation and projected expenditure to be incurred for the above mentioned assets is summarized below:

[₹ in lakh]

Apportioned approved cost	Actual Cost Incurred as on the date of commercial operation	Proposed Expenditure from the date of commercial operation to 31.3.2011	Proposed Expenditure for 2011-12	Total Expenditure completion cost
4,20,000	4,00,000	1,00,000	20,000	5,20,000

(iii)

Average Rate of Depreciation Calculated as per rates Specified in Appendix-III	5.3	5.2	5.2	5.2

Additional capital expenditure of 20,000 lakh has been considered out of 1,00,000 lakh for the year 2010-11 and no further additional capital expenditure has been considered as capital cost has been restricted to apportioned approved cost in the absence of revised capital expenditure.

Solution:

Computation of Depreciation

Particulars	2010-11	2011-12	2012-13	2013-14
A. Opening Gross Block	4,00,000	4,20,000	4,20,000	4,20,000
B. Additional Capital exp.	20,000	0.00	0.00	0.00
C. Closing Gross Block [A+B]	4,20,000	4,20,000	4,20,000	4,20,000
D. Average Gross Block [(A+C)/2]	4,10,000	4,20,000	4,20,000	4,20,000
E. Weighted Average Rate of Depreciation	5.3	5.2	5.2	5.2
F. Period	7 months	12 months	12 months	12 months
G. Depreciation (D × E × F/12)	12,676	21,840	21,840	21,840

Illustration 15.

Calculate depreciation upto 2013-14 as per 2009 regulations from the following information of XYZ Power generation Project

Date of commercial operation/Work Completed Date 11-Jan-1996

Beginning of Current year 1-Apr-2011

Useful life 35 years

		(Figures in ₹ Crores)
1.	Capital Cost at beginning of the year 2011-12	222.00
2.	Additional Capltiisation during the year: 2012-13	10.56
	2013-14	29.44
3.	Value of Freehold Land	12.00
4.	Depreciation recovered up to 2009-10	48.60
5.	Depreciation recovered in 2010-11	5.40

Note: Capital Cost and Accumulated Depreciation at the beginning of the year are as per tariff order FY 2011-12

Solution:

Name of the Power Station: XYZ Power Generation Project

Date of commercial operation/Work Completed Date: 11-Jan-1996

Beginning of Current year: 1-Apr-2011
Useful life: 35 years
Remaining Useful life: 20 years

Statement showing the Calculation of Depreciation

Particulars	2011-12	2012-13	2013-14
A. Opening Capital Cost	222.00	222.00	232.56
B. Additional Capital Cost	0.00	10.56	29.44
C Closing Capital Cost	222.00	232.56	262.00
D. Average Capital Cost [(A + C)/2]	222.00	227.28	247.28
E. Less: Cost of Freehold Land	12.00	12.00	12.00
F. Average Capital Cost for Depreciation (D - E)	210.00	215.28	235.28
G. Depreciable value (90% of F)	189.00	193.75	211.75
H. Depreciation recovered upto prev. year *(48.6 + 5.4)	*54.00	60.75	67.75
I. Balance Depreciation to be recovered (G - H)	135.00	133.00	144
J. Balance useful life out of 35 years	20.00	19.00	18.00
K. Yearly depreciation from 2011-12 (I/J)	6.75	7.00	8.00
L. Depreciation recovered upto the year (H + K)	60.75	67.75	75.75

How to calculate Advance Against Depreciation (AAD) for the purpose of tariff as per Regulation 21

AAD shall be the **least** of the following **two** amounts:

1. Difference between loan repayment amount (not exceeding 10% of loan amount as per regulation 20) and Depreciation as per Schedule
2. Difference between Cumulative Repayment of Loan and Cumulative Depreciation up to that year.
3. Statement showing the Calculation of AAD for Tariff Purposes

Particulars	1st year	2nd year	3rd year
A. Repayment of Loan (Not exceeding 10% of Loan Amount) B. Depreciation during the year C. Difference between A & B (A - B) D. Cumulative Repayment of Loan E. Cumulative Depreciation (Excluding AAD) at the beginning F. Difference between D & E (D - E) G. Advance Against Depreciation (AAD) (Minimum of C & F)			

Statement showing the Calculation of Depreciation for Tariff Purposes

Particulars	1st year	2nd year	3rd year
A. Opening Capital Cost B. Additional Capital Cost C. Closing Capital Cost D. Average Capital Cost [(A+ C}/2] E. Less: Cost of Freehold Land F. Average Capital Cost for Depreciation (D - E) G. Weighted Average Rate of Depreciation H. Annualized Depreciation (F x G) I. Advance Against Depreciation (AAD) J. Total Depreciation (including AAD) for Tariff (H + I)			

Illustration 16.

From the following information Calculate Depreciation and Advance against Depreciation as per Regulation 21 of the Central Electricity Regulatory Commission (Terms and Conditions of Tariff) Regulations, 2004.

- Date of Commercial Operation of COD = 1st April 2010
- Approved opening Capital cost as on 1st April 2010 = 1,50,000
- Weighted Average Rate of Depreciation: 3.5%
- Details of allowed Additional Capital Expenditure. Repayment of Loan and Weighted Average Rate of Interest on Loan is as follows:

	1st year	**2nd year**	**3rd year**	**4th year**
Additional Capital Expenditure (Allowed}	10,000	3,000	2,000	2,000
Repayment of Loan	8,000	10,000	10,000	11,000
Weighted Average Rate of Interest on Loan	7.4	7.5	7.6	7.5

Solution:

1. COMPUTATION OF DEPRECIATION

Particulars	**1st year**	**2nd year**	**3rd year**	**4th year**
A. Opening Capital Cost	1,50,000	1,60,000	1,63,000	1,65,000
B. Additional Capital Cost	10,000	3,000	2,000	2,000
C. Closing Capital Cost (A + B)	1,60,000	1,63,000	1,65,000	1,67,000
D. Average Capital Cost [(A + C)/2]	1,55,000	1,61,500	1,64,000	1,66,000
E. Weighted Average Rate of Dep.	3.5%	3.5%	3.5%	3.5%
F. Annualized Depreciation (D × E)	5,425	5,652.50	5,740	5,810
G. Advance Against Depreciation (AAD)	2,575	4,347.50	4,260	5,190
H. Total Depreciation (including AAD) for Tariff (F +G)	8,000	10,000	10,000	11,000

2. COMPUTATION OF ADVANCE AGAINST DEPRECIATION (AAD)

Particulars	1st year	2nd year	3rd year	4th year
A. Repayment of Loan (10% of Loan Amount	8,000	10,000	10,000	11,000
B. Depreciation (Excluding AAD)	5,425	5,652.5	5,740	5,810
C. Difference between A & B (A - B)	2,575	4,347.50	4,260	5,190.50
D. Cumulative Repayment of Loan	8,000	18,000	28,000	39,000
E. Cumulative Depreciation (Excluding AAD) at the beg.	5,425	11,077.5	16,817.50	22,627.5
F. Difference between D & E (D - E)	2,575	6,922.50	11,182.50	16,372.5
G. Advance Against Depreciation (AAD) (Minimum of C & F)	2,575	4,347.50	4,260	5,190

Debt-Equity Ratio as per Regulation 20

1. In case of the generating stations for which investment approval is accorded on or after 1.4.2004, Debt and Equity in the ratio of **70:30** shall be considered for determination of tariff.
2. Where Equity actually employed is more than 30%, Equity in excess of 30% shall be treated as Notional Loan.
3. Where Equity actually employed is less than 30%, the acutal Debt and Equity shall be considered for determination of tariff.

How to calculate Interest on Loan Capital as per Regulation 21

(i) Interest on loan capital shall be computed loan-wise on the loans arrived at in the manner indicated in Regulation 20.

(ii) Statement showing the Calculation of Interest on Loan

Particulars	1st year	2nd year	3rd year
A. Opening Loan (70% or Actual% of Opening Capital w.e.f)			
B. Additional Loan (70% of admitted Add. Capital Exp.)			
c. Less: Repayment of Loan during the year			
D. Net Closing Loan (A + B-C)			
E. Average Loan [(A+ D)/2]			
F. Weighted Average Rate of Interest on Loan			
G. Interest on Loan (E x F)			

How to calculate Return on Equity for the Purpose of Tariff as per Regulation 21

1. Return on Equity shall be computed on the Equity base (as per Regulation 20) @ 14% p.a.
2. Statement showing the Calculation of Return on Equity

Particulars	1st year	2nd year	3rd year
A. Opening Equity (30% or Actual% of Opening Capital w.e.f.)			
B. Additional Equity (30% of admitted Add. Capital Exp.)			
C. Closing Equity (A + B)			
D. Average Equity [(A+ C)/2]			
E. Return on Equity (D × 14%)			

Illustration 17.

From the following information Calculate Return on Equity as per Regulation 21 of the Central Electricity Regulatory Commission (Terms and Conditons of Tariff) Regulations, 2004:

1. Date of Commercial Operation of COD = 1st April 2010
2. Approved Opening Capital Cost as on 1st April 2010 = ₹ 15,00,000
3. Details of allowed Additional Capital Expenditure. Repayment of Loan and Weighted Average

Rate of Interest on Loan is as Follows

	1st year	2nd year	3rd year	4th year
Additional Capital Expenditure (Allowed)	1,00,000	30,000	20,000	10,000

Solution:

Computation of Return of Equity

Particulars	1st year	2nd year	3rd year	4th year
A. Opening Equity (30%)	4,50,000	4,80,000	4,89,000	4,95,000
B. Additional Equity (30%)	30,000	9,000	6,000	3,000
c. Closing Equity (A + B)	4,80,000	4,89,000	4,95,000	4,98,000
D. Average Equity [(A + C)/2]	4,65,000	4,84,500	4,92,000	4,96,500
E. Return on Equity (D × 14%)	65,100	67,830	68,880	69,510

Illustration 18.

The trial balance of MM Electric Supply Ltd. For the year ended 31st March, 2013 is as below:

Particulars	*Dr.* Amount (₹ in '000)	*Cr.* Amount (₹ in '000)
Share Capital:		
Equity Shares of ₹10 each		50,000
14% Preference Shares of ₹100 each		15,000
Patents and trade mark	2,504	
15% Debentures		24,700
16% term loan		15,300
Land (additons during the year 20,50)	12,450	
Building (additions during the year 50,80)	35,134	
Plant & Machinery	57,058	
Mains	4,524	
Meters	3,150	
Electrical Instruments	1,530	
Office Rurniture	2,450	
Capital Reserve		4,020
Contingency Reserves		12,030
General Reserve		1,000
Transformers	16,440	
Opening Balance of Profit & Loss Account		350
Profit for the year 2012-13 subject to adjustments		5,000
Stock in hand	12,050	
Sundry Debtors	6,246	
Contingency Reserve Investments:		
SBI Bonds-2020	10,010	
Other Investments	2,000	
Cash & Bank	3,254	
Public lamps	3,040	
Depreciation Fund		25,816
Sundry Creditiors		6,524
Proposed dividend		12,100
	1,71,840	1,71,840

During 2012-13 1,00,000, 14% Preference Shares were redeemed at a premium of 10% out of proceeds of fresh issue of equity shares of necessary amounts at a premium of 10%

Required prepare for the above period general balance sheet as on 31st March, 2013 as per the schedule III:

Adjustments:

1. Transfer to Contingency Reserve ₹ 1,70,000 & to General Reserve ₹ 2,00,000
2. Loss on Contingency Reserve Investment ₹ 10,000

3. Make a Provision for debts considered doubtful of ₹ 1,014,000.

Solution:

MM Electric Supply Ltd.
Balance Sheet as at 31st March, 2013

Particulars	**Note No.**	**(₹ in '000)**
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds		
(a) Share Capital	1	65,000
(b) Reserves and Surplus	2	21,376
(2) Non-Current Liabilities		
(a) Long-term Borrowings	3	40,000
(3) Current Liabilities		
(a) Trade Payables		6,524
(b) Short-Term Provisions	4	12,100
Total		1,45,000
II. ASSETS		
(1) Non-Current Assets		
(a) Fixed Assets	5	
(i) Tangible Assets		1,09,960
(ii) Intangible Assets		2,504
(b) Non-Current Investments	6	12,000
(2) Current Assets		
(a) Inventories		12,050
(b) Trade Receivables	7	5,232
(c) Cash and Cash Equivalents		3,254
Total		1,45,000

Notes to Accounts:

1. Share Capital

Authorised Capital	
50,00,000 shares of 10 each	50,000
2,50,000 14% Pref. Shares of 100 each	25,000
	75,000

Issued & Subscribed Capital	
50,00,000 shares of 10 each	50,000
2,50,000 14% Pref. Shares of 100 each	25,000
Less: 1,00,000 14% Pref. Shares of 100 each	(10,000)
	65,000

2. Reserves and Surplus

Capital Reserve		4,020
Contingency Reserve (12,030 + 170 – 10		12,190
General Reserve (1,000 + 200)		1,200
Profit & Loss Account		
Opening Balance	350	
Add: Profit for the period	5,000	
Less: Transfer to General Reserve	(200)	
Less: Transfer to Contingency Reserve	(170)	
Less: Provision for Doubtful Debts	(1,014)	3,966
Total		21,376

3. Long-term Borrowings

15% Debentures	24,700
16% Term Loan	15,300
	40,000

4. Short-term Provisions

Proposed Dividend	12,100
	12,100

5. Tangible Assets

Land (10,400 + 20,50)	12,450
Building (30,054 + 50,80)	35,134
Plant & Machinery	57,058
Mains	4,524
Meters	3,150
Electrical Instruments	1,530
Office Rumiture	2 450
Transformers	16 440
Public lamps	3 040
Less: Depreciation Fund	(25 816)
Total	**1,09,960**

6. Non-Current Investments

SBI Bond-2020 (10,010 – 10)	10,000
Other Investments	2,000
	12,000

7. Trade Receivables

Sundry Debtors	6,246
Less : Provision for Doubtful Debts	(1,014)
	5,232

OPTIMISED DEPRECIATED REPLACEMENT COST (ODRC METHOD)

15.1 The Optimised Depreciated Replacement Cost [ODRC] Method involves:

(i) Assessment of the gross current replacement cost of modern equivalent assets.
(ii) Making an adjustment for over design, over capacity and redundant assets and then,
(iii) Depreciating this optimum gross current replacement cost to reflect the anticipated effective working life of the asset from new, the age of the asset and the estimated residual value at the end of the asset's working life.

The ODRC method comprises the following steps:

Step 1: Preparing a detail Asset Register containing data on quantity, location, physical condition, age and maintenance of the assets.

Step 2: Calculation of the Replacement Cost (i.e. Cost of replacing the assets with modern equivalent assets).

Step 3: Assessment of Depreciation. The new assets at replacement costs identified earlier need to be depreciated in case the life of the existing asset is lower than the life of the new assets.

Step 4: System Optimisation: This is done to measure the most cost effective way of delivering service, in terms of capacity and quality to meet the requirements.

This involves three levels:

- Capacity Optimisation both in size and number
- Optimisation of spares
- Optimisation of unit costs

An immediate shift to the ODRC Method Is not recommended due to:

– Problems in producing a detailed Asset Register.
– Absence of norms for standard lives of assets.
– Absence of construction cost estimates
– Lack of data on future load growth.

The ODRC Method would be better because:

– It will ensure that the price shocks are gradually administered to the customers.
– It will ensure greater acceptability to users since over capacity issues will be addressed and cost reductions possible from new technologies will be incorporated in the valuation.
– The valuation will reflect the cost of replacement utitlites will be able to assess the timing and financing requirements with a greater degree of certainty.

4.3 ACCOUNTS OF INSURANCE COMPANY

INTRODUCTION

Several people exposed to a particular type of risk contribute small amounts called premiums to an insurance fund from which the unfortunates who actually suffer the risk are compensated. Insurance business is essentially a way of averaging the risks.
A policy is a contract entered into between the insurance companies called the 'insurer' and the person insuring his risk called the 'insured'.
Policy specifies all the conditions subject to which the policy is issued. These conditions bind both the parties.
The policy is in the form of a document which the insurance company issues after receiving the premium.

Thus Insurance is essentially a method of averaging risks.

Types of Policies

Depending on the type of risk, there are several types of insurance policies.
Risks of fire are covered by **fire policies**.
Marine risks of goods, vessels and freights of goods are covered by **marine insurance policies.**
Losses of theft are covered by **Burglary insurance**.

There are miscellaneous policies to insure **accidents, fidelity of employees, loss of profits in the event of fire and accidents and deaths to employees at work spots.**

Life insurance takes primarily two forms. In the case of **endowment policy**, the insured obtains a specified sum in the event of the insured obtaining a specified age or to the family in case the insured dies before attaining specified age. They may be again with or without profit policies. Whereas in the case of whole life policies the family of the insured (to be exact the nominee mentioned in the policy) receives a specified sum on the death of insured.

The premiums would be less in the case of whole life policies compared to endowment policies for the insured of the same age.

Principles of Insurance

There are several principles governing insurance business, the important of which are discussed below.

Principle of indemnity. Insurance is a contract of indemnity. The insurer is called indemnifier and the insured is the indemnified. In a contract of indemnity, only those who suffer loss are compensated to the extent of actual loss suffered by them. One cannot make profit by insuring his risks.

Insurable interest. All and sundry cannot enter into contracts of insurance. For example, *A* cannot insure the life of B who is a total stranger. But if *B*, happens to be his wife or his debtor or business manager, *A* has insurable interest and therefore he can insure the life of B. For every type of policy insurable interest is insisted upon. In the absence of such interest the contract will amount to a wagering contract.

Principle of uberrimae fidei. Under ordinary law of contract there is no positive duty to tell the whole truth in relation to the subject-matter of the contract. There is only the negative obligation to tell nothing but the truth. In a contract of insurance, however there is an implied condition that each party must disclose every material fact known to him. This is because all contracts of insurance are contracts *of uberrimea fidei, i.e.,* contracts of utmost good faith. This is because the assessment of the risk and the determination of the premium by the insurer depends on the full and frank disclosure of all material facts in the proposal form.

Distinction between Life and Non-life Insurance

There are certain basic differences between life policies and other types of policies. These are listed below:

(1) Human life cannot be valued exactly. Therefore each insured is permitted to insure his life for a specified sum, depending on his capacity to pay premiums. This is also one form of investment and the policy amount depends on his investment decision. In the event of the policy maturing the insurer must pay the policy amount as actual loss cannot be determined. This is not the case with other policies. Other policies are contracts of indemnity. Therefore not withstanding the amount for which the policy is taken, the insurer would pay (reimburse) only the actual loss suffered or the liability incurred.

(2) Life insurance contracts are long-term contracts. Once a policy is taken premiums have to be paid for number of years till maturity and the policy amount is paid on maturity. Of course, a life policy can be surrendered after certain number of years and the insured is paid a proportion of the premiums paid known as surrender value. In the case of other policies they are for a short period of one year although the policy can be renewed year after year.

(3) Life insurance is known also by another term 'assurance' since the insured gets an assured sum. Other policies are known as insurance.

(4) The determination of profit is by different methods for life and general insurance business. In the case of life business periodically actuaries estimate the liability under existing policies.

On that basis a valuation Balance Sheet is prepared to determine the profit. In the case of general insurance business a portion of the premium is carried forward as a provision for unexpired liability and the balance net of claims and expenses is taken as profit (or loss).

IMPORTANT PROVISIONS OF THE INSURANCE ACT, 1938

The Insurance Act, 1938 and the rules framed thereunder have an important bearing on the preparation of accounts by insurance companies. Some of the provisions have become irrelevant after the nationalization of general insurance. Some provisions have been amended by The Insurance Laws (Amendment) Act, 2015 and these have been separately listed.

(1) Forms for final accounts [Sec 11(1)]. Every insurer, on or after the date of the commencement of the Insurance Laws (Amendment) Act,2015, in respect of insurance business transacted by him and in respect of his shareholders' funds, shall at the expiration of each financial year, prepare with reference to that year, balance sheet, a profit and loss account, a separate account of receipts and payments, a revenue account in accordance with the regulations as may be specified.

(2) Audit. The Act provides that the company carrying on general insurance business be audited as per the requirements of the Companies Act, 2013.

(3) Register of policies [Sec 14](1)(a)] Every insurer shall maintain a record of policies, in which shall be entered, in respect of every policy issued by the insurer, the name and address of the policyholder, the date when the policy was effected and a record of any transfer, assignment or nomination of which the insurer has notice.

(4) Register of claims. The insurer must also maintain a register of claims for record of claims, every claim made together with the date of the claim, the name and address of the claimant and the date on which the claim was discharged, or in the case of a claim which is rejected, the date of rejection and the grounds thereof.

(5) Approved investments (27B) All assets of an insurer carrying on general insurance business shall subject to such conditions, if any, as may be prescribed, be deemed to be assets invested or kept invested in approved investments specified in this section.

(6) Payment of commission to authorized agents (Sec 40). No person shall, pay or contract to pay any remuneration or reward, whether by way of commission or otherwise for soliciting or procuring insurance business in India to any person except an insurance agent or an intermediary or insurance intermediary in such manner as may be specified by the regulations.

(7) Sec 40 (C). Every insurer transacting insurance business in India shall furnish to the Authority, the details of expenses of management in such manner and form as may be specified by the regulations made under this Act.

(8) Sec 64VA Every insurer and re-insurer shall at all times maintain an excess of value of assets over the amount of liabilities of, not less than fifty per cent of the amount of minimum capital as stated under Section 6 and arrived at in the manner specified by the regulations.

BOOKS REQUIRED TO BE MAINTAINED BY INSURANCE COMPANIES

Under the Insurance Act, 1938 it is obligatory on the part of all insurance companies including the general insurance companies to maintain the following books which may be called 'statutory books'.

1. **The registrar of policies.** This book contains the following particulars in respect of each policy issued:
   (a) The name and address of the policyholder;
   (b) The date when the policy was effected; and
   (c) A record of any assignment of the policy.

2. **The register of claims.** This book should contain the following particulars in respect of each claim:
   (a) The date of claim;
   (b) The name and address of the claimant;
   (c) The date on which the claim was discharged; and
   (d) In the case of a claim which is rejected, the date of rejection and the ground for rejection.

3. **The register of licensed insurance agents.** This book should contain the following particulars in respect of each agent:
   (a) Name and address of every insurance agent appointed;
   (b) The date of appointment; and
   (c) The date on which appointment ceased, if any.

   In addition to the statutory books mentioned above, insurance companies also maintain the following subsidiary books for recording the transactions:
   (i) Proposal register
   (ii) New premium cash book
   (iii) Renewal premium cash book
   (iv) Agency and branch cash book
   (v) Petty cash book
   (vi) Claims cash book
   (vii) General cash book
   (viii) Agency credit journal
   (ix) Agency debit journal
   (x) Lapsed and cancelled policies book
   (xi) Chief journal
   (xii) Commission book
   (xiii) Agency ledger
   (xiv) Policy loan ledger
   (xv) General loan ledger
   (xvi) Investment ledger

ACCOUNTS OF LIFE INSURANCE BUSINESS

Nationalization of Life Insurance Business. In 1956 life insurance business was nationalized by transferring all such business to the Life Insurance Corporation established for the purpose. The main objects of nationalization were:

(1) To ensure absolute security to the policy holder in the matter of life insurance protection.
(2) To spread insurance much more widely and in particular to the rural areas, and
(3) As a further step in the direction of more effective mobilization of public savings.

Some of the important provisions of the Life Insurance Corporation Act, 1956 which are worth noting are stated below:

(1) **Section 30.** Except to the extent otherwise expressly provided in this Act, on and from the appointed day the Corporation shall have the exclusive privilege of carrying on life insurance business in India; and on and from the said day any certificate to registration under the Insurance Act held by any insurer immediately before the said day shall cease to have effect in so far as it authorises him to carry on life insurance business in India.
(2) **Section 37**. The sums assured by all policies issued by the Corporation including any bonuses declared in respect thereof and, subject to the provisions contained in section 14 the amounts assured by all policies issued by any insurer the liabilities under which have vested in the Corporation under this Act, and all bonuses declared in respect thereof, whether before or after the appointed, day shall be guaranteed as to payment in cash by the Central Government.
(3) **Section 6.** Functions of the Corporation.
    (a) The general duty of the Corporation is to carry on life insurance business whether in or outside India and to develop the life insurance business to the best advantage of the community.
    (b) In addition the Corporation has the power:
        (i) To carry on capital redemption business, annuity certain business or re-insurance business,
        (ii) To invest the funds of the Corporation,
        (iii) To acquire, hold and dispose of any property for the purpose of its business, and
        (iv) To advance or lend money upon the security of any movable or immovable property or otherwise.
        (v) **Sections 18 and 19.** The central office is located at Mumbai and has zonal offices at Mumbai, Kolkata, Delhi, Kanpur and Chennai.

There may be established as many divisional offices and branches in each zone as may be decided by the Corporation in accordance with the guidelines issued by the Insurance Regulatory and Development Authority established under the Insurance Regulatory and Development Authority Act, 1999 in this regard.

The general superintendence and direction of the Corporation affairs is carried on by an executive committee consisting of not more than 5 members. The investment committee advises the Corporation in matters relating to investment of funds. This committee can have a maximum of 8 members of which 4 must be members of the Corporation.

As per Section 4 the Corporation consists of not more than 15 members appointed by the Central Government and one of them nominated will act as the Chairman.

(4) **Sections 20.** The Corporation may appoint one or more persons to be the Managing Director or Directors of the Corporation, and every Managing Director shall be a whole-time officer of the Corporation and shall exercise such powers and perform such duties as may be entrusted or delegated to him by the Executive Committee or the Corporation
(5) **Section 24.** The Corporation has its own fund and all the receipts are credited to such fund and all payments are made there from.
(6) **Section 25.** The accounts of the Corporation shall be audited by auditors duly qualified to act as auditors of companies under the law for the time being in force relating to companies, and the auditors shall be appointed by the Corporation with the previous approval of the Central Government and shall receive such remuneration from the Corporation as the Central Government may fix.

Every auditor in the performance of his duties shall have at all reasonable times access to the books, accounts and other documents of the Corporation.

The auditors shall submit their report to the Corporation and shall also forward a copy of their report to the Central Government..

(7) **Section 26.** There must be an actuarial valuation at least once in every year and the Corporation must submit the report to the Central Government.
(8) **Section 27.** At the end of each financial year the Corporation is required to prepare and submit a report to the Central Government giving an account of its activities during the previous financial

year and also an account of the planned activities for the next financial year.

(9) **Section 28.** Ninety-five percent (or a higher percentage approved by the Central Government) from actuarial valuation made under Section 26 shall be allocated to or reserved for the policyholders of the Corporation and the remainder either paid to the Central Government or utilized for such purposes and in such manner as the Government may determine.

(10) **Section 28A.** If for any financial year profits accrue from any business (other than life insurance business) carried on by the Corporation, then, after making provision for reserves and other matters for which provision is necessary or expedient, the balance of such profits shall be paid to the Central Government.

(11) **Section 29.** The Central Government shall cause the report of the auditors under section 25, the report of the actuaries under section 26 and the report giving an account of the activities of the Corporation under section 27 to be laid before both Houses of Parliament as soon as may be after each such report is received by the Central Government.

Types of Policies:

As stated earlier, under a contract of life insurance an insurance company guarantees to pay a fixed sum of money to the insured on his attaining a certain age or to his nominees or legal heirs on his death. The contract in its written form is called a policy and broadly there are two types of policies. They are

(1) whole life policy, and (2) Endowment policy. Under whole life policy the insured does not get the amount during his life time. The amount is paid only to his nominees or heirs on his death. In the case of Endowment policy the amount is paid to the insured on his attainment of a specified age or if he dies before, the amount is paid to his nominees or heirs. As explained later life insurance company ascertains the profits once in two years. 95% of such profits are distributed to policyholders as bonus. Such bonus is to be credited only to 'with profit policies'. The holders of 'without profit policies' have no right to the bonus. Naturally the premium is comparatively less in the case of 'without profit policies' than in the case of 'with profit policies'. In recent years the reversionary bonus has been around ₹ 20 per thousand sum assured per annum on Endowment policies and ₹ 25 per thousand sum assured per annum on whole life policies.

Annuity Business:

Life insurance companies also do annuity business. Annuity refers to fixed annual payment made by the insurance company to the insured on his attaining a specified age. The insured deposits lump sum amount by way of consideration for the annuity granted. This is a method under which the person purchasing the annuity receives back his money with interest. Annuity paid represents an expenditure of the life insurance business and the consideration received for annuities is an item of income.

Surrender Value:

In the case of life policy, the policy normally has value only when it matures. But to facilitate the promotion of business, insurance companies assign value to the policy on the basis of the premiums paid. Insurance companies will be prepared to pay such value on the surrender of the policy by a needy policy holder desiring to realize the policy. Therefore the value is referred to as 'surrender value'. Surrender value is usually nil until at least two annual premiums are paid. Amount paid as surrender value is an expenditure and is similar to claims paid.

Paid-up Policy:

A policy holder, who has difficulty in paying the premium, may be allowed an option to get the policy paid-up. In such a case, the policyholder is relieved from the obligation of paying off the rest of premium, but he will not get the full value of policy which is calculated as follows:

$$\text{Paid- up value} = \text{Sum assured} \times \frac{\text{No. of Premiums paid}}{\text{Total number of premiums payable}}$$

The amount paid on maturity in respect of paid-up policies is included in the amount of claims.

Bonus: It is nothing but the share of profit which is payable by the insurance company to the policyholders. Bonus may be of three types –

Cash Bonus: It is paid to the policyholders in cash when the Valuation Balance Sheet is prepared.

Reversionary Bonus: It is added to the policy amount and is paid together with the policy amount when matured for payment.

Bonus in reduction of premium: It is just applied in reducing further premiums.

Interim Bonus — It is a bonus declared between dates of two valuation Balance Sheets. It is for a period for which valuation is not complete.

Bonus in Reduction of Premium: In all the cases of general insurance the policy is always taken for one year and it is to be renewed after the expiry of the policy. Whether the policy is renewed with the same company, or a fresh policy is taken with some other company, it is a standing practice that the company usually grants a reduction in premium at the prescribed rate if the insured has not made any claim. This rate of reduction increases every year for usually three years if the insured does not make any claim continuously year after year.

Premium: The payment made by the insured to the Insurance Company in consideration of the contract of Insurance. The premium is generally paid annually. In some cases it may be paid at shorter intervals. A point to be noted is the premium amount has to be paid "front end" i.e., before the commencement of the insurance cover/policy.

Claims: A claim occurs when any policy fail due for payment. In case of Life Insurance, it arises on death or on maturity of policy. In case of General Insurance, it arises only when the loss occurs. While calculating the claim outstanding at the end, the claim intimated as well as the claim intimated and accepted both are considered.

The adjustment entry required is:

Claims A/c Dr.

To Claims intimated and accepted but not paid A/c

To Claims intimated but not accepted and paid A/c

At the starting of the next period a reverse entry is passed, so that when these claims intimated are paid, they may not influence the claims account of next year. However, if company rejects any claim, such amount should be transferred to the insurance fund account and not to the claims account.

Commission: Generally, Insurance Companies get business through agents; these agents receive commission on the basis of the amount of premium they generate for the Insurance Company. Commission paid to Agents is shown as a debit (expense) in the Revenue Accounts.

Re-insurance:

Re-insurance means the transfer of a part of risk by the insurer. This is particularly done when the amount of insurance is very high and when it is very difficult to bear the entire risk by a single insurer, a part of the risk is to be insured with some other insurance companies.

Double Insurance: When the same risk and the same subject matter is insured with more than one insurer, i.e., more than one insurance company, the same is called Double Insurance.

Ceding Company: An insurance company that shifts part or all of a risk it has assumed to another insurance company. The Ceding company shares the premium amount it has received to cover the risk, with the second insurance company called the Reinsurer. In return the Reinsurer company pays commission to the Ceding company for getting the business.

Life Assurance Fund.

This represents the excess of revenue receipts over revenue expenditure relating to life business. The fund is available to meet the aggregate liability on all policies outstanding. Revenue Account is prepared every year to ascertain the balance of life insurance fund at the end of the year. In the preparation of Revenue Account, the opening balance of the life insurance fund is the starting point. Other items of revenue income are credited to the fund and revenue items of expense are debited. The resulting figure is the closing balance of the revenue fund.

Illustration 19.

The Revenue Account of a life insurance company shows the life assurance fund on 31st March, 2013 at ₹ 62,21,310 before taking into account the following items:

(i) Claims covered under re-insurance ₹ 12,000.
(ii) Bonus utilized in reduction of life insurance premium ₹ 4,500.
(iii) Interest accrued on securities ₹ 8,260.

(iv) Outstanding premium ₹ 5,410.
(v) Claims intimated but not admitted ₹ 26,500.

What is the life assurance fund after taking into account the above omissions?

Solution:

Statement showing Life Assurance Fund

Particulars	Amount (₹)	Amount (₹)	Amount (₹)
Balance of Fund as on 31st March, 2013			62,21,310
Add:			
Interest on securities		8,260	
Premium outstanding		5,410	13,670
			62,34,980
Less:			
Claims outstanding	26,500		
Covered under re-insurance	12,000	14,500	
Bonus in reduction of premium		4,500	19,000
Balance of Life Assurance Fund			62,15,980

Valuation Balance Sheet

The balance in the life assurance fund cannot be taken as the profit made by the life insurance business. For the purpose of ascertaining the profit, the insurance company should calculate its net liability on all outstanding policies. This calculation is done by experts called actuaries and is a highly complicated mathematical process. Prior to nationalization, insurance companies were having this computation once in three years. Since nationalization, L.I.C. is having such valuation once every two years. For calculating net liability, the actuaries calculate the present value of future liability on all the policies in force as well as present value of future premium to be received on policies in force. The excess of the present value of future liability over the present value on future premium is called the net liability.

It is by comparing the life insurance fund and net liability in respect of policies, that profit in respect of life insurance business can be ascertained. If the life insurance fund is more than the net liability, the difference represents the profit. On the other hand, the excess of net liability over the life assurance fund represents the loss for the inter-valuation period.
According to Section 28 of the Life Insurance Corporation Act, 1956, 95% of the profit of life business must be distributed to the policyholders by way of "Bonus" on with-profit policies and the remaining 5% has to be utilized for such purposes as the Government may determine. The profit or loss of life insurance business is ascertained by preparing a statement called 'Valuation Balance Sheet' which is reproduced below.

Valuation Balance Sheet as on..............................

To Net liability as per actuary's valuation		By Life Assurance Fund as per Balance Sheet
To Surplus (Net Profit)		By Deficiency (Net loss)

Illustration 20:
The life insurance fund of Prakash Life Insurance Co. Ltd. was ₹ 34,00,000 on 31st March, 2013. Its actuarial valuation on 31st March, 2013 disclosed a net liability of ₹ 28,80,000. An interim bonus of ₹ 40,000 was paid to the policyholders during the previous two years. It is now proposed to carry forward ₹ 1,10,000 and to divide the balance between the policyholders and the shareholders. Show (a) the Valuation Balance Sheet, (b) the net profit for the two-year period, and (c) the distribution of the profits.

Solution:

In the Books of Prakash Life Insurance Co. Ltd. Valuation Balance Sheet as on 31st March, 2013

Liabilities	Amount (₹)	Assets	Amount (₹)
To Net liability To Net Profit	2,880,000 520,000	By Life Assurance Fund	3,400,000
	3,400,000		3,400,000

Net profit for the two-year period	
Profit as per Valuation Balance Sheet	5,20,000
Add: Interim Bonus paid during the previous two years	40,000
Net Profit	5,60,000
Distribution of the profits	
Net Profit	5,60,000
Less: Amount proposed to be carried forward	1,10,000
Balance	4,50,000
Share of policyholders (95% of ₹ 4,50,000)	4,27,500
Less: Interim bonus paid	40,000
Amount due to policyholders	3,87,500
Share of Shareholders (5% of ₹ 4,50,000)	22,500

Illustration 21:

From the following figures of Well Life assurance Co. Ltd. prepare a Valuation Balance Sheet and Profit Distribution Statement for the year ended 31st March 2014. Also pass necessary journal entries to record the above transactions with narrations:

Particulars	₹ (in lakhs)
Balance of Life Assurance Fund as on 1.4.2013	167.15
Interim bonus paid in the valuation period	25.00
Balance of Revenue Account for the year ended 31.3.2014	240.00
Net Liability as per valueer's Certificates as on 31.3.2014	165.00

The company declares a revesionary bonus of ₹185 per ₹1,000 and gave the policyholders an option to take bonus in cash ₹105 per ₹1,000. Total business conducted by the company was ₹600 lakhs. The company issued profit policy only, 3/5 th of the policyholders in value opted for cash bonus.

Solution:

In the Books of Well Assurance Co. Ltd.

Valuation Balance Sheet As at 31st March 2014

Liabilities	Amount (₹)	Assets	Amount (₹)
Net Liabilities as per Actuarial Valuation Surplus/Net Profit	1,65,00,000 75,00,000	Life Insurance Fund	2,40,00,000
	2,40,00,000		2,40,00,000

Distribution Statement, i.e. Distribution of Surplus	₹
Surplus/ Net Profit Add: Interim Bonus Paid	75,00,000 25,00,000
	1,00,00,000

Policyholders' shares @95% of ₹1,00,00,000 Less: Interim Bonus paid	95,00,000 25,00,000
	70,00,000

Shareholders' Share @ 5% of ₹1,00,00,000	5,00,000

Journal

Date	Particulars	L.F.	Debit ₹	Credit ₹
?	Life Assurance Fund A/c Dr. To, Profit and Loss A/c (Surplus/Net Profit transferred to P&L A/c as per Valuation Balance Sheet)		75,00,000	75,00,000
	Profit and Loss A/c Dr. To, Bonus (in cash) Payable A/c (Bonus paid in cash)		37,80,000	37,80,000
	Profit and Loss A/c Dr. To, Life Assurance Fund A/c (Revisionary Bonus payable transferred to Life assurance Fund)		44,40,000	44,40,000

Workings:

1. Bonus payable in cash
@ ₹105 per rs.100
On 3,60,00,000 (₹6,00,00,000 × $\frac{3}{5}$)
$= ₹\frac{3,60,00,000}{1,000} \times 105$
= ₹37,80,000

2. Revisionary Bonus
@ ₹185 per ₹1,000
On 2,40,00,000 (₹6,00,00,000 × $\frac{2}{5}$)
$= ₹\frac{2,40,00,000}{1,000} \times 185$
= ₹44,40,000

IRDA REGULATIONS REGARDING PREPARATION OF FINANCIAL STATEMENTS

IRDA has issued fresh regulations regarding the preparation of financial statements and Auditor's Report on 14th August, 2000. The salient features which differ from the requirements of Insurance Act, 1938 are listed below.

(1) Insurers will in addition to the earlier statements will have to prepare a receipts and payments account (cash flow statement). This statement must be prepared in accordance with AS-3 using the direct method given in the standard.

(2) Insurers doing life insurance business should comply with the requirements of Schedule A. The Schedule, among other things, gives the following forms:

Revenue Account	Form A-RA
Profit and Loss Account	Form A-PL
Balance Sheet	Form A-BS

The profit and loss account and balance sheet are given in summary form.
There are 15 Schedules, the first four relating to profit and loss account and the remaining eleven relate to balance sheet which give the details of the summary heads. Schedule 5 deals with share capital. It is followed by a connected Schedule 5A, which, gives the pattern of shareholding.

(3) Insurers doing general insurance business should comply with the requirements of Schedule B. The schedule among other things gives the following forms:

Revenue Account	Form B-RA
Profit and Loss Account	Form B-PL

Balance Sheet Form B-BS

As in the case of life business the profit and loss account and the balance sheet are given in summary form. The details are to be shown in the accompanying schedules. Here also the first four relate to profit and loss account and the rest eleven pertaining to balance sheet. Schedule 5A gives the pattern of shareholding. In both the schedules profit and loss appropriation account is dispensed with and the appropriations are accommodated in the profit and loss account.

(4) The report of the auditors on the financial statements of every insurer and re-insurer must conform to the requirements of Schedule C. The Authority reserves the right to issue guidelines on the appointment, continuance or removal of auditors. These guidelines can include matters relating to qualifications, experience, rotation and period of appointment of auditors.

(5) The financial statements must be accompanied by a management report given in part (iv) in Schedules A and B as well. The report deals with compliance of certain requirements of the regulations, provision of solvency margins, disclosure with regard to the overall risk exposure and the strategy adopted to mitigate the same. It also includes ageing of claims indicating the average period taken to settle the claims, computing market value of investments, its impact on balance sheet and a review of asset quality performance of investments in terms of portfolios such as real estate, loans, investments, etc. Finally, the report includes a responsibility statement indicating the compliance with the accounting standards, financial statements reflecting a true and fair view, maintenance of adequate accounting records, preparation of accounts on a going-concern basis and the existence of an internal audit system consistent with the size and nature of business.

(6) The financial statements should disclose the contingent liabilities, the accounting policies and the departures from such policies with reasons therefore.

(7) Premium recognition. Premium is the main revenue for insurance business. In the case of life business premium is to be recognized on due basis. In the case of general insurance premium is to be recognized as income over the contract period or the period of risk whichever is appropriate.

Unearned premium and premium received in advance both of which represent income not relating to the accounting period must be disclosed separately in the financial statements. Unearned premium is the premium for the period of unexpired risk. Premium received in advance represents the premium received prior to the commencement of risk. In other words, the premium relates entirely to subsequent accounting periods. A provision should be made for unearned premium. Both premium received in advance and unearned premium are shown separately in the balance sheet under the heading 'Current Liabilities'.

(8) Premium Deficiency. It is the sum of expected claim costs, related expenses and maintenance costs exceeding the related unearned premium.

(9) Actuarial Valuation of claims liability-in some cases. Previously there was no need for actuarial valuation in general insurance. Now the regulations require estimation of claims made in respect of contracts exceeding four years, must be recognized on actuarial basis, subject to the regulations of the Authority.

(10) Catastrophe reserve. Such a reserve should be created by the insurers towards losses which might arise due to entirely unexpected set of events and not for any specific known purpose. Investment of the funds of this reserve must be made in accordance with the prescription of Authority.

(11) Valuation of investments must be made in the manner prescribed by the Authority.

(12) Loans must be measured on historical cost subject to impairment provisions.

The Regulations issued by IRDA regarding the preparation of Financial Statements and Auditors' Report of Insurance Companies on 14th August, 2000 are given in Appendix. The student is advised to familiarize with new forms of Revenue Accounts and Final Accounts and the connected Schedule.

APPENDIX INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY, NEW DELHI

The Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditors' Report of Insurance Companies) Regulations, 2000

In exercise of the powers conferred by Section 114A of the Insurance Act, 1938, (4 of 1938), the Authority, in consultation with the Insurance Advisory Committee, hereby makes the following regulations, namely:

1. Short title and commencement-

(1) These regulations may be called the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditors' Report of Insurance Companies) Regulations, 2002.

(2) They shall come into force from the date of their publication in the Official Gazette.

2. Definitions

(1) In these regulations, unless the context otherwise requires

(a) "Act" means the Insurance Act, 1938 (4 of 1938) ;

(b) 'Authority" means the Insurance Regulatory and Development Authority established under sub-section (1) of Section 3 of the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999);

(c) All words and expressions used herein 'and not defined but defined in the Insurance Act, 1938 (4 of 1938), or in the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999), or in the Companies Act, 1956 (1 of 1956), shall have the meanings respectively assigned to them in those Acts.

3. Preparation of financial statements, management report and auditor's report

(1) An insurer carrying on life insurance business, after the commencement of these Regulations, shall comply with the requirements of Schedule A.

(2) An insurer carrying on general insurance business, after the commencement of these Regulations, shall comply with the requirements of Schedule B:Provided that this sub-regulation shall apply, mutatis mutandis, to reinsurers, until separate regulations are made.

(3) The report of the auditors on the financial statements of every insurer and reinsurer, shall be in conformity with the requirements of Schedule C, or as near as thereto as the circumstances permit.

(4) The Authority may, from time to time, issue separate guidelines in the matter of appointment, continuance or removal of auditors of an insurer or reinsurer, as the case may be, and such guidelines may include prescriptions regarding qualifications and experience of auditors, their rotation, period of appointment, etc.

SCHEDULE A

(See Regulation 3)

PART I

Accounting principles for preparation of financial statements:

1. **Applicability of Accounting Standards:** Every Balance Sheet, Revenue Account [Policyholders' Account], Receipts and Payments Account [Cash Flow Statement] and Profit and Loss Account [Shareholders' Account] of an insurer shall be in conformity with the Accounting Standards (AS) issued by the ICAI, to the extent applicable to insurers carrying on life insurance business, except that:

   (i) Accounting Standard 3 (AS 3)-Cash Flow Statements-Cash Flow Statement shall be prepared only under the Direct Method.

   (ii) Accounting Standard 17 (AS 17)-Segment Reporting-shall apply irrespective of whether the securities of the insurer are traded publicly or not.

2. **Premium:** Premium shall be recognized as income when due. For linked business the due date for payment may be taken as the date when the associated units are created.

3. **Premium Deficiency:** Premium deficiency shall be recognized if the sum of expected claim costs, related expenses and maintenance costs exceeds related unearned premiums.

4. **Acquisition Costs:** Acquisition costs, if any, shall be expensed in the period in which they are incurred.

   Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. The most essential test is the obligatory relationship between costs and the execution of insurance contracts (i.e., commencement of risk).

5. **Claims Cost:** The ultimate cost of claims shall comprise the policy benefit amount and claims

settlement costs, wherever applicable.

6. **Actuarial Valuation:** The estimation of liability against life policies in force shall be determined by the appointed actuary of the insurer pursuant to his annual investigation of the life insurance business. Actuarial assumptions are to be disclosed by way of notes to the account.

   The liability shall be so calculated that together with future premium payments and investment income, the insurer can meet all future claims (including bonus entitlements to policyholders) and expenses.

7. **Procedure to determine the Values of Investments:** An insurer shall determine the values of investments in the following manner:

(a) Real Estate-Investment Property: The value of investment property shall be determined at historical cost, subject to revaluation at least once in every three years. The change in the carrying amount of the investment property shall be taken to Revaluation Reserve.

The insurer shall assess at each balance sheet date whether any impairment of the investment property has occurred.

Gains/losses arising due to changes in the carrying amount of real estate shall be taken to Equity under 'Revaluation Reserve'. The 'Profit on sale of investments' or 'Loss on sale of investments', as the case may be, shall include accumulated changes in the carrying amount previously recognized in Equity under the heading 'Revaluation Reserve' in respect of a particular property and being recycled to the relevant Revenue Account or Profit and Loss Account on sale of that property.

The bases for revaluation shall be disclosed in the notes to account. The Authority (IRDA) may issue directions specifying the amount to be released from the revaluation reserve for declaring bonus to the policyholders. For the removal of doubt, it is clarified that except for the amount that is released to policyholders as per the authority's direction, no other amount shall be distributed to shareholders out of Revaluation Reserve Account.

An impairment loss shall be recognized as an expense in the Revenue/Profit and Loss Account immediately, unless the asset is carried at revalued amount. Any impairment loss of a revalued asset shall be treated as a revaluation decrease of that asset and if the impairment loss exceeds the corresponding Revaluation Reserve, such excess shall be recognized as an expense in the Revenue/Profit and Loss Account.

(b) Debt Securities. Debt securities, including Government Securities and Redeemable Preference Shares, shall be considered as "held to maturity" securities and shall be measured at historical cost subject to amortisation.

(c) Equity Securities and Derivative Instruments that are traded in active markets: Listed equity securities and derivative instruments that are traded in active markets shall be measured at fair value on the balance sheet date. For the purpose of calculation of fair value, the lowest of the last quoted closing price at the stock exchanges where the securities are listed shall be taken.

The insurer shall assess on each balance sheet date whether any impairment of listed equity security (ies) /derivative(s) instruments has occurred.

An active market shall mean a market, where the securities traded are homogeneous, availability of willing buyers and willing sellers is normal and the prices are publicly available.

Unrealised gains/losses arising due to changes in the fair value of listed equity shares and derivative instruments shall be taken to equity under the head "Fair Value Change Account". The 'Profit on sale of investments' or 'Loss on sale of investments', as the case may be, shall include accumulated changes in the fair value previously recognized in equity under the heading 'Fair Vale Change Account', in respect of a particular security and being recycled to the relevant Revenue Account or Profit and Loss Account on actual sale of that listed security.

The Authority may issue directions specifying the amount to be released from the Fair Value Change Account for declaring bonus to the policyholders. For the removal of doubt, it is clarified that except for the amount that is released to policyholders as per the Authority's prescription, no other amount shall be distributed to shareholders out of Fair Value Change Account. Also, any debit balance in Fair Value Change Account shall be reduced from Profit/Free Reserves while declaring dividends.

The insurer shall assess, on each balance sheet date, whether any impairment has occurred. An impairment loss shall be recognized as an expense in Revenue/Profit and Loss Account to the extent of the difference between the remeasured fair value of the security/investment and its acquisition cost as reduced by any previous impairment loss recognized as expense in Revenue/ Profit and Loss Account. Any reversal of impairment loss, earlier recognized in Revenue/ Profit and Loss Account shall be recognized in Revenue/Profit and Loss Account.

(d) Unlisted and other than actively traded Equity Securities and Derivative Instruments:
Unlisted equity securities and derivative instruments and listed equity securities and derivative instruments that are not regularly traded in active markets shall be measured at historical cost. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of the investment over its carrying amount. The increased carrying amount of the investment due to the reversal of the provision shall not exceed the historical cost.

For the purposes of this regulation, a security shall be considered as being not actively traded, if its trading volume does not exceed ten thousand units in any trading session during the last twelve months.

8. Loans: Loans shall be measured at historical cost subject to impairment provisions. The insurer shall assess the quality of its loan assets and shall provide for impairment. The impairment provision shall not be less than the aggregate amount of loans which are subject to defaults of the nature mentioned below:

(i) interest remaining unpaid for over a period of six months; and

(ii) installment(s) of loan falling due and remaining unpaid during the last six months.

9. Linked Business: The accounting principles used for valuation of investments are to be consistent with principles enumerated above. A separate set of financial statements, for each segregated fund of the linked businesses, shall be annexed.

Segregated funds represent funds maintained in accounts to meet specific investment objectives of policyholders who bear the investment risk. Investment income/gains and losses generally accrue directly to the policyholders. The assets of each account are segregated and are not subject to claims that arise out of any other business of the insurer.

10. Funds for Future Appropriation: The funds for future appropriation shall be presented separately.

The funds for future appropriation represent all funds, the allocation of which, either to the policyholders or to the shareholders, has not been determined by the end of the financial year.

PART II

Disclosures forming part of Financial Statements

A. The following shall be disclosed by way of notes to the Balance Sheet:

1. Contingent Liabilities:
   (a) Partly paid-up investments
   (b) Underwriting commitments outstanding
   (c) Claims, other than those under policies, not acknowledged as debts
   (d) Guarantees given by or on behalf of the company
   (e) Statutory demands/liabilities in dispute, not provided for
   (f) Re-insurance obligations
   (g) Others (to be specified).
2. Actuarial assumptions for valuation of liabilities for life policies in force.
3. Encumbrances to assets of the company in and outside India.
4. Commitments made and outstanding for Loans, Investments and Fixed Assets.
5. Basis of amortisation of debt securities.
6. Claims settled and remaining outstanding for a period of more than six months on balance sheet date.
7. Value of contracts in relation to investments, for:
   (a) Purchases where deliveries are pending; and
   (b) Sales where payments are overdue.

5. Operating expenses relating to insurance business: basis of allocation of expenditure to various segments of business.
6. Computation of managerial remuneration.
7. Historical costs of those investments valued on fair value basis.
8. Basis of revaluation of investment property.

B. The following accounting policies shall form an integral part of the financial statements:

1. All significant accounting policies in terms of the accounting standards issued by the ICAI and significant principles and policies given in Part I of Accounting Principles. Any other accounting policies, followed by the insurer, shall be stated in the manner required under Accounting Standard (AS-1) issued by ICAI.
2. Any departure from the accounting policies shall be separately disclosed with reasons such departure.

C. The following information shall also be disclosed:

1. Investments made in accordance with any statutory requirement should be disclosed separately together with its amount, nature, security and any special rights in and outside India;
2. Segregation into performing/non-performing investments for purpose of income recognition as per the directions, if any, issued by the Authority;
3. Assets to the extent required to be deposited under local laws or otherwise encumbered in or outside India;
4. Percentage of business sector-wise;
5. A summary of financial statements for the last five years, in the manner as may be prescribed by the Authority;
6. Bases of allocation of investments and income thereon between Policyholders' Account and Shareholders' Account; and
7. Accounting Ratios as may be prescribed by the Authority.

PART III

General instructions for preparation of Financial Statements

1. The corresponding amounts for the immediately preceding financial year for all items shown in the Balance Sheet, Revenue Account, Profit and Loss Account and Receipts and Payments Account shall be given.
2. The figures in the financial statements may be rounded off to the nearest thousands.
3. Interest, dividends and rentals receivable in connection with an investment should be stated at gross amount, the amount of Income Tax Deducted at Source should be included under Advance Taxes paid and Taxes Deducted at Source.
4. (I) For the purposes of financial statements, unless the context otherwise requires
    - (a) the expression 'Provision' shall, subject to (II) below mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability or loss of which the amount cannot be determined with substantial accuracy;
    - (b) the expression 'Reserve' shall not, subject to as aforesaid, include any amount written off or retained by way of providing for depreciation, renewal or diminution in value of assets or retained by way of providing for any known liability or loss;
    - (c) The expression 'Capital Reserve' shall not include any amount regarded as free for distribution through the Profit and Loss Account; and the expression 'Revenue Reserve' shall mean any reserve other than a Capital Reserve;
    - (d) the expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

    (II) Where:
    - (a) any amount written off or retained by way of providing for depreciation renewals or diminution in value of assets, or

(b) any amount retained by way of providing for any known liability or loss is in excess of the amount which in the opinion of the Directors is reasonably necessary for the purpose, the excess shall be treated as a Reserve and not Provision.

5. The company shall make provisions for damages under lawsuits where the management is of the opinion that the award may go against the insurer.

6. Risks assumed in excess of the statutory provisions, if any, shall be separately disclosed indicating the amount of premiums involved and the amount of risks covered.

7. Any Debit Balance of the Profit and Loss Account shall be shown as deduction from uncommitted Reserves and the balance, if any, shall be shown separately.

PART IV

Contents of Management Report

There shall be attached to the financial statements, a management report containing, inter alia, the following duly authenticated by the management:

1. Confirmation regarding the continued validity of the registration granted by the Authority;
2. Certification that all the dues payable to the Statutory Authorities have been duly paid;
3. Confirmation to the effect that the Shareholding Pattern and any transfer of shares during the year are in accordance with the statutory or regulatory requirements;
4. Declaration that the management has not directly or indirectly invested outside India the funds of the holders of policies issued in India;
5. Confirmation that the required Solvency Margins have been maintained;
6. Certification to the effect that the values of all the assets have been reviewed on the date of Balance Sheet and that in his (Insurer's) belief the assets set forth in the Balance Sheets are shown in the aggregate at amounts not exceeding their realisable or market value under the several headings "Loans", "Investments", "Agents Balances", "Outstanding Premiums", "Interest, Dividends and Rents outstanding", "Interest, Dividends and Rents accruing but not due", "Amount due from other persons or Bodies carrying on insurance business", "Sundry Debtors", "Bills Receivable", "Cash" and the several items specified under "Other Accounts";
7. Certification to the effect that no part of the life insurance fund has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938, relating to the application and investment of the life insurance funds;
8. Disclosure with regard to the overall risk exposure and strategy adopted to mitigate the same;
9. Operations in other countries, if any, with a separate statement giving the management's estimate of country risk and exposure risk and the hedging strategy adopted;
10. Ageing of claims indicating the trends in average claim settlement time during the preceding five years;
11. Certification to the effect as to how the values, as shown in the Balance Sheet, of the investments and stocks and shares have been arrived at, and how the Market Value thereof has been ascertained for the purpose of comparison with the values so shown;
12. Review of asset quality and performance of investment in terms of Portfolios, i.e., separately in terms of Real Estate, Loans, Investments, etc.; and,
13. A responsibility statement indicating therein that—
    (a) In the preparation of Financial Statements, the applicable accountings tender principles and policies have been followed along with proper explanations relating to material departures, if any,
    (b) The management has adopted accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give true and fair view of the state of affairs of the company at the end of the financial year and of the Operating Profit or Loss and of the Profit or Loss of the company for the year,
    (c) The management has taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the applicable provisions of the Insurance Act, 1938/ Companies Act, 1956, for safeguarding the assets of the company and for preventing and detectingfraud and other irregularities,
    (d) The management has prepared the financial statements on a Going Concern Basis, and
    (e) The management has ensured that an Internal Audit System commensurate with the size and nature of the business exists and is operating effectively.

PART V

Preparation of Financial Statements

(1) An insurer shall prepare the Revenue Account [Policyholders' Account], Profit and Loss Account [Shareholders' Account] and the Balance Sheet in Form A-RA, Form A-PL and Form A-BS, as prescribed in this Part, or as near thereto as the circumstances permit.
Provided that an insurer shall prepare Revenue Account for the under mentioned businesses separately and to that extent the application of AS-17 shall stand modified:
  - (a) Participating policies and Non-Participating Policies;
  - (b) Linked, Non-linked and Health Insurance;
  - (c) Business within India and Business outside India.

(2) An insurer shall prepare separate Receipts and Payments Account in accordance with the Direct Method prescribed in AS 3-"Cash Flow Statement" issued by the ICAI.
The new format of Revenue Account (Policyholders' Account Form A-RA), Profit and Loss Account (Shareholders' Account Form A-PL) and Balance Sheet (Form A-BS) are given below :

LIFE INSURANCE BUSINESS

Name of the Insurer:

FORM A-RA

Registration No. and date of Registration with the IRDA

REVENUE ACCOUNT for the year ended 31st March, 20...
Policy holders' Account (Technical Account)

Particulars	Schedule	Current Year (₹ '000)	Previous Year (₹ '000)
Premiums Earned-Net			
(a) Premium	1		
(b) Re-insurance ceded			
(c) Re-insurance accepted			
Income from Investments			
(a) Interest, Dividends & Rent-Gross			
(b) Profit on sale/Redemption of Investments			
(c) Loss on sale/Redemption of Investments			
(d) Transfer/Gain on revaluation/ change in Fair Value*			
Other Income (to be specified)			
Total (A)	2		
Commission	3		
Operating Expenses related to Insurance Business			
Other Expenses (to be specified)			
Provisions (other than taxation)			
(a) For diminution in the value of investments (Net)			
(b) Others (to be specified)			
Total (B)	4		
Benefits Paid (Net)			
Interim Bonuses Paid			
Change in valuation of liability against life policies in force			
(a) Gross**			
(b) Amount ceded in Re-insurance			
(c) Amount accepted in Re-insurance			
Total (C)			
Surplus/(Deficit) (D) = (A) - (B) - (C)			
Appropriations			
Transfer to Shareholders' Account			
Transfer to Other Reserves (to be specified)			
Transfer to Funds for Future Appropriations			
Total (D)			

Notes:

* Represents the deemed realised gain as per norms specified by IRDA.

** Represents Mathematical Reserves after Allocation of Bonus.

The Total Surplus shall be disclosed separately with the following details:

(a) Interim Bonus Paid:

(b) Allocation of Bonus to Policyholders:

(c) Surplus shown in the Revenue Account

(d) Total Surplus: [(a) + (b) + (c)):

Name of the Insurer:

FORM A-PL

Registration No. and Date of Registration with the IRDA

PROFIT & LOSS ACCOUNT for the year ended 31st March, 20…..

Shareholders' Account (Non-technical Account)

Particulars	**Schedule**	**Current Year (₹ '000)**	**Previous Year (₹ '000)**
Balance brought forward from/transferred to the Policyholders Account (Technical Account) Income from Investments: (a) Interest, Dividends & Rent-Gross (b) Profit on sale/Redemption of Investments (c) Loss on sale/Redemption of Investments Other Income (To be specified)			
Total (A)			
Expenses other than those directly related to the insurance business Provisions (Other than taxation) (a) For diminution in the value of investments (Net) (b) Others (to be specified)			
Total (B)			
Profit/ (Loss) before tax Provision for Taxation Profit/ (Loss) after tax **Appropriations** (a) Brought forward Reserve/Surplus from the Balance Sheet (b) Interim dividends paid during the year (c) Proposed Final Dividend (d) Dividend Distribution on Tax (e) Transfer to reserves/other accounts (to be specified)			
Profit carried forward to the Balance Sheet			

Notes:

(a) In case of premiums, **less** re-insurance in respect of any segment of insurance business of total premium earned, the same shall be disclosed separately.

(b) Premium income received from business concluded in and outside India shall be separately disclosed.

(c) Re-insurance premiums whether on business ceded or accepted are to be brought into account gross (i.e., before deducting commissions) under the head Re-insurance premiums.

(d) Claims incurred shall comprise claims paid, settlement costs wherever applicable and change in the outstanding provision for claims at the year-end.

(e) Items of expenses and income in excess of one per cent of the total premiums (*less* re-insurance) or ₹ 5,00,000 whichever is higher, shall be shown as a separate line item.

(f) Fees and expenses connected with claims shall be included in claims.

(g) Under the sub-head "Others" shall be included items like foreign exchange gains or losses and other items.

(h) Interest, dividends and rentals receivable in connection with an investment should be stated as gross amount, the amount of income tax deducted at source being included under 'Advance Taxes paid and Taxes Deducted at Source'.

(i) Income from rent shall include only the Realised Rent. It shall not include any Notional Rent.

Name of the Insurer:

FORM A-BS

Registration No. and date of Registration with the IRDA

BALANCE SHEET As At 31st March, 20.......

Particular	Schedule	Current Year (₹ '000)	Previous Year (₹ '000)
Sources of funds			
Shareholders' funds:			
Share Capital	5		
Reserves and Surplus	6		
Credit/[Debit] Fair value change account			
Sub-total			
Borrowings	7		
Policyholders' Funds:			
Credit/ [Debit] Fair value change account			
Policy Liabilities			
Insurance Reserves			
Provision for Linked Liabilities			
Sub-total			
Funds for Future Appropriations			
Total			
Application of Funds:			
Investments			
Shareholders'	8		
Policyholders'	8A		
Assets held to cover linked liabilities			
Loans	9		
Fixed Assets	10		
Current Assets:			
Cash and Bank Balances	11		
Advances and Other Assets	12		
Sub-Total (A)			
Current Liabilities	13		
Provisions	14		
Sub-Total (B)			
Net current assets (C) = (A – B)			
Miscellaneous Expenditure (to the extent not written off or adjusted)	15		
Debit Balance in Profit & Loss Account (Shareholders' Account)			
Total			

Contingent Liabilities

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Partly paid-up investments		
2. Claims, other than against policies, not acknowledged as debts by the Company		
3. Underwriting Commitments outstanding		
4. Guarantees given by or on behalf of the Company		
5. Statutory Demands/Liabilities in dispute, not provided for		
6. Re-insurance obligations		
7. Others (to be specified)		
Total		

Schedules Forming Part of Financial Statements

Schedule 1- Premium

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. First year premiums		
2. Renewal Premiums		
3. Single Premiums		
Total Premiums		
Premium Income from business written:		
1. In India		
2. Outside India		
Total premium (Net)		

Notes. Re-insurance premiums whether *on* business ceded *or* accepted are to be brought into account, before deducting commission, under the head *of* Re-insurance premiums.

Schedule 2 -

Commission Expenses

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Commission Paid		
Direct-First year Premiums		
- Renewal Premiums		
- Single Premiums		
Add: Commission on Re-insurance Accepted		
Less: Commission *on* Re-insurance Ceded		
Net Commission		

Note. The profits/commissions if any, are to be combined with the Re-insurance accepted *or* Re- insurance ceded figures.

Schedule 3 - Operating Expenses Related to Insurance Business

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Employees' Remuneration & Welfare Benefits		
2. Travel, Conveyance and Vehicle Running Expenses		
3. Rents, Rates & Taxes		
4. Repairs		
5. Printing & Stationery		
6. Communication Expenses		
7. Legal & Professional Charges		
8. Medical Fees		
9. Auditors' Fees, Expenses, etc		
(a) as auditor		
(b) as adviser or in any other capacity, in respect of		
(i) Taxation Matters		
(ii) Insurance Matters		
(iii) Management Services; and		
(c) in any other capacity		
10. Advertisement and Publicity		
11. Interest & Bank Charges		
12. Others (to be specified)		
13. Depreciation		
14. Total		

Notes:

(a) Items of expenses in excess of one per cent of the net premium or ₹5,00,000 which-ever is higher, shall be shown as a separate line item.

(b) Under the sub-head "Others", 'Operating Expenses (Insurance Business)' shall include items like foreign exchange gains or losses and other items.

Schedule 4 - Benefits Paid [Net]

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Insurance Claims:		
(a) Claims by Death,		
(b) Claims by Maturity,		
(c) Annuities/Pensions in payment,		
(d) Other benefits, specify		
2. (Amount ceded in Re-insurance):		
(a) Claims by Death,		
(b) Claims by Maturity,		
(c) Annuities/Pensions in payment,		
(d) Other benefits, specify		
3. Amount accepted in Re-insurance:		
(a) Claims by Death,		
(b) Claims by Maturity,		
(c) Annuities/Pensions in payment,		
(d) Other benefits, specify		

Total		
Benefits paid to claimants: 1. In India 2. Outside India **Total Benefits paid (Net)**		

Notes:

(a) Claims include claims settlement costs, wherever applicable.
(b) The legal and other fees and expenses shall also form part of the claims cost, wherever applicable.

Schedule 5 - Share Capital

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. **Authorized Capital** Equity Shares of ₹........ each 2. **Issued Capital** Equity Shares of ₹....... each 3. **Subscribed Capital** …….. Equity Shares of ....₹ 4. **Called-up Capital** Equity Shares of...... ₹ 5. **Less:** Calls unpaid **Add:** Shares forfeited (Amount originally paid up) **Less:** Par value of Equity Shares bought back **Less:** Preliminary Expenses [**Expenses including commission or brokerage on Underwriting or subscription of shares]** **Total**		

Notes:

(a) Particulars of the different classes of Capital should be separately stated.
(b) The amount capitalized on account of issue of Bonus Shares should be disclosed.
(c) In case any part of the Capital is held by a holding company, the same should be separately disclosed.

Schedule 5A – Pattern of Shareholding

[As certified by the Management]

Shareholders	Current Year		Previous Year	
	Number of Shares	% of Holding	Number of Shares	% of Holding
Shares Promoters • Indian • Foreign Others				
Total				

Schedule 6 – Reserves and Surplus (Shareholders)

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Capital Reserve 2. Capital Redemption Reserve 3. Share Premium 4. Revaluation Reserve 5. General Reserves **Less:** Debit balance in Profit and Loss Account, if any **Less:** Amount utilised for buy-back 6. Catastrophe Reserve 7. Other Reserves (to be specified) 8. Balance of Profit in Profit and Loss Account **Total**		

Note. Additions to and deductions from the Reserves should be disclosed under each of the specified heads.

The Reserves and Surplus (Shareholders) as above shall be further segregated and disclosed as Reserves and Surplus — (1) In India, and (2) Outside India

Schedule 6A may be prepared for Insurance Reserves of Policyholders.

Schedule 7 – Borrowings

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Debentures/ Bonds 2. Fixed Deposits 3. Banks 4. Financial Institutions 5. Other entities carrying on insurance business 6. Other (to be specified)		
Total		

Notes:

(a) The extent to which the borrowings are secured shall be separately disclosed stating the nature of the Security under each sub-head.

(b) Amounts due within 12 months from the date of Balance Sheet should be shown separately.

Schedule 8 – Investments-Shareholders

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Long-term investments		
1. Government Securities and Government Guaranteed Bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments		
(a) Shares		
– Equity		
– Preference		
(b) Mutual Funds		
(c) Derivative Instruments		
(d) Debentures/Bonds		
(e) Other Securities (to be specified)		
(f) Subsidiaries		
(g) Investment Properties-Real Estate		
Short-term Investments		
1. Government Securities and Government Guaranteed Bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments		
(a) Shares		
– Equity		
– Preference		
(b) Mutual Funds		
(c) Derivative Instruments		
(d) Debentures/Bonds		
(e) Other Securities (to be specified)		
(f) Subsidiaries		
(g) Investment Properties-Real Estate		
Total		
Investments		
1. In India		
2. Outside India		
Total		

Schedule 8A Investments-Policyholders

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Long-term Investments		
1. Government Securities and Government Guaranteed Bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments		
(a) Shares		
– Equity		
– Preference		
(b) Mutual Funds		
(c) Derivative Instruments		
(d) Debentures/Bonds		
(e) Other Securities (to be specified)		
(f) Subsidiaries		
(g) Investment Properties-Real Estate		
4. Investments in Infrastructure and Social sector		
5. Other than Approved Investments		
Short-term Investments		
1. Government securities and Government Guaranteed Bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments		
(a) Shares		
– Equity		
– Preference		
(b) Mutual Funds		
(c) Derivative Instruments		
(d) Debentures/Bonds		
(e) Other Securities (to be specified)		
(f) Subsidiaries		
(g) Investment Properties-Real Estate		
4. Investments in Infrastructure and Social Sector		
5. Other than Approved Investments		
Total		
Investments		
1 . In India		
2 . Outside India		
Total		

Notes: (applicable to Schedules-8 and 8A):

(a) Investments in subsidiary/holding companies, joint ventures and associates shall be separately disclosed, at cost.

(i) **Holding company** and subsidiary shall be construed as defined in the Companies Act, 1956.

(ii) **Joint Venture** is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint contro1.

(iii) **Joint control** is the contractually agreed sharing of power to govern the financial and operating policies of an economic activity to obtain benefits from it.

(iv) **Associate** is an enterprise in which the company has significant influence and which is neither a subsidiary nor a joint venture of the company.

(v) **Significant influence** (for the purpose of this Schedule) means participation in the financial and operating policy decisions of a company, but not control of those policies. Significant influence may be exercised in several ways, for examples, by representation on the board of directors, participation in the policy-making process, material inter-company transactions, interchange of managerial personnel or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiaries, 20 per cent or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demon started that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiaries, less than 20 per cent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence is clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

(b) Aggregate amount of company's investments other than listed equity securities and derivative instruments and also the market value thereof shall be disclosed.

(c) Investments made out of catastrophe reserve should be shown separately.

(d) Debt securities will be considered as "held to maturity" securities and will be measured at historical costs subject to amortization

(e) Investment property means a property [land or building or part of a building or both) held to earn rental income or for capital appreciation or for both, rather than for use in services or for administrative purposes.

Schedule 9 – Loans

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. **Security-wise Classification Secured**		
(a) On mortgage of property		
– In India		
– Outside India		
(b) On shares, Bonds, Govt. Securities, etc.		
(c) Others (to be specified)		
Unsecured		
(a) Loans against policies		
(b) Others (to be specified)		
Total		
2. **Borrower-wise classification**		
(a) Central and State Governments		
(b) Banks and Financial Institutions		
(c) Subsidiaries		
(d) Companies		
(e) Loans against policies		
(f) Others (to be specified)		
Total		
3. **Performance-wise classification**		
(a) Loans classified as standard		
– In India		
– Outside India		
(b) Non-standard loans **less** provisions		
– In India		
– Outside India		
Total		
4. **Maturity-wise classification**		
(a) Short-term		
(b) Long-term		
Total		

Notes:

(a) Short-term loans shall include those, which are repayable within 12 months from the date of Balance Sheet. Long-term loans shall be the loans other than short-term loans.

(b) Provisions against Non-Performing loans shall be shown separately.

(c) The nature of the Security in case of all Long-Term Secured Loans shall be specified in each case. Secured Loans for the purposes of this schedule, means Loans Secured wholly or partly against an asset of the Company.

(d) Loans considered doubtful and the amount of provision created against such Loans shall be is closed.

SCHEDULE 10 – Fixed Assets

(₹'000)

Particulars	Cost/ Gross Block				Depreciation				Net Block	
	Opening	Additions	Deductions	Closing	Up to Last Year	For the Year	On Sales/ Adjustments	To Date	As at year end	Previous year
Goodwill										
Intangibles (specify)										
Land-Freehold										
Leasehold Property										
Buildings										
Furniture and Fittings										
Information Technology Equipment										
Vehicles										
Office Equipment										
Others (Specify nature)										
TOTAL										
PREVIOUS YEAR										

Note:

Assets included in land, property and building above exclude Investment Properties as defined in Note

(d) to Schedule 8.

Schedule 11– Cash and Bank Balances

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Cash (including Cheques, Drafts and Stamps) 2. Bank Balances (a) Deposit Accounts • Short-term (due within 12 months of the date of Balance Sheet) • Others (b) Current Accounts (c) Others (to be specified) 3. Money at Call and Short Notice (a) With Banks (b) With other Institutions 4. Others (to be specified)		
Total		
Balances with non-scheduled banks included in 2 and 3 above		
Cash & Bank Balances 1. In India 2. Outside India		
Total		

Note: Bank balance may include Remittances-in-transit. If so, the nature and amount should be separately stated.

Schedule 12 – Advances and other assets

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Advances 1. Reserve Deposits with Ceding Companies 2. Advances to ceding companies 3. Application money for investments 4. Pre-Payments 5. Advances to Officers/Directors 6. Advance Tax paid and Taxes Deducted at Source 7. Others (to be specified)		
Total (A)		
Other Assets 1. Income accrued on investments 2. Outstanding premiums 3. Agents' Balances 4. Foreign agencies' Balances 5. Due from other entities carrying on Insurance business 6. Due from Subsidiaries/Holding Company 7. Re-insurance claims/balances receivable 8. Deposit with Reserve Bank of India [Pursuant to Section 7 of Insurance Act, 1938] 9. Others (to be specified)		
Total (B)		
Total (A + B)		

Notes:

(a) The items under the above heads shall not be shown net of provisions for doubtful amounts. The amount of provision against each head should be shown separately.

(b) The term 'officer' should conform to the definition of the word 'officer' under the Companies Act, 1956.

Schedule 13 – Current Liabilities

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Agents' Balances 2. Balances due to other insurance companies 3. Advances from Treaty Companies 4. Deposits held on re-insurance ceded 5. Premiums received in advance 6. Sundry creditors 7. Due to subsidiaries/holding company 8. Claims outstanding 9. Annuities due 10. Due to Officers/Directors 11. Others (to be specified)		
Total		

Schedule 14 – Provisions

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. For taxation (**less** payments and taxes deducted at source) 2. For proposed Dividends 3. For Dividend Distribution Tax 4. Bonus Payable to the Policyholders 5. Others (to be specified)		
Total		

Schedule 15 – Miscellaneous Expenditure

(To the extent not written off or adjusted)

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Discount allowed in issue of shares/debentures 2. Others (to be specified)		
Total		

Notes:

(a) No item shall be included under the head "Miscellaneous Expenditure" and carried forward unless:

1. Some benefit from the expenditure can reasonably be expected to be received in future, and
2. the amount of such benefit is reasonably determinable.

(b) The amount to be carried forward in respect of any item included under the head "Miscellaneous Expenditure" shall not exceed the expected future revenue/other benefits related to the expenditure.

Illustration 22.

The following balances appeared in the books of Happy Mutual Life Assurance Society Ltd. as on 31 March 2014:

(₹ in lakh)

Dr. **Cr.**

Particulars	₹	Particulars	₹
Claims less reassurance paid during the year		Life Assurance Fund at the beginning of the year	1,00,000
By death	4,400	Premium less Re-assurances	30,000
By maturity	3,000	Claims less reassurances outstanding	
Annuities	12	At the beginning of the year:	
Furniture and Office Equipment at cost (including ₹80 lakh bought during the year)	500	By death	1,800
		By maturity	1,200
Printing and Stationery	154	Credit balances pending adjustments	120
Cash with Bank in current account	2,700	Consideration for annuities granted	4
Cash and stamp in hand	60	Interest, dividends and rents	3,600
Surrenders less Reassurances	80	Registration and other Fees	4
Commission	500	Sundry Deposits	200
Expenses of Management	6,200	Taxation Provision	600
Sundry Deposits with Electricity Companies	2	Premium Deposits	2,300
Advance Payment of Tax	100	Sundry Creditors	700
Sundry Debtors	100	Contingency Reserve	300
Agents Balances	200	Furniture and Office Equipment Depreciation Account	80
Income Tax	900	Building Depreciation Account	600
Income Tax on Interest, Dividend and Rents	1,000		
Loans and Mortgages	300		
Loans on Policies	6,500		
Investments (₹500 lakh deposited with Reserve Bank of India)	1,04,000		
House Property at Cost (including ₹ 170 lakh added during the year)	10,800		
	1,41,508		1,41,508

From the foregoing balances and the following information, prepare the Balance Sheet of Happy Mutual Life Assurance Society Ltd. as on 31st March 2014 and its Revenue Account for the year ended on that date:

(i) Claims less reassurance outstanding at the end of the year: By death ₹ 1,200 lakh, By maturity ₹ 800 lakh.

(ii) Expenses outstanding ₹ 120 lakh and prepaid ₹ 30 lakh.

(iii) Provide ₹ 90 lakh for depreciation on buildings,₹ 30 lakh for depreciation on furniture and office equipment and ₹ 220 lakh for taxation.

(iv) Premiums outstanding ₹4056 lakh, commission thereon ₹ 130 lakhs.

(v) Interests, dividends and rents outstanding (net) ₹ 60 lakh and interests and rents accrued (net) ₹ 700 lakh.

Solution:

Happy Mutual Life Assurance Society Ltd.
Form A-RA
Revenue Account for the Year Ended 31 st March 2014

Particulars	Schedule	Current Year (₹ in lakh)	Previous Year (₹ in lakh)
Premium earned-net	1	34,056	
Income from Investments			
Interest, Dividends and Rent (Gross) (3600 + 60 + 700)		4,360	
Other Income:			
Annuities granted		4	
Registration and other Fees		4	
Total (A)		38,424	
Commission	2	630	
Operating Expenses	3	6,564	
Provision for Tax		1,520	
Total (B)		8,714	
Benefits paid (net)	4	6,492	
Total (c)		6,492	
Surplus (D)=A-B-C		23,218	

Form A-BS
Balance Sheet as on 31st March 2014

Particulars	Schedule	Current Year (₹ in lakh)	Previous Year (₹ in lakh)
Share Capital	5		
Reserves and Surplus	6	1,23,518	
Borrowings	7	2,500	
Total		1,26,018	
Application of Funds			
Investment:			
Shareholders'	8	1,13,610	
Loans	9	6,800	
Fixed Assets	10	390	
Total		1,20,800	
Current Assets:			
Cash and Bank Balance	11	2,760	
Advances and Other Assets	12	5,748	
Sub-Total (A)		8,508	
Current Liabilities	13	3,070	
Provisions	14	220	
Sub-Total (B)		3,290	
Net Current Assets = Sub-Total (A) - Sub-Total (B)		1,26,018	

Note: Since the question is silent about the preparation of Profit & Loss Account, as such (From A-PL) is not prepared.
Thus Provision for Taxation and adjustments are shown in Revenue Account.
Schedules forming parts of Financial Statements

Workings:

Schedule 1: Premium Earned	₹
Premium	30,000
Add: Outstanding	4,056
	34,056

Schedule 2: Commission	₹
Commission Paid Add: Commission on Re-Insurance Accepted	500 130
	630

Schedule 3: Operating Expenses	₹	₹
Expenses of management Add: Outstanding	6,200 120	
 Less: Prepaid	6,320 30	6,290
Printing & Stationary Depreciation on: Building Furniture	 90 30	154 120
		6,564

Schedule 4: Benefits (Paid)	₹	₹
Insurance Claims: By Death- Paid Add: Outstanding at the ends	 4,400 1,200	
 Less: Outstanding at the beginning	5,600 1,800	3,800
By Maturity- Paid Add: Outstanding at the end	 3,000 800	
 Less: Outstanding at beginning	3,800 1,200	2,600
Annuities		12
Surrender, less Re-insurance		80
		6,492

Schedule 5: Share Capital	₹
Share Capital	Nil
	Nil

Schedule 6: Reserves & Surplus	₹
Contingency Reserve Add: Other Life Assurance Fund	300 1,23,218
	1,23,518

Schedule 7: Borrowings	₹
Premium Deposit Add: Sundry Deposits	2,300 200
	2,500

Schedule 8: Investments	₹	₹
Investment in House Property Additions	10,630 170	
 Less: Depreciation Other Investments	10,800 690	 10,110 1,03,500
		1,13,610

Schedule 9: Loans	₹
Mortgage Policies	300 6,500
	6,800

Schedule 10: Fixed Assets	₹
Furniture (420-30)	390
	390

Schedule 11: Cash and Book Balance	₹
Cash + Stamps Bank at Current A/c	60 2,700
	2,760

Schedule 12: Advance and Other Assets	₹	₹
Advances:		
Prepaid Expenses	30	
Adv. Payment of Tax	100	
Other Assets:		130
Int. Dividend & Rent Outstanding		60
Int. Dividend Rent Accruing		700
Outstanding Premium		4,056
Agents' balance		200
Sundry Debtors		100
Deposit with RBI		500
Deposit with Electricity Co.		2
		5,748

Schedule 13: Current Liabilities	₹
Creditors Outstanding Expenses Com. Due but not paid Claims outstanding Credit balance Pending adjustments	700 120 130 2,000 120
	3,070

Schedule 14: Provisions	₹
Provisions for Tax	220
	220

Schedule 15: Miscellaneous	₹
Misc. Expenses	Nil
	Nil

B. GENERAL INSURANCE

General Insurance consists of (i) Fire; (ii) Marine (iii) Accidental Insurance. Before incorporating I.R.D.A. (in 2012) general insurance was administrated by General Insurance Corporation of India (GICI). Every general insurance company must prepare their accounts separately for each type of insurance. Usually the policies are issued for one year. It must be remembered that liabilities of the insurer will arise when the insured suffers any loss due to fire accident etc. If no loss is suffered by the insured no compensation will be paid and the premium which has already been paid will neither be adjusted nor be carried forward for the next year.

(a) Fire Insurance: Fire insurance means insurance against any loss which is caused by fire. As per Sec 2(6A) of the insurance Act "Fire Insurance Business means the business of effecting otherwise than incidentally to some other class of business contracts of insurance against loss by or incidental to fire or other occurrence customarily included among the risks insured against in fire Insurance policy. "

(b) Marine Insurance: As per Sec 3 of Marine Insurance Act, 1963 "A contract of marine insurance is an agreement whereby the insurer undertakes to indemnify the assured, in the manner and to the extent thereby agreed, against marine losses, that is to say , losses incidental to marine adventure. Similarly, Sec 4 (1) states that "a contract of marine insurance may, by its express terms, Or by usage of trade, be extended so as to protect the insured against losses on inland water or any land risk which may be incidental to any sea voyage.

(c) Accidental Insurance: Usually accidental insurance policies contain various conditions which safeguards the interest of insurer. Question of compensation will not arise if no accident happens. Practically, it is mere a contract by which the insurer promises to pay a certain some of money to the insured in case of injury by accident and to the dependants of the insured in case of death by accident. It is not a contract of indemnity. The insurer is not required to indemnity assured.

In our country some private Companies have come to play: some of them are: Reliance General Insurance Company, Bajaj Alliance General Insurance Co. Ltd. Tata AIG, General Insurance, HDFC - Chubb General Insurance etc.

EXPLANATION OF SPECIAL TERMS PECULIAR TO INSURANCE BUSINESS

Nature of business of an insurance company is different from that of a manufacturing, a trading or a banking company. Because of this, types and sources of expenses and incomes of such a company are different from those usually found in other business concerns. In order to explain these incomes and expenses some new terms are used. It is thus necessary for a student to understand these terms first.

Claims. The business of an insurance company is to cover the risk of the insured for a consideration called premium. If the risk falls on the insured then he makes a claim on the insurance company. This is the first item which appears on the debit side of revenue account. Claim is shown after deducting the Re-insurance claim and also after adjusting it in the light of information given in the problem. It may be noted that it is not the actual amount paid but the actual loss borne which is important for revenue account. In order to calculate the loss on account of claim the claim outstanding at the end is added and claim outstanding in the beginning is deducted. It should be noted that in keeping with the convention of conservatism, the claim intimated is taken at par with the claim intimated and accepted but not paid. Thus while calculating the claim outstanding at the end the claim intimated as well as the claim intimated and accepted both are considered. The adjustment entry required for this will be as follows:

Debit Claims account
Credit Claims intimated and accepted but not paid account
Credit Claims intimated but not accepted and paid account

At the commencement of the next period a reverse entry is passed, so that when these claims intimated are paid, they may not influence the claims account of next year. However, if company rejects any claim, such amount should be transferred to the insurance fund account and not to the claims account.

Illustration 23.

From the following, you are required to calculate the loss on account of claim to be shown in the revenue account for the year ending 31st December, 2012 :

Claims:

Intimated in	Admitted in	Paid in	₹
2011	2011	2012	15,000
2012	2012	2013	10,000
2010	2011	2011	5,000
2010	2011	2012	12,000
2012	2013	2013	8,000
2012	2012	2012	1,02,000

Claim on account of re-insurance was ₹25,000

	₹
Total claim paid in 2012: ₹(1,02,000 + 12,000 + 15,000)	1,29,000
Less: Outstanding in the beginning i. e., intimated in 2011 or earlier whether accepted in 2011 & accepted in 2012 (₹15,000 + ₹12,000)	27,000
	1,02,000
Add: Outstanding at the end i. e., intimated in 2012 whether accepted in 2012 or in 2013 ₹(10,000 + 8,000)	18,000
	1,20,000
Less: re-insurance claim	25,000
Claims to be shown in revenue account	95,000

Notes:

1. It may be seen that the column for 'admitted in' is useless for calculating loss on account of claim. This is a mere information.
2. No.3 item 'intimated in 2010, admitted in 2011, paid in 2011 ₹ 5,000 is useless as the amount paid in 2011 is not included in the amount paid in 2012.

Claims must include all expenses directly incurred in relation to assessment of claims. For examples expenses like survey fees, fees of Police Reports, Legal fees, Court expenses and other similar charges should be included under the head claims. However, it should not include any establishment or administrative expenses except in so far as they relate to any employee, exclusively employed or surveyor assessment of losses [Note (a) to the revenues account] When the account is furnished under the Provision of Sec. 11 of the Insurance Act, 1938, separate figures for claims paid to claimants in India and claimants paid outside India should be given [Note (d) to the revenue account].

Bonus in reduction of premium:

In all the cases of general insurance the policy is always taken for one year and it is to be renewed after the expiry of the policy. Whether the policy is renewed with the same company, or a fresh policy is taken with some other company, it is a standing practice that the company usually grants a reduction in premium at the prescribed rate if the insured has not made any claim. This rate of reduction increases every year for usually three years if the insured does not make any claim continuously year after year. For example, the General Insurance Companies in India allow the following rates of reduction for a motor cycle: 1st year 15%; 2nd year 25%;

3rd year 30%. This reduction is called bonus in reduction of premium. In fact this transaction should be divided into two parts-first, the total premium (without any reduction) should be assumed to be received and then reduction granted should be assumed to be paid separately. Thus total premium (without reduction) should be treated as income and bonus which is subtracted should be treated as an expense. Thus-

If net premium received is	126
Bonus in reduction of premium is	14

The revenue account on the credit side will show ₹ 140 (₹ 126 + ₹ 14) as income and on the debit side ₹ 14 as an expense. The journal entry is :

Bonus in reduction of premium A/c Dr.

To Premium Account

Bonus:

In the case of life policies with profits, policyholders are given the right to participate in the profits of the business. After nationalization, policyholders are given 95% of profits of L.I.C. by way of bonus. Bonus can be paid in cash, adjusted against the future premiums due from the policy holders or it can be paid on the maturity of the policy, together with the policy amount. Bonus paid in the end along with the policy amount is called **Reversionary Bonus**.

Re-insurance:

Sometimes the insurer considers a particular risk too much for his capacity and may re-insure a part of the risk with some other insurer. Such an arrangement between two insurers is referred to as reinsurance. In such a case the first insurer cannot retain all the premium on the policy for himself. Depending on the share of risk undertaken by the second insurer, proportionate premium must be ceded by the first insurer. Likewise if such a policy matures, the claim will have to be shared by both the insurers in the agreed ratio. These adjustments will have to be shown in the accounts of both the insurers. In the accounts of the first insurer amount of claim recovered from the second insurer has to be deducted from the total claim payable by him. Similarly, the premium ceded to the second insurer has to be deducted from the total premium received. In the accounts of the second insurer, claims paid include claims paid on account of Re-insurance and premiums received include premium received on re-insurance business.

Commission on re-insurance ceded /accepted:

The business of the company is fetched through its agents who are paid commission according to the amount of business they are getting for the company. When company gets re-insurance business it has to pay commission to some other company. This commission is called **'commission on re-insurance accepted'** and is shown as an expense in the revenue account. When a company passes on a part of business to some other company then this company (which gives business) gets commission from the company to whom such business is given. This commission is called **'commission on re-insurance ceded'** and is a gain to the company surrendering the business. It appears on the credit side of revenue account.

Reserve for unexpired risk:

This is applicable in General Insurance business only. This is in the nature of provision for claims that may arise in respect of policies which are subsisting on the date of balance sheet. Since premium has already been received in respect of such policies, provision must be made for the claims that may arise out of such policies. Insurance business is peculiar in that the premium is received in advance but the risk can arise on any day. In general insurance the policy is issued for a year which means the risk is covered for a year. Chances of the risk covered occurring do not come down proportionately with the passage of time. For example, if on the balance sheet date the unexpired period of a particular policy is one month (eleven months having expired) we cannot say that the risk on the policy is reduced to 1/ 12th of the total risk. Even on the last day of the policy company's risk is as high as it was on the day the policy was issued. Therefore, insurance companies must provide for the risks associated with all such policies for which the premia has been received and the policies are still in force. Thus a large portion of the premia collected must be kept in reserve for unexpired risk. Keeping in view the nature of the business, the Executive Committee of the General Insurance Council
(which has been set up under the Insurance Act to supervise general insurance companies)
has laid down that in the case of marine insurance the provision for unexpired risk should be 100% of the net premium and in the case of other businesses (like accident, fire, theft, etc.) the provision should be 50% of the net premium. The provision made on the balance sheet date will be shown on the debit side of the revenue account instead of subtracting from premia. The balance of provision also appears in the balance sheet on the liabilities side under the heading 'balance of funds and accounts'. This provision will be transferred to the credit side of next year's revenue account. Thus in the revenue account the balance of the previous year appears on the credit side and the balance provided for the current year appears on the debit side.

Additional reserve for unexpired risk:

In a particular year the management may feel that the percentage of premia recommended by the General Insurance Council is not sufficient to meet the unexpired risks. In such a situation they may provide additional reserve. Such additional reserve will also be debited to the revenue account. The balance will be shown in the balance sheet as in the case of normal reserve, and will be transferred to the credit of next year's revenue account. If in the problem given, there is no instruction regarding additional reserve it means no such reserve is required. As the provision of additional reserve is the discretionary right of the management it is not correct to carry forward such reserve even though there is no instruction about it in the problem.

REVENUE ACCOUNT (Form B-RA):

As per IRDA Regulations 2012, every General Insurance Company must prepare their Revenue Account according to Schedule B. Needless to say that separate Revenue Account should be prepared for each individual unit viz marine, fire etc. Naturally, the result of the operation of each individual unit can be known from this account for a particular accounting period which is very important. It is prepared under accrual basis of accounting.

Financial Statement of General Insurance Companies:

As per IRDA regulations, financial statement of General Insurance Companies consists of three parts viz (a) Revenue Account, (b) Profit and Loss Account and (c) Balance Sheet.

Name of the Insurer:

FORM B - RA

Registration No. and Date of Registration with the IRDA Revenue Account for the year ended 31st March, 20..
(To be prepared separately fire, marine and miscellaneous insurance)

Particulars	Schedule	Current Year (₹ '000)	Previous Year (₹ '000)
Premiums Earned (net) Others (to be specified) Interest, Dividend and Rent -Gross	1		
Total (A)			
Claims Incurred (Net) Commission Operating Expenses related to Insurance Business Others – To be specified	2 3 4		
Total (B)			
Operating Profit / (loss) from Fire/ Marine/ Miscellaneous Business (A-B)			

Profit and Loss Account (Form B-PL):

Profit and Loss Account of General Insurance Company is prepared to know the overall operating result of the company. It includes income from investment in the form of dividend, interest, rent etc. Similarly it also includes expenses relating to insurance business, bad debts, provision for doubtful debts, provision for taxation etc. At the same time, all appropriation items, viz payment of dividend (interim and proposed), transfer to reserve etc. will appear in its appropriation part.

Name of the Insurer:

FORM B – PL

Registration No. and Date of Registration with the IRDA
Profit & Loss Account
for the year ended 31st March 20...

Particulars	Schedule	Current Year (₹ '000)	Previous Year (₹ '000)
1. **Operating Profit/(Loss)** (a) Fire Insurance (b) Marine Insurance (c) Miscellaneous Insurance 2. **Income from investments** (a) Interest, Dividend & Rent-Gross (b) Profit on sale of investments Less: Loss on sale of investments 3. Other income (To be specified)			
Total (A)			
4. **Provisions (other than taxation)**			

(a) For diminution in the value of investments (b) Others (to be specified) 5. **Other expenses** (a) Expenses other than those related to Insurance Business (b) Others (To be specified) **Total (B)** Profit Before Tax Less: Provision for Taxation Profit After Tax Less: Catastrophe Reserve* Profit available for appropriation			

Particulars	Schedule	Current Year (₹ '000)	Previous Year (₹ '000)
Appropriations Interim Dividends paid during the year Proposed Final Dividend Dividend Distribution Tax Transfer to any Reserves or Other Accounts (to be specified)			
Balance of profit/loss brought forward from last year			
Balance carried forward to Balance Sheet			

* Cumulative Shortfall in the Catastrophe appropriation ₹…….pending surplus.

Balance Sheet (Form B-BS)

As per IRDA regulation 2002, Balance Sheet of General Insurance Company is prepared under vertical form. It has two sections, viz (a) Sources of funds and (b) Application of funds.

FORM – B –BS

Name of the Insurer :
Registration No. and Date of Registration with the IRDA
Balance Sheet as at 31st March, 20……..

Particulars	Schedule	Current Year (₹ '000)	Previous Year (₹ '000)
Sources of Funds: Shareholders' Funds: Share Capital Reserves and Surplus Fair Value Change account **Borrowings**	 5 6 7		
Total			
Application of Funds: Investments Loans Fixed assets Current Assets: Cash and bank balance Advances and other assets	 8 9 10 11 12		
Sub-total (A)			
Current Liabilities Provision	13 14		
Sub-total (B)			
Net Current Assets (C) = (A)- (B) Miscellaneous expenditure (to the extent not written-off or	 15		

adjusted) Debit balance in Profit & Loss Account			
Total			

Contingent Liabilities

Particulars	Schedule	Current Year (₹ '000)	Previous Year (₹ '000)
1. Partly paid-up Investments 2. Claims, other than against Policies, not acknowledged as Debts by the Company 3. Underwriting Commitments Outstanding 4. Guarantees given by or on behalf of the Company 5. Statutory Demands/Liabilities in dispute, not provided for 6. Re-insurance Obligations 7. Others (to be specified)			
Total			

Schedules Forming Part of Financial Statements

Schedule 1- Premium Earned (Net)

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Premium from direct business written Add: Premium on reinsurance accepted Less: Premium on reinsurance ceded		
Net Premium Adjustment for changes in unearned Premium Adjustment for changes in premium received in advance		
Total Premium Earned (Net)		
Less: Adjustment for change in provision for Unexpired		
Risks		
Premium Income from business effected: In India		
Outside India Total Premium Earned (Net)		

Notes:

(a) In case of premiums less re-insurance, in respect of any segment of insurance business exceeds 10 per cent of total premium earned, the same shall be disclosed separately.

(b) Re-insurance premiums whether on business ceded or accepted are to be brought into account, before deducting commission, under the head of re-insurance premiums.

Schedule 2 - Claims Incurred (Net)

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Claim paid Direct Add: Re-insurance accepted Less: Re-insurance Ceded Net Claims paid		
Total Claims Incurred		
Claims paid to claimants In India Outside India		
Total Claims Incurred		

Notes:

(a) Incurred But Not Reported (IBNR), Incurred But Not Enough Reported (IBNER)claims should be included in the amount for Claims.
(b) Claims include Claims Settlement Costs.
(c) The Surveyor Fees, Legal and Other Expenses shall also form part of Claims Cost.
(d) Claims cost should be adjusted for estimated salvage value if there is a sufficient certainty of its realisation.

Schedule 3 - Commission

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Commission paid Direct **Add:** Re-insurance Accepted **Less:** Commission on Re-insurance Ceded		
Net Commission		

Note: The profit/commission, if any, are to be combined with the Re-insurance accepted or Re-insurance ceded figures.

Schedule 4 - Operating Expenses Related to Insurance Business

Particulars	Current Year (₹'000)	Previous Year (₹'000)
1. Employees' remuneration & welfare benefits		
2. Managerial Remuneration		
3. Travel, Conveyance & Vehicle running expenses		
4. Rents, rates & taxes		
5. Repairs		
6. Printing & Stationary		
7. Communication expenses		
8. Legal & professional charges		
9. Medical fees		
10. Auditors' fees, expenses etc.		
(a) As auditor		
(b) As advisor or in any other capacity, in respect of		
(i) Taxation matters		
(ii) Insurance matters		
(iii) Management services; and		
(c) In any other capacity		
11. Advertisement and Publicity		
12. Interest & Bank Charges		
13. Others (to be specified)		
14. Depreciation		
Total		

Notes:

(a) Items of expenses in excess of one per cent of net premium or ₹ 5,00,000, whichever is higher, shall be shown as a separate line item.
(b) Under the sub-head "Others", "Operating Expenses (Insurance Business)" shall include items like foreign exchange gains or losses and other items.

Schedule 5 - Share Capital

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. **Authorized Capital** Equity Shares of ₹each 2. **Issued Capital** Equity Shares of ₹ .... each 3. **Subscribed Capital** Equity Shares of ₹ .... each 4. **Called-up Capital** Equity Shares of ₹ .... each 5. **Less:** Calls unpaid **Add:** Equity shares forfeited (Amount originally paid up) **Less:** Preliminary expenses **[Expenses including commission or brokerage on underwriting or subscription of shares]**		
Total		

Notes:

(a) Particulars of the different classes of capital should be seperately stated.

(b) The amount capitalized on account of issue of bonus shares should be disclosed.

(c) In case any part of the capital is held by a holding company, the same should be sepa- rately disclosed.

Schedule 5A

Share Capital Pattern of Shareholding
[As certified by the Management]

	Current Year		Previous Year	
	Number of Shares	%of Holding	Number of Shares	%of Holding
Promoters * Indian * Foreign Others				
Total				

Schedule 6 - Reserves and Surplus

Particulars	Current Year (₹'000)	Previous Year (₹'000)
1. Capital Reserve 2. Capital Redemption Reserve 3. Share Premium 4. General Reserves Less: Debit balance in Profit and Loss Account Less: Amount utilized for Buy-back 5. Catastrophe Reserve 6. Other reserves (to be specified) 7. Balance of Profit in Profit & Loss Account		
Total		

Note: Additions to and deductions from the reserves should be disclosed under each of the specified heads.

The Reserves and Surplus (Shareholders) as above shall be further segregated and disclosed as Reserves and Surplus – (1) In India, and (2) Outside India.

Schedule 7 - Borrowings

Particulars	Current Year (₹'000)	Previous Year (₹'000)
1. Debentures / Bonds		
2. Fixed Deposits		
3. Banks		
4. Financial Institutions		
5. Other entities carrying on insurance business		
6. Others (to be specified)		
Total		

Notes:

(a) The extent to which the borrowings are secured shall be separately disclosed stating the nature of the security under each sub-head.

(b) Amounts due within 12 months from the date of Balance Sheet should be shown separately.

Schedule 8 - Investments

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
Long-term Investments		
1. Government Securities and Government Guaranteed bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments		
(a) Shares		
– Equity		
– Preference		
(b) Mutual Funds		
(c) Derivative Instruments		
(d) Debentures/Bonds		
(e) Other Securities (to be specified)		
(f) Subsidiaries		
(g) Investment Properties-Real Estate		
Short-term Investments		
1. Government Securities and Government Guaranteed bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments		
(a) Shares		
– Equity		
– Preference		
(b) Mutual Funds		
(c) Derivative Instruments		
(d) Debentures/Bonds		
(e) Other Securities (to be specified)		
(f) Subsidiaries		
(g) Investments Properties-Real Estate		
Total Investments		
1. In India		
2. Outside India		
Total		

Notes:

(a) Investments in subsidiary/holding companies, joint ventures and associates shall be separately disclosed, at cost.

(i) **Holding company** and Subsidiary shall be construed as. Significant influence may be exercised in several ways, for example, by representation on the board of directors, participation in the policy-making process, material inter-company transactions, interchange of managerial defined in the Companies Act, 1956.

(ii) **Joint venture** is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

(iii) **Joint control** is the contractually agreed sharing of power to govern the financial and operating policies of an economic activity to obtain benefits from it.

(iv) **Associate** is an enterprise in which the company has significant int1uence and which is neither a subsidiary nor a joint venture of the company.

(v) **Significant influence** (for the purpose of this Schedule) means participation in the financial and operating policy decisions of a company, but not necessarily control of those policies personnel or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiaries, 20 per cent or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiaries, less than 20 per cent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence is clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

(b) Aggregate amount of company's investments other than listed equity securities and derivative instruments and also the market value thereof shall be disclosed.

(c) Investments made out of catastrophe reserve should be shown separately.

(d) Debt securities will be considered as "held to maturity" securities and will be measured at historical cost subject to amortisation.

(e) Investment property means a property [land or building or part of a building or both] held to earn rental income or for capital appreciation or for both, rather than for use in services or for administrative purposes.

Schedule 9 - Loans

Particulars	Current Year (₹'000)	Previous Year (₹'000)
1. **Security-Wise Classification:**		
Secured:		
(a) On mortgage of property		
(i) In India		
(ii) Outside India		
(b) Other Shares, Bonds, Govt. Securities		
(c) Others (to be specified)		
Unsecured:		
Total		
2. **Borrower-Wise Classification:**		
(a) Central and State Governments		
(b) Banks and Financial Institutes		
(c) Subsidiaries		
(d) Others (to be specified)		
Total		
3. **Performance-Wise Classification:**		
(a) Loans classified as standard		
(i) In India		
(ii) Outside India		
(b) Non-performing loans less provisions		
(i) In India		
(ii) Outside India		
Total		
4. **Maturity-Wise Classification:**		
(a) Short Term		
(b) Long Term		
Total		

Notes:

(a) Short-term loans shall include those, which are repayable within 12 months of the balance sheet date. Long-term loans shall be the loans other than short-term loans.

(b) Provisions against non-performing loans shall be shown separately.

(c) The nature of the security in case of all long-term secured loans shall be specified in each case. Secured loans for the purpose of this schedule, means secured wholly or partially against an asset of the company.

(d) Loans considered doubtful and the amount of provision created against such loans shall be disclosed.

Note : Assets included in land, building and property above exclude Investment Properties as defined in Note (e) to Schedule 8.

Schedule 10 - Fixed Assets

Particulars	Cost/Gross Block Depreciation				Depreciation				Net Block	
	Opening	Additions	Deductions	Closing	Upto Last Year	For the Year	On Sales/ Adjustments	To Date	As at year end	Previous Year
Goodwill Intangibles (specify) Land-Freehold Leasehold Property Buildings Furniture & Fittings Information Technology Equipment Vehicles Office Equipment Others (Specify nature)										
Total										
Previous Year										

Schedule 11 – Cash and Bank Balances

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Cash (including Cheques, Drafts and Stamps) 2. Bank Balances (a) Deposit Accounts – Short-term (due within 12 months of date of Balance Sheet) – Others (b) Current Accounts (c) Others (to be specified) 3. Money at Call and Short Notice (a) With Banks (b) With other Institutions 4. Others (to be specified) **Total** Balances with Non-Scheduled banks included in 2 and 3 above		
Cash & Bank Balances		
1. In India		
2. Outside India		
Total		

Note: Bank balance may include remittances-in-transit. If so, the nature and amount should be separately stated.

Schedule 12 – Advances and other Assets

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Advances 1. Reserve deposits with ceding companies 2. Advances to ceding companies 3. Application money for investments 4. Prepayments 5. Advances to Officers/ Directors 6. Advance tax paid & taxes deducted at source 7. Others (to be specified)		
Total (A)		
Other Assets 1. Income accrued on investments 2. Outstanding Premiums 3. Agents' Balances 4. Foreign Agencies' balances 5. Due from other Insurance Entities 6. Due from subsidiaries/holding 7. Reinsurance claims/balances receivable 8. Deposit with Reserve Bank of India [Pursuant to Section 7 of Insurance Act,1938] 9. Others (to be specified)		
Total (B) **Total (A+B)**		

Notes:

(a) The items under the above heads shall not be shown net of provisions for doubtful amounts. The amount of provision against each head should be shown separately.

(b) The term 'officer' should conform to the definition of the word 'officer' given under the Companies Act, 2013.

Schedule 13 – Current Liabilities

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Reserve for Licensed premium 2. Agents Balances 3. Balances due to other insurance companies 4. Advances from Treaty Companies 5. Deposits held on re-insurance ceded 6. Premiums received in advance 7. Sundry Creditors 8. Due to subsidiaries/holding company 9. Claims Outstanding 10. Due to Officers/Directors 11. Others (to be specified)		
Total		

Schedule 14 – Provisions

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Reserve for Unexpired risk 2. For taxation (less advance tax paid and taxes deducted at source) 3. For proposed dividends 4. For dividend distribution tax 5. Others (to be specified)		
Total		

Schedule-15
Miscellaneous Expenditure

(To the extent not written off or adjusted)

Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
1. Discount Allowed in issue of shares/ debentures 2. Others (to be specified)		
Total		

Notes:

1. No item shall be included under the head "Miscellaneous Expenditure" and carried forward unless:
   (a) some benefit from the expenditure can reasonably be expected to be received in future, and
   (b) The amount of such benefit is reasonably determinable.
2. The amount to be carried forward in respect of any item included under the head "Miscellaneous Expenditure" shall not exceed the expected future revenue/other benefits related to the expenditure.

Computation of "premium income," "claims expense" and "commission expense" in the case of an insurance company:

Premium Income: The payment made by the insured as consideration for the grant of insurance is known as premium. The amount of premium income to be credited to revenue account for a year may be computed as:

	₹
Premium received on risks undertaken during the year (direct & re-insurance accepted)	–
Add : Receivable at the end of year (direct & re-insurance accepted)	–
Less : Receivable at the beginning of year (direct & re-insurance accepted)	–
Premium on re-insurance ceded:	

Less : Paid during the year	–	
Add : Payable at the end of year	–	
Less : Payable at the beginning of year	–	
Premium income		–

Claims expenses : A claim occurs when a policy falls due for payment. In the case of a life insurance business, it will arise either on death or maturity of policy that is, on the expiry of the specified term of years. In the case of general insurance business, a claim arises only when the loss occurs or the liability arises.

Claims Incurred:	₹	
Claims Settled during the year	—	
— Direct business	—	
— Re-insurance acceptor	—	
Add: Legal charges, if any	—	
Add: Surveyor's charges	—	
Add: Payment to Co-insurance		—
	—	
Less: Received from Co-insurance	—	
Received from Re-insurance	—	—
	—	
Add: Estimated liability at the end of the year		—
Less: Estimated liability at the beginning of the year	—	—
Claims as expenses		—

Commission expenses : Insurance Regulatory and Development Authority Act, 1999 regulates the commission payable on policies to agents. Commission expense to be charged to revenue account is computed as follows :

	₹
Commission paid (direct & re-insurance accepted)	–
Add : Commission payable at the end of the year (direct & re-insurance accepted)	–
Less : Commission payable at the beginning of the year (direct & re-insurance accepted)	–
Commission expense	–

Illustration 24.

Khush Raho Insurance Co. Ltd. furnishes you the following information :

(i) On 31.3.2013 it had reserve for unexpired risks to the tune of ₹100 crore. It comprised of ₹37.5 crore in respect of machine insurance business; ₹50 crore in respect of fire insurance business and ₹12.5 crore in respect of miscellaneous insurance business.

(ii) It is the practice of Khush Raho Insurance Co. Ltd. to create reserve at 100% of net premium income in respect of marine insurance policies and at 50% of net premium in respect of fire and miscellaneous insurance business.

(iii) During the year 31st March, 2014 the following business was conducted :

Particulars	Marine (₹ crores)	Fire (₹ crores)	Miscellaneous (₹ crores)
Premia collected from : (a) Insured (other than insurance companies) in respect of policies issued	45	107.5	30
(b) Other insurance companies in respect of risks undertaken	17.5	12.5	10
Premia paid/payable to other insurance companies on business ceded	16.75	10.75	17.5

Khush Raho Insurance Co. Ltd. asks you to :

(i) Pass journal entries relating to "unexpired risks reserve"

(ii) Show in columnar form Unexpired Risks Reserve Account for the year ended 31st March, 2014.

Solution:

Journals

Date	Particulars	L.F	Dr. ₹ Crore	Cr. ₹ Crore
31.3.14	Marine Revenue A/c Dr. To Unexpired Risks Reserve A/c (Excess of closing provision for unexpired risks of ₹ 45.75 crore over opening provision of ₹ 37.50 crore charged to Marine Revenue A/c)		8.25	8.25
31.3.14	Fire Revenue A/c Dr. To Unexpired Risks Reserve A/c (Excess of closing provision for unexpired risks of ₹ 54.63 crore over opening provision of ₹ 50.00 crore charged to Fire Revenue A/c)		4.63	4.63
31.3.14	Unexpired Risks Revenue A/c Dr. To Miscellaneous Revenue A/c (Excess of opening provision for unexpired risks of ₹ 12.5 crore over the required closing balance of ₹ 11.25 crore in the provision account credited to Miscellaneous Reserve Account)		1.25	1.25

Working Notes :

Required closing balance in Unexpired Risks Reserve Account:
For Marine business = ₹ (45 +17.5 –16.75)= ₹ 45.75
For Fire business = [(107.5 + 12.5 – 10.75)/2] = ₹ 54.63
For miscellaneous business = [(30 + 10 – 17.5)/2] = ₹ 11.25

Dr. Unexpired Risks Reserve Account (₹ in crore) Cr.

Date	Particulars	Marine	Fire	Misc.	Date	Particulars	Marine	Fire	Misc.
2014	To, Revenue A/c	—	—	1.25	2014	By, Balance b/d	37.5	50.00	12.5
	To, Balance c/d	45.75	54.63	11.25		By, Revenue A/c	8.25	4.63	—
		45.75	54.63	12.50			45.75	54.63	12.50

Illustration 25.

From the following figures appearing in the books of Fire Insurance division of a General Insurance Company, show the amount of claim as it would appear in the Revenue Account for the year ended 31st March, 2014 :

Particulars	Direct Business	Re-Insurance
	₹	₹
Claim paid during the year	46,70,000	7,00,000
Claim Payable — 1st April, 2013	7,63,000	87,000
31st March, 2014	8,12,000	53,000
Claims received	–	2,30,000
Claims Receivable — 1st April, 2013	–	66,000
31st March, 2014	–	1,13,000
Expenses of Management	2,30,000	–
(includes ₹ 35,000 Surveyor's fee and ₹ 45,000		
Legal expenses for settlement of claims)		

Solution:

General Insurance Company
(Abstract showing the amount of claims)

Particulars	**₹ '000**	**₹ '000**
Claims less Re-insurance :		
Paid during the year	52,20	
Add : Outstanding claims at the end of the year	7,52	
	59,72	
Less : Outstanding claims at the beginning of the year	7,84	51,88

Working Notes :

	Particulars	**₹ '000**	**₹ '000**
1.	Claims paid during the year		
	Direct business	46,70	
	Reinsurance	7,00	53,70
	Add : Surveyor's fee	35	
	Legal expenses	45	80
			54,50
	Less : Claims received from re-insurers		2,30
			52,20
2.	Claims outstanding on 31st March, 2014		
	Direct business	8,12	
	Reinsurance	53	8,65
	Less : Claims receivable from re-insurers		1,13
			7,52
3.	Claims outstanding on 1st April, 2013		
	Direct business	763	
	Reinsurance	87	8,50
	Less : Claims receivable from re-insurers		66
			7,84

Illustration 26.

Prepare the Fire Insurance Revenue A/c as per IRDA regulations for the year ended 31st March, 2014 from the following details:

Particulars	₹
Claims paid	4,90,000
Legal expenses regarding claims	10,000
Premiums received	13,00,000
Re-insurance premium paid	1,00,000
Commission	3,00,000
Expenses of management	2,00,000
Provision against unexpired risk on 1st April, 2013	5,50,000
Claims unpaid on 1st April, 2013	50,000
Claims unpaid on 31st March, 2014	80,000

Create Reserve for Unexpired Risk @ 50%.

Solution:

Name of the Insurer:

FORM B – RA

Registration No. and Date of Registration with the IRDA:

Fire Insurance Revenue Account for the year ended 31st March, 2014

	Particulars	Schedule	Amount (₹)
(1)	Premium earned	1	11,50,000
(2)	Other income		-
(3)	Interest, dividend and rent		-
	Total (A)		11,50,000
(4)	Claims incurred	2	5,30,000
(5)	Commission	3	3,00,000
(6)	Operating expenses related to Insurance business	4	2,00,000
	Total (B)		10,30,000
	Operating Profit (A)- (B)		1,20,000

Schedule 1 : Premium earned (net)	₹
Premium received	13,00,000
Less: Re-insurance premium	1,00,000
Net premium	12,00,000
Adjustment for change in reserve for unexpired risks (Refer W.N.)	50,000
	11,50,000

Schedule 2 : Claims Incurred	₹
Claims paid including legal expenses (4,90,000 + 10,000)	5,00,000
Add : Claims outstanding at the end of the year	80,000
Less : Claims outstanding at the beginning of the year	(50,000)
Total claims incurred	5,30,000

Schedule 3 : Commission	₹
Commission paid	3,00,000
	3,00,000

Schedule 4: Operating expenses	₹
Expenses of management	2,00,000
	2,00,000

Working Note:

Change in the provision for unexpired risk	₹
Unexpired risk reserve on 31^{st} March, 2012 =50% of net premium	
i.e. 50% of ₹12,00,000 (See Schedule 1)	6,00,000
Less : Unexpired risk reserve as on 1^{st} April 2013	5,50,000
Change in the provision for unexpired risk	50,000

SELF EXAMINATION QUESTION:

1. **Fill in the blanks:**
   (i) Sometimes the insurer considers a particular risk too much for his capacity and may ______________ a part of the risk with some other insurer.

   (ii) Bonus paid at the end along with the policy amount to the policy holders is called __________ ____________.

   (iii) In the case of a _________insurance business claim will arise either on death or maturity of policy.

   (iv) In relation to an Electricity Company the amount of Security Deposit = Load × Load Factor of the category in which the consumer falls × ______________× Current tariff.

   (v) _______________ advance means where a bank grants advance to its customers against any tangible security.

   (vi) Losses of theft are covered by Burglary insurance.

   (vii) The __________ ___________ Fund is available to meet the aggregate liability on all policies outstanding.

   (viii) Revenue Account of life Insurance Business is relevant with Form - ________________.

   (ix) In case of Insurance Company the date of discharge of claim is mentioned in the register of _____________.

   (x) Rebate on Bills Discounted = Amount of Bill × Rate of Discount × __________________.

Answer:

(i) Re-insurance;
(ii) Reversionary Bonus;
(iii) Life;
(iv) (Billing cycle + 45 days);
(v) Secured;
(vi) Burglary;
(vii) Life Assurance;
(viii) A – RA;
(ix) Claims;
(x) $\frac{\text{Unexpired Period}}{12}$

2. **State whether the following statements are 'TRUE' or 'FALSE':**
   (i) Every banking company incorporated in India is required to transfer at least 15% of its profit to the reserve fund.

   (ii) A bank can maintain Cash reserve with itself or by way of a balance in the Current account with the reserve bank or by way of net balance in current accounts or in one or more of the aforesaid ways.

(iii) Every banking company is required to submit a return in the prescribed form and manner to the Reserve Bank of India at the end of each calendar year of all accounts in India which could not be operated for 5 years.

(iv) Non-performing assets bear a little amount of risk like normal risk and they do not create any trouble regarding their realization.

(v) The Electricity Act, 2003 replaced four existing legislations.

(vi) The Central Electricity Regulatory Commission shall consist of a chairperson and 3 Members

(vii) In case of Electricity Company, Balance of Security Deposit A/c at the end of the accounting period should be disclosed as a Non-current liability in the Balance Sheet.

(viii) The value base for the purpose of depreciation for the purpose of Tariff as per Regulation 21 shall be the historical cost of the asset.

(ix) ODRC represents Optimised Depreciated Replacement Cost.

(x) When the same risk and the same subject matter is insured with more than one insurer, i.e., more than one insurance company, the same is called Re-insurance Insurance.

Answer:

(i) FALSE.

(ii) TRUE.

(iii) FALSE.

(iv) FALSE.

(v) FALSE.

(vi) TRUE.

(vii) TRUE.

(viii) TRUE.

(ix) TRUE.

(x) FALSE.

STUDY NOTE: 5
ACCOUNTING STANDARDS

THIS STUDY NOTE INCLUDES:

[Corresponding Indian Accounting Standards (Ind AS) are included along with the Accounting Standards (AS)]

5.1 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.

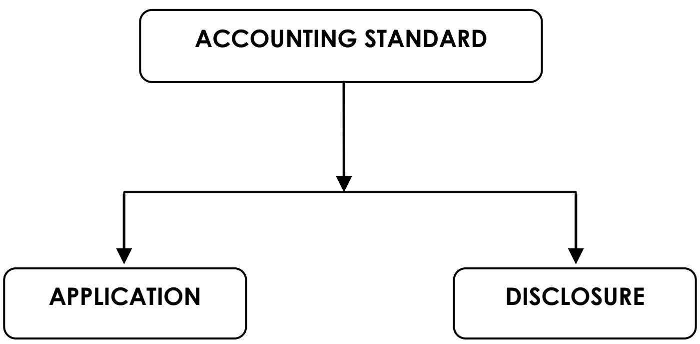
Advantages:-

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 ACOUNTING 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

5.2 AS 11: ACCOUNTING FOR 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 corresponding creditor would be recorded at ₹ 46.60

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

Illustration 2:

A Ltd. purchased fixed assets costing ₹ 5,100 lakhs on 1.1.10 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal installments. Exchange rates were 1 Dollar = ₹ 42.50 and ₹ 45.00 as on 1.1.10 and 31.12.10 respectively. First installment was paid on 31.12.10. The entire difference in foreign exchange has been capitalized.

You are required to state, how these transactions would be accounted for.

Solution:

As per AS 11 The Effects of Changes in Foreign Exchange Rates', exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognized as income or expenses in the period in which they arise. Thus exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets are recognized as income or expense.

Calculation of Exchange Difference:

Foreign currency loan= $\frac{₹5{,}100\text{Lakhs}}{₹42.50} = \text{US}\ \$120\text{Lakhs}$

Exchange difference = ₹120 lakhs US Dollars ×(45.00 - 42.50)
= ₹ 300 lakhs (including exchange loss on payment of first installment)

Therefore, entire loss due to exchange differences amounting ₹ 300 lakhs should be charged to profit and loss account for the year.

INDIAN ACCOUNTING STANDARD (IND AS) 21 — THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

Objective

(a) An entity may carry on foreign activities in two ways. It may have transactions in foreign currencies or it may have foreign operations. In addition, an entity may present its financial statements in a foreign currency. The objective of this Standard is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.

(b) The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements.

Scope

This Standard shall be applied:

(a) in accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of Ind AS 109, Financial Instruments;

(b) in translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation or the equity method; and

(c) in translating an entity's results and financial position into a presentation currency.

This Standard applies to the presentation of an entity's financial statements in a foreign currency and sets out requirements for the resulting financial statements to be described as complying with Indian Accounting Standards (Ind ASs). For translations of financial information into a foreign currency that do not meet these requirements, this Standard specifies information to be disclosed.
This Standard does not apply to the presentation in a statement of cash flows of the cash flows arising from transactions in a foreign currency, or to the translation of cash flows of a foreign operation (see Ind AS 7, Statement of Cash Flows).
This Standard does not also apply to long-term foreign currency monetary items for which an entity has opted for the exemption. Such an entity may continue to apply the accounting policy so opted for such long-term foreign currency monetary items.

Definitions

The following terms are used in this Standard with the meanings specified:

Closing rate is the spot exchange rate at the end of the reporting period.

Exchange difference is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Exchange rate is the ratio of exchange for two currencies.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Foreign currency is a currency other than the functional currency of the entity.

Foreign operation is an entity that is a subsidiary, associate, joint arrangement or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

Functional currency is the currency of the primary economic environment in which the entity operates.

A **group** is a parent and all its subsidiaries.

Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.
Example: pension or provisions that are to be settled in cash etc.

Conversely, the essential feature of a non-monetary item is the absence of a right

Net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation.
Presentation currency is the currency in which the financial statements are presented.
Spot exchange rate is the exchange rate for immediate delivery.

Comparison between Ind AS 21 and AS 11

	Ind AS -21	**AS - 11**
1.	Forward exchange contracts and other similar financial instruments are excluded from the scope of this standard.	Forward exchange contracts and other similar financial instruments are not excluded from the scope of this standard.
2.	Factors for determining the functional currency of an entity is same as the indicators in existing AS 11 to determine the non-integral foreign operations. There is no substantive differences in respect of the accounting procedure.	There are two aspects – integral foreign operations and non-integral foreign operations for accounting.
3.	There is an option to recognise the exchange differences arising on translation of any long-term monetary items from foreign currency to	There is no such permission.

	functional currency and it is permitted. Accumulated exchange differences are to be transferred to P& L Account in a appropriate way.	

5.3 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.

INDIAN ACCOUNTING STANDARD (IND AS) 20 — ACCOUNTING FOR GOVERNMENT GRANTS AND DISCLOSURE OF GOVERNMENT ASSISTANCE

Scope

This Standard shall be applied in accounting for, and in the disclosure of, government grants and in the disclosure of other forms of government assistance.

This Standard does not deal with:

(a) the special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature.
(b) government assistance that is provided for an entity in the form of benefits that are available in determining taxable profit or tax loss, or are determined or limited on the basis of income tax liability. Examples of such benefits are income tax holidays, investment tax credits, accelerated depreciation.
(c) government participation in the ownership of the entity.
(d) government grants covered by Ind AS 41, Agriculture.

Definitions

The following terms are used in this Standard with the meanings specified:

Government refers to government, government agencies and similar bodies whether local, national or international.

Government assistance is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria. Government assistance for the purpose of this Standard does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity.

They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

Grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Other conditions restricting the type or location of the assets or the acquisition or holding period may also be attached.

Grants related to income are government grants other than those related to assets.

Forgivable loans are loans which the lender undertakes to waive repayment of under certain prescribed conditions.

Comparison between Ind AS 20 and AS 12

	Ind AS – 20	AS – 12
1.	Deals with the other forms of government assistance that do not fall within the definition of government grants. It requires an indication of other forms of government assistance from which the entity has directly benefited, that should be disclosed in the financial statements.	Does not deal with such government assistance.
2.	Based on the principle that all government grants would normally have certain obligations attached to them and these grants should be recognised as income over the periods which bear the relevant cost of obligation. It, therefore, specifically prohibits recognition of grants directly in the shareholders' funds.	Requires that in case the grant is in respect of non-depreciable assets, the amount of the grant should be shown as capital reserve. If a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income. Also gives an alternative to treat the grants as a deduction from the cost of asset.
3.	Does not recognise government grants which is in the nature of promoters' contribution.	As per this some government grants have the characteristics similar to those of promoters' contribution. It requires that such grants should be credited directly to capital reserve.
4.	It requires to value non-monetary grants at their fair value, since it results into presentation of more relevant information.	Requires that government grants in the form of nonmonetary assets, given at a concessional rate, should be accounted for on the basis of their acquisition cost. If it a non-monetary asset it is given free of cost, it should be recorded at a nominal value.

5.4 AS-15: ACCOUNTING FOR 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:

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

Indian Accounting Standard (Ind AS) 19 — ACCOUNTING FOR Employee Benefits

Objective

The objective of this Standard is to prescribe the accounting and disclosure for employee benefits. The Standard requires an entity to recognise:

(a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and
(b) an expense when the entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Scope

This Standard shall be applied by an employer in accounting for all employee benefits, except those to which Ind AS 102, Share-based Payment, applies.

This Standard does not deal with reporting by employee benefit plans.

The employee benefits to which this Standard applies include those provided:

(a) under formal plans or other formal agreements between an entity and individual employees, groups of employees or their representatives;
(b) under legislative requirements, or through industry arrangements, whereby entities are required to contribute to national, state, industry or other multi-employer plans; or
(c) by those informal practices that give rise to a constructive obligation.

Employee benefits include:

The following short-term employee benefits , if expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services:

(i) wages, salaries and social security contributions;
(ii) paid annual leave and paid sick leave;
(iii) profit-sharing and bonuses; and
(iv) non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

Post-employment benefits, such as the following:

(i) retirement benefits (e.g., pensions and lump sum payments on retirement); and
(ii) other post-employment benefits, such as post-employment life insurance an post-employment medical care;

Other long-term employee benefits, such as the following:

(i) long-term paid absences such as long-service leave or sabbatical leave;
(ii) jubilee or other long-service benefits; and
(iii) long-term disability benefits; and

Termination benefits:

- Employee benefits include benefits provided either to employees or to their dependants or beneficiaries and may be settled by payments (or the provision of goods or services) made either directly to the employees, to their spouses, children or other dependants or to others, such as insurance companies.
- An employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of this Standard, employees include directors and other management personnel.

Definitions

The following terms are used in this Standard with the meanings specified:

Definitions of employee benefits —

Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment.
Short-term employee benefits are employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service.
Post-employment benefits are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.
Other long-term employee benefits are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.
Termination benefits are employee benefits provided in exchange for the termination of an employee's employment as a result of either:
(a) an entity's decision to terminate an employee's employment before the normal retirement date; or
(b) an employee's decision to accept an offer of benefits in exchange for the termination of employment.

Definitions relating to classification of plans

Post-employment benefit plans are formal or informal arrangements under which an entity provides post-employment benefits for one or more employees.
Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.
Defined benefit plans are post-employment benefit plans other than defined contribution plans.
Multi-employer plans are defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:
(a) pool the assets contributed by various entities that are not under common control; and
(b) use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees.

Definitions relating to the net defined benefit liability (asset)

The net defined benefit liability (asset) is the deficit or surplus, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

The deficit or surplus is:
(a) the present value of the defined benefit obligation less
(b) the fair value of plan assets (if any).

The asset ceiling is the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

The present value of a defined benefit obligation is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

Plan assets comprise:

(a) assets held by a long-term employee benefit fund; and
(b) qualifying insurance policies.

Assets held by a long-term employee benefit fund are assets (other than non-transferable financial instruments issued by the reporting entity) that:

(a) are held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and
(b) are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own creditors (even in bankruptcy), and cannot be returned to the reporting entity, unless either:
    (i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or
    (ii) the assets are returned to the reporting entity to reimburse it for employee benefits already paid.

A qualifying insurance policy is an insurance policy* issued by an insurer that is not a related party (as defined in Ind AS 24, Related Party Disclosures) of the reporting entity, if the proceeds of the policy:

(a) can be used only to pay or fund employee benefits under a defined benefit plan; and
(b) are not available to the reporting entity's own creditors (even in bankruptcy) and cannot be paid to the reporting entity, unless either:
    i. the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or
    ii. the proceeds are returned to the reporting entity to reimburse it for employee benefits already paid.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Definitions relating to defined benefit cost

Service cost comprises:
(a) current service cost, which is the increase in the present value of the defined benefit obligation resulting from employee service in the current period;
(b) past service cost, which is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by a plan); and
(c) any gain or loss on settlement.

Net interest on the net defined benefit liability (asset) is the change during the period in the net defined benefit liability (asset) that arises from the passage of time.

Remeasurements of the net defined benefit liability (asset) comprise:
(a) actuarial gains and losses;
(b) the return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and
(c) any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

Actuarial gains and losses are changes in the present value of the defined benefit obligation resulting from:

(a) experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and
(b) the effects of changes in actuarial assumptions.

The return on plan assets is interest, dividends and other income derived from the plan assets, together with realised and unrealised gains or losses on the plan assets, less:

(a) any costs of managing plan assets; and
(b) any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the present value of the defined benefit obligation.

A settlement is a transaction that eliminates all further legal or constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.

Short-term employee benefits

Short-term employee benefits include items such as the following, if expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services:

(a) wages, salaries and social security contributions;
(b) paid annual leave and paid sick leave;
(c) profit-sharing and bonuses; and
(d) non-monetary benefits.

An entity need not reclassify a short-term employee benefit if the entity's expectations of the timing of settlement change temporarily. However, if the characteristics of the benefit change (such as a change from a non-accumulating benefit to an accumulating benefit) or if a change in expectations of the timing of settlement is not temporary, then the entity considers whether the benefit still meets the definition of short-term employee benefits.

Comparison between Ind AS 19 and AS 15

Ind AS – 19	AS – 15
It covers employee benefits arising from constructive obligations	Not dealt in.
Employee Includes whole time Directors.	Employee Includes Directors.
It deals with the situations where there is a contractual agreement between a multi-employer plan and its participants that determines how the surplus in the plan will be distributed to the participants.	Not dealt in.
Entity to involve a qualified actuary in the measurement of all material post-employment benefit obligations • Encourages, but does not require, an	Entity to involve a qualified actuary in the measurement all material post-employment benefit obligations • Neither required nor encouraged.
Financial assumptions • To be based on market expectations, at the end of the reporting period, for the period over which the obligations are to be settled.	No such clarification
Requires recognition of the actuarial gains and losses in other comprehensive income, both for post –employment defined benefit plans and other long-term employment benefit plans. The actuarial gains and losses recognised in other comprehensive income should be recognised immediately in retained earnings and should not be reclassified to profit or loss in a subsequent period.	Requires recognition of the actuarial of the gains and losses immediately in the statement of profit and loss as income or expense.

5.5 AS 16: BORROWING COSTS

Borrowing costs are interests and other costs incurred by an enterprise in connection with the borrowing of funds.

A qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use or sale.

Examples of qualifying assets:

- Any tangible fixed assets, which are in construction process or acquired tangible fixed assets, which are not ready for use or resale. Such as plants and machinery.
- Any intangible assets, which are in development phase or acquired but not ready for use or resale, such as patent.
- Investment property.
- Inventories that require a substantial period (i.e. generally more than one accounting period) to bring them to a saleable condition.

The standard is applied in accounting for borrowing costs which include:

1. Interest and commitment charges on bank borrowing and other short term borrowings;
2. Amortization of discounts/premium relating to borrowings;
3. Amortization of ancillary cost incurred in connection with arrangement of borrowings;
4. Finance charges for assets acquired under finance lease or other similar arrangement.
5. Exchange difference in foreign currency borrowing to the extent it relates to interest element;

Borrowing cost incurred on assets, which takes substantial period, is treated as cost of that asset in respect of (1) above.

As per the Guidance Note on Audit of Miscellaneous Expenditure issued by ICAI, deferment for amortization cost upto the time the asset is put to use, in respect of (2) and (3), should be capitalized (see below for AS-16 provision).

Finance charges as in (4) can be capitalized upto the time the asset is put to use (AS-19 deals with elaborate provision)

Conditions for capitalization of borrowing costs:

- Directly attributable costs for acquisition, construction or production of qualifying asset, are eligible for capitalization. Directly attributable costs are those costs that would have been avoided if the expenditure on qualifying asset have not been made.
- Qualifying assets will render future economic benefit to the enterprise and the cost can be measured reliably.

Amount of borrowing costs eligible for capitalization (specific borrowing) :

- Amount of borrowing cost eligible for capitalization = Actual borrowing cost incurred during the period **less** any income generated on the temporary investment of amount borrowed.

Commencement of capitalization of borrowing cost

Following three conditions must be fulfilled before the commencement of capitalization of borrowing cost:

- Activities, which are essential to prepare the asset for its intended use, should be in progress.
- Borrowing cost is incurred
- Expenditure for acquisition, construction or production of a qualifying asset is being incurred.

All other borrowing costs are charged to P & L Account :

AS-16 establishes a key test for capitalization which states that "borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those costs that would have been avoided if the expenditure on the qualifying asset had not been made".

Accounting treatment of borrowing cost as per AS-16 :

(a) Borrowing costs should either be capitalized or charged to P&L Account depending on the situation but deferment is not permitted.

(b) Borrowing costs are capitalized as part of cost of qualifying asset when it is probable that they will result in future economic benefits and cost can be measured reliably - other borrowing costs are charged to P&L Account in the accounting period in which they are incurred.

(c) Capitalization, on one hand reflects closely the total investment in the asset and on the other hand to charge the cost to future period against accrual of revenue.

(d) Notional interest cost are not allowed to be capitalized.

(e) A qualifying asset is an asset that necessarily takes a substantial period of time (usually a period of 12 months unless otherwise justified on the basis of facts and circumstances) to get ready for its intended use or sale.

(f) Capitalization should be suspended during extended period in which active development is interrupted.

(g) Capitalization should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

(h) Capitalization also ceases 'when part is completed, which is capable of being used independently of the whole.

Disclosure under AS-16

(a) Accounting Policy adopted

(b) Amount of borrowing cost capitalized during the accounting period

Illustration 7.

Calculate the value of the qualifying assets from the following particulars as presented by X Ltd.:

A Ltd. incurred ₹ 25,00,000 to construct a factory premises which was ready for use on 31.12.2013. It used the funds from working capital facility given by a commercial bank on which interest was payable @12% p.a. It was found during the period of construction the average balance of loan for working capital had never fallen below ₹ 30 lakhs.

The expenditure which were incurred during the period from July 2013-Dec. 2013 are:

	₹
2013- July	3,00,000
August	4,00,000
September	6,00,000
October	5,00,000
November	4,00,000
December	3,00,000
	25,00,000

Solution:

Statement showing the Value of the Qualifying Assets

Year	Month	Expenditure Incurred on Qualifying Assets ₹	Interest ₹	Cumulative Expenditure Interest ₹
2013	July	3,00,000	---	3,00,000
	August	4,00,000	3,000	7,03,000
	September	6,00,000	7,030	13,10,030
	October	5,00,000	13,100	18,23,130
	November	4,00,000	18,231	22,41,361
	December	3,00,000	22,414	25,63,775
		25,00,000	63,775	

[Interest to be capitalised @ 12% p.a. i.e. 1% p.m.]

∴ The value of the qualifying asset is ₹ 25,63,775.

Illustration 8.

On 20.4.2012, M Ltd obtained a loan from the bank for ₹ 50 lakhs to be utilised as:

Particulars	₹ (in lakhs)
Construction of a shed	20
Purchase of Machinery	15
Working Capital	10
Advance for purchase of Truck	5

In March 2013, construction of shed was completed and machinery installed. Delivery of truck was not received. Total interest charged by the bank for the year ending 31.3.2013 was ₹ 9 lakhs.

Show the treatment of interest under AS 16.

Solution:

As per AS 16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying assets should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard. Other borrowing cost should be recognised as an expense in the periods in which they are incurred.

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. As per AS 16, if an asset is ready for its intended use or sale at the time of acquisition, the same cannot be treated as a qualifying asset.

Treatment of Interest

Items	Nature of Asset	Interest to be capitalized ₹ (in lakhs)	Interest to be charged to P&L A/c ₹ (in lakhs)
Constructions of a shed	Qualifying Asset	$₹3.60\left(\frac{₹20}{₹50} \times ₹9\right)$	---
Purchase of a Machinery	Not a qualifying Asset	---	$₹2.70\left(\frac{₹15}{₹50} \times ₹9\right)$
Working Capital	Not a qualifying Asset	—	$₹1.80\left(\frac{₹10}{₹50} \times ₹9\right)$
Advance in purchase of Truck	Not a qualifying Asset	—	$₹0.90\left(\frac{₹5}{₹50} \times ₹9\right)$
		₹ 3.60 lakhs	₹ 5.40 lakhs

Illustration 9.

M Ltd. has obtained an institutional loan of ₹ 680 lakhs for modernisation and renovation of its Plant and Machinery. Plant and Machinery acquired under the Modernisation Scheme and installation completed on 31.3.2013 amounted to ₹520 lakhs. ₹30 lakhs has been advanced to suppliers for additional assets and the balance loan of ₹130 lakhs has been utilised for Working Capital purpose. The total interest paid for the above loan amounted to ₹ 68 lakhs during 2012-2013.

You are required to state how the interest on the institutional loan is to be accounted for in the year 2012-2013.

Solution:

Interest on borrowed Capital which are used for the purpose of acquisition/construction of fixed asset during the period up to the completion stage or acquisition should be added to the gross book value of the concerned fixed assets. As such, the institution loan amounting to ₹ 520 lakhs together with interest of ₹ 52 lakhs (shown below) should be added to the gross book value of the fixed asset.

But, advance to supplier for additional assets amounting to ₹ 30 lakhs together with interest of ₹ 3 lakhs (shown below) may be treated as capital work-in-progress and the same should be capitalised at a subsequent date.

Similarly, loan taken for working capital purpose amounting to ₹ 130 lakhs and interest on it of ₹ 13 lakhs (shown below) should be charged against current year's Profit and Loss Account.

Thus, the whole matter stands as:

Items	Percentage of Term Loans to Total	Amount ₹	Amount of Interest ₹
Acquisition of Plant & Machinery	76.47%	520	52
Advance to Suppliers	4.41%	30	3
Working Capital Loan	19.12%	130	13
	100.00%	680	68

Illustration 10.

The Notes to account of M Ltd. for the year 2012-2013, include:

"Interest on bridge loan from banks and financial institutions and on debentures specially obtained for the company's fertiliser project amounting to ₹1,80,80,000 has been capitalised during the year, which include approximately ₹1,70,33,465 capitalised in respect of the utilisation of loan and debenture money for the said purpose".

Ascertain the amount of revenue expenditure.

Solution:

As per para 6, AS 16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Statement. Other borrowing costs should be recognised as an expense in the period in which they are issued.

In the present case, however, M Ltd. incurred ₹ 1,80,80,000 on account of interest of which ₹ 1,70,33,465 is directly attributable to the construction of the project. As per AS 16, the said amount should be capitalised and the balance ₹ 10,46,535 (i.e. ₹ 1,80,80,000 - ₹ 1,70,33,465), is treated as expense, i.e. revenue in nature, and, as such, the same should be adjusted against the Profit and Loss Statement.

Illustration 11.

G Ltd. purchased machinery from P Ltd. on 30.9.2012. The price was ₹ 370.44 lakhs after charging 8% sales-tax and giving a trade discount of 2% on the Quoted price. Transport charges were 0.25% on the quoted price and installation charges came to 1% on the quoted price.

A loan of ₹ 300 lakhs was taken from the bank on which interest at 15% p.a. was to be paid. Expenditure incurred on the trial run was materials ₹ 35,000, wages ₹ 25,000 and overhead ₹ 15,000. Machinery was ready for use on 1.12.2012. However, it was actually put to use only on 1.05.2013.

Find out the cost of the machine and suggest the accounting treatment for the expenses incurred in the interval between the dates 1.12.2012 and 1.5.2013. The entire loan amount remain unpaid on 1.05.2013.

Solution:

As per para 6, AS 16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as all expense in the period in which they are incurred.

The total cost of the machine is calculated as:

Cost of the Machine

Particulars	₹ (in lakhs)
Quoted Price $₹370.44 \times \left(\frac{100}{108} \times \frac{100}{98}\right) =$	350.000
(Since the price was given after charging sales tax and trade discount) Less: Trade Discount @ 2% on ₹ 350 lakhs	7.000
	343.000
Add: Sales-Tax @ 8% on ₹ 3,43,000 lakhs	27.440
	370.440
Add: Transportation cost @ 0.25% on ₹ 350 lakhs	0.875
Add: Installation Charges @ 1% on ₹ 350 lakhs	371.315

	3.500
Add: Expenditure to be incurred for Trial run	374.815
Materials 0.350	
Wages 0.250	
Overheads 0.150	0.750
Add: Cost of borrowing @ 15% on ₹ 300 lakhs (from 30.9.2012 to 1.12.2012)	7.500
Cost of the machine	383.065

As per para 19 and para 20, of AS 16, capitalisations of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Similarly, an asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. Hence, capitalisation of borrowing cost @ 15% on ₹ 300 lakhs for 5 months amounting to ₹ 18.75 lakhs should be treated as an expense and, as such, should be adjusted against Profit and Loss Statement.

INDIAN ACCOUNTING STANDARD (IND AS 23) — BORROWING COSTS

Objectives

Borrowing costs or finance costs are the costs which are incurred in connection with borrowing of funds. Entities borrow funds for short- and long term purposes. There are various costs incurred in connection with such borrowings, such as processing fees, interest costs, prepayment charges, stamp duty etc. Ind AS 23 prescribes accounting for such borrowing costs.

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense.

Scope

- An entity shall apply this Standard in accounting for borrowing costs.
- The Standard does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability.
- An entity is not required to apply the Standard to borrowing costs directly attributable to the acquisition, construction or production of:

(a) a qualifying asset measured at fair value, for example, a biological asset within the scope of Ind AS 41 Agriculture; or
(b) inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis.

Definitions

Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds. It may include the following:

(a) Interest expense calculated using the effective interest method under Ind AS 109;
(b) Finance charges in respect of finance lease recognized under Ind AS 17; and
(c) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.
Depending on the circumstances, any of the following may be qualifying assets:
(a) inventories
(b) manufacturing plants
(c) power generation facilities
(d) intangible assets
(e) investment properties
(f) bearer plants.

Examples that are not qualifying assets:

(a) Finance assets;
(b) Inventories that are manufactured, or otherwise produced, over a short period of time;
(c) Assets that are ready for their intended use or sale when acquired.

Recognition

An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.

Borrowing costs eligible for capitalization

A. Specific Borrowings

When an entity borrows funds specifically for the purpose of obtaining a qualifying asset, then the amount of borrowing costs eligible for capitalization is the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

B. General Borrowings

When an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, then the amount of borrowing costs eligible for capitalisation is by applying a capitalisation rate to the expenditures on that asset.

The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period , other than borrowings made specifically for the purpose of obtaining a qualifying asset.

The amount of borrowing costs that an entity capitalises during a period should not exceed the amount of borrowing costs it incurred during that period.

When the carrying amount of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down.

Comparison between Ind AS 23 and AS 16

	Ind AS - 23	**AS – 16**
1.	There is a relaxation to the entity to avoid application of the following – borrowing cost directly attributable to the acquisition, construction or production of a qualifying asset measured at fair value and inventories that are manufactured, or otherwise produced in large quantities on a repetitive basis.	There is no such relaxation. It is applicable to all inventories that require substantial period of time to bring them in saleable condition.
2.	There is no explanation of the meaning of 'Substantial Period of Time' in relation to qualifying asset.	There is an explanation of the meaning of 'Substantial Period of Time' in relation to qualifying asset.
3.	Interest expense is calculated using the effective interest rate method as described in Ind AS 39	As per this AS, Borrowing cost includes – (a) Interest and commitment charges on bank borrowings and other short-term and long-term borrowings; (b) Amortisation of discounts or premiums relating to borrowings; (c) Amortisation of ancillary costs incurred in connection with the arrangement of borrowings.
4.	Appropriateness is provided for inclusion of all borrowings of the parent and its subsidiaries at the time of computations of weighted average	There is no such provision.

	borrowing cost and for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowing in other circumstances	
5.	There is a disclosure requirement for the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.	There is no such disclosure requirement.

5.6 AS 17: SEGMENT REPORTING

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 is 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.

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.

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.

Illustration 12.

Following details are given for Lily Ltd. for the year ended 31st March,2014: (₹ in lakh)

Particulars	Amount (₹)	Amount (₹)
Sales:		
Sports accessories	11,300	
Packaging Materials	1,250	
Health and Fitness Equipments	690	
Others	324	13,564
Expenses:		
Sports accessories	6,670	
Packaging Materials	850	
Health and Fitness Equipments	444	
Others	400	8,364
Other Items:		
General Corporate Expenses		1,124
Income from investments		264
Interest Expenses		130
Identifiable Assets:		
Sports accessories	14,640	
Packaging Materials	2,640	
Health and Fitness Equipments	2,100	
Others	1,330	20,710
General Corporate Assets:		1,444
Other Information:		
(a) Inter-segment sales are as below:		
Sports accessories		110
Packaging Materials		144
Health and Fitness Equipments		42
Others		14
(b) Operating profit includes ₹66 lakhs on inter-segment sales.		
(c) Information about inter-segment expenses are not available.		

You are required to prepare a statement showing financial information about Lily Ltd.'s operations in different industry segments.

Solution:

Information about Lily Ltd. operations in different industry segments in furnished in the following statement:

(₹ in lakh)

Particulars	Sports accessories ₹	Packaging Materials ₹	Health and Fitness Equipments ₹	Others ₹	Inter-segment Elimination ₹	Consolidated ₹
External Sales	11,190	1,106	624	310	-	13,254
Inter-segment	110	144	42	14	310	-
Total	11,300	1,250	690	324	310	13,254
Segment Expenses	6,670	850	444	400	244	8,120
Operating Profit	4,630	400	246	(76)	66	5,134
General Corporate Expenses						(1,124)
Income from Investments						264
Interest						(130)
Income from continuing operations						4,144
Identifiable assets	14,640	2,640	2,100	1,330		20,710
Corporate Assets	-	-	-	-	-	1,444
Total Assets						22,154

Illustration 13.

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 Loss	40	(60)	90	10	(30)	140 (90)
4. % of segment Result, absolute amount of profit/loss 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	

INDIAN ACCOUNTING STANDARD (IND AS) 108 — OPERATING SEGMENTS

Objectives

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

(a) This Accounting Standard shall apply to companies to which Indian Accounting Standards (Ind ASs) notified under the Companies Act apply.

(b) If an entity that is not required to apply this Ind AS chooses to disclose information about segments that does not comply with this Ind AS, it shall not describe the information as segment information.

(c) If a financial report contains both the consolidated financial statements of a parent that is within the scope of this Ind AS 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:

I. 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),
II. whose operating results are regularly reviewed by the entity's chief operating decision maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance, and
III. for which discrete financial information is available.

Important Points:

I. An operating segment may engage in business activities for which it has yet to earn revenues.
II. Not every part of an entity is necessarily an operating segment or part of an operating segment.
III. For the purposes of this Ind AS, an entity's post-employment benefit plans are not operating segments.
IV. The term 'chief operating decision maker' identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the performance of the operating segments of an entity. Often the chief operating decision maker of an entity is its chief executive officer or chief operating officer but, for example, it may be a group of executive directors or others.
V. Generally, an operating segment which is also identified as a function has a segment manager who is directly accountable to and maintains regular contact with the CODM;
VI. At times, managers are held responsible for two or more overlapping sets of components/segments referred to as a matrix form of organization with different geographical and product/services. Entity shall determine which set of components constitutes the operating segments by reference to the core principle mentioned earlier.

Reportable Segments

An entity shall report separately information about each operating segment that:
(a) has been identified in accordance with the core principle mentioned earlier;
(b) exceeds the quantitative thresholds.

Aggregation criteria

Operating segments having similar economic characteristics may be aggregated into a single operating segment if aggregation is consistent with the core principle of this Ind AS, the segment has similar economic characteristics, and the segments are similar in each of the following respects:

(a) the nature of the products and services;
(b) the nature of the production processes;

(c) the type or class of customer for their products and services;
(d) the methods used to distribute their products or provide their services; and
(e) if applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

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 both sales to external customers and intersegment sales or transfers, is 10 per cent 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 per cent 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 segments that reported a loss.
(c) Its assets are 10 per cent 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.
Operating segments that do not meet any of the quantitative thresholds may be combined to produce a reportable segment only if the operating segments have similar economic characteristics and share a majority of the aggregation criteria listed earlier.
If management judges that an operating segment that was reportable in the preceding period is of continuing significance, then it should continue to be reported in the current period even if it no longer meets the criteria.
Prior period presents for comparative purpose shall be rested to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the criteria for deportability in the prior period.
If the number of segments that are reportable increases above 10, the entity should consider whether a particular limit has been reached.

Comparison between Ind AS 108 and AS 17

	Ind AS - 108	AS – 17
1.	Identification of segments is based on 'management approach' i.e. identified based on the internal reports regularly reviewed by the entity's chief operating decision maker.	Identification of two sets segments – one based on related products and services,

5.7 AS 18: ACCOUNTING STANDARD RELATED PARTY DISCLOSURES

Objectives

Generally business transactions between related parties lose the feature and character of the arms length transactions. Related party relationship affects the volume and decision of business of one enterprise for the benefit of the other enterprise one. Hence, it is necessary to disclose the related transaction for proper understanding of financial performance and financial position of an enterprise.

Related Party

A related party is essentially any party that controls or can significantly influence the management or operating policies of the company during the reporting period.

AS-18, deals only with the following relationships:

- Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with the reporting enterprise;
- Associates and joint ventures of the reporting enterprise and the investing party or venture in respect of which the reporting enterprise is an associate or a joint venture;
- Individuals owing, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise and relatives of any such indi-

vidual.

Here "relative" means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by that individual in his/her dealings with the reporting enterprise.

- Key management personnel and relatives of such personnel are those persons who have authority and responsibility for planning, directing and controlling the activities of the reporting enterprise; and enterprise over which individual or key management personnel described as above is able to exercise significant influence.

Disclosure

According to this accounting standard, following facts should be disclosed:

♦ Related party relationship
♦ Transactions between a reporting enterprise and its related parties.

Classification

The concept and definition of related parties is based on the following basis :

Control concept - One party has the ability to control the other party in following ways —

- Control by ownership (directly or indirectly) more than 50% of voting power of an enterprise.
- Control over composition of board of directors or other governing body.
- Control of substantial interest in the voting power and power to direct the financial or operating policies of the enterprise - for example associate and joint venture companies.

Significant influence - It can be exercised in many ways —

- By representation of the Board of directors
- Participation in policy-making process
- Material inter-company transactions
- Inter-change of managerial personnel
- Dependence on technical information

Exceptions

- Two companies have a director in common but director is not able to influence the mutual dealing between the companies.
- A single customer or supplier or franchiser or distributor or general agent with whom enterprise's transactions are in significant volume.
- Providers of finance.
- Trade union.
- Government departments and agencies.
- State controlled enterprises as regards related party relationship with other State controlled enterprises.

Related party transactions means a transfer of resource or obligations between related parties regardless of whether or not a price is charged.

Example:

♦ Purchase or sales of goods (finished or unfinished)
♦ Purchase or sales of fixed assets
♦ Rendering or receiving of services
♦ Leasing or hire purchase or licence arrangements
♦ Transfer of research and development
♦ Finance (including loan and equity contributions)
♦ Guarantees and collaterals
♦ Management contracts including for deputation of employees.

Disclosure

For the purpose of disclosure related parties relationship can be categorized as under:
When the existence of relationship is due to the concept of the control -even when there are no transactions between the related parties, still the following disclosure is needed :

- ♦ Name of the related party should be disclosed and
- ♦ Nature of the related party relationship should be disclosed.

Accordingly, by virtue of the above quoted paragraph of AS-18 also, the company would not be required to make any disclosures in its financial statements as regards related relationships and transactions with IDBI, which is also a 'state-controlled enterprise'.

Illustration 14.

Ankur Limited has two associates, Bankur Limited and Chakor Limited, and owns 25% of voting power of Bankur Limited and 30% of voting power of Chakor Limited. Would Bankur Limited is considered a related party in the financial statements of Chakor Limited?

Solution:

Both Bankur Limited and Chakor Limited are associates of Aankur Limited. Co-associates cannot be regarded as related parties only by virtue of this relationship. As per AS-18 "associates and joint ventures of the reporting enterprise and the investing party or venture in respect of which the reporting enterprise is an associate or a joint venture" are related parties. As Bankur Limited is not an associate of Chakor Limited nor is it being controlled, directly or indirectly, by Chakor Limited or is not so controlling Chakor Limited, it is not a related party of Chakor Limited.

Illuatrstion 15.

Please identify the related parties in respect of all the enterprises mentioned under AS-18, if —
Momo Limited holds 51% of Yummy Limited
Yummy Limited holds 51% of Top Limited
Tasty Limited holds 49% of Top Limited

Solution:

Momo Limited, Yummy Limited and Top Limited are related to each other. Tasty Limited and Top Limited are also related to each other by virtue of associate relationship. However, neither Momo nor Yummy Limited is related to Tasty Limited and vice versa.

Illustration 16.

State whether remuneration paid to Key Management Personnel or Non-Executive Directors or Board of Directors, a related party transaction or not?

Solution:

Key Management Personnel are related parties under AS-18. Hence, remuneration paid to Key Management Personnel will be a related party transaction requiring disclosure under AS-18.
Non-Executive Directors or the board of directors are not related parties as per Accounting Standard Interpretation (ASI) 21. Hence, remuneration paid to them will not be considered a related party transaction.

INDIAN ACCOUNTING STANDARD (IND AS) 24 — RELATED PARTY DISCLOSURES

Objective

The objective of this Standard is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties.

Scope

This Standard shall be applied in:

(a) identifying related party relationships and transactions;
(b) identifying outstanding balances, including commitments, between an entity and its related parties;
(c) identifying the circumstances in which disclosure of the items in (a) and (b) is required; and
(d) determining the disclosures to be made about those items.

This Standard requires disclosure of related party relationships, transactions and outstanding balances, including commitments, in the consolidated and separate financial statements of a parent or investors with joint control of, or significant influence over, an investee presented in accordance with Ind AS 110, Consolidated Financial Statements, or Ind AS 27, Separate Financial Statements. This Standard also applies to individual financial statements.

Intragroup related party transactions and outstanding balances are eliminated, except for those between an investment entity and its subsidiaries measured at fair value through profit or loss, in the preparation of consolidated financial statements of the group.
Related party disclosure requirements as laid down in this Standard do not apply in circumstances where providing such disclosures would conflict with the reporting entity's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority.

Purpose of related party disclosures

Related party relationships are a normal feature of commerce and business. Entities frequently carry on parts of their activities through subsidiaries, joint ventures and associates, thus, the entity has the ability to affect the financial and operating policies and profit or loss of the investee through the presence of control, joint control or significant influence.

They may enter into transactions that unrelated parties would not. Also, transactions between related parties may not be made at the same amounts as between unrelated parties.

The profit or loss and financial position of an entity may be affected by a related party relationship even if related party transactions do not occur. Mere existence of the relationship may be sufficient to affect the transactions of the entity with other parties.

For these reasons, knowledge of an entity's transactions, outstanding balances, including commitments, and relationships with related parties may affect assessments of its operations by users of financial statements, including assessments of the risks and opportunities facing the entity.

Definitions

A **related party** is a person or entity that is related to the reporting entity.

(a) A person or a close member of that person's family is related to a reporting entity if that person:
  (i) has control or joint control of the reporting entity;
  (ii) has significant influence over the reporting entity; or
  (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

(b) An entity is related to a reporting entity if any of the following conditions applies:
  (i) The entity and the reporting entity are members of the same group.
  (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
  (iii) Both entities are joint ventures of the same third party.
  (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
  (v) The entity is a post-employment benefit plan.
  (vi) The entity is controlled or jointly controlled by a person identified in (a).
  (vii) A person identified in (a)(i) has significant influence.
  (viii) The entity or any group member provides key management personnel services.

In considering each possible related party relationship, attention is directed to the substance of the relationship and not merely the legal form.

Government-related entities

A reporting entity is exempt from the disclosure requirements in relation to related party transactions and outstanding balances, including commitments, with:

(a) a government that has control or joint control of, or significant influence over, the reporting entity; and
(b) another entity that is a related party because the same government has control or joint control of, or significant influence over, both the reporting entity and the other entity.

	Ind AS - 24	AS - 18
1.	A related party in relation to the reporting enterprise is a person or entity that is related and includes: • A person or close member of that person's family if that person has control, joint control, significant influence over the reporting enterprises or is a member of Key Management Personnel of their reporting enterprises or of a parent of the reporting enterprises; • Parent, subsidiary, joint venture, associates of the reporting enterprise.	Parties are related if at any time during the reporting period, one party controls or exercises significant influence over the other party in taking financial and/or operating decisions.
2.	Close members of the person are the persons defined as 'relative' under the Companies Act, 2013 and that person's domestic partner, person's or spouse's children and dependants of the person or spouse.	Only relatives are defined and close member has not been mentioned in the AS.
3.	Related party includes post-employment benefit plans for the benefit of employees of the reporting entity or any entity that is a related party of the reporting entity.	Post-Employment benefit plans are not considered as related party.
4.	If an entity has transactions with the related party during the reporting period, the reporting entity has to disclose the transactions value and the outstanding balance with the related party including commitments.	If an entity has transactions with the related party during the reporting period, the reporting entity has to disclose the transactions value [or appropriate proportions] and the outstanding balance [or appropriate proportions] with the related party.
5.	Key Management Personnel compensation is disclosed in total and aggregate for a) Short-term employee benefits; b) Post-employment benefits; c) Other long-term benefits; d) Terminating benefits and e) Share based payments.	Total compensation of Key Management Personnel is disclosed in aggregate except in cases where separate disclosure is more appropriate

5.8 AS 19: ACCOUNTING FOR 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

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 17:

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.

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 18:

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 19:

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 lessee.

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

Dr. **Cr.**

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)

Dr. **Cr.**

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 20:

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 21:

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 To, Bank A/c	 Dr.	 44,000	 44,000
	Payment of first Year's Lease: Bank A/c To, Lease Rent A/c	 Dr.	 22,000	 22,000
	Depreciation for First Year: Depreciation A/c To, Computer A/c	 Dr.	 17,600	 1 7,600

	Transfer to Profit & Loss Account: Profit & Loss A/c Dr. To, Depreciation A/c Lease Rent A/c Dr. To, Profit & Loss A/c	17,600 22,000	 17,600 22,000
2nd	**Payment of Second Year's Lease:** Bank A/c Dr. To, Lease Rent A/c	13,640	 13,640
	Depreciation for Second Year: Depreciation A/c Dr. To, Computer A/c	10,560	 10,560
	Transfer to Profit & Loss Account: Profit & Loss A/c Dr. To, Depreciation A/c Lease Rent A/c Dr. To, Profit & Loss A/c	10,560 13,640	 10,560 13,640
3rd	**Payment of Third Year's Lease:** Bank A/c Dr. To, Lease Rent A/c	6,820	 6,820
	Depreciation for Third Year: Depreciation A/c Dr. To, Computer A/c	6,336	 6,336
	Transfer to Profit & Loss Account: Profit & Loss A/c Dr. To, Depreciation A/c Lease Rent A/c Dr. To, Profit & Loss A/c	6,336 6,820	 6,336 6,820
4th	**Payment of Fourth Year's Lease:** Bank A/c Dr. To, Lease Rent A/c	3,410	 3,410
	Depreciation for Fourth Year: Depreciation A/c Dr. To, Computer A/c	3,802	 3,802
	Transfer to Profit & Loss Account: Profit & Loss A/c Dr. To, Depreciation A/c Lease Rent A/c Dr. To, Profit & Loss A/c	3,802 3,410	 3,802 3,410
	Sale of Lease assets: Bank A/c Dr. Loss on Sale A/c Dr. To, Computer A/c	3,000 2,702	 5,702

INDIAN ACCOUNTING STANDARD (IND AS) 17 — LEASES

Objective

The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosure to apply in relation to leases.

Scope

This Standard shall be applied in accounting for all leases other than:

(a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and
(b) licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

However, this Standard shall not be applied as the basis of measurement for:

(a) property held by lessees that is accounted for as investment property (see Ind AS 40, Investment Property);
(b) investment property provided by lessors under operating leases (see Ind AS 40, Investment Property);
(c) biological assets within the scope of Ind AS 41 Agriculture held by lessees under finance leases; or
(d) biological assets within the scope of Ind AS 41 provided by lessors under operating leases.

This Standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets.
This Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

Definitions

A **lease** is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

A **finance** lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

An **operating lease** is a lease other than a finance lease.

A **non-cancellable lease** is a lease that is cancellable only:

(a) upon the occurrence of some remote contingency;
(b) with the permission of the lessor;
(c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or
(d) upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is reasonably certain.

The **lease term** is the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

(a) for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or
(b) for a lessor, any residual value guaranteed to the lessor by:
  (i) the lessee;
  (ii) a party related to the lessee; or
  (iii) a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

Economic life is either:

(a) the period over which an asset is expected to be economically usable by one or more users; or
(b) the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life is the estimated remaining period, from the commencement of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity.

Guaranteed residual value is:

(a) for a lessee, that part of the residual value that is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and

(b) for a lessor, that part of the residual value that is guaranteed by the lessee or by a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

Unguaranteed residual value is that portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Initial direct costs are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors.

Gross investment in the lease is the aggregate of:

(a) the minimum lease payments receivable by the lessor under a finance lease, and
(b) any unguaranteed residual value accruing to the lessor.

Net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease.

Unearned finance income is the difference between:

(a) the gross investment in the lease, and
(b) the net investment in the lease.

The **interest rate implicit** in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor.

The **lessee's incremental borrowing rate of interest** is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (e.g. percentage of future sales, amount of future use, future price indices, future market rates of interest).

Classification of leases

The classification of leases adopted in this Standard is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

Because the transaction between a lessor and a lessee is based on a lease agreement between them, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the lessor and lessee may result in the same lease being classified differently by them.

	Ind AS - 17	AS – 19
1.	In this case lease is recognized as operating of finance lease as per the definition and classification criteria , As per this standard land has an indefinite economic life period.	Land is recorded and classified as fixed one.
2.	Incentaives of operating lease is to be recognized both by the lessor and the lessee as a reduction of rental income and expenditure over the lease	There are no such matters.

	term, it is to be recognized on a straight-line basis unless another basis is more representative of the time pattern	
2.	In case of Finance leases the initial direct costs are : • To be included in measurement of finance lease receivable and the amount of income is reduced • It is to be recognized over the lease term • Initial lease costs recognized by manufacturer or dealer lessors are to be recognized as expenditure when profit on sales is recognised	As per this standard Finance leases related initial direct costs are recognized • immediately in the statement of profit and loss or allocated against the finance income over the lease term • to the manufacturers or dealer lessores it is an expenditure at the inception .
3.	In case of Operating leases the initial direct costs are : • To be added to the carrying amount of the asset and recognized as expenditure over the lease term on the basis as in case of lease income	• As per this standard Operating leases related initial direct costs are deferred and allocated to the income over the lease term in the proportion of lease income • Or it is recognized as expenditure in the statement of P& L in the period of incurrence
4.	Arrangements which do not take any legal form but fulfillment of which is dependent on the use of any specific asset and it convey the right to use the assets - is to be accounted for as a lease	There is no such guideline Payment under any such arrangements are to be recognized in accordance with the nature of expenditure incurred

SELF EXAMINATION QUESTIONS:

1. **Fill in the blanks:**
   (i) _____________ costs are interest and other costs that an entity incurs in connection with the borrowing of funds.
   (ii) ___________ currency is a currency other than the functional currency of the entity.
   (iii) Any assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity is known as ___________ __________.
   (iv) ___________ __________ are all forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment.
   (v) Segment result is _________ _________ less segment expense.

Answer:

(i) Borrowing;
(ii) Foreign;
(iii) Government Grant;
(iv) Employee Benefits;
(v) Segment Revenue.

STUDY NOTE: 6
AUDITING CONCEPTS

THIS STUDY NOTE INCLUDES:

6.1 NATURE, SCOPE AND SIGNIFICANCE OF AUDITING

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 "Timor 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.

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.

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.

The Essential Features of Auditing

The essential features of auditing are enumerated below;

(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.

6.1.1 NATURE OF AUDITING

Auditing has generally been associated with only accounting and financial records. Thus, IAASB defines the term 'audit' as "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 (C.A) 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.

6.1.2 SCOPE OF AUDITING

Development in the last two decades has 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. Furthermore, much of the evidence available to the auditor can enable him to draw only reasonable conclusion there from. 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.

RELATIONSHIP AND DISTINCTION BETWEEN ACCOUNTING & AUDITING

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 the client

Accounting and Auditing are related. Auditing begins where Accounting ends, but they are distinct from each other. The basic distinction between Accounting and Auditing is enumerated bellow;

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 his 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 w orks fo r/ under t he 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.
ix. Accounting is done as per the principles set by Indian Accounting standards	Auditing is done as per the principal set in standards an auditing.

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 (CA) an auditor must possess the integrity and be objective and independent in his approach to the audit work.

(iii) 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 (CA) 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.

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:

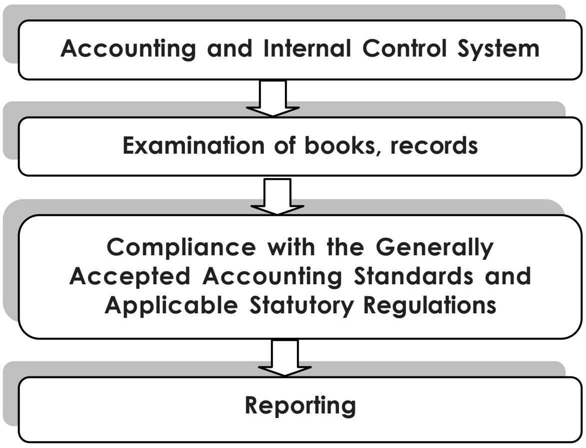
	BASIS	AUDIT	INVESTIGATION
i.	**Meaning**	Auditing is an independent and systematic examination of the evidence underlying the accounting or other data in accordance with the generally accepted auditing practices to ascertain the true and fair view of the financial statements of an enterprise.	An investigation 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.	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 principle.	Investigations involve an extended auditing procedure.
v.	**Evidence**	An auditor will evaluate the accounting records predominantly based on persuasive evidence.	An investigator can draw his conclusions only on the basis of substantial or sometimes conclusive evidence.
vi.	**Approach**	Auditor is sceptical 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).	Investigation may spread over a gap period longer than one year.

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 INDIAN Accounting standards, guidance notes issued by ICAI (CA) 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. Made there under.

(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.

OBJECTIVES OF AUDITING

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:

Objective of Auditing

Primary Objective   Secondary Objective

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.

BASIC PRINCIPLES GOVERNING AN AUDIT

SA 200 issued by ICAI (CA) 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. He should maintain impartiality and be free of any interest.

(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. Working paper which is maintained is to demonstrate that the audit is in adherence to the basic principles.

(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.

6.1.3 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 Indian 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:

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.

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.

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.

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.

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 (CA). 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 (CA). 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 (CA), 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.

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 (CA) 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 judgment, 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.

FUNCTIONAL CLASSIFICATION OF AUDIT – COMPARISON BETWEEN 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.

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

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.

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 the 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 ₹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.

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 (ICAI-CA) 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 its inventory on FIFO basis. The same basis of valuation is adopted in subsequent year also as per the Principle of consistency.

(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 when 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 which are enunciated below;

(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.

Ind 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 enumerated below;

(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.

Types of Audit

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 global business environment.

CLASSIFICATION OF VARIOUS TYPE OF AUDIT

(i) Organisational Structure

(a) Voluntary Audit/ Private 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.

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.

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 funds 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

ADVANTAGES OF AUDITING FOR PARTNERSHIP FIRMS & OTHERS

The added advantages besides other advantages are enumerated below;
(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 to get the underlying befits.

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.

STATUTORY AUDIT

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 (CAG) of India 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 IRDAI/RBI (Insurance regulatory & Development Authority of India & Reserve Bank of India) guidelines. Co-operative banks are also governed by the Co-operative Societies Act, 1912.

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.

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.

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.

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 adhered.

(xv) For settlement of insurance claims or other recoveries from government bodies or otherwise.

GOVERMENT AUDIT

Meaning: United Nations (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."

Authorization: The Comptroller & Auditor General (CAG) of India is the Supreme Audit Institution.

Types of Government Audit

(a) Transaction audit
  i. Expenditure Audit
  ii. Receipts Audit

(b) Efficiency cum Performance Audit

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.

DIFFERENCE BETWEEN PRIVATE (VOLUNTARY) AUDIT AND STATUTORY (MANDATORY) AUDIT

SL NO.	Basis	Private audit	Statutory audit
i.	**Appointing Authority**	Discretionary for the management.	Mandatory and prescribed by different statute/ laws.
	Object	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.
ii.	**Approach**	Proprietary oriented approach.	Compliance oriented approach.
iii.	**Scope**	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.
iv.	**Report**	Report is to be given to the management within the stipulated time as mutually decided. However there is no specific format for report.	Report is to be given to the shareholder or owner within the stipulated time as stated by the statue as per the format prescribe by the Law.

DIFFERENCE BETWEEN STATUTORY AUDIT AND GOVERNMENT AUDIT

SL No.	Basic	Statutory Audit	Government Audit
i.	**Applicability**	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.	**Appointing Authority**	(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 c o r p o r ation : as per the provisions of the special statute for that corporation. (c) In case of government company: Company Law Board, on the ad- vice of the Comptroller and Auditor General.
iii.	**Report**	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.

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.

INTERNAL AUDIT

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".

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.

FORENSIC AUDIT

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.

The Companies (Auditors' Report) Order, 2016, 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.

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.

SOCIAL AUDIT

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.

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.

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.

ENVIRONMENTAL AUDIT

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."

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.

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.

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:

i. Identify and control the environmental impact of its activities, products or services.
ii. Improve its environmental performance continually.
iii. Implement a systematic approach to setting environmental objectives and targets, to achieving

these and to demonstrating that they have been achieved.

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.

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.

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.

PROPRIETY AUDIT

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.

It is an essential element of a Government Audit. The Comptroller and Auditor General (CAG) 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.
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.

OPERATIONAL AUDIT

Operational Audit involves examination of all the operations and activities of the entity under audit.

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.

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.

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.

CONTINUOUS AUDIT

Definition: According to the 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. It becomes an integral part of modern auditing at 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.

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 enable it.
v. It provides advance notice about errors and irregularities detected.
vi. Surprise visits by the auditor are involved.

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.

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. Guidance: 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.

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 inconvenient at work.
iii. The client may suffer due to the clash of duties between his staff and that of the auditor clash of work.
iv. It is more expensive because the auditor has to devote more time to this audit expensive /Luxury
v. The work of audit becomes too mechanical and repetitive repetitive work.

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."

FINAL AUDIT

Meaning: Annual Audit is conducted at the end of the accounting year, after the books of accounts have been closed.

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.

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.

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.

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.

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.

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.

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.

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.

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.

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 brokerage. Also see that the provisions of section 40 have not been contravened.
iii. V ouch 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.

Self Examination questions

1. Define the term Auditing? State the benefits that accrue out of Auditing?
2. Briefly state the scope of Auditing and various aspects covered in Audit.
3. Distinguish between the following:
   a. Audit and Investigation
   b. Accounting and Auditing
   c. Book keeping, Accounting and Auditing
4. What are the various principles governing an Audit?
5. Write short note on the concept of Materiality in Audit.
6. "Accounting is a necessity but Auditing is a Luxury-Comment.
7. Critically comment on "True and Fair Report of the Auditor on the Financial Statements, ensures the future viability of the enterprise".
8. Differentiate between External and Internal Audit.
9. What are the qualities of Auditors?
10. What are the advantages accrue out of audit in a Sole proprietorship and partnership firm?
11. Differentiate between Private and statutory audit.
12. Distinguish between the following;
    a. Statutory Audit and Government audit
    b. Company and firm
    c. Statutory audit and Internal audit
    d. Statutory audit and forensic audit
13. Write a short note on the followings;
    a. Social audit
    b. Environmental audit
    c. Continuous audit
    d. Proprietary audit
    e. Interim audit
    f. Balance sheet audit
    g. Statutory Report
    h. Concurrent Audit

State whether the following statements are true or false.

1. For the benefit of the organisation, quality auditing should only report non-conformances and corrective actions, but should not highlight areas of good practice.
2. An auditor is not insurer.
3. There is no difference between Statutory and external audit.
4. The time required and costs involved in an external audit are much higher as compared to internal audits.
5. The auditor examines in depth the implementation of the quality system.
6. An investigation is done with the generally accepted auditing procedure.
7. The primary objective of the audit is for detecting frauds and error in the books of accounts and financial records of the clients business.
8. Auditor has right to disclose the client information to a third party.
9. The concept of true or fair is a fundamental concept in auditing.

[**Answer**: F, T, F, T, F, F, F, F, F,]

Fill in the blanks

1. Audit is derived from _______________.
2. Auditing is the examination of _________ of business.
3. Auditing is done with the principal set in ___________________.
4. An in depth examination to detect a suspected fraud is termed as ______________.
5. An audit in which auditor review the performance of entity is termed as _____________.
6. An audit in which the auditor reviews the adherence of policy made by the management is _______________.
7. ________________ audit is conducted at the end of the accounting year.
8. ________________ audit is conducted between two annual audits.

[**Answer:** Audire, Books of Account, Standards on Auditing, Investigation, Operational Audit, Internal Audit, Annual Audit, Interim Audit.]

Match the following

	Column A		Column B
1	Statutory Audit	**A**	Comptroller & Auditor General of India
2	Functional classification of Audit.	**B**	Audit against provision of funds
3	Tax Audit limit for a person carrying on profession.	**C**	Basic principal governing an audit
4	Primary objective of business	**D**	Tax Audit
5	The authority for Government Audit.	**E**	Final Audit
6	Scope of work	**F**	Determine whether financial statement presents true and fair view.
7	SA 200	**G**	Audit Engagement
8	Tax Audit limit for a company	**H**	External and Internal Audit
9	To ensure that the expenditure is made according to limit.	**I**	Twenty five Lakh rupees
10	Annual Audit	**J**	Hundred Lakh rupees

[Answer: D, H, I, F, A, G, C,J, B, E]

Multiple choice questions

1. Various types of quality audits are;
   A. Product
   B. Process
   C. Management (system)
   D. Registration (certification)
   E. All of above
2. When the auditor is an employee of the organization being audited (auditee), the audit is classified as a........ Quality audit.
   A) Internal
   B) External
   C) Compliance
   D) Both A & B
3. The most comprehensive type of audit is the .... system audit, which examines suitability and effectiveness of the system as a whole.
   A) Quantity
   B) Quality
   C) Preliminary
   D) Sequential
4. Each of the three parties involved in an audit .... plays a role that contributes to its success.
   A) the client, the auditor, and the auditeer
   B) the client, the auditor, and the audite
   C) the client, the moderator, and the auditee
   D) the client, the auditor, and the auditee

5. An audit is usually conducted in three steps:
   (1) A pre-examination or opening meeting with the auditee marks the beginning of the process.
   (2) involves a suitability audit of the documented procedures against the selected reference standard.
   (3) the auditor examines in depth the implementation of the quality system.
      A) True
      B) False
6. Audit is a fact-finding process that compares actual results with.....................
   A) Specified standards and plans
   B) Expected results
   C) Premature results
   D) Preliminary results
7. The .... is also expected to provide the resources needed and select staff members to accompany the auditors.
   A) Auditor
   B) Client
   C) Internal auditor
   D) Auditee

[Answer: E, A, B, D, A, A, D,]

6.2 AUDIT ENGAGEMENT, AUDIT PROGRAM, AUDIT WORKING PAPERS, AUDIT NOTE BOOK, AUDIT EVIDENCE AND AUDIT REPORT

6.2.1AUDIT ENGAGEMENT

An audit engagement refers to an audit that an auditor performs. More specifically, it refers only to the initial stage of an audit during which the auditor notifies the client he has accepted the audit work and clarifies his understanding of the audit's purpose and scope.

The engagement letter is one firm's contract with your client. It is the starting point, and oftentimes the ending point, for the relationship. Most Chartered Accountants firms receive a signed engagement letter and file it away.

The Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India is issuing the following illustrative formats for engagement letter for audit of Financial Statements under the Companies Act, 2013 and the Rules there under.

Illustrative formats – 1

Example of an Audit Engagement Letter

Audit of Financial Statements under the companies Act 2013 and the Rules Thereunder

(When Reporting u/s 143(3) (i) is Applicable)

Part A: Audit of Financial Statements

To, the Board of Directors of ………………………………… (Name of the Entity)

(Address)

Dear Sirs,

I/We refer to the letter dated……………informing me/us about my /our (re) Appointment/ratification as the auditors of the Company. You have requested that I / we audit the financial statements of the Company as defined in Section 2(40) of the Companies Act, 2013 ('2013 Act'), for the financial year(s) beginning April 1, 20XX and ending March 31, 20YY. The financial statements of the Company include, where applicable, consolidated financial statements of the Company and of all its subsidiaries, associate companies and joint ventures. I am / we are pleased to confirm my/ our acceptance and my / our understanding of this audit engagement by means of this letter.

My / Our audit will be conducted with the objective of me / our expressing an opinion if the aforesaid financial statements give the information required by the 2013 Act in the manner so required, and give a true and fair view in conformity with the applicable accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 20YY, and its profit/loss and its cash flows for the year ended on that date which, inter alia, includes reporting in conjunction whether the Company has an adequate internal financial controls system over financial reporting in place and the operating effectiveness of such controls. In forming my / our opinion on the financial statements, I / we will rely on the work of branch auditors appointed by the Company and my / our report would expressly state the fact of such reliance.

I / We will conduct my / our audit in accordance with the Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI) and deemed to be prescribed by the Central Government in accordance with Section 143(10) of the 2013 Act. Those Standards require that I / we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements. An audit involves performing procedures to obtain audit evidence about the amounts and the disclosures in the financial statements. 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 financial control relevant to the Company's preparation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances.

The terms of reference for my / our audit of internal financial controls over financial reporting carried out in conjunction with our audit of the Company's financial statements will be as stated in the separate engagement letter for conducting such audit and should be read in conjunction with this letter.

An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of accounting estimates made by the Management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, including the possibility of collusion or improper management override of controls, there is an unavoidable risk that material misstatements due to fraud or error may occur and not be detected, even though the audit is properly planned and performed in accordance with the SAs. Also, projections of any evaluation of the internal financial controls over financial reporting to future periods are subject to the risk that the internal financial control over financial reporting may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

My / Our audit will be conducted on the basis that the Management and those charged with governance (Audit Committee / Board) acknowledge and understand that they have the responsibility:

(a) For the preparation of financial statements that give a true and fair view in accordance with the applicable Financial Reporting Standards and other generally accepted accounting principles in India. This includes:

- Compliance with the applicable provisions of the 2013 Act;
- Proper maintenance of accounts and other matters connected therewith;
- The responsibility for the preparation of the financial statements on a going concern basis;
- The preparation of the annual accounts in accordance with, the applicable accounting standards and providing proper explanation relating to any material departures from those accounting standards;
- Selection of accounting policies and applying them consistently and making judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the Company at the end of the financial year and of the profit and loss of the Company for that period;
- Taking proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding the assets of the Company and for preventing and detecting fraud and other irregularities;
- Laying down internal financial controls to be followed by the Company and that such internal financial controls are adequate and were operating effectively; and

- Devising proper systems to ensure compliance with the provisions of all applicable laws and those systems were adequate and operating effectively.

(b) Identifying and informing me / us of financial transactions or matters that may have any adverse effect on the functioning of the Company.

(c) Identifying and informing me / us of:

- All the pending litigations and confirming that the impact of the pending litigations on the Company's financial position has been disclosed in its financial statements;
- All material foreseeable losses, if any, on long term contracts including derivative contracts and the accrual for such losses as required under any law or accounting standards; and
- Any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company.

(d) Informing me / us of facts that may affect the financial statements, of which Management may become aware during the period from the date of my / our report to the date the financial statements are issued.

(e) Identifying and informing me / us as to whether any director is disqualified as on March 31, 20YY from being appointed as a director in terms of Section 164 (2) of the 2013 Act. This should be supported by written representations received from the directors as on March 31, 20YY and taken on record by the Board of Directors.

(f) To provide me / us, inter alia, with:

(i) Access, at all times, to all information, including the books, accounts, vouchers and other records and documentation of the Company, whether kept at the Head Office or elsewhere, of which the Management is aware that are relevant to the preparation of the financial statements such as records, documentation and other matters. This will include books of account maintained in electronic mode;

(ii) Access, at all times, to the records of all the subsidiaries (including associate companies and joint ventures as per Explanation to Section 129(3) of the 2013 Act) of the Company in so far as it relates to the consolidation of its financial statements, as envisaged in the 2013 Act;

(iii) Access to reports, if any, relating to internal reporting on frauds (e.g., vigil mechanism reports etc.), including those submitted by cost accountant or company secretary in practice to the extent it relates to their reporting on frauds in accordance with the requirements of Section 143(12) of the 2013 Act;

(iv) Additional information that I / we may request from the Management for the purposes of my / our audit;

(v) Unrestricted access to persons within the Company from whom I / we deem it necessary to obtain audit evidence. This includes my / our entitlement to require from the officers of the Company such information and explanations as I / we may think necessary for the performance of my / our duties as the auditors of the Company; and

(vi) All the required support to discharge my / our duties as the statutory auditors as stipulated under the Companies Act, 2013/ ICAI standards on auditing and applicable guidance.

As part of my / our audit process, I / we will request from the Management written confirmation concerning representations made to me / us in connection with my / our audit.

My / Our report prepared in accordance with relevant provisions of the 2013 Act would be addressed to the shareholders of the Company for adoption of the accounts at the Annual General Meeting. In respect of other services, my / our report would be addressed to the Board of Directors. The form and content of my / our report may need to be amended in the light of my / our audit findings.

In accordance with the requirements of Section 143(12) of the 2013 Act, if in the course of performance of my / our duties as auditor, I / we have reason to believe that an offence involving fraud is being or has been committed against the Company by officers or employees of the Company, I / we will be required to report to the Central Government, in accordance with the rules prescribed in this regard which, inter alia, requires me / us to forward my / our report to the Board or Audit Committee, as the case may be, seeking their reply or observations, to enable me / us to forward the same to the Central Government.

As stated above, given that I am / we are required as per Section 143(12) of the Act to report on frauds, such reporting will be made in good faith and, therefore, cannot be considered as breach of maintenance of client confidentiality requirements or be subject to any suit, prosecution or other legal proceeding since it is done in pursuance of the 2013 Act or of any rules or orders made thereunder.

I / We also wish to invite your attention to the fact that our audit process is subject to 'peer review' / 'quality review' under the Chartered Accountants Act, 1949. The reviewer(s) may inspect, examine or take abstract of my / our working papers during the course of the peer review/quality review.

I / We may involve specialists and staff from our affiliated network firms to perform certain specific audit procedures during the course of my / our audit.

In terms of Standard on Auditing 720 - "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements" issued by the ICAI and deemed to be prescribed by the Central Government in accordance with Section 143(10) of the 2013 Act , I / we request you to provide to me / us a Draft of the Annual Report containing the audited financial statements so as to enable me / us to read the same and communicate material inconsistencies, if any, with the audited financial statements, before issuing the auditor's report on the financial statements.

{Other relevant Information}

{Insert Other information, such as fee arrangements, billings and other specific terms, as appropriate.}

This letter should be read in conjunction with my / our letter dated _ _ for the Audit of Internal Financial Controls Over Financial Reporting under the 2013 Act, in respect of which separate fees have been fixed/will be mutually agreed.

I / We look forward to full cooperation from your staff during my / our audit.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for my / our audit of the financial statements including our respective responsibilities.
Yours faithfully,

(Signature)
(Name of the Member)
(Designation)
(Name of the Firm)

Date:

Place:

Copy to: Chairman, Audit Committee

Acknowledged on behalf of «Name of the entity»

Name and Designation:

Date:

Example of an Audit Engagement Letter

Audit of Financial Statements When Reporting u/s 143 (3)(i) is Applicable

Part B: Audit of Internal Financial Controls over Financial Reporting

(Refer Illustrative Format Provided in Appendix 1 of the
Guidance Note on Audit of Internal Financial Controls Over Financial Reporting)

Illustrative format – 2

Example of an Audit Engagement Letter

Audit of Financial Statements under the Companies Act 2013 and the Rules Thereunder

(When Reporting u/s 143(3)(i) of the Companies Act, 2013 is Not Applicable)

To,
The Board of Directors of……………………….(name of the Entity)
(Address)

Dear Sirs,

I / We refer to the letter dated ________________ informing m e / u s about my / our (re) appointment /ratification as the auditors of the Company. You have requested that I / we audit the financial statements of the Company as defined in Section 2(40) of the Companies Act, 2013 ('2013 Act'), for the financial year(s) beginning April 1, 20XX and ending March 31, 20YY. The financial statements of the Company include, where applicable, consolidated financial statements of the Company and of all its subsidiaries, associate companies and joint ventures. I am / We are pleased to confirm my / our acceptance and my / our understanding of this audit engagement by means of this letter.

My / Our audit will be conducted with the objective of me / our expressing an opinion if the aforesaid financial statements give the information required by the 2013 Act in the manner so required, and give a true and fair view in conformity with the applicable accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 20YY, and its profit/loss and its cash flows for the year ended on that date. In forming my / our opinion on the financial statements, I / we will rely on the work of branch auditors appointed by the Company and my / our report would expressly state the fact of such reliance.

I / We will conduct my / our audit in accordance with the Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI) and deemed to be prescribed by the Central Government in accordance with Section 143(10) of the 2013 Act. Those Standards require that I / we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements. An audit involves performing procedures to obtain audit evidence about the amounts and the disclosures in the financial statements. 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.

An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of accounting estimates made by the Management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, including the possibility of collusion or improper management override of controls, there is an unavoidable risk that material misstatements due to fraud or error may occur and not be detected, even though the audit is properly planned and performed in accordance with the SAs.

In making our risk assessments, we consider 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. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

My / Our audit will be conducted on the basis that the Management and those charged with governance (Audit Committee / Board) acknowledge and understand that they have the responsibility:

(a) For the preparation of financial statements that give a true and fair view in accordance with the applicable Financial Reporting Standards and other generally accepted accounting principles in India. This includes:
    - Compliance with the applicable provisions of the 2013 Act;
    - Proper maintenance of accounts and other matters connected therewith;
    - The responsibility for the preparation of the financial statements on a going concern basis;
    - The preparation of the annual accounts in accordance with, the applicable accounting standards and providing proper explanation relating to any material departures from those accounting standards;
    - Selection of accounting policies and applying them consistently and making judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the Company at the end of the financial year and of the profit and loss of the Company for that period;
    - Taking proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding the assets of the Company and for preventing and detecting fraud and other irregularities;
    - Laying down internal financial controls to be followed by the Company and that such internal financial controls are adequate and were operating effectively; and

- Devising proper systems to ensure compliance with the provisions of all applicable laws and those systems were adequate and operating effectively.

(b) Identifying and informing me / us of financial transactions or matters that may have any adverse effect on the functioning of the Company.

(c) Identifying and informing me / us of :
- All the pending litigations and confirming that the impact of the pending litigations on the Company's financial position has been disclosed in its financial statements;
- All material foreseeable losses, if any, on long term contracts including derivative contracts and the accrual for such losses as required under any law or accounting standards; and
- Any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company.

(d) Informing me / us of facts that may affect the financial statements, of which Management may become aware during the period from the date of my / our report to the date the financial statements are issued.

(e) Identifying and informing me / us as to whether any director is disqualified as on March 31, 20YY from being appointed as a director in terms of Section 164 (2) of the 2013 Act. This should be supported by written representations received from the directors as on March 31, 20YY and taken on record by the Board of Directors.

(f) To provide me / us, inter alia, with:

(i) Access, at all times, to all information, including the books, accounts, vouchers and other records and documentation of the Company, whether kept at the Head Office or elsewhere, of which the Management is aware that are relevant to the preparation of the financial statements such as records, documentation and other matters. This will include books of account maintained in electronic mode;

(ii) Access, at all times, to the records of all the subsidiaries (including associate companies and joint ventures as per Explanation to Section 129(3) of the 2013 Act) of the Company in so far as it relates to the consolidation of its financial statements, as envisaged in the 2013 Act;

(iii) Access to reports, if any, relating to internal reporting on frauds (e.g., vigil mechanism reports etc.), including those submitted by cost accountant or company secretary in practice to the extent it relates to their reporting on frauds in accordance with the requirements of Section 143(12) of the 2013 Act;

(iv) Additional information that I / we may request from the Management for the purposes of my / our audit;

(v) Unrestricted access to persons within the Company from whom I / we deem it necessary to obtain audit evidence. This includes my / our entitlement to require from the officers of the Company such information and explanations as I / we may think necessary for the performance of my / our duties as the auditors of the Company; and

(vi) All the required support to discharge my / our duties as the statutory auditors as stipulated under the Companies Act, 2013/ ICAI standards on auditing and applicable guidance.

As part of my / our audit process, I / we will request from the Management written confirmation concerning representations made to me / us in connection with my / our audit.

My / Our report prepared in accordance with relevant provisions of the 2013 Act would be addressed to the shareholders of the Company for adoption of the accounts at the Annual General Meeting. In respect of other services, my / our report would be addressed to the Board of Directors. The form and content of my / our report may need to be amended in the light of my / our audit findings.

In accordance with the provisions of Section 143(12) and 143(13) of the 2013 Act, if in the course of performance of my / our duties as auditor, I / we have reason to believe that an offence involving fraud is being or has been committed against the Company by officers or employees of the Company, I / we will be required to report to the Central Government, in accordance with the rules prescribed in this regard which, inter alia, requires me / us to forward my / our report to the Board or Audit Committee, as the case may be, seeking their reply or observations, to enable me / us to forward the same to the Central Government. Such reporting will be made in good faith and, therefore, cannot be considered as breach of maintenance of client confidentiality requirements or be subject to any suit, prosecution or other legal proceeding since it is done in pursuance of the 2013 Act or of any rules or orders made thereunder.

I / We also wish to invite your attention to the fact that my / our audit process is subject to 'peer review' / 'quality review' under the Chartered Accountants Act, 1949. The reviewer(s) may inspect, examine or take abstract of my / our working papers during the course of the peer review/quality review.

I / We may involve specialists and staff from my / our affiliated network firms to perform certain specific audit procedures during the course of my / our audit.

In terms of Standard on Auditing 720 - "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements" issued by the ICAI and deemed to be prescribed by the Central Government in accordance with Section 143(10) of the 2013 Act, I / we request you to provide to me / us a Draft of the Annual Report containing the audited financial statements so as to enable me / us to read the same and communicate material inconsistencies, if any, with the audited financial statements, before issuing the auditor's report on the financial statements.

{Other relevant information}

{Insert other information, such as fee arrangements, billings and other specific terms, as appropriate.}

I / We look forward to full cooperation from your staff during my / our audit.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for my / our audit of the financial statements including our respective responsibilities.

Yours faithfully,

(Signature)

(Name of the Member)

(Designation)

(Name of the Firm)

Date:

Place:

Copy to: Chairman, Audit Committee

Acknowledged on behalf of < < Name of the entity >>

Name and Designation: ____________________

Date:

6.2.2 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

The main advantages of an audit programme are enumerated below;

(i) It serves as a ready check list of audit procedures to be performed.
(ii) The audit work can be properly allocated to the audit assistants or the article clerks.
(iii) 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.
(iv) 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.
(v) A uniformity of the work can be attained as the same programme would be followed from time to time.
(vi) It is a useful basis for planning the programme for the following year it is useful in selection of team members & delegation of responsibilities to them.
(vii) It may be used as evidence by the auditor in the event when any charge is brought against him.
(viii) It is useful in selection of Team members and delegation of responsibilities to them.

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 enumerated below;

(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.

6.2.3 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 (CA) deals with the 'working papers'. As per this Standards on Audit, 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. Memorandum of Association and Article of Association 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.

6.2.4 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.

Contents of Audit Note Book

i. Name of the business enterprise.

ii. Organisation structure.

iii. Important provisions of Memorandum of Association (MOA) and Articles of Association (AOA).

iv. Communication with the previous auditor, if any.

v. Management representations and instructions.

vi. List of books of accounts maintained by the enterprise.

vii. Accounting methods, internal control systems followed by the enterprise, applicable laws etc.

viii. Key management personnel.

ix. Errors and fraud discovered.

x. Matters requiring explanations or clarifications.

xi. Special points that need attention in the audit report.

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.

"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.

i. **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.
ii. **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
iii. **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

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.

6.2.5 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.

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.

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.

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.

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 impliedly 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 (Computer Assisted Audit Technique) such as a generalized audit software or an embedded audit module.

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.

6.2.6 AUDIT REPORT

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

Lancaster – "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.

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.

The Basic Elements of the Auditors' Report are -

i. Title: The Auditor's Report should have an appropriate title i.e. "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.

Self Examination Questions

1. Pankaj & Associates a C hartered Accountant firm in Kolkata has been appointed by XYZ Company limited for conducting an audit. Draw an audit engagement letter that needs to be furnished by XYZ Company limited for effecting this engagement.
2. What do you mean by audit programme? Discuss the advantages accrue to the auditor by preparing the audit programme.
3. Discuss the disadvantages of Audit programme and means to overcome such disadvantages.
4. Critically examine that "Audit working papers are the property of the Auditor".
5. Distinguish between Permanent & Current Audit file.
6. Discuss the contents of Audit note book.
7. What do you mean by Audit Evidence? List down the need for Audit Evidence.
8. Discuss the basic elements of the Auditor's Report.

State whether the following statements are true or false.

1. An Audit report is the end product of the auditing.

2. An audit engagement is the initial stage of a audit during which the auditor notifies the client that he has accepted the audit work.
3. An audit programme is a detailed plan of the auditing.
4. An Audit note book is a bound book in which a large variety of matters observed during the course of audit are recorded.
5. An Audit note book does not contain details about the name of key management personnel.
6. As per ICAI (C.A) auditor need to retain the working papers for a period of 5 yrs.
7. An audit work reflects the work done by the management.
8. An audit report should have a proper title.
9. In an audit report the Membership number of the Chartered Accountants is irrelevant.
10. Is reporting in Audit report should comply with the requirements as made by statues.

[Answer: T, T, T, T, F, F, F, T, F, T]

Fill in the blanks

1. An Audit report reflects the work done by the ____________________.
2. Audit programme act as a __________ of audit procedures to be performed.
3. The reliability of audit evidence depends on its source _________ or ___________.
4. An audit report is the _____________ product of every audit.
5. Audit report reflects the real position of the _________________of the company.
6. Audit working papers are the record of the ___________ and execution of the audit engagement.
7. An audit note book act as a _______________ tool available as a defence with the auditors in the event of any charges is brought against him.

[**Answer:** Auditor, Check list, Internal or External, Final, Financial Status, Planning, Evidential]

Match the following

	Column A		Column B
1	SA 210	**A**	Audit Note Book
2	SA 230	**B**	Audit Sampling
3	Detailed of audit work to be performed	**C**	Opinion on Financial Statement
4	Copies of Management letters	**D**	Audit Working Papers
5	Analysis of significant ratios & trends	**E**	Audit Planning
6	SA 530	**F**	Current Audit File
7	Detail about the name and organisation structure.	**G**	Permanent Audit File
8	Property of Auditor	**H**	Audit Programme
9	SA 300	**I**	Agreeing the terms of Audit Engagements
10	Objective of an audit	**J**	Audit Documentation

[Answer: I, J, H, F, G, B, A, D, E, C]

Multiple choice questions

1. CAATS stands for-
   A. Cornwall Air Ambulance Trust
   B. Children Air Ambulance Trust
   C. Center for alternatives to Animal Testing
   D. Computer Assisted Auditing Technique

2. Chartered Accountants have to retain the working papers for-
   A. 2 yrs
   B. 3 yrs.
   C. 5 yrs.
   D. 7 yrs.

3. SA 210 stands for-
   A. Quality control for an audit of financial Statements
   B. Agreeing the terms of Audit engagements.

C. Audit Documentation
D. Responsibility of Joint Auditor

4. SA 230 stands for-
A. Quality control for an audit of financial Statements
B. Agreeing the terms of Audit engagements.
C. Audit Documentation
D. Responsibility of Joint Auditor

5. SA 530 stands for-
A. Quality control for an audit of financial Statements
B. Agreeing the terms of Audit engagements.
C. Audit Documentation
D. Audit Sampling

6. SA 300 stands for
A. Audit Planning'
B. Audit Sampling
C. Audit Documentation
D. None of these

7. Permanent Audit file contains –
A. Copies of management letters
B. Audit Programme
C. Analysis of transaction and balances
D. Analysis of significant ratios and trends

8. Current Audit file contains-
A. AOA and MOA of the company
B. Analysis of significant ratios and trends
C. Notes regarding significant accounting policies
D. Audit programme.

9. Objective of an Audit is to formulate an overall opinion on
A. Cost Statement
B. Financial Statement
C. Books of Accounts
D. None of these

[Answer: D, D, B, C, D, A, D, D, B,]

6.3 INTERNAL CHECK, INTERNAL CONTROL, INTERNAL AUDIT – INDUSTRY SPECIFIC

6.3.1 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 customer. The cashier makes the payment to the cashier. The cashier makes the payment against the token and records it in the cash register.

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 thorough 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 judgment.

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 stimulation to thinking along recognized channels.

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.

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 (BOD)?
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?

DIFFERENCE BETWEEN A CHECKLIST AND 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	It is issued to various people at dif- ferent

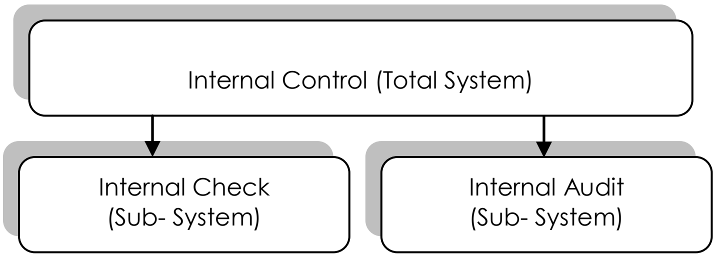
		followed by them during audit and reported back at completion.	levels in the organization.
iii.	**Contents**	It contains instructions to be followed by audit assistants.	It contains questions to be answered by the employees of the organization.
iv.	**Objective**	It works as a guideline for audit staff so that no are mains unchecked	This is used to collect the information to know about the internal control system and to evaluate the weaknesses therein.

DISTINCTION BETWEEN INTERNAL AUDIT, INTERNAL CONTROL AND INTERNAL CHECK

Internal Audit: It is a continuous critical review of financial and operating activities by a staff member of the auditor.

Internal Control: 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.

Internal Check: 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.



S No.	Basis	Internal Audit	Internal Control	Internal Check
i.	**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
ii.	**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
iii.	**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.
iv.	**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.
v.	**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.
vi.	**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.

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.

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 of the Indian Accounting Standards and the relevant Statute.

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.

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.

6.3.2 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 (information Technology) 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.

Essentials of an Internal Control System

An efficient internal control system should provide the followings;

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 of accounts and safeguard all business assets.
v. Proper internal checks
vi. Proper internal audit system.

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 enumerated below:

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 that was governing an 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.

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: A good internal control system errors the protection of organisation resources from misappropriation and do safeguard from any irregularities.

Employees' satisfaction: It protects the interests of employees by segregation of duties and delegation of responsibilities.

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:

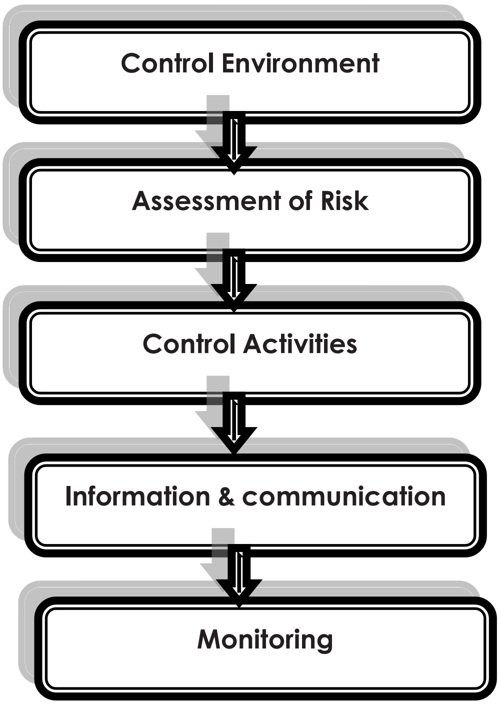
- Reviews of Performance: Management compares information about current performance to budgets, forecasts, prior periods, or other benchmarks to measure the extent to which goals and objectives are being achieved and to identify unexpected results or unusual conditions that require follow-up.
- Reconciliations: 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.

Steps in Internal Control

An effective internal control system consists of certain important steps:

(i) **Control Environment:** Establish Integrity & ethical value.
(ii) **Assessment of Risk:** Establishment of plan to prevent risks.
(iii) **Control Activities:** Formulating policies & procedures.
(iv) **Information & communication:** Evaluation of employee performance.
(v) **Monitoring:** Assessing overall performance of the Organisation.



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 on "Communicating deficiencies in internal control to those charged with Governance and Management" 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".

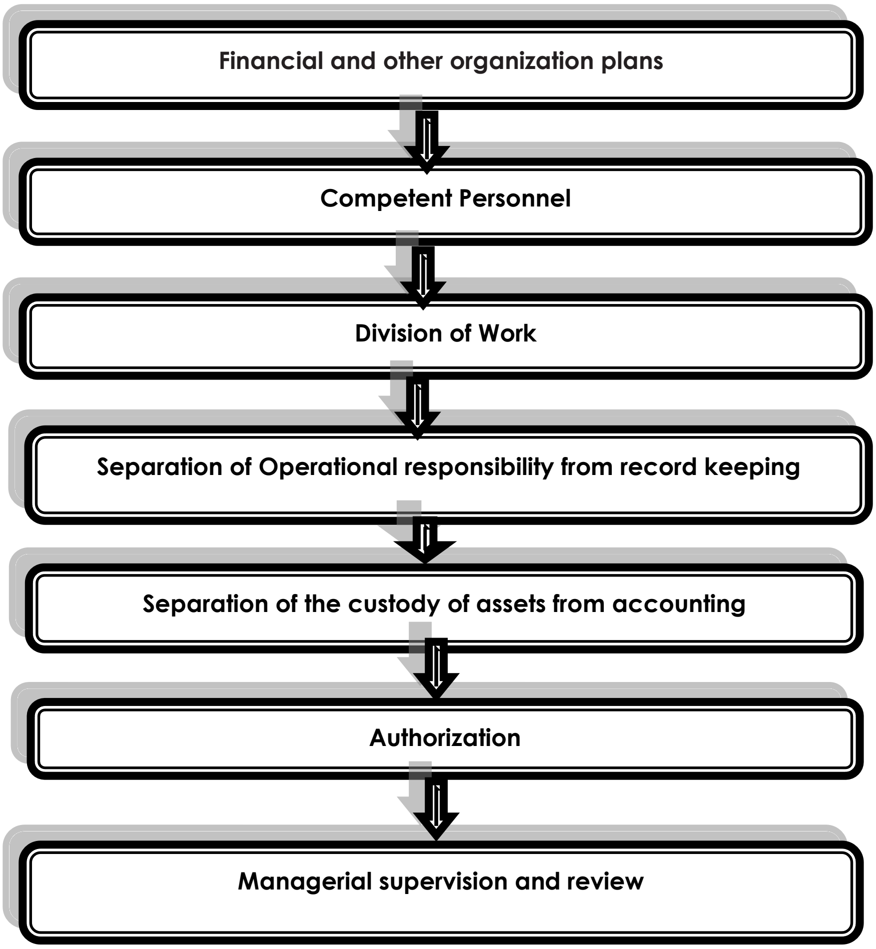
(ii) Scope: SA 265 defines 'accounting system' as "series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records". The system of internal control "extends beyond those matters which relate directly to the functions of the accounting system" and 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.

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.

Important of Int ernal Controls: The various benefits accrue out of the Internal control system are enumerated below;

i) **Attainment of goal & Objectives**: - A sound internal control helps the entity towards the attainment of goal & objective of the business.

ii) **Reliable financial Information**: A sound internal control helps the organization to set reliable financial information for managerial decision making.

iii) **Compliance with law & Regulations**: Sound Internal control system ensures various compliance with laws & regulation prevailing in the country

iv) **Efficient & Effect ive operation: -** A sound internal control system ensures efficient and effective operations that accomplish the goals of the organizations and protect employees and assets of the business.

v) **Prevention of fra ud & errors:** - A sound internal control system prevents and detects frauds and errors and ensures timely preparations of financial statements and various reports for decision making.

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:** Due to misunderstanding of the concept of internal control human errors may occur while carrying out Internal Control System.

ix. **Frequent follow-up measures:** Follow-up procedures need to be frequent to ensure its effectiveness, which is extremely time-consuming.

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".

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:

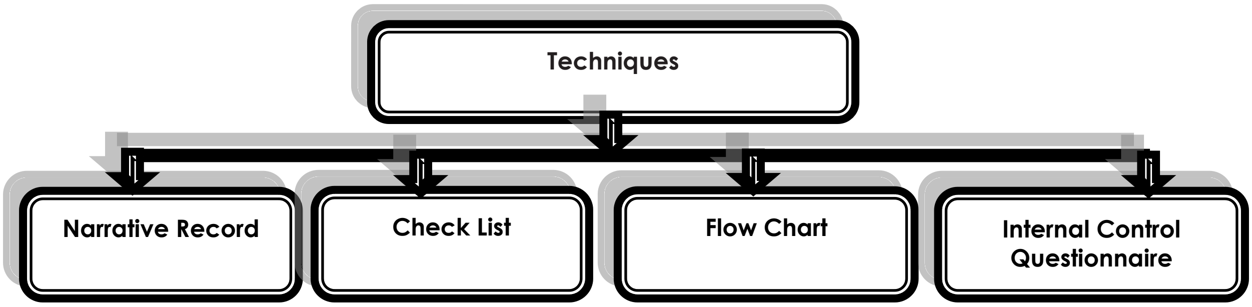
These tests deal with checking the compliance of the procedures laid down by the management in respect of transactional flow at each stage. They provide reasonable assurance about the proper implementation and effectiveness of internal controls.

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.

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''.

6.3.3 INTERNAL AUDIT - INDUSTRY SPECIFIC

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.

Features of Internal Audit

i. 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 reasonable cost.

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:
   i. That its policies are fulfilled.
   ii. 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.
   iii. That the organisation's assets are safeguarded.
   iv. That the internal control system is well designed.
   v. 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:
   i. Being concerned with the implementation of social responsibility policies adopted by top management.
   ii. Being concerned with the response of the internal control system to errors and required changes to prevent errors.
   iii. 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.
   iv. Acting as a training officer in internal control matters.
   v. Auditing the information given to management particularly interim accounts and management accounting reports.
   vi. Taking a share of the external auditor's responsibility in relation to the figures in the annual accounts and
   vii. Being concerned with the compliance with external regulations such as those on the environment, financial services, related parties etc.

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:

i. Review the reliability and integrity of financial and operating information and the means to locate, identify measure, classify and report such information.
ii. Appraise the economy and efficiency with which resources are employed.
iii. 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.
iv. Review the means of safeguarding assets and as appropriate verify the existence of such assets.
v. 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.
vi. 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.

Need of Internal Audit

The need for internal audit has becoming in demand due to the enunciated 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, 2016.
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.

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.

Difference between Internal Audit and Operational Audit:

SL. NO	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

6.3.4 VOUCHING & VERIFICATION

Voucher- meaning

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.

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.

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"

TEEMING & LADING/ LAPPING

Teeming & Lading 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 lading 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 lading:

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.

AUDIT OF RECEIPTS

(1) Cash sales

i. Ensure that the entity internal control is in place over receipt from sales. Examine authorisation level for making cash sales and receiving the amount.
ii. Examine few bills in order to check the accuracy of rate, amount, discount and tax computations.
iii. Examine the cash sales summary book if the volume of cash sales is voluminous .
iv. Cash sales need t
v. o be verified with carbon copy of cash memos.

vi. Examine with the entry made in cash book with reference to date on memos.
vii. Examine the system followed by the entity to deposit the cash sales in bank account. It needs to be verified with the bank statement.
viii. Examine the cancelled cash memos with its original copy to prevent misappropriation.

(2) Sale of Assets

i. Ensure that the entity internal control is in place in respect of authorisation for making the sale.
ii. Ensure the means to sale the assets, is it is a direct sale or by means of agent. If it is a direct sale then check the amount collected with reference of copy of receipt issued and if it is by agent then examines terms with them.
iii. Ensure the sale value of assets is reasonable.
iv. Check that the amount of sale proceeds is duly accounted for.
v. The profit or loss arising from the sale of assets is duly reflected in the financial statement.

AUDIT OF EXPENDITURE

(1) Transactions with Directors

i. **Compliance with Sec 188 of C o. Act, 2013:** 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. **Disclosure of int erest by Director:** 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. **Compliance with Sec 197 of Co. Act, 2013:** 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. **Authorization:** The payment for acquisition of assets should be made under proper authorization and be duly supported by receipt for amount paid.
ii. **Ownership:** 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. **Existence:** The auditor should also verify the existence, value and the title of the assets acquired.
iv. **Compliance with Sec 179 of Co. Act, 2013:** In case of a company, ensure that the provisions of section 179 of the Companies Act, 2013 have been complied with.
v. **Capitalization of Assets:** 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.

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.

Self Examination questions

1. What do you mean by Internal check and do discuss the auditor duty in regard to Internal Check System?
2. Distinguish between the followings;
   a. Checklist and Internal Control Questionnaire
   b. Internal Audit, Internal Control and Internal Check
   c. Internal Audit and External Audit
   d. Internal Audit and Operational Audit
   e. Test checking and Statistical Sampling
3. Write a short notes on the followings;
   a. Walk through test
   b. Teaming & Lading
   c. Internal Control and its objective
   d. Cut off Procedures
   e. Missing Voucher
4. Critically comment on "Proving the Truth".

State whether the following statements are true or false.

1. Internal Audit is an Independent Appraisal activity.
2. Internal Check and Internal Audit are one and the same.
3. Internal auditor has a big role to play in preventing fraud.
4. Audit committee is only luxury to the company.
5. Internal Auditing is a function distinct from authorisation and recording.
6. Special consideration is applicable for audit of expenses of a company.
7. Internal auditor of a company cannot be its Cost Auditor.
8. Cut off procedures are generally applied to trading transactions.
9. An unexplained decrease in the Gross Profit ratio may result due to fictitious sales.
10. Proving the truth means vouching of expenses.

[**Answer:** T, F, T, F, T, T, T, T, F, F]

Fill in the blanks

1. Internal Check is a valuable part of the ______________ control.
2. Internal Audit is an Independent __________ activity.
3. Proving the truth means vouching of __________________.
4. Cut off procedures are generally applied to ____________ transactions.
5. Test checking is _______________ and depends upon the choice of the auditor.
6. The Internal Auditor is appointed by the _______________.
7. Concept related to Internal Check is known as _____________.
8. Vouching is said to be the essence of ________________.

[Answer: Internal, Appraisal, Expenses, Trading, Subjective, Management, Organisational Independence, Auditing,]

Match the following

	Column A		Column B
1	GAR 7 challan	**A**	Excise Duty
2	Ind As 37	**B**	Contingent Liability
3	SA 265	**C**	Communication deficiencies in Internal Control to those charged with Governance and Management.
4	Proving the Truth	**D**	Verification
5	Section 138 of the Companies Act	**E**	Intangible Assets

[Answer: A, B, C, D, E]

Multiple choice questions

1. The purpose of internal audit is to protect the
   A. Assets
   B. Audit staff.
   C. Accountant
   D. Management
2. The purpose of Internal audit is to detect the error in the;
   A. Accounting records
   B. Employees records
   C. Cash records
   D. Bank records
3. The purpose of internal audit is to determine liabilities of;
   A. Employer
   B. Employees
   C. Accountant
   D. External auditor
4. The assets protection is possible through
   A. Internal Audit
   B. Internal Control
   C. Internal Check
   D. None of the above
5. The function of internal audit is meant for-
   A. Dearth of Staff
   B. Dearth of time
   C. Dearth of time and funds
   D. Dearth of funds
6. Review of internal control system is very important for the auditor as the effectives of internal control system will determine the extent of checking to be done by the;
   A. Management
   B. Auditor
   C. Accountant
   D. None of the above

7. Proving the truth means vouching of ___________________.
   A. Payment
   B. Expenses
   C. Assets
   D. Liabilities
8. Check list contains the instruction to be followed by the –
   A. Internal Auditor
   B. External Auditor
   C. Audit Assistants
   D. Employee of the organisation
9. Internal Control Questionnaire contains the questions need to be followed by the-
   A. Employer of the organisation
   B. Employee of the organsation
   C. Auditor of the entity
   D. Banker to the organsation

[Answer: A, A, B, A, A, B, B, C, B]

STUDY NOTE 7
PROVISION RELATING TO AUDIT UNDER COMPANIES ACT

THIS STUDY NOTE INCLUDES:

7.1 AUDITOR'S QUALIFICATIONS, DISQUALIFICATIONS, APPOINTMENT, REMUNERATION, REMOVAL, POWERS AND DUTIES

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.

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 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.

General Circular No. 33/2014

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 Companies Act, 2013.

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 Companies Act 2013. 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.

CLASS OF COMPANIES

As per the Companies (Audit and Auditors) Amendment Rules 2015 for the purposes of sub-section (2) of section 139 of Companies Act, 2013, 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.

7.1.1 MANNER OF ROTATION OF AUDITORS BY THE COMPANIES ON EXPIRY OF THEIR TERM

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.

(1) 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.
(2) 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.

7.1.2 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.

7.1.3 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 practicing 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.

7.1.4 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.

7.1.5 POWERS AND DUTIES OF AUDITORS

(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 of Companies Act, 2013, 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) In section 143 of the principal Act, for sub-section (12), the following sub-section shall be substituted, namely:

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 of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees. The auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed:

Provided that in case of a fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed:
Provided further that the companies, whose auditors have reported frauds under this sub-section to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board's report 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.

7.1.6 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.

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.

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.

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.

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.

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.

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.

Audit Committee- Section 177

Constitution of an Audit committee is mandatory for the;

(i) Every listed Company; and

(ii) Such directors or classes of the companies, as may be prescribed.

As per the Rule 6 of the Companies (Meetings of the Board and its Power) Rules, 2014 following class of the companies have been prescribed for this purpose;

(i) All public companies with a paid up share capital ₹ 10 Crore or more;

(ii) All Public Companies having turnover of ₹ 100 Crore or more;

(iii) All Public Companies having in aggregate, outstanding Loans, or borrowings and debentures or deposits exceeding ₹ 50 Crore or more.

An Audit committee shall have minimum 3 Directors majority of them should be Independent Director. Majority of the member of the Audit Committee able to read & understand the financial statement.

Function of Audit Committee: The various Functions of the Audit Committee is enumerated below;

(i) For the appointment and fixation of the remuneration of Auditor.

(ii) Examination of the Financial Statement.

(iii) Scrutiny of Inter Corporate Loans and Investment,

(iv) Valuation of the Assets of the Company,

(v) Evaluation of the internal financial control and risk management system of the entity.

(vi) Evaluation of the use of the funds rose through public offers.

(vii) Evaluation of any related party transaction.

Powers of the Audit Committee: The powers of the Audit Committee are enumerated below;

(i) Audit Committee has the power to call for comments of the Auditor about Internal Control Systems and the scope of the Audit including its observation.

(ii) Before submission of the report to the Board the Audit Committee have the power to review the Financial Statement.

(iii) Power to discuss any issues with the Statutory & Internal Auditor and the Management of the Company in relation to matter contained in the Financial Statement.

Self Examination questions

1. Is an auditor entitled to attend the general meetings? Discuss the rights of an auditor while he is present in general meeting?
2. Discuss the procedure of appointment of the first auditor of a company.
3. State the procedure of for removal of statutory auditor before the expiry of his term.
4. Discuss the provision of section 140 of the companies Act 2013.
5. Who are qualified to act as auditor of the company? Discuss the person who is disqualified to become as an auditor of a company.
6. State the provision relating to audit of branch office of a company in India and Abroad.
7. Discuss the reporting requirement of Frauds by Auditor.
8. List down the certain services which are not to be rendered by the Auditor of the Company.
9. Write short notes on Audit Committee.
10. Why Central Government permission is required, when the auditor is to be removed before the expiry of their term?

State whether the following statements are true or false.

1. In case of Government Company auditor is appointed by the CAG within 182 Days from the commencement of Financial Year.
2. Cooling period of Individual Auditor is 2 consecutive terms of 5 years.
3. The first auditor appointed shall hold office till the conclusion of first AGM.
4. Government Company means a c ompany where 21% of shares are hold by the Central government or State Government or partly by Central Government or State Government.
5. A Body Corporate can become Auditor of the company.
6. The auditor shall have access at all times to the books of account and voucher of the company.
7. An auditor of a company can render Investment Banking Service.
8. The auditor report shall be signed only by the person appointed as an auditor of the company.
9. All notices of the general meeting shall be forwarded to the auditor of the company.
10. An audit committee shall have minimum 5 directors.

[**Answer:** False, False, True, False, False, True, False, True, True, False]

Fill in the blanks

1. An Audit committee shall have ________ directors.
2. Audit committee formation is mandatory for a public company having ________ paid up share capital.
3. Cost Audit is mandatory only when specific order is issued by the _______________.
4. Cost Audit report is submitted to the Central Government within ________ days.
5. First auditor is appointed by the BOD of the company within ____ days.
6. Cost Audit is conducted by the _____________________ in practice.
7. Any fraud to involve an amount of ___________ is to be reported to the Central Government.
8. The auditor shall have a right to be ______________ at Annual General Meetings.
9. Punishment for contravention of section 139 is ______________.
10. Auditor of Government Company is appointed by _________________.

[Answer: 3, 10 Crore or more, Central Government, 30 days, 30 days, Cost Accountants, 1 crore, Heard, 25000, Comptroller and Auditor General of India.]

Match the following

	Column A		**Column B**
1	Maximum term of Firm as Auditor	**A**	2 Consecutive terms of 5 years
2	Minimum fees for contravention of section 139	**B**	BOD
3	Maximum fees for contravention of section	**C**	A company which is a s ubsidiary of

	139		Government Company.
4	Independent Directors	**D**	Section 145 of the Companies Act 2013
5	First auditor appointment is done by	**E**	1 term of 5 years
6	Auditor Remuneration is to be fixed at	**F**	Special Resolution
7	Government Company	**G**	₹ 25,000
8	Maximum term of Individual Auditor	**H**	₹ 500,000
9	Resolution for removal of auditor before expiry of term	**I**	General Meeting
10	Signing of audit report	**J**	Audit Committee

[Answer: E, G, H, J, B, I, C, A, F, D]

Multiple choice questions

1. First auditor of the company is appointed by the BOD within
   A. 15 days
   B. 30 days
   C. 45 days
   D. 60 days
2. Cost Audit is covered under
   A. Section 204
   B. Section 148
   C. Section 139
   D. None of the above
3. Secretarial Audit is covered under section
   A. Section 204
   B. Section 148
   C. Section 139
   D. None of the above
4. Appointment of auditor for government company is done by
   A. BOD
   B. Audit committee
   C. Managing Director
   D. CAG
5. While conducting audit of financial statement auditor need to comply with
   A. Cost Audit Standards
   B. Secretarial standards
   C. Auditing Standards
   D. None of the above

[Answer: B, B, A, D, C]

7.2 COST AUDIT, SECRETARIAL AUDIT

Cost Audit Provision of Section 148 of the Companies Act.

148. (1) Notwithstanding anything contained in this Chapter, the Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, 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:

Provided that the Central Government shall, before issuing such order in respect of any class of companies regulated under a special Act, consult the regulatory body constituted or established under such special Act.

(2) 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 subsection (1) 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.

(3) The audit under sub-section (2) shall be conducted by a Cost Accountant in practice who shall be appointed by the Board on such remuneration as may be determined by the members in such manner as may be prescribed:

Provided that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records:

Provided further that the auditor conducting the cost audit shall comply with the cost auditing standards.

Explanation.—For the purposes of this sub-section, the expression "cost auditing standards" mean such standards as are issued by the Institute of Cost and Works Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government.

(4) An audit conducted under this section shall be in addition to the audit conducted under section 143.

(5) The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company:

Provided that the report on the audit of cost records shall be submitted by the cost accountant in practice to the Board of Directors of the company.

(6) A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared in pursuance of a direction under sub-section (2) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein.

(7) If, after considering the cost audit report referred to under this section and the information and explanation furnished by the company under sub-section (6), the Central Government is of the opinion that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.

(8) If any default is made in complying with the provisions of this section,—

(a) The company and every officer of the company who is in default shall be punishable in the manner as provided in sub-section (1) of section 147;

(b) The cost auditor of the company who is in default shall be punishable in the manner as provided in sub-sections (2) to (4) of section 147.

PROCEDURE FOR COST AUDIT AND APPOINTMENT OF COST AUDITOR (FOR FINANCIAL YEAR COMMENCING ON OR AFTER 1ST APRIL, 2014 ONWARDS)

Pursuant to Companies Act 2013 and in supersession of Cost Accounting Records Rules 2011 and Companies (Cost Audit Report) Rules 2011, the Ministry of Corporate Affairs notified Companies (Cost Records and Audit) Rules 2014 on 30th June 2014 which were amended vide Companies (Cost Records and Audit) Amendment Rules 2014 on 31st December 2014. The mechanism with respect to maintenance of cost records, cost audit and appointment of cost auditors has been changed and shall be in accordance with Companies (Cost Records and Audit) Rules 2014 as amended.

The applicability of maintenance of Cost Records and Cost Audit shall be for those sectors which are mentioned in the Tables 'A' and 'B' to the Companies (Cost Records and Audit) Amendment Rules 2014 dated 31st December 2014 notified by the Government vide GSR 1/2015(E) dated 1st January 2015.

Maintenance of Cost Accounting Records and Cost Audit

The Rules state that cost records are to be maintained in Form CRA-1, which provides principles to be followed for different cost elements. The principles are in sync with the cost accounting standards issued by the Institute of Cost Accountants of India. Since the Rules are principle based, no format has been prescribed for maintenance of cost accounting records like pre-2011 industry specific rules. It is opened for industry to maintain cost accounting records according to its size and nature of business so long as it determines a true and fair view of the cost of production, cost of sales and margin of the products/services.

The cost audit report is required to be in conformity with the "cost auditing standards" as referred to in Section 148 of the Companies Act, 2013.

It may be noted that the Council of the Institute of Cost Accountants of India has made it mandatory for cost accountants in practice to follow and conform to the Cost Accounting Standards issued by it and it is incumbent on the cost auditors to report any deviations from cost accounting standards.

Applicability of Cost Audit

a) The Rules have classified sectors/industries under Regulated and Non-Regulated sectors. The sectors/industries covered under Table A of the Rules are under the Regulated Sector and sectors/industries covered under Table B are under the Non-Regulated Sector.

b) Every company, including foreign companies defined in clause (42) of section 2 of the Act, engaged in the production of the goods or providing services, specified in Tables A and B, having an overall turnover from all its products and services of rupees thirty five crore or more during the immediately preceding financial year, shall be required to maintain cost accounting records.

However, foreign companies having only liaison office in India and engaged in production, import and supply or trading of medical devices listed in Sl. 33 of Table B are exempted. Further, companies which are classified as a micro enterprise or a small enterprise including as per the turnover criteria under sub-section (9) of section 7 of the Micro, Small and Medium Enterprises Development Act, 2006 (27 of 2006) are also excluded from the purview of the Rules.

c) The Rules are effective from April 1, 2014 in respect of certain class of companies and for the others it is effective from April 1, 2015 as detailed below:

Rules Applicable from April 1, 2014 - Regulated Sectors		
SL	**Industry /Sector/ Product/Service**	**CETA Heading**
1.	Telecommunication services made available to users by means of any transmission or reception of signs, signals, writing, images and sounds or intelligence of any nature (other than broadcasting services) and regulated by the Telecom Regulatory Authority of India under the Telecom	Not applicable
	Regulatory Authority of India Act, 1997 (24 of 1997);	
2.	Generation, transmission, distribution and supply of electricity regulated by the relevant regulatory body or authority under the Electricity Act, 2003 (36 of 2003), other than for captive generation (referred to in the Electricity Rules, 2005);	…………
3.	Petroleum products regulated by the Petroleum and Natural Gas Regulatory Board under the Petroleum and Natural Gas Regulatory Board Act, 2006 (19 of 2006);	2709 to 2715;
4.	Drugs and pharmaceuticals	2901 to 2942; 3001 to 3006.
5.	Fertilizers;	3102 to 3105.
6.	Sugar and industrial alcohol;	1701; 1703; 2207

Rules Applicable from April 1, 2014 - Non-Regulated Sectors		
Sl.	**Industry /Sector/ Product/Service**	**CETA Heading**
1.	Machinery and mechanical appliances used in defence, space and atomic energy sectors excluding any ancillary item or items; Explanation. - For the purposes of this sub-clause, any company which is engaged in any item or items supplied exclusively for use under this clause, shall be deemed to be covered under these rules.	8401 to 8402; 8801 to 8805; 8901 to 8908
2.	Turbo jets and turbo propellers;	8411
3.	Arms and ammunitions;	3601 to 3603; 9301 to 9306.
4.	Propellant powders; prepared explosives (other than propellant powders); safety fuses; detonating fuses; percussion or detonating caps; igniters; electric detonators;	3601 to 3603
5.	Radar apparatus, radio navigational aid apparatus and radio remote control apparatus;	8526
6.	Tanks and other armoured fighting vehicles, motorised, whether or not fitted with weapons and parts of such vehicles, that are funded (investment made in the company) to the extent of	8710

	ninety percent or more by the Government or Government agencies;	
7.	Port services of stevedoring, pilotage, hauling, mooring, re-mooring, hooking, measuring, loading and unloading services rendered by a Port in relation to a vessel or goods regulated by the Tariff Authority for Major Ports under section 111 of the Major Port Trusts Act, 1963 (38 of 1963);	Not applicable
8.	Aeronautical services of air traffic management, aircraft operations, ground safety services, ground handling, cargo facilities and supplying fuel rendered by airports and regulated by the Airports Economic Regulatory Authority under the Airports Economic Regulatory Authority of India Act, 2008 (27 of 2008);	Not applicable
9.	Steel;	7201 to 7229; 7301 to 7326
10.	Roads and other infrastructure projects corresponding to para No.(1) (a) as specified in Schedule VI of the Companies Act, 2013;	Not applicable
11.	Rubber and allied products being regulated by the Rubber Board constituted under the Rubber Act, 1947 (XXIV of 1947)	4001 to 4017
12.	Railway or tramway locomotives, rolling stock, railway or tramway fixtures and fittings, mechanical (including electro mechanical) traffic signalling equipment's of all kind;	8601 to 8608.
13.	Cement;	2523; 6811 to 6812
14.	Ores and Mineral Products;	2502 to 2522; 2524 to 2526; 2528 to 2530; 2601 to 2617
15.	Mineral fuels (other than Petroleum), mineral oils etc.;	2701 to 2708
16.	Base metals;	7401 to 7403; 7405 to 7413; 7419; 7501 to 7508; 7601 to 7614; 7801 to 7802; 7804; 7806; 7901 to 7905; 7907; 8001; 8003; 8007; 8101 to 8113.
17.	Inorganic chemicals, organic or inorganic compounds of precious metals, rare-earth metals of radioactive elements or isotopes, and Organic Chemicals;	2801 to 2853; 2901 to 2942; 3801 to 3807; 3402 to 3403; 3809 to 3824.
18.	Jute and Jute Products;	5303, 5310
19.	Edible Oil;	1507 to 1518
20.	Construction Industry as per para No.(5) (a) as specified in Schedule VI of the Companies Act, 2013 (18 of 2013)	Not applicable.
21.	Health services, namely functioning as or running hospitals, diagnostic centres, clinical centres or test laboratories;	Not applicable.
22.	Education services, other than such similar services falling under philanthropy or as part of social spend which do not form part of any business.	Not applicable.
23.	Production, import and supply or trading of following medical devices, namely:	
	Cardiac Stents, Drug Eluting Stents, Catheters, Intra Ocular Lenses, Bone Cements, Heart Valves, Orthopedic Implants, Internal Prosthetic Replacements, Scalp Vein Set, Deep Brain Stimulator, Ventricular peripheral Shod, Spinal Implants, Automatic Impalpable Cardiac Deflobillator, Pacemaker (temporary and permanent), patent ducts arteriosus, atrial septal defect and ventricular sepal defect closure device, Cardiac Re-synchronize Therapy, Urethra Spinicture Devices, Sling male or female, Prostate occlusion device, Urethral Stents	9018 to 9022

Rules Applicable from April 1, 2015 - Non-Regulated Sectors		
Sl.	**Industry /Sector/ Product/Service**	**CETA Heading**
1.	Coffee and tea;	0901 to 0902

2.	Milk powder;	0402
3.	Insecticides;	3808
4.	Plastics and Polymers;	3901 to 3914; 3916 and 3921; 3925
5.	Tyres and Tubes;	4011 to 4013
6.	Paper;	4801 to 4802
7.	Textiles;	5004 to 5007; 5106 to 5113; 5205 to 5212; 5303; 5310; 5401 to 5408; 5501 to 5516
8.	Glass;	7003 to 7008, 7011, 7016
9.	Other machinery;	8403 to 8487
10.	Electricals or electronic machinery;	8501 to 8507; 8511 to 8512; 8514 to 8515; 8517; 8525 to 8536; 8538 to 8547.

7.2.1 APPOINTMENT OF COST AUDITOR

(a) Procedure

The cost auditor is to be appointed by the Board of Directors (BOD) on the recommendation of the Audit Committee, where the company is required to have an Audit Committee. The cost auditor proposed to be appointed is required to give a letter of consent to the Board of Directors. The company shall inform the cost auditor concerned of his or its appointment as such and file a notice of such appointment with the Central Government within a period of thirty days of the Board meeting in which such appointment is made or within a period of one hundred and eighty days of the commencement of the financial year, whichever is earlier, through electronic mode, in form CRA-2 along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014

Any casual vacancy in the office of a cost auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors (BOD) within thirty days of occurrence of such vacancy and the company shall inform the Central Government in Form CRA-2 within thirty days of such appointment of cost auditor.

(b) Who can be appointed cost auditor?

Only a Cost Accountant, as defined under section 2(28) of the Companies Act, 2013, can be appointed as a cost auditor.
Clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 defines "Cost Accountant". It means a Cost Accountant who holds a valid certificate of practice under sub-section (1) of section 6 of the Cost and Works Accountants Act, 1959 and is in whole-time practice. Cost Accountant includes a Firm of Cost Accountants and a LLP of cost accountants.

(c) Eligibility criteria for appointment as a cost auditor

Eligibility Criteria under Section 141 of the Companies Act, 2013 read with Rule 10 of the Companies (Audit and Auditors) Rules, 2014 and Section 148 of the Companies Act, 2013. The following persons are not eligible for appointment as a cost auditor:

a) A body corporate. However, a Limited Liability partnership registered under the Limited Liability Partnership Act, 2008 can be appointed. [Section 141(3)(a)].
b) An officer or employee of the company. [Section 141(3)(b)].
c) A person who is a partner, or who is in the employment, of an officer or employee of the company. [Section 141(3)(c)].
d) A person who, or his relative or partner is holding any security of or interest in the company or any of its subsidiary or of its holding or associate company or a subsidiary of such holding company. [Section 141(3)(d)(i)].
e) Relatives of any partner of the firm holding any security of or interest in the company of face value exceeding ₹ 1 lakh. [Section 141(3)(d)(i) and Rule 10(1) of Companies (Audit and Auditors) Rules, 2014].
f) A person who is indebted to the company or its subsidiary, or its holding or associate company or a subsidiary or such holding company, for an amount exceeding ₹ 5 lakhs. [Section 141(3)(d)(ii) and Rule 10(2) of Companies (Audit and Auditors) Rules, 2014].
g) A person who has given any 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 an amount exceeding ₹ 1 lakh. [Section 141(3)(d)(iii) and Rule 10(3) of Companies (Audit and Auditors) Rules, 2014].

h) 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. [Section 141(3)(e) and Rule 10(4) of Companies (Audit and Auditors) Rules, 2014].

"**Business Relationship**" is defined in Rule 10(4) of Companies (Audit and Auditors) Rules, 2014 and the same shall be construed as any transaction entered into for a commercial purpose, except commercial transactions which are in the nature of professional services permitted to be rendered by a cost auditor or a cost audit firm under the Act and commercial transactions which are in the ordinary course of business of the company at arm's length price - like sale of products or services to the cost auditor, as customer, in the ordinary course of business, by companies engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses.

i) A person whose relative is a director or is in the employment of the company as a director or key managerial personnel of the company. [Section 141(3)(f)].

j) A person who is in the full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor if such person or persons is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies. [Section 141(3)(g)].

k) A person who has been convicted by a court for an offence involving fraud and a period of ten years has not elapsed from the date of such conviction. [Section 141(3)(h)].

l) Any person whose subsidiary or associate company or any other form of entity, is engaged as on date of appointment in consulting and providing specialised services to the company and its subsidiary companies: [Section 141(3)(i) and Section 144].
   (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

(d) Is Rotation applicable to cost auditor?

The provisions for maintenance of cost accounting records and cost audit are governed by Section 148 of the Companies Act, 2013. The provisions of Section 148 clearly states that no person appointed under Section 139 as an auditor of the company shall be appointed for conducting audit of cost records of the company. Section 148 also provides that qualifications, disqualifications, rights, duties and obligations applicable to auditors (financial) shall apply to a cost auditor appointed under this section. The eligibility, qualifications and disqualifications are provided in Section 141 of the Act and powers and duties are provided in Section 143. Section 143(14) specifically states that the provisions of Section 143 shall mutatis mutandis apply to a cost auditor appointed under Section 148. There are no other provisions governing the appointment of a cost auditor.

Section 139(3) of the Act, applicable to appointment of auditors (financial), and Rule 6 of Companies (Audit and Auditors) Rules, 2014 deals with the provision of rotation of auditors and these provisions are applicable only to appointment of auditors (financial). The Act does not provide for rotation in case of appointment of cost auditors and the same is not applicable to a cost auditor. It may, however, be noted that though there is no statutory provision for rotation of cost auditors, individual companies may do so as a part of their policy, as is the practice with Public Sector Undertakings.

(e) Authority for fixing Remuneration of a Cost Auditor

Rule 14 of the Companies (Audit and Auditors) Rules, 2014 has laid down the procedure of appointment and fixing the remuneration of a cost auditor. It states as follows:

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.

(f) Obligation to report offence of fraud

Sub-rule (7) of Rule 6 of the Companies (Cost Records and Audit) Rules 2014 states that "the provisions of sub-section (12) of section 143 of the Act and the relevant rules made thereunder shall apply mutatis mutandis to a cost auditor during performance of his functions under section 148 of the Act and these rules".

As per sub-section (12) of section 143 of the Companies Act 2013, extract of which is given above, it is obligatory on the part of cost auditor to report offence of fraud which is being or has been committed in the company by its officers or employees, to the Central Government as per the prescribed procedure under the Rules.

As per the proviso to above sub-section, it has been stated that in case of a fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.

Cost Audit Report

As per sub-rule (4) of Rule 6 of the Companies (Cost Records and Audit) Rules 2014 as amended, a Cost Auditor is required to submit the Cost Audit Report along with his or its reservations or qualifications or observations or suggestions, if any, in form **CRA-3** to Board of Directors of the company within a period of one hundred and eighty days from the closure of the financial year to which the report relates.

Form for filing Cost Audit Report with the Central Government

As per sub-rule (6) of Rule 6 of the Companies (Cost Records and Audit) Rules 2014 as amended, every company to whom cost auditor submits his or its report shall, within a period of thirty days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein, in form CRA-4 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.

It is to be noted that the cost audit report is required to be filed in XBRL format.

7.2.2 SECRETARIAL AUDIT

Extract of Provision of Section 204 of the Companies Act 2013

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.

As per section 204(1) of Companies Act, 2013 read with rule 9 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014, the following companies are required to obtain Secretarial Audit Report:

(i) Every listed company;
(ii) Every public company having a paid-up share capital of fifty crore rupees or more; or-
(iii) Every public company having a turnover of two hundred fifty crore rupees or more.

However the "Turnover" means the aggregate value of the realisation of amount made from the Sale, Supply or Distribution of goods or on account of services rendered, or both, by the company during a financial year [Section 2(91)].
The Secretarial Audit Report is required to be provided in the format prescribed in Form MR-3 (Rule 9 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014).

Procedures of appointment of Secretarial Auditor

As per Rule 8 of the Companies (Meetings of Board and its powers) Rules, 2014, Secretarial Auditor is required to be appointed by means of resolution passed at a duly convened Board meeting. It is advisable for the Secretarial Auditor to get a letter of engagement from the company. Secretarial Auditor should accept the letter of engagement. However, it is advisable that any changes in the Secretarial Auditor during the financial year are to be reported to the members in the Board's Report.

Self Examination questions

1. Which Rules govern maintenance of cost accounting records and cost audit as per Section 148 of the Companies Act, 2013?
2. What is the applicability of the Companies (Cost Records and Audit) Rules, 2014 and what is the date on which it becomes effective and applicable?
3. The Rules state that cost records are to be maintained in Form CRA-1. However, CRA-1 does not prescribe any format but only provides principles to be followed for different cost elements. What are the role and status of Cost Accounting Standards/GACAP and its applicability vis-à-vis CRA-1?
4. What is the procedure for appointment of cost auditor under the Companies Act, 2013?
5. Who can be appointed as a cost auditor?
6. What are the eligibility criteria for appointment as a cost auditor?
7. The Companies Act, 2013 has introduced provision regarding rotation of auditors. Is the provision of rotation of auditors applicable to cost auditors also?
8. What is the procedure to be followed for fixing the remuneration of a cost auditor?
9. Who can conduct the Secretarial Audit and which company have to undergo such?
10. Discuss the procedures of appointment of Secretarial Auditor.

State whether the following statements are true or false.

1. Cost Records are to be maintained as per Form CRA-1.
2. The Cost Auditor has to follow the Cost Auditing Standards while conducting Cost Audit.
3. Cost Accounting Standards is mandatory as per section 143 of the companies Act 2013.
4. CRA-2 is used to intimate the appointment of Cost Auditor to the Central Government.
5. Chartered Accountants are eligible to conduct Secretarial Audit having valid certificate of practice.
6. Company Secretaries are eligible to conduct Cost Audit having valid certificate of practice.
7. Secretarial Audit is applicable to all unlisted companies.
8. Secretarial Audit report is given as per the Form MR-3.
9. Appointment of Secretarial Auditor is done by means of resolution at Board Meetings.
10. Secretarial Audit Report is attached with the Board report.

[**Answer:** T, T, F, T, F, F, F, T, T, T]

Fill in the blanks

1. Secretarial Audit is applicable to all _______ companies.
2. Cost Audit is done by _____________ in practice having valid certificate of practice.
3. Secretarial Audit is done by _____________ in practice having valid certificate of practice.

4. Cost Records are to be maintained in form _____________.
5. Format for Secretarial Audit report is form _________.
6. Secretarial Audit is applicable to public companies having paid up share capital of ____________ crore or more.
7. Secretarial Audit is applicable to public companies having turnover of ____________ crore or more.
8. Secretarial Audit is covered under Section ______ of the companies Act 2013.
9. Cost Audit is covered under Section ______ of the companies Act 2013.
10. Cost Auditor is required to be appointed by the __________ of the company on recommendation of Audit Committee.

[Answer: Listed, Cost Accountant, Company Secretary, CRA-1, MR-3, 50 cro re, 200 cro re, 204, 148, Board of Directors]

Match the following

	Column A		Column B
1	Secretarial Audit Report	**A**	CRA-1
2	Sec 204 of the companies Act	**B**	Cost Audit
3	Secretarial Audit	**C**	Board of Directors
4	Intimation for appointment of cost auditor to Central Government	**D**	CRA-4
5	Casual vacancy in the office of a Cost Auditor is filled by-	**E**	Cost Audit report by the Auditor to Company
6	Form for filing Cost Audit Report with the Central Government	**F**	MR-3
7	Sec 148 of the companies Act	**G**	1 Lakh rupees which can extend to 5 Lakh rupees
8	CRA 3	**H**	Secretarial Audit
9	Cost Accounting Records	**I**	Listed Companies
10	Penalty for non compliance of Sec 204	**J**	CRA-2

[Answer: F, H, I, J, C, D, B, E, A, G]

Multiple choice questions

1. Cost Audit can be done by the-
   A. Employee of the organization
   B. Cost Auditor
   C. Secretarial Auditor
   D. None of the above
2. Secretarial Audit can be done by-
   A. Employee of the organization
   B. Cost Auditor
   C. Secretarial Auditor
   D. None of the above
3. Form for maintainenece of Cost Records by the Company.
   A. CRA-1
   B. CRA-2
   C. CRA-3
   D. CRA-4
4. Secretarial Audit is applicable to the public sector company having the paid up share capital of-
   A. 50 crore
   B. 75 crore
   C. 100 crore
   D. 200 crore
5. Secretarial Audit is applicable to the public sector company having the turnover of-
   A. 100 crore
   B. 200 crore
   C. 250 crore

D. 300 crore

6. Form for Secretarial Audit Report is-
   A. MR-2
   B. MR-3
   C. MR-4
   D. MR-5
7. Cost Auditor is appointed by the-
   A. Audit Committee
   B. BOD
   C. BOD on recommendation Audit Committee
   D. None of the above

[Answer: B, C, A, A, C, B, C]

7.3 REPORTING REQUIREMENTS UNDER COMPANIES ACT, REPORT Vs. CERTIFICATE, CONTENTS OF THE REPORTS AND QUALIFICATIONS IN THE REPORT

SCOPE, BASIC ELEMENTS AND SIGNFICANCE OF AUDIT REPORT

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.

Lancaster – "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.

Importance of Audit Report

i. An Audit report is the end product of the auditing & 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.

The Basic Elements of the Auditors' Report are –

i. Title: The Auditor's Report should have an appropriate title i.e. "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 standards on auditing 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 on "Forming an opinion and reporting on financial statements."

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 Standards on Auditing 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.

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 Indian 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.

   vii. Disclosure: All the disclosures statutorily required or otherwise relevant have been made appropriately.

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.

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."

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.

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.

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.

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.

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.

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, (b) 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".

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.

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 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".

Situation	Auditor's Duties
When the limitation of scope infringes the duties of the Auditor under the statute.	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 where 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 Audit Report	Qualified Audit 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	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

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.	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.

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 judgment to obtain all that information and explanations, which are necessary for the performance of conducting the audit.

(b) Under the Chartered Accountants (CA) Act 1959, a (CA) Chartered Accountant 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 be 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 the 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: Every 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;

(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.

CARO – COMPANIES (AUDITOR'S REPORT) ORDER, 2016

CARO – COMPANIES (AUDITOR'S REPORT) ORDER, 2016 issued by the Central Government as per the power granted under section 143(11) of the Companies Act, 2013.

According to Sec 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.

(i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);

(ii) an insurance company as defined under the Insurance Act, 1938 (4 of 1938);

(iii) a company licensed to operate under section 8 of the Companies Act;

(iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act and a small company as defined under clause (85) of section 2 of the Companies Act; and a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements.

2. **Auditor's report to contain matters specified in paragraphs 3 and 4.** - Every report made by the auditor under section 143 of the Companies Act, 2013 on the accounts of every company audited by him, to which this Order applies, for the financial years commencing on or after 1st April, 2015, shall in addition, contain the matters specified in paragraphs 3 and 4, as may be applicable:

   Provided the Order shall not apply to the auditor's report on consolidated financial statements.

3. **Matters to be included in the auditor's report.** - The auditor's report on the accounts of a company to which this Order applies shall include a statement on the following matters, namely:-

(i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;

(b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

(c) whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof;

(ii) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account;

(iii) whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so,

(a) whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;

(b) whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;

(c) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;

(iv) in respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.

(v) in case, the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?

(vi) whether maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act, 2013 and whether such accounts and records have been so made and maintained.

(vii) (a) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable. shall be indicated;

(b) where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not be treated as a dispute).

(viii) Whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).

(ix) Whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;

(x) whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;

(xi) Whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provisions of section 197 read with Schedule V to the Companies Act? If not, state the amount involved and steps taken by the company for securing refund of the same;

(xii) Whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1: 20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;

(xiii) Whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards;

(xiv) Whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;

(xv) Whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with;

(xvi) Whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

4. Reasons to be stated for unfavorable or qualified answers.-

(1) Where, in the auditor's report, the answer to any of the questions referred to in paragraph 3 is unfavorable or qualified, the auditor's report shall also state the basis for such unfavorable or qualified answer, as the case may be.

(2) Where the auditor is unable to express any opinion on any specified matter, his report shall indicate such fact together with the reasons as to why it is not possible for him to give his opinion on the same.

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 enumerated below;

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 (CA) The relevant paragraph of the Report may appear as under -

"As per the opinion of the ICAI (CA) a Company cannot re-open and revise the accounts once adopted by the Shareholders at an Annual General Meeting (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)."

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 AGM, 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.

7.3.1 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.

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.

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 348 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.

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.

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 Ind AS - 27, 18 & 31.

(b) To enable the Auditor to express an opinion on the true and fair view presented by the CFS(Consolidated Financial Statement).

iii. **Features of CFS:**

(a) CFS are 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.
Exclusion	• 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.

7.3.2 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. (Reserve Bank of India). 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

Sl.	Basis	Audit Report	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".

Self Examination questions

1. Describe the procedure of submission of Cost Audit report by the Auditor of the Company.
2. Distinguish between the followings
   A. Qualified Report and Adverse Report
   B. Explanatory Notes and Qualificatory Notes
3. Write short notes on signing the Audit Report.
4. Write short notes on Qualification of Company Auditor under section 141 of the Companies Act 2013.
5. Explain the matters that do and do not affect the auditor's opinion.
6. What do you mean by Qualified Audit Report and Piecemeal Opinion?
7. What consideration should an auditor bear in mind when he is drafting a certificate for a special purpose? Discuss the scope and contents of such reports.
8. What are the various types of opinion that an auditor can express as a result of his audit? Under what circumstances should an auditor express an adverse opinion or disclaimer of opinion?
9. Explain the nature of verification the auditor should conduct before issuing report or certificate on financial information in offer documents.

State whether the following statements are true or false.

1. SA 700 stands for "Forming an opinion and reporting on Financial Statement".
2. Audit report reflects the work done by the employees.
3. An audit report is addressed to the authority appointing the Auditor.
4. The auditor gives a clean report when he doesn't have any significant reservation in respect of matters contained in the Financial Statements.
5. A disclaimer of opinion is issued by the auditor when he cannot form an overall opinion about the matters contained in the Financial Statements.
6. A piecemeal opinion is issued when whole of the matters contained in the financial statement is true and fair.
7. An adverse report s given when the auditor concludes that based on his examination he does not agree with the affirmations made in the financial report.
8. CARO order 2016 is applicable to the Banking Company.

[**Answer:** T, F, T, T, T, F, T, F,]

Fill in the blanks

1. Violation of section 143 (12) imply a fine of ₹ ______
2. A report is statement of __________ & __________ facts.
3. The audit report shall either contain as ______________ of regarding financial statements.
4. Audit report is meant for the _______ of the company.
5. Audit report reflects the work done by the ____________.
6. The audit report should be signed in the personal name of the _____________.

[**Answer:** 1 Lakh Rupees, Collected and Considered, Expression of opinion, Shareholders, Auditor, Auditor]

Match the following

	Column A		Column B
1	True and Fair Audit Report	**A**	Forming an opinion and Reporting on Financial Statements.
2	Audit report with certain reservations	**B**	Audit Report
3	SA 700	**C**	Unable to form overall opinion on Financial Statement
4	Negative report	**E**	One Lakh Rupees.
5	Fine for violation of sec143 (12)	**F**	Four times.
6	SA 600	**G**	Unqualified Opinion.
7	Expression of opinion on Financial Statement	**H**	Using the work of another Auditor
8	Disclaimer of opinion	**I**	Does not agree with affirmation made by the management in the books.
9	Scope paragraph	**J**	Qualified Report.

[Answer: G, J, A, I, E, H, B, C, D]

Multiple choice questions

1. The meetings of Audit committee should be _____ in a year.
   A. 4
   B. 5
   C. 3
   D. 2
2. An audit committee should have ______ directors.
   A. 3
   B. 2
   C. 1
   D. 4
3. The __________ shall act as the secretary of the Audit Committee.
   A. Employee
   B. Auditor
   C. Company Secretary
   D. Chairman
4. A nomination and remuneration committee should have _____ directors.
   A. 3
   B. 2
   C. 1
   D. 4
5. An audit report is the __________ product of audit.
   A. Main
   B. Final
   C. Semi final
   D. None of the above

[Answer: A, A, C, A, B]

7.4 MISCELLANEOUS AUDIT

i. BRANCH AUDIT, JOINT AUDIT

"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 and Rule 12(1) of Companies (Audit and Auditors) Amendment Rules, 2015. 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.

Joint Audit

In big corporate more than one persons or firm of Chartered Accountants are appointed as a Joint Auditor for conducting the audit of the company. This practice of appointing joint auditor accrues great advantages to the company. In a big organisation the task of carrying audit cannot be accomplished with single individual so for overcoming such situation joint auditor wheres appointed.

Advantages of Joint Audit: The various advantages that accrue out of Joint Audit are enumerated below;

i. Lower workload
ii. Timely completion of work
iii. Sharing of expertise
iv. Improved quality of services
v. Healthy competition
vi. Quality of performance

Disadvantages of Joint Audit: The disadvantages of Joint Audit are enumerated below;

i. Superiority complex of some auditor
ii. Costly for small entity
iii. Lack of coordination in work
iv. Uncertainty about liability of work
v. Psychological problem
vi. Difficulty in fixation of work among other

SA 299 issued by The Institute of Cost Accountants of India on "Responsibility of Joint Auditor" lay down the responsibilities on joint auditors. The responsibilities of joint auditor's

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.

ii. AUDIT OF SHARESAND DEBENTURES

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:

i. 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.
ii. 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.

iii. To check whether minimum amount has been subscribed or not as stated in the prospectus.

iv. 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.

v. 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.

vi. Examine the Board minute's for the purpose for which securities is issued and utilized for the same.

vii. 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.

viii. 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.

ix. 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.

Alteration of Share Capital [Section 61]

i. Confirm that alteration was authorised by articles.

ii. Verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.

iii. Verify that alteration had been effected in copies of Memorandum, Articles, etc.

iv. Obtain the reasons for which the memorandum of the company is altered.

v. 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.

vi. To confirm that the alter share capital's denomination should be more than ₹1.

vii. 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.

Issue of Bonus Shares [Section 63]

i. Confirm that issue of Bonus Share was authorized by articles.

ii. Verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.

iii. Check that the company has issue fully paid-up bonus shares to its members only.

iv. Confirm that the issue of bonus shares shall not be made by capitalising reserves created by the revaluation of assets.

v. 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.

vi. 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.

vii. Whether the partly paid-up shares are made fully paid-up.

viii. Check whether the bonus shares shall not be issued in lieu of dividend.

Power of company to Purchase its Own Securities [Section 68]

i. Confirm that Buy-Back was authorized by articles.

ii. Verify the minutes of the Board meeting and special resolution passed in the general meeting in which the approval of members is obtained.

iii. 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.

iv. 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.

v. 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.

vi. 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.

vii. To check that all the shares or other specified securities for buy-back should be fully paid-up.

viii. 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.

ix. 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.

x. 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).

xi. 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.

xii. 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.

xiii. 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.

xiv. 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.

xv. Whether the company has maintained any register of the shares or securities so bought.

xvi. 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.

Splitting of shares of face value from ₹ 10 to ₹ 1 per share

i. Confirm that alteration was authorised by articles.
ii. Verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.
iii. Verify that alteration had been effected in copies of Memorandum, Articles, etc.
iv. 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.

Share Transfer Audit:

The following aspects are required to be examined by the auditor in conducting the share transfer audit:

i. 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.
ii. 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.
iii. 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.
iv. 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 within 60 days exaction.
   (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.

v. 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).

vi. Ascertaining that none of the transferees is disqualified from holding shares in the company.

vii. 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.

viii. Verification of postings from the Share Journal to the Register of Members.

ix. 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.

x. Check whether the transfer to firms, etc. have been rejected or not and whether notes of trust has been entered in the share register.

xi. 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.

xii. Inspection of the power of attorney and specimen signatures if transfer executed by an agent.

xiii. Inspection of letters of indemnity for lost certificates and ensuring that duplicate certificates have been issued on proper authority.

xiv. 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.

xv. Refer to the minutes book to ensure that all transfers recorded in the share transfer journal have been approved by the Board.

xvi. Checking of counterfoils of new certificates.

xvii. 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.

xviii. 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.

xix. Ensuring that, in case of any share transactions by directors, corresponding entries have been made in the Register of Directors' shareholding.

Re-issue of forfeited shares

i. 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.

ii. 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.

iii. Verify that computation of surplus amount arising on the reissue of shares credited to Capital Reserve Account and

iv. 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.

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;

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. Appointment debenture trustee is mordatary for the following –

i. The offer of issue of debenture is made to public
ii. The company makes the offer to members exceeding five hundred in number.

The purpose of appointment of debenture trustee is for the protection of interest L & redden grievances of debenture holders.

Auditor's Duty:

i. The auditor should verify that the prospectus had been duly filed with the registrar before the date of allotment of debentures.
ii. 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.
iii. He should examine the debenture trust deed and note the conditions contained therein as to issue and repayment.
iv. 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.
v. Compliance with SEBI guidelines should also be ensured.
vi. 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.

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:

i. 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.
ii. The auditor should reconcile the total amount paid with the total amount due and payable with the amount of interest outstanding for payment.
iii. 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.

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:

i. The auditor should inspect the debentures or trust deed for the terms and conditions regarding redemption of debentures.

ii. He should see the Director's minute book authorizing the redemption of debentures.

iii. He should also vouch the redemption with the help of debenture bonds cancelled and the cash book.

iv. He should also examine the accounting treatment thoroughly.

Debenture issued as Collateral Security

If the debentures are issued as collateral security to the banks or creditors then auditor needs to ensure that such issue is approved by Board of Directors and very by the term as per loan agreement.

iii. AUDIT OF DIVISIBLE PROFITS & DIVIDENDS

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.

Provided also that no company shall declare dividend unless carried over previous losses and depreciation not provided in previous year or years are set off against profit of the company for the current year.

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.

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:

i. 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.
ii. All shares in respect of which dividend has not been paid or claimed for seven consecutive years or more under sun-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.
iii. 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.
iv. 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.

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) education, awareness and protection;
- (b) the refund in respect of unclaimed dividends, matured deposits, matured debentures, the application money due for refund and interest thereon; promotion of investors'
- (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:

- i. 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.
- ii. 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:

- i. 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.
- ii. The Central Government may provide to the authority such offices, officers, employees and other resources in accordance with such rules as may be prescribed.
- iii. 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.
- iv. 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:

- i. 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.
- ii. 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.

iv. STATUTORY AUDITOR VS. INTERNAL AUDITOR

Statutory Audit is the act of checking books of accounts as per the provision of Companies Act, whereas Internal Audit is conducted by the either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board of the Company to detect weakness in internal control system and for their improvement. However both of these types of audit check books of accounts, detect frauds & errors however they differ from each other which is reproduced below;

SL No.	Basis	Statutory Audit	Internal Audit
i.	**Appointing Authority**	Statutory Auditor is appointed by the shareholder in the general meeting.	Internal Auditor is appointed by the Board.
ii.	**Scope of the work**	The scope of work is defined in the Companies Act.	The scope of work includes the adherence of management policies and procedures and indentifies the weakness in the internal control.
iii.	**Removal of Auditor**	Statutory Auditor can be removed by the shareholders.	Internal Auditor can be removed by the Board.
iv.	**Remuneration**	It is fixed by the shareholders.	It is fixed by the board.
v.	**Audit Report**	It is submitted to the appointing Authority.	It is submitted to the Board as a suggestion to improve weakness in the internal control.

v. (i) AUDITING AND ASSURANCE STANDARDS RELATING TO AUDIT OF INVENTORIES

Inventories are tangible property held for sale in the ordinary course of business, or in the process of production for such sale, or for consumption in the production of goods or services for sale, including maintenance supplies and consumable stores and spare parts meant for replacement in the normal course. Inventories normally comprise raw materials including components, work-in-process, finished goods including by-products, maintenance supplies, stores and spare parts, and loose tools.

Inventories normally constitute a significant portion of the total assets, particularly in the case of manufacturing and trading entities as well as some service rendering entities. Audit of inventories, therefore, assumes special importance.

The following features of inventories have an impact on the related audit procedures:

(i) By their very nature, inventories normally turn over rapidly.

(ii) Inventories are susceptible to obsolescence and spoilage. Further, some of the items of inventory may be slow-moving while others may follow a seasonal pattern of movement.

(iii) Inventories are normally movable in nature, although there may be some instances of immovable inventories also, e.g., in the case of an entity dealing in real-estate.

(iv) All the items of inventory may not be located at one place but may be held at different locations such as factories and warehouses, or with third parties such as selling agents.

(v) The individual items of inventory may not be significant in value, but taken together, they normally constitute a significant proportion of total assets and current assets of manufacturing, trading and certain service entities.

(vi) Physical condition (e.g., stage of completion of work-in-process in certain industries) and existence of certain items of inventories may be difficult to determine.

(vii) Valuation of inventories may involve varying degrees of estimation, including expert opinions, e.g., in the case of jewelry.

v. (ii) AUDITING AND ASSURANCE STANDARDS RELATING TO AUDIT OF FIXED ASSETS

Introduction

1. The term Property, plant and equipment in respect of those entities which are required to comply with the relevant Revised AS refers to such tangible items that**:**

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
(b) are expected to be used during more than one period.

2. An asset can be classified as a PPE or otherwise, depending upon the use to which it is put or intended to be put. For example, assets which are classified as PPE in one type of business may be considered as current assets in another. Similarly, the same asset may be classified differently in an entity at different points of time. The recognition of Property, Plant and Equipment should be done as per the principles laid down in the "relevant applicable AS".

vi. EDUCATION 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.

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.

CO- OPERATIVE SOCIETIES

1. Definition: A Co-operative society may broadly be defined as an association of persons who have voluntarily joined together to achieve a common economic objective through the formation of a democratically- controlled business organization, making equitable contributions to the capital as required, and accepting a fair share of risks and benefits of the undertaking. Elimination of middlemen and sharing of gains of economic activities seems to be the hallmark of a co-operative society.

A co-operative society may be formed for different purposes. Accordingly, there may be consumers' co-operative societies, housing co-operative societies, industrial co-operative societies , urban and rural co-operative banks, etc.

2. **Audit as per Section 17 of the Co-Operative Societies Act, 1912**

(1) The Registrar shall audit or cause to be audited by some person authorised by him by general or special order in writing in this behalf the accounts of every registered society once at least in every year.
(2) The audit under sub-section (1) shall include an examination of overdue debts, if any, and a valuation of the assets and liabilities of the society.
(3) The Registrar, the Collector or any person authorised by general or special order in writing in this behalf by the Registrar shall at all times have access to all the books, accounts, papers and securities of a society, and every officer of the society shall furnish such information in regard to the transactions and working of the society as the person making such inspection may require.
"Registrar" means a person appointed to perform the duties of a Registrar of Co operative Societies under this Act.

3. The following points should be kept in mind where awains of an Co-operative society;

(i) **Qualifications of auditor**: generally, only a chartered accountant within the meaning of the Chartered Accountants Act 1949, can be appointed as the auditor of a co-operative society. However, in certain State Co-operative societies Act, a person holding a government diploma in co-operative accounts, or in co- operation and accounts, or a reason who has served as an auditor in the Co-operative Department of Government, may also be appointed as the auditor.

The auditor should ensure that he is duly qualified to act as auditor of the society.
(ii) **Appointment of the Auditor:** An auditor of a co-operative society is appointed by the Registrar of Co-operative Societies-and the auditor so appointed conducts the audit on behalf of the Registrar and submits his report to him as also to the society. The audit fees are paid by the society on the basis of statutory scale of fees prescribed by the Registrar, according to the category of the society audited. For example, the audit fees of co-operative credit society and Urban Co-operative Banks are to be calculated with reference to working capital at the prescribed rates. 'Working Capital' here means funds at the disposal of the society inclusive of paid up share capital, funds built up out of profits and monies raised by borrowing and by other means.
(iii) **Books of accounting records:** Under section 43(h) of the Co-operative Societies Act, a state government can frame rules prescribing the books and accounts to be kept by a co-operative society.
For example In Maharashtra the co-operative societies are required to maintain cash book, general ledger, personal ledger, stock register, property register, etc.

- **Cash book.** It may be maintained to record particulars regarding cash receipts and expenses under suitable heads, with clear distinction between capital and revenue items of receipts and expenses.
- **Stock register.** It may contain detailed information as regards receipts, issues and balances of stock-in-trade, date-wise. In a producers' co-operative society, perpetual inventory records may be maintained based on an appropriate costing method.
- **Register of assets and investments**. It will contain detailed particulars regarding the various immovable and movable assets belonging to the society, such as, types of assets, location, date of acquisition, cost, depreciation provided, and so on.
- **Register of fixed deposits**. In the case of a co-operative credit society, or a co-operative bank, or any other society which is authorised by its bye-laws to accept deposits from members/non-members, a register of fixed deposits may be maintained giving details as regards the dates of acceptance, maturity, interest accrual, repayment, etc.
- **Register of sureties**. In the case of a co-operative credit society, loans are given against personal security of members as also surety (guarantee) provided by two other members. The Register of Sureties will give particulars about the number of borrowers in respect of which a member has stood surety, and show whether it is within the overall limit of surety-ship that may.

(iv) **Restriction on sha reholding:** Shareholding in a co-operative society is subject to the limit prescribed in Sec. 5 of the Co-operative Societies Act 1912. Accordingly, no member of the society, other than a registered society, can hold more than twenty per cent of the total number of shares of the society, or such number of shares which in value exceeds Rs. 1,000. A co-operative society cannot prescribe any other limit in its bye-laws which is violative of this provision. In addition to this, the Acts passed by the states may also passed by the States may also prescribe other restrictions as regards shareholding.

The auditor should see that the provision regarding shareholding is duly followed.

(v) **Restriction on Loan:** As per section 29 A registered co-operative society can only grant loans to its members though, with prior approval of the Registrar, it may grant loans to other registered co-operative societies. The auditor should see that the loans granted by the society are in conformity with this provision.

(vi) **Restriction on Borrowing:** Subject to the restrictions imposed by its bye-laws, a co-operative society may accept loans and deposits from its members as well as non-members. It is the, auditor's duty to ascertain that the restrictions, if any, laid down by the bye-laws are carefully observed

(vii) **Investment of Funds:** There are restrictions on investment of funds belonging to a co-operative society. Accordingly, a society may invest its funds in any of the following (Sec.32 of the Central Co-operative Societies Act):

(a) Central or State Co-operative Bank,
(b) Any securities specified in Section 20 of the Indian Trusts Act, 1882.
(c) Any shares, securities, bonds or debentures of any other Co-operative society with limited liability.
(d) Any bank, or person carrying on banking business or a Co- operative bank, other than a Central or State co-operative bank, as duly approved by the Registrar;
(e) In any other manners as duly permitted by the requisite authority.

Auditor's duty: The auditor should ascertain whether the requirement as to investment of the society funds are being observed.

(viii) **Appropriation of profits:** According to the Central Co-operatives Societies Act, 25% of the profits of a co-operatives society should be transferred to a Reserve Fund before distribution of dividend or payment of bonus to its members. However, the Registrar may, having regard to the financial position of the society, reduce the percentage of profits to be transferred to the Reserve Fund. But in any case, he cannot reduce it to less than 10% of the profits of the society.
Apart from the above mandatory provision, a co-operative society may, subject to the provisions of its bye-laws, appropriate its profits by way of transfer to other reserves, distribution of dividends to members, etc. However, appropriation of profits must be duly approved by the members of the society in the general meeting called for the purpose.

(ix) **Contributions to charitable Purposes:** According to Section 34, a registered society may, with the sanction of the Registrar, contribute an amount not exceeding 10% of the net profits remaining after the compulsory transfer to the reserve fund for any charitable purpose as defined in section 2 of the Charitable Endowments Act, 1890.

SPECIAL POINTS IN A CO-OPERATIVE SOCIETY

1. **General Points**: - **In general while conducting audit of Co-operative society 'The auditor need to look into the followings: -**
   i. The auditor should carefully go through the bye-laws of the society and see that they are being observed both in letter and spirit.
   ii. He should examine the Register of Members of the society and individual shareholdings.
   iii. He should test-check the internal check and control system operated by the society and model his audit examination based on its strengths and weaknesses.
2. **Audit of income:** He should carefully vouch the receipt of cash. Cash receipts on account of share capital should be vouched with the Register of Members. Cash received against sales should be vouched with the cash memos and invoices issued to customers as also Sales Account. Receipt of cash in respect of payment of interest and repayment of loans advanced by the society should be vouched with the loan agreements. Cash received from members towards construction of houses or their maintenance, should be vouched with the Register of Members, demands made by the society from time to time, and money receipts.
3. **Audit of Expenditure:**
   i. He should vouch all expenditure with reference to authorisation from the Managing Committee, particularly in the case of large capital expenditure, as also the bills received from individual parties, the money receipts obtained from them, and entries in the Bank Pass Book along with counter-foils of cheques.

ii. He should vouch the payment of loans from the loan agreements entered into with borrower-members.
iii. He should vouch establishment expenses with reference to the resolutions of the Managing Committee, agreements with the persons concerned, and money rec(:pts obtained from them.

Other aspects points:

i. He should appropriately classify overdue debts for a period from six months to five years and more, and report them to the members, with a note regarding the effects these might have on the financial position of the society. He should also put a note regarding the probability of recovery of such debts.
ii. Similarly, he should make a special reference to the overdue amount of interest from members. Generally, interest on overdue debts should not be credited to Interest Account but to the Overdue Interest Reserve Account.
iii. Writing off of bad debts should be after prior authorisation from the Managing Committee of the society. According to the Maharashtra Co-operative Societies Rules, a bad debt can be written off only when it is certified to be irrecoverable by the auditor. This casts a special obligation on the auditor to ascertain whether the debt in question was created within the Rules of the society, and whether it has now really become bad and irrecoverable.

BANK AUDIT

1. Introduction:

The banking industry is the pivot of any economy and its financial system. Banks are one of the foremost agents of financial intermediation in an economy like India and, therefore, development of a strong banking system is of utmost importance. The banking institutions in the country are working in a competitive environment and their regulatory framework is aligned with the international best practices. Thus, financial deepening has taken place in India and continues to be in progress with a focus on orderly conditions in financial markets while sustaining the growth momentum.

The Reserve Bank of India (hereinafter referred to as RBI) acts as the monetary authority and the central bank of the country.

2. Type of Banking institutions prevailing in India:

(a) Commercial banks;
(b) Regional Rural banks;
(c) Co-operative banks;
(d) Development banks (more commonly known as 'term-lending institutions');
(e) Payment Banks; and
(f) Small Finance Banks

3. Financial Statements of a bank

As per the Third Schedule to the Banking Regulation Act, 1949, the Balance Sheet of a Bank should be presented in the following manner, with comparative figures for previous financial year –

Balance Sheet (Form A)	Schedule	P & L Account (Form B)	Schedule
Capital and Liabilities: Capital Reserves and Surplus Deposits borrowings Other Liabilities & Provisions	 **1** **2** **3** **4** **5**	**I. Income:** Interest Earned Other Income	**13** **14**
Total		**Total**	
		II. Expenditure: Interest Expended Operating Expenses Provisions & Contingencies	 **15** **16**
		Total	
Assets: Cash & Balances with RBI Balances with Banks & Money at Call & Short Notice Investments	 **6** **7** **8**	**III. Profit / Loss:** Net Profit / (Loss) for the year Profit / (Loss) brought forward	

		Total	
Advances Fixed Assets Other Assets	**9** **10** **11**	**IV. Appropriations:** Transfer to Statutory Reserves Transfer to Other Reserves Transfer to Government / Proposed Dividend Balance carried over to Balance Sheet	
Total		**Total**	

4. Auditing aspects of banking of financial Statement.

a. Advances: In relation advances made by bank an auditor need to review the followings:

i. Ensure the internal control is in place in relation to advances made.

ii. To scrutrise the subsidiary, ledger, & control accounts

iii. To ensure the proper documentation of account.

iv. To scrutining the overdue account and scheme for recovery of such amount.

b. Cash balance with RBI and other bank and money at call and short Notice.

Cash in hand:

i. Ensure that the Internal control is in place.

ii. Visit the bank branch and inspects physical cash and ensure that it will tallies withs the banks cash book balance.

iii. To verity the amount of foreign currency held by bank and its transalation at make rate on the date at which financial statement is prepared.

Balance with RBI:

i) Inspect the ledger balance in each account with (a) bank confirmation certificates from Reserve Bank of India and (b) Reconciliation Statement.

ii) **Balance with other bank:**
Inspection of reconciliation statement to ensure that no debit or credit for interest have been taken to Revenue account to the year. To examines the large transition and balances with banks outside India. Ensure that they are converted at market rate as on financial statement preparation

Money at call & short notice:

i. Examinees the system of autharisation for unding money at short and call notice

ii. The call loan made by bank are not nettled off against call loan received by it.

iii. Ensure that money market lending's for more than 6^{th} days are not classified under this head but as a deposit or advance based on their nature of learning.

Fixed and other Assets: -

The auditor has to ensure the following while audit of F .A (Fixed Assets) held by banks

- Accounting method of bank
- Ownership document
- To examine with reference to schedule of fixed assets to find neew assets acquired.
- To examise sale deed in relation to sale of assets by bank.
- To ensure appropriateness of basis of revaluation of fixed assets.
- Ensure compliance of sec 9 of banking Regulation Act.

Banking and Deposits:

Barrowings:

(i) To ensure that amount have been property disclosed for
  a) Barrowing in India farm RBI.
  b) Barrowing outside India.

(ii) Ensure the rate of interest paid payable with duration of borrowing.

(iii) Verity whether the barrowings of maney at call and short notice are property authorized.

Deposits: -

i) To ensure the interest accered but not due on deposits is not under other liabilities and provision

ii) See Whether there is any instances of window dressing reporting in LFAR.

Capital Reserve and Surplus:

Capital:

i) Examine the opening balance of capital
ii) Examine with special resolution of shareholder or MOA about increase in authorized capital durig the year.
iii) Examine with prospectus about increase in subscribed/ paid up capital
iv) Examine with Government notification for any fresh contribution from them.

Reserve and Surplus:

To examine the opening balance of different type of Reserve.

i) Addition/ deduction from reserves.
ii) Reason for appropriation of any fund from such account.
iii) Dividend paid by bank
iv) In respect of foreign branch ensure compliance with foreign laws.

Other Liabilities and provision:

The auditor may verify the various items under the head "other liabilities and provisions' in the following manner.

Bills Payable

The auditor should evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following:

(i) Drafts, mail transfers, traveller's cheques, etc., should be made out in standard printed forms.
(ii) Unused forms relating to drafts, traveller's cheques, etc., should be kept under the custody of a responsible officer.
(iii) The bank should have a reliable private code known only to the responsible officers of its branches coding and decoding of the telegrams should be done only by such officers.
(iv) The signatures on a demand draft should be checked by an officer with the specimen signature book.
(v) AW the telegraphic transfers and demand drafts issued by a branch should be immediately confirmed by advices to the branches concerned. On payment of these instruments, the paying branch should send a debit advice to the originating branch.
(vi) If the paying branch does not receive proper confirmation of any telegraphic transfers or demand draft from the issuing branch, it should take immediate steps to ascertain the reasons.
(vii) In case an instrument prepared on a security paper, e.g., draft, has to be cancelled (say, due to error in preparation), it should be examined whether the manner of cancellation is such that the instrument cannot be misused. (For example, in the case of drafts, banks generally cut the distinctive serial number printed on the form and paste it in the book in which drafts issued are entered.) Cases of frequent cancellation and reissuance of drafts, pay orders, etc., should be carefully looked into by a responsible official.

Others (Including Provisions)

It may be noted that the figure of advances and investments in the balance sheet of a bank excludes provisions in respect thereof made to the satisfaction of auditors. The issue of determining the adequacy of provision for doubtful advances is discussed in detail under advances chapter of this Guidance Note. The auditor should examine other provisions and other items of liabilities in the same manner as in the case of other entities. Specifically, in case of tax deducted by the bank and payable to the government authorities before the due date, this function may be centralized or decentralized. While verifying this, the auditor must check whether tax has been correctly deducted from payments as per the provisions of the Income Tax /Act, 1961 and paid on or before the due date as specified under the /Act or Rules therefore. Many a times in case of branch audit, reporting has to be done before the due date of paying tax deducted at source for the month of March. In such cases the auditor should report delays observed till the date of his verification and clearly bring out the fact that he has not verified the payment of tax, due date of which would be after the date of the audit report.

Contingent Liabilities and Bills for Collection:

In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. To this end, the auditor should, generally follow the audit procedures given below:

(i) The auditor should verify whether there exists a system whereby the non fund based facilities to parties are extended only to their regular constituents, etc.
(ii) Ascertain whether there are adequate internal controls to ensure that transactions giving rise to contingent liabilities are executed only by persons authorised to do so and in accordance with the laid down procedures.
(iii) The auditor should also examine whether in case of LCs for import of goods, as required by the abovementioned Master Circular on guarantees and co-acceptances, the payment to the overseas suppliers is made on the basis of shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs.
(iv) Ascertain whether the accounting system of the bank provides for maintenance of adequate records in respect of such obligations and whether the internal controls ensure that contingent liabilities are properly identified and recorded.
(v) Performs substantive audit tests to establish the completeness of the recorded obligations. Such tests include confirmation procedures as well as examination of relevant records in appropriate cases.
(vi) Review the reasonableness of the year-end amount of contingent liabilities in the light of previous experience and knowledge of the current year's activities.
(vii) Review whether comfort letters issued by the bank has been considered for disclosure of contingent liabilities.

Bills for Collection

(i) The auditor should examine whether the bills drawn on other branches of the bank are not included in bills for collection.
(ii) Inward bills are generally available with the bank on the closing day and the auditor may inspect them at that time. The bank dispatches outward bills for collection soon after they are received. They are, therefore, not likely to be in hand at the date of the balance sheet. The auditor may verify them with reference to the register maintained for outward bills for collection.
(iii) The auditor should also examine collections made subsequent to the date of the balance sheet to obtain further evidence about the existence and completeness of bills for collection.
(iv) In regard to bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected. The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its agents, etc. This procedure is in consonance with the nature of obligations of the bank in respect of bills for collection.

Treasury Operation-Foreign Exchange and Derivatives:

(i) While innovative products and ways of trading create new possibilities for earnings for the bank, they also introduce novel and sometimes unfamiliar risks that must be identified and managed. Failure to do so can result losses entailing financial and reputational consequences that linger long after the loss has been recognized in financial statements. Hence, auditor should assess controls as part of audit work.

(ii) It is imperative that an auditor obtains a complete overview of the treasury operations of a bank before the commencement of the statutory audit. After conducting appropriate risk assessment of the treasury processes, the audit program needs to be designed in a manner that it dovetails into not just the control assessments of the treasury process but there is an assurance that the figures appearing in the financial statements as well as the disclosures are true and reflect fairly the affairs of the bank treasury.

Reports to be given to be given by bank Auditors:

i. The Auditors' Report should state whether the Balance Sheet, Profit and Loss Account and Cash Flow Statement of the Bank, show a true and fair view of the financial position / result of operations / cash flows respectively, for the period under audit. This is applicable in respect of Nationalised Banks, as well as Banking Companies.
ii. **Unaudited Branches:** Information relating to number of unaudited Branches should be given. Also, information in respect of Advances, Deposits, Interest Income and Interest Expense for such unaudited Branches should be collected and disclosed in the Audit Report.
iii. **Additional Matters:** Sec.30 (3) of Banking Regulation Act requires the Auditor to state the following -
    (a) Whether or not the information and explanations required by him have been found to be satisfactory,

(b) Whether or not transactions of the Company fall within the powers of a Banking Company,

(c) Whether or not the returns received from the Branch Offices of the Company have been found adequate for the purposes of his audit,

(d) Whether the Profit & Loss Account shows a true balance of Profit or Loss for the period covered by such account, &

(e) Any other matter, which the Auditor considers should be brought to the notice of Shareholders of the Company.

iv. **LFAR:** Auditors of Public Sector Banks, Private Sector Banks & Foreign Banks (as well as their Branches), are required to submit Long Form Audit Report (LFAR) on various matters specified by RBI.

v. **Certificates:** In addition to Reports, the Auditors of Bank Branches as well as Central Statutory Auditors of Banks, have to furnish / issue various "Certificates" as required by RBI and other Regulations.

v) AUDIT OF TRUSTs

When conducting the audit of a charitable institution, the auditor should consider the following matters:

(i) **Constitution:** 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) **Interest of members**: 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) **Budget:** 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) **Internal Check**: Examination of the system of internal check, especially as regards the accounting of the amounts collected.

(v) **Collection & Deposit of income**: Check that the amounts received towards income have been duly collected, received and deposited into the bank regularly and promptly.

(vi) **Subscription and donation**: 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) **Legacies received:** Verify the amounts of legacies received by reference to correspondence with any figures and other available information's.

(viii) **Income from Investment**: 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) **Rent:** 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) **Income/Expenditure relating to concert**: 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) **Expenditure-a major area of concern**: 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) **Physical verification**: The auditor should physically verify the cash in hand, inventories and fixed assets.

vi) AUDIT OF MUNICIPALITIES AND PANCHAYATS (LOCAL BODIES)

The major objective of audit of Municipalities and Panchayats are enumerated below;

(i) To ensure on the fairness and correctness of contents in the Financial Statement
(ii) To report on adequacy of Internal control
(iii) To ensure value of money is fully received on amount spent.
(iv) To detect the frauds and errors.

The following points are to be considered necessary for carrying on audit of Municipalities and panchayats (Local Bodies);

(i) To ensure that the expediters incurred conform to the relevant provision of the law and is in accordance with the financial Rules and regulation formed by the compliant authority.
(ii) To encase that sanction is accorded by the competent authority either special or general.
(iii) To encase that there is provision of funds for expenditure and is authorized by competent Authority.
(iv) To ensure that where huge financial expenditure is made is run economically and is expected to contribute growth.

Self Examination Questions:

1. Write short notes on Branch and Joint Audit.
2. What are the factors to be considered while carrying on audit of Share and Debentures?
3. Precautions to be taken care of while carrying on audit of divisible profits and dividends.
4. Distinguish between Statutory and Internal Audit.
5. Discuss the Auditing and Assurance Standards relating to audit of Inventories and Fixed Assets.
6. Mention the special steps involved in conducting the audit of college?
7. What are the points which you as an Auditor would look into while auditing the accounts of a Hospital?
8. Discuss the important points in an audit of Co operative Society.
9. While carrying an audit of a Bank what are the special factors considered by you.
10. Write short notes on audit of Local Bodies.

State whether the following statements are true or false.

1. "Branch office", in relation to a company, means any establishment described as such by the company.
2. Where a company has a branch office, the accounts of that office shall be audited by auditor appointed at EGM.
3. Where the branch office of a company 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.
4. The branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the Audit committee.
5. In big corporate more than one persons or firm of Chartered Accountants are appointed as a Joint Auditor for conducting the audit of the company.
6. “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.
7. Final dividend is declared in the general meeting.
8. Statutory Auditor is appointed by the shareholder in the general meeting.
9. Internal Auditor can be removed by the Board.
10. If the debentures are issued as collateral security to the banks or creditors then auditor needs to ensure that such issue is approved by debenture trustee.

[**Answer:** True, False, True, False, True, True, True, True, True, False.]

Fill in the blanks

1. Final dividend is declared in the _____________.

2. If the debentures are issued as collateral security to the banks or creditors then auditor needs to ensure that such issue is approved by ___________________.
3. A predetermined ____________ rate of interest is payable on debentures irrespective of the fact that company has earned the profit or not.
4. Debenture holders are ______________ of the company.
5. Where debentures are issued by a company, then company shall create a __________________ account out of the profits of the company.
6. For protecting the interest of debenture holders the company is bound to form ________________.
7. Responsibility to report fraud, as applicable to company's auditor applies to ___________auditor.
8. Splitting of shares shall be authorised by ________________.
9. A company may issue debentures with an option to convert such debentures into ____________.
10. Statutory Auditor is appointed by the shareholder in the______________ meeting.

[**Answer:** General Meeting, BOD, Rate, Creditors, Debenture Redemption Reserve, Debenture Trustee, Branch, AOA, Shares, General]

Match the following

	Column A		Column B
1	More than one persons or firm of Chartered Accountants are appointed	**A**	Branch Audit
2	Section 68 of the Co. Act 2013	**B**	Alteration of Share Capital
3	Section 63 the Co. Act 2013	**C**	Power of company to Purchase its Own Securities
4	Section 61 of the Co. Act 2013	**D**	Joint Audit
5	Section 139 of the Companies Act 2013.	**E**	Issue of Bonus Shares

[Answer: D, C, E, B, A]

Multiple choice questions

1. Audit of debenture is covered under section-
   A. Section 70
   B. Section 71
   C. Section 72
   D. Section 73
2. Declaration of dividend is covered under setion-
   A. Section 122
   B. Section 123
   C. Section 124
   D. Section 125
3. Statutory Auditor is appointed by the shareholder in the
   A. General Meeting
   B. Statutory Meeting
   C. EGM
   D. Board Meeting
4. Statutory Auditor can be removed by the
   A. Shareholders
   B. Audit committee
   C. BOD
   D. None of the above.
5. Internal Auditor is appointed by the
   A. Board
   B. Audit committee
   C. Shareholder
   D. None of the above

[**Answer:** B, B, A, A, A]