INTERMEDIATE
Paper 10

Corporate Accounting and Auditing

Study Notes
SYLLABUS 2022

The Institute of Cost Accountants of India
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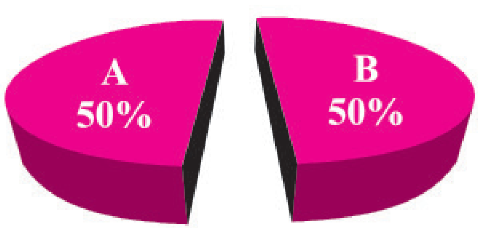
PAPER 10: CORPORATE ACCOUNTING AND AUDITING

Syllabus Structure:

The syllabus in this paper comprises the following topics and study weightage:

Module No.	Module Description	Weight
	Section A: Corporate Accounting	**50%**
1	Accounting for Shares and Debentures	10%
2	Preparation of the Statement of Profit and Loss and Balance Sheet (As per Schedule III of Companies Act, 2013)	10%
3	Cash Flow Statement	10%
4	Accounts of Banking, Electricity and Insurance Companies	10%
5	Accounting Standards	10%
	Section B: Auditing	**50%**
6	Basic Concepts of Auditing	10%
7	Provision Relating to Audit under Companies Act, 2013	30%
8	Auditing of Different Types of Undertakings	10%



Learning Environment

Subject Title	**CORPORATE ACCOUNTING AND AUDITING**
Subject Code	**CAA**
Paper No.	**10**
Course Description	The subject Corporate Accounting focuses on selected aspects of corporate financial accounting with special emphasis on preparation of periodic financial statements as per the Indian regulations and covers important issues of corporate accounting guided by the Ind ASs. The subject Auditing highlights the fundamental concepts of financial audit and further emphasises on various aspects of statutory auditing guided by the Indian regulations.
CMA Course Learning Objectives (CMLOs)	1. Interpret and appreciate emerging national and global concerns affecting organisations and be in a state of readiness for business management. a. Identify emerging national and global forces responsible for enhanced/varied business challenges. b. Assess how far these forces pose threats to the status-quo and creating new opportunities. c. Find out ways and means to convert challenges into opportunities 2. Acquire skill sets for critical thinking, analyses and evaluations, comprehension, syntheses, and applications for optimization of sustainable goals. a. Be equipped with the appropriate tools for analyses of business risks and hurdles. b. Learn to apply tools and systems for evaluation of decision alternatives with a 360-degree approach. c. Develop solutions through critical thinking to optimize sustainable goals. 3. Develop an understanding of strategic, financial, cost and risk-enabled performance management in a dynamic business environment. a. Study the impacts of dynamic business environment on existing business strategies. b. Learn to adopt, adapt and innovate financial, cost and operating strategies to cope up with the dynamic business environment. c. Come up with strategies and tactics that create sustainable competitive advantages. 4. Learn to design the optimal approach for management of legal, institutional, regulatory and ESG frameworks, stakeholders' dynamics; monitoring, control, and reporting with application-oriented knowledge. a. Develop an understanding of the legal, institutional and regulatory and ESG frameworks within which a firm operates. b. Learn to articulate optimal responses to the changes in the above frameworks. c. Appreciate stakeholders' dynamics and expectations, and develop appropriate reporting mechanisms to address their concerns. 5. Prepare to adopt an integrated cross functional approach for decision management and execution with cost leadership, optimized value creations and deliveries. a. Acquire knowledge of cross functional tools for decision management. b. Take an industry specific approach towards cost optimization, and control to achieve sustainable cost leadership. c. Attain exclusive knowledge of data science and engineering to analyze and create value.

<table>
<tr>
<td>Subject Learning Objectives [SLOB(s)]</td>
<td>
A. Corporate Accounting
1. To obtain in-depth knowledge on accounting for issue of securities and change in capital structure. (CMLO 4 a, b)
2. To develop detail understanding on preparation of mandatory financial statements by companies (including Banking, Insurance and Electricity companies) in an Ind AS environment. (CMLO 4 c)
B. Auditing
1. To equip oneself with the fundamental concepts of auditing. (CMLO 4 a)
2. To develop in-depth understanding of various aspects of statutory auditing mechanism under the guidance of Companies Act and Assurance Standards. (CMLO 4 a)
3. To gain an insight into the auditing mechanism in undertakings other than companies. (CMLO 4 a)
</td>
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<tr>
<td>Subject Learning Outcome (SLOC) and Application Skill (APS)</td>
<td>
A. Corporate Accounting
SLOC(s)
1. Students will be able to perform accounting relating to formation of companies, subsequent changes in its capital structure and periodical finalization of accounts.
APS
1. Students will develop skills to independently draft mandatory financial statements of various companies as per the provisions of Companies Act and applicable Ind ASs.
B. Auditing
SLOC(s)
1. Students will be able organise an audit process and assess degree of adherence to the regulations in various phases of statutory audit.
APS
1. Students will develop necessary skill to conduct routine financial audit exercise in companies and other forms of organisations
</td>
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Module wise Mapping of SLOB(s)

Module No.	Topics	Additional Resources (Research articles, books, case studies, blogs)	SLOB Mapped
		Section A: Corporate Accounting	
1	Accounting for Shares and Debentures	The Problem with Accounting for Employees as Costs Instead of Assets - Ethan Rouen https://hbr.org/2019/10/the-problem-with-accounting-for-employees-as-costs-instead-of-assets	To obtain in-depth knowledge on accounting for issue of securities and change in capital structure
2	Preparation of the Statement of Profit and Loss and Balance Sheet (As Per Schedule III of Companies Act, 2013)	Where Financial Reporting Still Falls Short – Sherman & Young https://hbr.org/2016/07/where-financial-reporting-still-falls-short	To develop detail understanding on preparation of mandatory financial statements by companies (including Banking, Insurance and Electricity companies) in an Ind AS environment.
3	Cash Flow Statement	Cash Flow—It's Not the Bottom Line – Casey and Bartczak https://hbr.org/1984/07/cash-flow-its-not-the-bottom-line	
4	Accounts of Banking, Electricity and Insurance Companies	Banking Acts: https://financialservices.gov.in/act-rule/Banking/Banking-Acts Insurance Acts: https://financialservices.gov.in/act-rule/Insurance/Insurance-Acts Electricity Act: https://cercind.gov.in/Act-with-amendment.pdf	
5	Accounting Standards	Mind the GAAP – Govindaraja et al. https://hbr.org/2021/05/mind-the-gaap	
		Section B: Auditing	
6	Basic Concepts of Auditing	Why Good Accountants Do Bad Audits – Bazerman et al. https://hbr.org/2002/11/why-good-accountants-do-bad-audits	To equip oneself with the fundamental concepts of auditing
7	Provisions Relating to Audit under Companies Act, 2013	The Audit Committee's New Agenda – Sherman et al. https://hbr.org/2009/06/the-audit-committees-new-agenda	To develop in-depth understanding of various aspects of statutory auditing mechanism under the guidance of Companies Act and Assurance Standards.
8	Auditing of Different Types of Undertakings	How Banks Are Using Behavioral Science to Prevent Scandals – Engler and Wood https://hbr.org/2020/04/how-banks-are-using-behavioral-science-to-prevent-scandals	To gain an insight into the auditing mechanism in undertakings other than companies.

Contents as per Syllabus

Contents as per Syllabus

SECTION - A

CORPORATE ACCOUNTING

Accounting for Shares and Debentures 1

This Module includes:

1.1 Issue of Shares, Forfeiture of Shares, Rights Issue, Bonus Issue, Sweat Equity Shares, Employee Stock Option and Stock Purchase Scheme, Buy- back of Shares

1.2 Redemption of Preference Shares, Issue and Redemption of Debentures

1.3 Underwriting of Securities

Accounting for Shares and Debentures

SLOB Mapped against the Module

To obtain in-depth knowledge on accounting for issue of securities and change in capital structure (CMLO 4 a, b)

Module Learning Objectives:

After studying this module, the students will be able to –

- Understand the process and accounting of various forms of share issue
- Know the process and accounting of buyback of equity shares and redemption of preference shares
- Equip themselves with detail understanding of the process and accounting of issue and redemption of debentures
- Determine the liability of underwriters and accounting of underwriting arrangements in the books of the issuing company

Introduction 1

A company is described as a voluntary association of persons who have come together for carrying on some business and sharing the profits with capital divided into numerous transferable shares. 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 [hereinafter referred to as Act] 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, a company 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.

A company is a legal entity quite distinct and separate from the persons who are its members, also known as shareholders. A shareholder is not the agent of the company. He cannot incur any debt so as to bind the company. Moreover, the ownership is divorced from management because a joint stock company is managed by a Board of Directors elected by the shareholders.

Following are the main characteristics of a company:

a. It is a distinct legal entity existing independent of its members.

b. In a company, liability of the members is limited to the extent of the face value of shares held by them.

c. It has a perpetual succession.

d. The shares of a company are freely transferable except in case of a Private limited Company.

e. A company being a legal person is capable of owing, enjoying and disposing of the property in its own name.

f. A company, being a separate body can sue and be sued in its own name.

g. 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.

h. It is a voluntary association of persons usually for profit.

⦿ Types of Companies

As per Companies Act, 2013, a company may be formed as –

(i) A company limited by shares, where the Memorandum of Association specifies that the liabilities of the shareholders are limited to the amount still unpaid on shares they hold.

(ii) A company limited by guarantee, where as per the Memorandum of Association, the liability of a shareholder is limited to the amount guaranteed by the shareholder.

(iii) An unlimited company, where there is no limit on the liability of the shareholders.

Companies may also be classified as Private Company and Public Company.

a. Private Company [Section 2(68)] means a company having a minimum paid-up share capital as may be prescribed, and which by its articles, —

   (i) restricts the right to transfer its shares;

   (ii) except in case of One Person Company, limits the number of its members to two hundred:

   (iii) prohibits any invitation to the public to subscribe for any securities of the company.

b. Public Company [Section 2(71)] means a company which —

   (i) is not a private company and;

   (ii) has a minimum paid-up share capital as may be prescribed.

A few other classes of companies defined under Companies Act, 2013 are:

a. One Person Company [Section 2(62)], which is a company which has only one person as a member;

b. Small Company [Section 2(85)] means a company, other than a public company, —

   (i) paid-up share capital of which does not exceed ₹4 crores or such higher amount as may be prescribed which shall not be more than ten crore rupees; and

   (ii) turnover of which does not exceed ₹40 crores or such higher amount as may be prescribed which shall not be more than one hundred crore rupees.

c. Not for Profit Company [Section 8 Company], which is a company that engages itself in promotion of art, science, sports, education, research, social welfare, religion, charity, protection of environment or any other such objects, provided it intends to apply its profits, if any, or other income in promoting its objects and intends to prohibit the payment of any dividend to its members.

d. Listed Company [Section 2(52)], which is a company whose securities are listed in a recognized stock exchange.

The Pivotal Role of Accounting in a Company Form of Organisation

Though accounting is a necessity in all forms of organisations, in companies, it assumes a pivotal role. In a company, the day-to-day business activities, both financial and non-financial, are managed by the Board of

Directors, an elected group of mangers. Unlike a sole proprietorship or partnership organisation, the owners of company's capital i.e., shareholders do not actively participate in the management of the company affairs. The Management acts as the stewards of the company and are responsible in managing its resources to achieve its stated objectives. Thus, there is a natural need for a mechanism to record and report how the activities undertaken by the Management are meeting such objectives. Accounting, in a company, helps managers to report to the shareholders how the resources entrusted with them have been utilized to enhance the surplus and the value of the shareholders' wealth. In addition, the accounting information also meet the needs for other stakeholders as well.

Distinguishing Features of Accounting in a Company Form of Organisation

Though the basic principles always remain the same, accounting in a company form of organisation has certain distinguishing features as follows:

a. The accounting process is highly regulated and guided by regulatory pronouncements.

b. Alternatives treatments of transactions are either limited or completely avoided.

c. The constituents of periodical accounts (i.e., income statement, balance sheet etc.) are specified by the law.

d. The form and contents of periodical financial statements are fixed. In other words, the format of financial statements is largely rule based rather than principle based.

e. The importance of compliance to the prescribed rules and regulations is paramount.

Regulatory Framework of Accounting in a Company Form of Organisation in India

In India, accounting in a company form of organisation is guided by the following regulatory sources:

a. The Companies Act, 2013: This is the primary source of law governing the operation including accounting in a company. Chapter IX of this Act, Accounts of Companies, mainly provides the provisions related to maintenance of accounts and preparation of financial statements. The relevant sections are Section 128 to Section 137. In addition, the Schedule III of this Act provides the format of financial statements.

b. The Company Rules: The Companies (Accounts) Rules, 2014 further provides important rules regarding accounting. In addition, some other rules such as Companies (Declaration and Payment of Dividend) Rules, 2014, Companies (Corporate Social Responsibility) Rules, 2014 etc. also provides important guidance on accounting of some specific transactions.

c. Accounting Standards: These are common sets of principles, standards, and procedures that define the basis of financial accounting policies and practices. As per Section 133 of Companies Act, 2013, in India, currently, two different sets of accounting standards are in force – Accounting Standards (or ASs) notified under Companies (Accounting Standards) Rules, 2021 [superseding Companies (Accounting Standards) Rules, 2006] and Indian Accounting Standards (or Ind ASs) notified under Companies (Indian Accounting Standards) Rules, 2015.

However, for special classes of companies such as banking companies, insurance companies, electricity companies and NBFCs, separate Acts and Rules, in addition to or in suppression of Companies Act, 2013, also provides important guidelines in accounting of transactions and preparation of financial statements.

- **Indian Accounting Standards have been modified as per the following rules. (From 2015 to 2023).**

  Companies (Indian Accounting Standards) Amendment Rules, 2023.

  Companies (Indian Accounting Standards) Amendment Rules, 2022.

  Companies (Indian Accounting Standards) Amendment Rules, 2021.

  Companies (Indian Accounting Standards) Amendment Rules, 2020.

  Companies (Indian Accounting Standards) Second Amendment Rules, 2019

  Companies (Indian Accounting Standards) Amendment Rules, 2019.

  Companies (Indian Accounting Standards) Second Amendment Rules, 2018.

  Companies (Indian Accounting Standards) Amendment Rules, 2018.

  Companies (Indian Accounting Standards) Amendment Rules, 2017.

  Companies (Indian Accounting Standards) Amendment Rules, 2016.

  Companies (Indian Accounting Standards) Amendment Rules, 2015.

- **Books of Accounts of a Company**

  The Companies Act, 2013 requires every company to maintain proper books of accounts and relevant books and papers.

  As per Section 2(12), "book and paper" and "book or paper" include books of account, deeds, vouchers, writings, documents, minutes and registers maintained on paper or in electronic form.

  Again, Section 2(13) specifies that, "books of account" includes records maintained in respect of —

  (i) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place;

  (ii) all sales and purchases of goods and services by the company;

  (iii) the assets and liabilities of the company; and

  (iv) the items of cost as may be prescribed under Section 148 in the case of a company which belongs to any class of companies specified under that section.

  Accordingly, the company should maintain Cash Book and Ledger [for (i) above], Day Books, Registers and Ledger [for (ii) above], Assets registers, Schedules and Ledger [for (iii) above] and Cost Books of Accounts [for (iv) above].

  Note: Section 128 of the Act has provided further that the company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.

- **Statutory Books**

Statutory books are those which a limited company is under statutory obligation to maintain at its registered office as per the provisions of different Sections of the Act.

The most important 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.

- **Annual Return**

As per Section 92 of the Act, every company shall prepare a return (hereinafter referred to as the annual return) in the prescribed form containing the particulars as they stood on the close of the financial year regarding—

(a) its registered office, principal business activities, particulars of its holding, subsidiary and associate companies;

(b) its shares, debentures and other securities and shareholding pattern;

(d) its members and debenture-holders along with changes therein since the close of the previous financial year;

(e) its promoters, Directors, key managerial personnel along with changes therein since the close of the previous financial year;

(f) meetings of members or a class thereof, Board and its various committees along with attendance details;

(g) remuneration of Directors and key managerial personnel;

(h) penalty or punishment imposed on the company, its Directors or officers and details of compounding of offences and appeals made against such penalty or punishment;

(i) matters relating to certification of compliances, disclosures as may be prescribed;

(j) details, as may be prescribed, in respect of shares held by or on behalf of the Foreign Institutional Investors; and

(k) such other matters as may be prescribed, and signed by a director and the company secretary, or where there is no company secretary, by a company secretary in practice.

Provided that in relation to One Person Company and small company, the annual return shall be signed by the company secretary, or where there is no company secretary, by the director of the company.

Section 92(4) further specifies that, every company shall file with the Registrar a copy of the annual return, within sixty days from the date on which the annual general meeting is held or where no annual general meeting is held in any year within sixty days from the date on which the annual general meeting should have been held together with the statement specifying the reasons for not holding the annual general meeting, with such fees or additional fees as may be prescribed.

Issue of Shares, Forfeiture of Shares, Rights Issue, Bonus Issue, Sweat Equity Shares, Employee Stock Option and Stock Purchase Scheme, Buy-back of Shares

1.1

Significance of Capital in a Company

In order to finance procurement of resources and to run its operations, every company requires capital. In a company form of organisation, this capital is raised not only from the promoters but also from others in the society i.e., public at large and institutional investors etc. This allows a traditional company (other than a one-person company) to raise huge amount of capital to finance operations at a larger scale.

Concept of Share and Share Capital

The total capital of a company is split into small equal parts. Each part therefore represents a 'share of the ownership' of the company. Investors subscribing to the same becomes the owner of the company and is known as shareholders or members of the company. Each such part of capital is sold in form of a security or instrument known as Share and the capital procured in the process is called Share Capital.

Thus, Share refers to a financial instrument that is issued by a company to its owners. It represents the smallest unit of ownership of a company. As per Section 2(84) of the Act, "share" means a share in the share capital of a company and includes stock.

Note: Stock represents aggregate of fully paid-up shares which are legally consolidated.

Features of Shares

Shares have the following features:

a. It represents the smallest unit of ownership.

b. Each share has a specific value representing the part of capital in value. Such value is called the face value or nominal value of share.

c. Shares of a specific series must have the same face value.

d. Share represents only a partial ownership of Share Capital of the company.

e. Shares are transferable and thereby ensures perpetual succession of the company.

f. Each share has a distinct number.

Types of Shares

On the basis of the rights enjoyed by the shareholders, shares can be divided into two categories as follows:

a. Preference Shares: These are shares in case of which the shareholders enjoy certain preferential right to receive dividend and repayment of capital in the event of liquidation of the company.

b. Equity Share: These are shares that are not preference shares. In other words, here, the shareholders do not enjoy the above two preferential rights.

Equity share capital may be: (As per Section 43 of the Companies Act 2023)

i. Equity share capital with voting rights or

ii. With differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed

Preference shares can further be classified into various types on different basis as shown below:

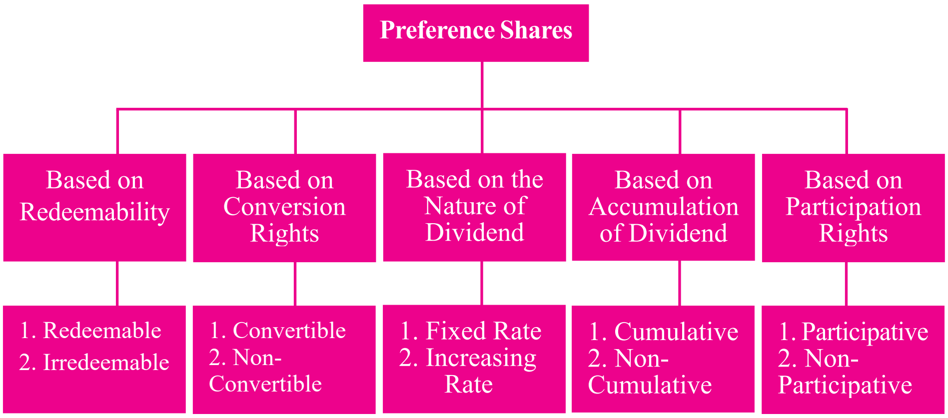

Figure 1.1: Different Types of Preference Shares

(i) Redeemable vs. Irredeemable Preference Shares

Redeemable preference shares are such where the capital is repaid on a fixed date after a period of time. In case of irredeemable preference shares, the capital is never repaid.

(ii) Convertible vs. Non-Convertible Preference Shares

Convertible preference shares are such which gives the preference shareholders to convert their shares into equity shares subject to the conditions specified. In case of non-convertible preference shares, the shareholders do not enjoy any such rights.

(iii) Fixed Rate vs. Increasing Rate Preference Shares

In case of fixed rate preference shares, the rate of dividend remain fixed throughout the term. However, in case of increasing rate[1] preference shares, the dividend rate increases after a certain period of time.

(iv) Cumulative vs. Non-Cumulative Preference Shares

Cumulative preference shares are such which carry the right to accumulated dividend. Thus, if the dividend is not paid in any year, it accumulates and becomes payable on subsequent year. Non-cumulative preference shares do not enjoy any such right.

(v) Participative vs. Non-Participative Preference Shares

Participatory preference shares are such where the holders have the right to participate (i.e., claim) into the residual distributable profit after paying equity dividend and to participate into the residual asset in the event of liquidation. This participatory right is in addition to their usual right to dividend and capital repayment. Non-participatory preference shares do not enjoy any such right.

[1] *See Ind AS 33*

Share Capital of a Company

Share capital means the capital raised by a company through issue of shares. It is the amount invested by the shareholders against the face value of shares. It is basically a part of a company's 'net worth' or 'equity'.

Types of Share Capital

Based on the type of shares used to raise the capital, share capital can be either Preference Share Capital or Equity Share Capital.

Again, on the basis of disclosure in the Balance Sheet, Share Capital is categorized as follows:

a. **Authorized Share Capital:** It is the amount of share capital that a company is permitted to issue. It is mentioned in the Capital Clause of the Memorandum of Association of the company. Authorized Share Capital is also known as Nominal Capital.

b. **Issued Share Capital:** It represents the portion of the Authorized Capital that has been offered by a company for subscription.

c. **Subscribed Capital:** It is that part of the issued capital for which applications are received from the public.

d. **Called up Capital:** It is that part of the subscribed capital that has been called up by the company for payment.

e. **Paid up Capital:** The part of the called-up capital which is offered and is actually paid by the members.

f. **Reserved Capital:** It is the portion of the uncalled capital of a company that is called-up for payment only in the event of liquidation of the company.

Reporting of Share Capital in Balance Sheet

In the Balance Sheet of a company prepared under Schedule III, Share Capital is reported under the head Shareholders' Fund in the section Equity and Liabilities with details given under Notes to Balance Sheet as follows:

Particulars	(₹)
Share Capital:	
Authorized Capital	
…Equity Shares of ₹…..each	*****
…. Preference Shares of ₹…. each	*****
	****
Issued and Subscribed Capital	
…Equity Shares of ₹…..each	*****
…. Preference Shares of ₹…. each	*****
	****
Called-up Capital	
…Equity Shares of ₹…..each	*****

…. Preference Shares of ₹…. each	*****
Less: Calls-in-arrear	(****)
Paid-up Capital	*****

Statement showing reconciliation of the Number and Amount of Shares

Particulars	Equity Shares of ₹…..each		Preference Shares of ₹…..each	
	No. of shares	(₹)	No. of shares	(₹)
Opening balance	****	****	****	****
Add: Fresh issue	****	****	****	****
Less: Buyback/Redemption	****	****	****	****
Closing balance	****	****	****	****

- **Various Types of Share Issue**

Following are some of the common types of share issue.

a. **Public Issue:** Here, the shares are offered directly to the investors for subscription. Accordingly, any person may become the shareholder of the company.

b. **Private Placement:** Here, the shares are issued by the company to a small number of selected investors preferably the financial institutions viz. large banks, mutual funds, insurance companies, pension funds etc.

c. **Rights Issue:** Here, the shares are offered to the existing shareholders of the company at a price below the market price on the basis of their proportionate shareholding.

d. **Bonus Issue:** Here, the shares are offered to the existing shareholders of the company without any consideration.

e. **Offers for sale:** An offer for sale (OFS) is a mechanism that allows promoters to reduce their holdings in listed companies transparently. These shares sold by the promoters are offered for sale directly to the public through a bidding process.

- **Issue Price of Shares**

The price at which the shares are offered for issue by a company may be either equal to, or above, or below the face value. Accordingly, shares can be issued at par, or at a premium, or at a discount.

a. **Issue at Par:** When share is issued at a price equal to its face value, it is called issue at Par.

b. **Issue at a Premium:** When share is issued at a price higher than its face value, it is called issue at Premium.

c. **Issue at a Discount:** When share is issued at a price lower than its face value, it is called issue at Discount.

Note: Relevant provisions of Companies Act, 2013 in this regard have been discussed later in this Module.

- **Public Issue of Shares**

A company issues its shares to the public at a specified price. Such price, in case of an Initial Public Offer (IPO) is determined under any of the following two approaches –

a. **Fixed Price Method:** Here shares are issued at a pre-determined price. The public is made known about the price through Prospectus and are requested to send application for subscription of the shares. The total proceeds can be collected either 'in lump sum' or 'in instalments'.

b. **Book Building Method:** Here shares are not offered at any pre-determined price but the final share price is determined after collecting bids from the investors at various prices within a Price Band having a minimum price known as Floor Price and a maximum price known as Cap Price. The price at which the shares are ultimately allotted is called 'cut-off price'. The proceeds are normally collected on lump-sum basis and accounted accordingly.

⦿ **Stages of Collection of Issue Price When Shares Are Issued in Instalments**

Under Fixed Price Method, normally the proceeds are collected through the following stages.

a. **Application Money:** It is the part of the issue price which is to be submitted along with the application for subscription.

b. **Allotment Money:** It is the money payable after shares are initially allotted.

c. **Call Money:** It is collected in subsequent instalment after collecting the allotment money. There may be multiple calls.

Note: Premium payable on shares may be collected with any of the above three instalments.

1.1.1 Accounting for Issue of Shares

Accounting entries for issue of equity shares and that of preference shares are similar. Therefore, in the following discussion on accounting entries for issue of shares, the term 'share' shall mean equity as well as preference shares.

⦿ **Issue of Shares at Par**

When shares are issued at par i.e., issue price equals to the face value per share, the journal entries for transactions relating to share issue will be as follows:

a. **Shares issued in lump sum**

(i) On receipt of application money

Bank A/c ……………………………………Dr.

To Share Application A/c

(ii) For excess share application money refunded

Share Application A/c ……………………. Dr.

To Bank A/c

(iii) On allotment of shares

Share Application A/c ………………………Dr.

To Share Capital A/c

Consider the following illustration.

Illustration 1

AK Ltd. made an issue of 10,00,000 equity shares of ₹ 10 each, payable fully on application. Subscriptions were received for 12,00,000 shares. Application money in respect of 2,00,000 shares was refunded and shares were duly allotted to the rest. Pass journal entries to give effect to these transactions.

Solution:

In the books of AK Ltd.

Journal **Dr.** **Cr.**

Date	Particulars	₹ ('000)	₹ ('000)
	Bank A/c …………………Dr. To Share Application A/c (Share application money on 12,00,000 shares @ ₹10 per share received.)	12,000	12,000
	Share Application A/c ……………. Dr. To Bank A/c (Share application money on 2,00,000 shares @ ₹10 per share refunded)	2,000	2,000
	Share Application A/c …………Dr. To Share Capital A/c (Share application money transferred to share capital account as per Board's resolution no.……. dated …)	10,000	10,000

b. Shares Issued in Installments

(i) On receipt of application money

Bank A/c …………………………………Dr.

To Share Application A/c

(ii) For excess share application money refunded

Share Application A/c ……………………. Dr.

To Bank A/c

(iii) For share application money transferred to share capital

Share Application A/c ………………………Dr.

To Share Capital A/c

(iv) For share allotment money due

Share Allotment A/c …………………………Dr.

To Share Capital A/c

(v) For share allotment money received

Bank A/c …………………………………Dr.

To Share Allotment A/c

(vi) For share call money due

Share Call A/c …………………………..Dr.

To Share Capital A/c

(vii)For share call money received

Bank A/c …………………………………Dr.

To Share Call A/c

Consider the following illustration.

Illustration 2

BK Ltd. made an issue of 10,00,000 equity shares of ₹10 each, payable @ ₹2 on application, ₹4 on Allotment and ₹4 on first and final call. Subscriptions were received for 12,00,000 shares. Application money in respect of 2,00,000 shares was refunded and shares were duly allotted to the rest. All the amounts were duly received. Pass journal entries to give effect to these transactions.

Solution:

In the books of BK Ltd.

Journal **Dr.** **Cr.**

Date	Particulars	₹ ('000)	₹ ('000)
	Bank A/c …………………Dr.	2,400	
	To Share Application A/c		2,400
	(Share application money on 12,00,000 shares @ ₹2 per share received.)		
	Share Application A/c ……………. Dr.	400	
	To Bank A/c		400
	(Share application money on 2,00,000 shares @ ₹2 per share refunded)		
	Share Application A/c …………Dr.	2,000	
	To Share Capital A/c		2,000
	(Share application money transferred to share capital account as per Board's resolution no.……. dated …)		
	Share Allotment A/c …………………………Dr.	4,000	
	To Share Capital A/c		4,000
	(Share allotment money due on 10,00,000 shares @ ₹4 per share as per Board's resolution no.……. dated …)		
	Bank A/c …………………………………Dr.	4,000	
	To Share Allotment A/c		4,000
	(Share allotment money received on 10,00,000 shares @ ₹ 4 per share)		

	Share First and final Call A/c……………………Dr. To Share Capital A/c (Share call money due on 10,00,000 shares @ ₹ 4 per share as per Board's resolution no.……. dated …)	4,000	 4,000
	Bank A/c …………………………………Dr. To Share First and final Call A/c A/c (Share call money received on 10,00,000 shares @ ₹ 4 per share)	4,000	 4,000

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:

1. For the issue of fully paid bonus shares to the members of the company;
2. For writing off preliminary expenses of the company;
3. For writing off the expenses of the commission paid or discount allowed on any issue of shares or debentures of the company; and
4. For providing premium payable on the redemption of any redeemable preference shares or debentures of the company.
5. For the purchase of its own shares or other securities u/s 68.

When shares are issued at premium, the journal entries for transactions relating to share issue will be as follows:

a. Shares issued in lump sum

(i) On receipt of application money (entire amount is received on application)

Bank A/c …………………………………Dr.

To Share Application A/c

(ii) For excess share application money refunded

Share Application A/c ……………………. Dr.

To Bank A/c

(iii) On allotment of shares

Share Application A/c ………………………Dr.

To Share Capital A/c (Face Value x no. of shares allotted)

To Securities Premium A/c (Premium x no. of shares allotted)

Illustration 3

AB & Co. Ltd. issued 5,00,00,000 Equity shares of ₹10 each at a premium of ₹4 per share payable on application. The shares were all subscribed and all money due was received. Give the Journal entries to record the above transactions.

Solution:

In the books of AB & Co. Ltd.

Journal **Dr.** **Cr.**

Date	Particulars	₹ (in lakh)	₹ (in lakh)
	Bank A/c …………………Dr.	7,000	
	To Share Application A/c		7,000
	(Share application money on 5,00,00,000 shares @ ₹14 per share received.)		
	Share Application A/c ………..Dr.	7,000	
	To Share Capital A/c		5,000
	To Securities Premium A/c		2,000
	(Share application money transferred to share capital account and Securities Premium account as per Board's resolution no.……. dated …)		

b. Shares Issued in Installments

Note: Unless otherwise stated premium is considered to be a part of allotment money.

(i) On receipt of application money

Bank A/c …………………………………Dr.

To Share Application A/c

(ii) For excess share application money refunded

Share Application A/c ……………………. Dr.

To Bank A/c

(iii) For share application money transferred to share capital

Share Application A/c ………………………Dr.

To Share Capital A/c

(iv) For share allotment money due

Share Allotment A/c …………………………Dr.

To Share Capital A/c

To Securities Premium A/c

(vi) For share allotment money received

Bank A/c …………………………………Dr.

To Share Allotment A/c

(vii)For share call money due

Share Call A/c …………………………..Dr.

To Share Capital A/c

(viii)For share call money received

Bank A/c ……………………………….Dr.

To Share Call A/c

Consider the following illustration.

Illustration 4

CD & 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. Give the Journal entries to record the above transactions.

Solution:

In the books of CD & Co. Ltd.

Dr. **Cash Book** **Cr.**

	₹ in Lakh		₹ in Lakh
To Equity Share Application A/c	500		
To Equity Share Allotment A/c	3,000		
To Equity Share 1st Call A/c	1,500		
To Equity Share Final Call A/c	2,000	By Balance c/d	7,000
	7,000		7,000

Journal

Particulars	Dr. ₹ In Lakh	Cr. ₹ In Lakh
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 …)	500	 500
Equity Share Allotment A/c To Equity Share Capital A/c To Securities Premium A/c (Share allotment money including premium due as per Board's resolution no.……. dated …)	3,000	 1,000 2,000
Equity Share First Call A/c To Equity Share Capital A/c (Share first call money due as per Board's resolution no.……. dated …)	1,500	 1,500
Equity Share Final Call A/c To Equity Share Capital A/c (Share final call money due as per Board's resolution no.……. dated …)	2,000	 2,000

Calls-in-Arrear

When the shareholders fail to pay any instalment (Allotment or call) that has been called up, the amount so unpaid is treated as calls-in-arrear and is accounted as such. If not ultimately received, the balance of Calls-in-arrear is deducted from Called-up Capital in the Notes to Balance Sheet (See **Reporting of Share Capital in the Balance Sheet**)

The accounting entry for calls-in-arrear is as follows:

Bank A/c …………………Dr. (Amount received)

Calls-in-arrear A/c………… Dr. (instalment amount not received)

To Share Allotment/Share Call A/c

If received subsequently, the entry will be –

Bank A/c …………………Dr.

To Calls-in-arrear A/c

Illustration 5

EF & 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 Journal entries to record the above transactions.

Solution:

In the books of EF & Co. Ltd.

Dr. **Cash Book** **Cr.**

	₹ in Lakh		₹ in Lakh
To Equity Share Application	500		
To Equity Share Allotment	3,000		
To Equity Share 1st Call	1,497		
To Equity Share Final Call	1,994	By Balance c/d	6,991
	6,991		6,991

Journal

Particulars	Dr. ₹ In Lakh	Cr. ₹ In Lakh
Equity Share Application A/c	500	
To Equity Share Capital A/c		500
(Share application money transferred to share capital account as per Board's resolution no.……. dated …)		

Equity Share Allotment A/c	3,000	
To Equity Share Capital A/c		1,000
To Securities Premium A/c		2,000
(Share allotment money including premium due as per Board's resolution no……. dated …)		
Equity Share First Call A/c	1,500	
To Equity Share Capital A/c		1,500
(Share first call money due as per Board's resolution no……. dated …)		
Equity Share Final Call A/c	2,000	
To Equity Share Capital A/c		2,000
(Share final call money due as per Board's resolution no……. dated …)		

Calls-in-Advance

Section 50 of the Companies Act, 2013, states that –

(1) A company may, if so authorised by its articles, accept from any member, the whole or a part of the amount remaining unpaid on any shares held by him, even if no part of that amount has been called up.

(2) A member of the company limited by shares shall not be entitled to any voting rights in respect of the amount paid by him under sub-section (1) until that amount has been called up.

Calls-in-advance generally arises when there is an over-subscription of shares. Here, the excess application money is adjusted against the amount due on allotment or calls. The excess application money, after adjustment against the allotment money due, is transferred to a separate account called 'Calls-in-Advance A/c'. Sometimes, shareholders may also prefer to pay the entire amount of issue price at the time of allotment. In such a situation also calls-in-advance arises and the same is adjusted against call money due subsequently. Balance of Calls-in-Advance on the reporting date is shown under Other Current Liabilities.

The accounting entry for calls-in-advance are as follows:

(i) For transferring excess application money

Share Application A/c ………………. Dr.

To Calls-in-Advance A/c

(ii) For money received in advance against call

Bank A/c ……………….Dr.

To Calls-in-Advance A/c

(iii) For adjustment of calls-in-advance

Calls-in-Advance A/c …………..Dr.

To Share Call A/c

Illustration 6

GH & Co. Ltd. issued 5,000 Equity shares of ₹10 each at par, payable ₹2 per share on application, ₹4 per share on allotment, ₹4 on first call and final call. The shares were all subscribed and all money due was received. One shareholder holding 200 shares paid the call money along with the allotment money. The amount was subsequently adjusted. Give the Journal entries to record the above transactions.

Solution:

In the books of GH & Co. Ltd.

Journal

Date	Particulars	Dr. ₹	Cr. ₹
	Bank A/c ……………........................…Dr. To Share Application A/c	10,000	10,000
	Share Application A/c ………..............Dr. To Share Capital A/c	10,000	10,000
	Share Allotment A/c …………..............Dr. To Share Capital A/c	20,000	20,000
	Bank A/c …………………......................Dr. To Share Allotment A/c	20,000	20,000
	Bank A/c ………….........................…Dr. To Calls-in-Advance A/c	800	800
	Share 1st and Final Call A/c ……………Dr. To Share Capital A/c	20,000	20,000
	Bank A/c …………….....................…Dr. Calls-in-Advance A/c……….............…Dr. To Share 1st and Final Call A/c	19,200 800	 20,000

Interest on Calls-in-Arrear

Interest on calls-in-arrear may be collected by the directors from the shareholders, if the Articles of Association so permit. In the absence of any specification, the company needs to follow 'Table F' according to which interest @ 10% p.a. from the due date to the date of actual payment is payable by the shareholders unless the same is waived by the Board.

The accounting entries for the same are as follows:

(i) For interest due

Shareholders A/c ………………Dr.

To Interest on Calls-in-Arrear A/c

(ii) On realization of interest

Bank A/c ……………………Dr.

To Shareholders A/c

(iii) For transferring interest to Profit and Loss Account

Interest on Calls-in-Arrear A/c ……………. Dr.

To Profit and Loss A/c

Interest on Calls-in-Advance

Interest may be paid by a company on calls-in-advance is the Articles of Association so provide. In the absence of any specification, the company needs to follow 'Table F' according to which interest @ 12% p.a. from the date of receipt to the due date of the concerned installment is payable.

The accounting entries for the same are as follows:

(i) For interest due on calls-in-advance

Interest on Calls-in-Arrear A/c ………………Dr.

To Shareholders A/c

(ii) On payment of interest

Shareholders A/c ……………………Dr.

To Bank A/c

(iii) For transferring interest to Profit and Loss Account

Profit and Loss A/c ……………. Dr.

To Interest on Calls-in-Arrear A/c

Consider the following illustrations.

Illustration 7

B Ltd issued 2,000 shares of ₹ 100 each at a premium of 10% payable as follows:

On application ₹ 20 (1st April 2023). On allotment ₹ 40 (including premium) (1st June 2023). On First Call ₹ 30 (1st July 2023). On Second & Final call ₹ 20 (1st Aug 2023).

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. 2023.

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 8

A limited Company was registered with a capital of ₹ 5,00,000 in share of ₹ 100 each and issued 2,000 such shares at a premium of ₹ 20 per share, payable as ₹ 20 per share on application, ₹ 50 per share on allotment (including premium) and ₹ 20 per share on first call made three months later. All the money payable on application, and allotment were duly received but when the first call was made, one shareholder paid the entire balance on his holding of 30 shares, and another shareholder holding 100 shares failed to pay the first call money.

Required: Give Journal entries to record the above transactions.

Solution:

In the books of ....

Journal

Particulars		Dr. ₹	Cr. ₹
Bank A/c	Dr.	40,000	
To Share Application A/c			40,000
[Being the issue of 2,000 shares and application money received @ ₹ 20 per share]			
Share Application A/c	Dr.	40,000	
To Share Capital A/c			40,000
[Being the transfer of application money on 2,000 shares @ ₹ 20 per share to Share Capital A/c)			
Share Allotment A/c	Dr.	1,00,000	
To Share Capital A/c			60,000
To Securities Premium A/c			40,000
(Being the allotment money on 2,000 shares @ ₹ 50 including premium made due)			
Bank A/c	Dr.	1,00,000	
To Share Allotment A/c			1,00,000
(Being the allotment money on 2,000 shares @ ₹ 50 per share received)			
Share First Call A/c	Dr.	40,000	
To Share Capital A/c			40,000
(Being the first call money on 2,000 shares @ ₹ 20 per share made due)			
Bank A/c	Dr.	38,900	
To Share First Call A/c			38,000
To Call-paid-in-advance A/c			900
(Being the first call money on 1,900 shares @ ₹20 per share and share Second call money on 30 shares @ ₹30 per share received)			
Calls in Arrear A/c	Dr.	2,000	
To Share First Call A/c			2,000
(Being the first call money for 100 shares is in arrear)			

Issue of Shares for Consideration other than Cash

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 A/c .... Dr.

To Share Capital A/c

(Being ... shares allotted……in consideration of purchase of an asset for the company)

If shares are issued to Promoters for their services, the following entry will be passed:

Goodwill A/c ………………………… Dr.

To Share Capital A/c

Similarly, if shares are issued to Underwriters for underwriting commission, the following entry will be passed:

Underwriters A/c …………………………. Dr.

To Share Capital A/c

Note: The fact should also be disclosed in the Balance Sheet while showing the issued, subscribed and paid-up capital.

Consider the following illustrations.

Illustration 9

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:

In the books of B Ltd.

Journal

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

Working Note:

Calculation of No. of Shares to be 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 10

D Ltd. issued 2,000 shares of ₹100 each credited as fully paid to the promoters for their services and issued 1,000 shares of ₹100 each credited as fully paid to the underwriters for their underwriting services. Journalise these transactions.

Solution:

In the books of D Ltd.
Journal

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

Prohibition on Issue of Shares at Discount [Section 53]

a. Except as provided in section 54, a company shall not issue shares at a discount.

b. Any share issued by a company at a discounted price shall be void. However, notwithstanding anything contained in sub-sections (1) and (2), a company may issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949].

c. Where any company fails to comply with the provisions of this section, such company and every officer who is in default shall be liable to a penalty which may extend to an amount equal to the amount raised through the issue of shares at a discount or five lakh rupees, whichever is less, and the company shall also be liable to refund all monies received with interest at the rate of twelve per cent. per annum from the date of issue of such shares to the persons to whom such shares have been issued.

- **Expense on Issue of Shares**

The common expenses associated with share issue are printing charges of prospectus and application forms, brokerage and commission, underwriting expenses, legal charges etc. These are written off against the profits of the company in the same year or over the years depending on the availability of profits and based on the pattern of benefit derivable from the same.

The accounting entries are:

(i) Upon expenditure incurred

Share Issue Expenses A/c .... Dr.

To Bank A/c

(ii) When the expenses are written off

Profit and Loss A/c .... Dr.

To Share Issue Expenses A/c

Note: Accordingly, in the Statement of Profit and Loss, the same is included under the head Other Expense.

- **Over Subscription, Pro-rata Allotment and Adjustment of Excess Application Money towards the Amount due on the Allotment**

Sometimes a company may receive more number of applications than the shares actually offered for subscription. This is called Over Subscription. In such a situation, the company may choose a few applicants while rejecting the others fully. However, this selection is not justifiable. In such a case, the company may issue shares on a pro-rata basis where the all the investors applying for shares get a certain percentage of their applications actually accepted. 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 might send 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 11

On 1st May 2023 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 2023 for 6,000 shares and allotment was made on 1st June 2023. 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, 2023 and 1st August 2023 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:

In the books of Supreman Ltd.

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
1.6.23	Equity Share Application A/c Dr.	1,10,000	
	To Equity Share Capital A/c		1,00,000
	To Share Allotment A/c		10,000
	(Being the transfer of application money @ ₹ 20 per share on 5,000 shares transferred to Share Capital A/c and @ ₹ 20 on 500 t/f to Share Allotment A/c)		
1.6.23	Equity Share Allotment A/c Dr.	1,50,000	
	To Equity Share Capital A/c		1,50,000
	(Being allotment money due on 5000 shares @ ₹ 30 per share		
1.7.23	Equity Share First Call A/c Dr.	1,00,000	
	To Equity Share Capital A/c		1,00,000
	(Being 1st call money due on 5000 shares @ ₹ 20 per share		
1.8.23	Calls-in-Arrear A/c Dr.	3,000	
	To Equity Share first call A/c		3,000
	(Being the non receipt of 1st call money on 150 equity shares @₹20 each transferred to calls-in-Arrear A/c)		
1.8.23	Equity Share Final Call A/c Dr.	1,50,000	
	To Equity Share Capital A/c		1,50,000
	(Being final call money due on 5000 shares @ ₹ 30 per share		
30.8.23	Shareholders A/c Dr.	25	
	To Interest on calls-in-arrear		25
	(Being the interest due on first call on ₹300 @ 5% for two months, assumed payment made on 30.8.23		
1.09.23	Calls-in-Arrear A/c Dr.	3,000	
	To Equity Share Final Call A/c		3,000
	(Being the transfer to calls-in-Arrear A/c final call money on 100 equity shares @ ₹30 per shares)		
31.10.23	Shareholders A/c Dr.	25	
	To Interest on Calls-in-Arrears A/c		25
	(Being the interest due on ₹ 3,000 @ 5% for two months)		

Cash Book (Bank Column)

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
15.5.23	To Equity Share Application A/c (Application money @ ₹ 20 per share on 6,000 shares)	1,20,000	01.6.23	By Equity Share Application A/c (Refund of application money @ ₹ 20 per share on 500 shares rejected)	10,000
15.6.23	To Equity Share Allotment A/c (Balance of allotment money)	1,40,000			
31.07.23	To Equity Share 1st Call A/c (1st Call money on 4,850 shares)	97,000			
30.08.23	To Equity Share Final A/c (Final call money on 4,900 Shares)	1,47,000			
30.08.23	To Calls-in-Arrear A/c (Arrear of 1st Call money @ ₹ 20 per Share on 1,50 Shares)	3,000			
1.9.23	Shareholders A/c (Interest on ₹ 3,000 for two months @ 5% p.a.)	25	31.10.23	By Balance c/d	4,97,025
		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	-

1.1.2 Forfeiture and Re-issue of Shares

Where issue proceeds on shares are collected in instalments, the shareholders are expected to pay the amount of allotment and subsequent call money as and when they become due. However, if the shareholder fails to pay the same, it results in calls-in-arrear. If the Articles of the company so permit, the company may confiscate the shares on the ground of non-payment of instalments. This is known as Forfeiture of Shares. On forfeiture, however, the amount received on shares till such date is not returnable and the same becomes a capital receipt for the company and transferred to Forfeited Shares A/c.

The shares so forfeited may again be re-issued by the company afresh to new shareholders. This process is called Re-issue of Forfeited Shares. These shares are generally re-issued at a price lower than the face value of shares. However, the minimum re-issue price must be equal to called up value less amount collected (capital portion) on each share before forfeiture. The resulting loss is adjusted against Forfeited Shares A/c. the balance of the Forfeited Shares A/c, representing the net profit on forfeiture and re-issue of shares, is transferred to Capital Reserve A/c.

In case the shares are re-issued at a price higher than the face value, the excess amount is not payable to the original shareholders. It is to be transferred to 'Securities Premium A/c'. For shares forfeited but not yet re-issued, the balance of Forfeited Shares A/c should be shown under the head Share Capital in the Balance Sheet.

The accounting entries for forfeiture and re-issue are as follows:

(i) On forfeiture of shares

Share Capital A/c ………………………Dr. (Called-up value)

Securities Premium A/c …………………Dr. (Premium due but not collected)

To Calls-in-Arrear A/c (Amount unpaid)

To Forfeited Shares A/c (Capital portion received on shares forfeited)

(ii) On re-issue of shares

Bank A/c ………………………. Dr. (Proceeds from re-issue)

Forfeited Shares A/c ………………. Dr. (Discount on re-issue)

To Share Capital A/c (Paid-up value of shares re-issued)

To Securities Premium A/c (Premium on shares re-issued, if any)

(iii) On transfer of profit

Forfeited Shares A/c (Net profit on forfeiture and re-issue)

To Capital Reserve A/c

The net profit on forfeiture and re-issue of shares can be calculated as shown in the following statement.

Profit on forfeiture $\left(\dfrac{\text{Total Profit on Forfeiture of Shares}}{\text{No. of Shares Forfeited}}\right) \times$ No. of Shares reissued	***
Less: Discount on re-issue	***
Net profit to be transferred to Capital Reserve	***

Consider the following illustrations

Illustration 12

ICC Ltd. forfeited 500 equity shares of ₹10 each fully called up which were issued at a premium 20%. Amount payable on shares were: on application ₹2; on allotment ₹5; on first and final call ₹5. Only application money was paid by the shareholders in respect of these shares. 300 shares out of the above were reissued at ₹9 per share fully paid. Pass journal entries for the forfeiture and re-issue.

Solution:

In the books of ICC Ltd.

Journal **Dr.** **Cr.**

Particulars			(₹)	(₹)
Equity Share Capital A/c	Dr.	(500x10)	5,000	
Securities Premium A/c	Dr.	(500x2)	1,000	
To Equity Share Allotment A/c (500 × 5)				2,500
To Equity Share Final Call A/c (500 × 5)				2,500
To Forfeited Shares A/c (500 × 2)				1,000
(Being the forfeiture of 500 equity shares of ₹10 each fully called up for nonpayment of allotment and final call money as per board resolution number. ……. Dated)				
Bank A/c	Dr.	(300 x 9)	2,700	
Forfeited Share A/c	Dr.	(300 x 1)	300	
To Equity Share Capital A/c				3,000
(Being reissue of 300 forfeited shares at ₹9 per share fully paid as per Board's resolution number…. Dated…)				
Forfeited Share A/c	Dr.		300	
To Capital Reserve A/c				300
(Being net profit on forfeiture and re-issue of 300 shares transferred to Capital Reserve)				

Working:

Calculation of net profit to be transferred to Capital Reserve

Profit on forfeiture $\frac{1000}{500} \times 300$	₹600
Less: Discount on re-issue (300 x 1)	₹300
Net profit to be transferred to Capital Reserve	₹300

Comprehensive Problems on Forfeiture and Re-issue of Shares

Illustration 13

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:

In the books of Priyanka Industries Ltd.
Journals

Particulars		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 as per Board's Resolution No.... dated....)			
Share Allotment A/c	Dr.	8,000	
To Share Capital A/c			8,000
(Being the allotment money due as per Board's Resolution No.... dated....)			
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 money due as per Board's Resolution No.... dated....)			
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 money due as per Board's Resolution No.... dated....)			

Bank A/c Dr. Calls in Arrear A/c Dr. To Share Second Call A/c (Being the second call received on 600 shares)		6,000 2,000	 8,000
Share Capital A/c Dr. To Forfeited Share A/c [(50×30) + (25 ×20)] To Calls in Arrear A/c [(50×30) + (25 ×10)] (Being 75 shares forfeited as per Board's Resolution No.... dated....)		3,750	 2,000 1,750

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) PPE and Intangible assets			
	(i) Tangible assets - PPE	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. PPE	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 14

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:

In the books of SOS Limited
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
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	By Balance c/d	71,750
	74,750		74,750

Journal

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

Share Second and Final Call A/c To Share Capital A/c [Being the second and final call money due on 5,900 Shares]	Dr.	11,800	 11,800
Calls –in-arrear A/c To Share Second and Final Call A/c [200×2]	Dr.	400	 400
Share Capital A/c (200×10) 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]	Dr.	2,000	 1,000 1,000
Forfeited Share A/c To Share Capital A/c [Being discount on 200 shares re-issued]	Dr.	300	 300
Forfeited Share A/c To Capital Reserve A/c [Being the transfer of profit on re-issue]	Dr.	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 = $\frac{5 \times 2 - 4 \times 2}{4 \text{ Shares}}$ = ₹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 – 100)× ₹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 15

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:

In the Books of Alpha Ltd.
Journals

Particulars		Dr. (₹)	Cr. (₹)
Bank A/c	Dr.	6,000	
To Share Application A/c			6,000
[Being the application money received on 3,000 shares)			
Share Application A/c	Dr.	6,000	
To Share Capital A/c			4,000
To Bank A/c			1,200
To Share Allotment A/c (2,000@ ₹0.40)			800
[Being the transfer and refund of application money received on 3,000 shares]			
Share Allotment A/c	Dr.	10,000	
To Share Capital A/c			6,000
To Securities Premium A/c			4,000
[Being the allotment money due]			
Bank A/c	Dr.	9,016	
Calls in Arrear A/c	Dr.	184	
To Share Allotment A/c			9,200
[Being the remaining allotment money received on 1,960 shares]**			
Share First Call A/c	Dr.	6,000	
To Share Capital A/c			6,000
[Being the first call money due]			
Bank A/c	Dr.	5,700	
Calls in Arrear A/c	Dr.	300	
To Share First Call A/c			6,000
[Being the first call money received on 1,900 shares @ ₹ 3 per share]**			

Share Capital A/c (40 × ₹8)	Dr.	320	
Securities Premium A/c	Dr.	80	
To Calls in Arrear A/c (184 +120)			304
To Forfeited Share A/c			96
[Being 40 shares forfeited for non-payment of full allotment money and the first call money]			
Share Second & Final Call A/c	Dr.	3,920	
To Share Capital A/c			3,920
[Being the second and final call due on 1,960 share]			
Bank A/c	Dr.	3,800	
Calls in Arrear A/c	Dr.	120	
To Share Second and Final Call A/c			3,920
[Being the second and final call received on 1,900 shares]			
Share Capital A/c	Dr.	600	
To Calls in Arrear A/c			300
To Forfeited Shares A/c			300
[Being 60 shares forfeited for non-payment on the first call and final call]			
Bank A/c	Dr.	720	
Forfeited Shares A/c	Dr.	80	
To Share Capital A/c			800
[Being the reissued of 80 shares @ ₹ 9 as fully paid up]			
Forfeited Shares A/c	Dr.	216	
To Capital Reserve A/c			216
[Being the transfer of profit on re-issue]			
[On 40 @ ₹(2.40 - 1.00) = 56			
On 40 @ ₹(5.00 – 1.00) =160 = 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) 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 16

Hero Limited issued 10,000 equity shares of ₹100 each at premium of ₹25 per share. Under the terms of the isue, the shares were to be paid for as follows:

2023 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, 2022.

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, 2022 the directors re-issued the forfeited shares as fully paid to Mohan, on receiving a payment of ₹10,500.

To prepare a statement as on February 1, 2022, showing the over-payment, under-payment to in respect of category of applicants: and

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)	(1,00,000)	15,00,000	1,50,000
In case of shortage, the shareholders will deposit the dues.			

(b) **Journals**

2023	Particulars	Dr. (₹)	Cr. (₹)
Jan. 01	Bank A/c Dr.	28,00,000	
	To Equity Share Application A/c		28,00,000
	(Application money received on 56,000 shares @ ₹ 50 per share)		
Feb. 01	Equity Share Application A/c Dr.	5,00,000	
	To Equity Share Capital A/c		2,50,000
	To Securities Premium A/c		2,50,000
	(Being application money on 10,000 shares transferred to share Capital and Securities Premium vide Board's resolution no........ dated........)		
	Equity Share Application A/c Dr.	16,50,000	
	To Bank A/c		16,50,000
	(Being excess application money refunded of vide Board's resolution no........ dated........)		

	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

Illustration 17

JK Ltd is a company with an authorized capital of ₹10 lacs in equity shares of ₹10 each, of which 600000 shares had been issued and fully paid on 30th June, 2022. The company proposed to make a further issue of 100000 of these ₹ 10 shares at a price of ₹14 each the arrangements for payment being:

₹ 2 per share payable on application, to be received by 1st July 2022.

Allotment to be made on 10th July and a further ₹5 per shares (including the premium) to be payable.

The final call for the balance to be made, and the money received by 31st January 2023.

Applications were received for 355000 shares and were dealt with as follows:

Applicants for 5000 shares received allotment in full.

Applicants for 30000 shares received an allotment of one share for every 2 applied for, no money was returned to the applicant, the surplus on application being used to reduce the amount due on allotment.

Applicants for 320000 shares received an allotment of one share for every four applied for, the money due on allotment was retained by the company, the excess being returned to the applicant.

The money due on final call was received on the due date.

You are required to record these transactions in the journal of JK Limited.

Solution:

Working note:

Category	Application	Allotment	Money received on application (₹)	Amount required on application (₹)	Amount adjusted on allotment (₹)	Refund 3-(4+5) (₹)	Amount due on allotment (₹)	Amount receivable on allotment 7-5 (₹)
1	5,000	5,000	10,000	10,000			25,000	25,000
2	30,000	15,000	60,000	30,000	30,000		75,000	45,000
3	3,20,000	80,000	6,40,000	1,60,000	4,00,000	80,000	4,00,000	
Total	3,55,000	1,00,000	7,10,000	2,00,000	4,30,000	80,000	5,00,000	70,000

In the books of JK Ltd.

Journal

Date	Particulars		Dr. (₹)	Cr. (₹)
1.7.2022	Bank A/c	Dr.	7,10,000	
	To Share Application A/c			7,10,000
10.07.2022	Equity Share Application A/c	Dr.	7,10,000	
	To Equity Share Capital A/c			2,00,000
	To Equity Share Allotment A/c			4,30,000
	To Bank A/c			80,000
	Equity Share Allotment A/c	Dr.	5,00,000	
	To Equity Share Capital A/c			1,00,000
	To Securities Premium A/c			4,00,000
	Bank A/c	Dr.	70,000	
	To Equity Share Allotment A/c			70,000
	Equity Share Final Call A/c	Dr.	7,00,000	
	To equity Share Capital A/c			7,00,000
31.01.2023	Bank A/c	Dr.	7,00,000	
	To Equity Share Final Call A/c			7,00,000

Illustration 18

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:

In the books of ....

Journals

Particulars	Dr. ₹ '000	Cr. ₹ '000
Bank A/c Dr.	2,60,000	
To Equity Share Application A/c		2,60,000
(Share application money received on 13,000,000 equity shares @ ₹20 each)		
Equity Share Application A/c Dr.	40,000	
To Bank A/c		40,000
(Application for 2,000,000 rejected)		
Equity Share Application A/c Dr.	2,20,000	
To Equity Share Capital A/c		2,00,000
To Equity Share Allotment A/c		20,000
(Share application money transferred to share capital account and excess money used for share allotment.)		
Equity Share Allotment A/c Dr.	4,00,000	
To Equity Share Capital A/c		3,00,000
To Security Premium A/c		1,00,000
(Share Allotment due on 10,000,000 shares @ ₹40 per share as per the resolution of the Board of Directors)		
Bank A/c Dr.	3,80,000	
To Equity Share Allotment A/c		3,80,000
(Allotment money received)		
Equity Share first call A/c Dr.	3,00,000	
To Equity Share Capital A/c		3,00,000
(First call money due)		
Bank A/c Dr.	3,00,000	
To Equity Share First call A/c		3,00,000
(First call money received)		

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

Working:

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

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 19

Give journal entries for the following:

(1) 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.

(2) 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.

(3) 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:

In the books of ....

Journals

	Particulars	Dr. ₹	Cr. ₹
a)	Equity Share Capital A/c Dr.	1,00,000	
	To Calls in Arrear A/c		50,000
	To Forfeited Share A/c		50,000
	(10,000 shares forfeited for non-payment of first and final call money)		
	Bank A/c Dr.	65,000	
	Forfeited Share A/c Dr.	35,000	
	To Equity Share Capital Account		1,00,000
	(Reissue of 10,000 sh. @ ₹ 6.50 each)		
	Forfeited Share A/c Dr.	15,000	
	To Capital Reserve A/c		15,000
	(Balance of Forfeited share Account transferred)		
b)	Equity Share Capital A/c Dr.	200,000	
	To Calls in Arrear A/c		60,000
	To Forfeited share A/c		140,000
	(20,000 shares forfeited for non-payment of final call money)		
	Bank A/c Dr.	60,000	
	Forfeited Share A/c Dr.	40,000	
	To Equity Share Capital A/c		100,000
	(Reissue of 10,000 sh. @ ₹ 6 each)		
	Forfeited Share A/c Dr.	30,000	
	To Capital Reserve A/c		30,000
	(Balance of Forfeited share A/c relating to 10,000 shares transferred) [10,000 × (7-4)]		
c)	Equity Share Capital A/c Dr.	150,000	
	Securities Premium A/c Dr.	75,000	
	To Calls in Arrear A/c		1,95,000
	To Forfeited share A/c		30,000
	(15,000 shares forfeited for non- payment of allotment and first and final call money)		

	Bank A/c Dr.	140,000	
	To Security Premium A/c		40,000
	To Equity Share Capital A/c		100,000
	(Reissue of 10,000 sh. @ ₹ 14 each)		
	Forfeited Share A/c Dr.	20,000	
	To Capital Reserve A/c		20,000
	(Balance of Forfeited share A/c on 10,000 shares transferred)(10,000×2)		

llustration 20

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:

In the books of X Ltd.

Journal (without narration)

	Particulars	Dr. ₹	Cr. ₹
(1)	Application Money Received:		
	Bank A/c Dr.	36,000	
	To Equity Shares Application A/c (12,000×3)		36,000
(2)	Refund of excess application money:		
	Equity Share Application A/c (2,000×3) Dr.	6,000	
	To Bank A/c		6,000
(3)	Transfer of share application to Share Capital:		
	Equity Shares Application A/c (10,000 ×3) Dr.	30,000	
	To Equity Shares Capital A/c (10,000×2)		20,000
	To Securities Premium A/c (10,000×1)		10,000
(4)	Allotment Money Due:		
	Equity Shares allotment A/c (10,000×4) Dr.	40,000	
	To Equity Share Capital A/c (10,000×3)		30,000
	To Securities Premium A/c (10,000×1)		10,000
(5)	Allotment Money Received:		
	Bank A/c (9,970×4) Dr.	39,880	
	Calls-in-Arear A/c (30×4) Dr.	120	
	To Equity Share Allotment A/c		40,000

(6)	Bank A/c Dr.	250	
	To Calls in Arrear A/c		250
(7)	Share Call Money Due:		
	Equity Share First & Final call A/c (10,000 × 5) Dr.	50,000	
	To Equity Share Capital A/c		50,000
(8)	Call Money Received, Adjustment of Calls-in-Advance:		
	Bank A/c (9,920 × 5) Dr.	49,600	
	Calls-in-Arrear A/c (30 × 5) Dr.	150	
	Calls-in-Advance A/c Dr.	250	
	To Equity Shares First & Final Call A/c		50,000
	(Received with Allotment, now adjusted)		
(9)	Forfeiture of Shares:		
	Equity Share Capital A/c (30×10) Dr.	300	
	Securities Premium A/c (30×1) Dr.	30	
	To Calls-in-Arrear A/c		270
	To Shares Forfeited A/c		60
(10)	Reissue of Forfeited Shares:		
	Bank A/c (25×9) Dr.	225	
	Share Forfeited A/c Dr.	25	
	To Equity Shares Capital A/c (25×10)		250
(11)	Transfer of Profit on Reissue of Forfeited shares		
	Shares Forfeited A/c Dr.	25	
	To Capital Reserve A/c [25 × (2 - 1)]		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

Illustration 21

JB Ltd. issued 60000 equity shares of ₹10 each at a premium of ₹2.50 per share. The amount payable on application is ₹ 4.50 (including premium). The amount payable on allotment was fixed at ₹ 4 per share and an equivalent sum was due on a call to be made.

Total applications received were for 110000 shares and after consulting the stock exchange, the following scheme for allotment was decided upon:

Category	A	B	C
Grouping of shares	1 to 100	101 to 500	Over 500
No of applications received	1200	175	5
No of shares applied for	70000	35000	5000
No of shares allotted	42000	14000	4000

It was decided that the excess amount received on applications would be utilised in payment of allotment money and surplus if any would be refunded to the applicant. Sanjay who was one of the applicants belonging to category A and had applied for 100 shares defaulted in payment of allotment money. Vivek, who belonged to category c, and who had been allotted 800 shares failed to pay the call money. Their shares were forfeited, after the respective calls were made and re-issued as fully paid up for ₹8 and ₹6 per share respectively. Show the necessary journal entries in the books of the company to record the above transactions.

Solution:

Workings:

Category	application	Allotment (₹)	Money received on application (₹)	Amount required on application (₹)	Amount adjusted on allotment (₹)	Refund. 3-(4+5) (₹)	Amount due on allotment (₹)	Amount receivable on allotment 7-5 (₹)
1	70,000	42,000	3,15,000	1,89,000	1,26,000	0	1,68,000	42,000
2	35,000	14,000	1,57,500	63,000	56,000	38,500	56,000	
3	5,000	4,000	22,500	18,000	4,500	0	16,000	11,500
Total	**1,10,000**	**60,000**	**4,95,000**	**2,70,000**	**1,86,500**	**38,500**	**2,40,000**	**53,500**

In the Books of JB Ltd.
Journal

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	4,95,000	
	To Share Application A/c			4,95,000
	Equity Share Application A/c	Dr.	4,95,000	
	To Equity Share Capital A/c			1,20,000
	To Securities Premium A/c			1,50,000
	To Equity Share Allotment A/c			1,86,500
	To Bank A/c			38,500
	Equity Share Allotment A/c	Dr.	2,40,000	
	To Equity Share Capital A/c			2,40,000
	Bank A/c	Dr.	53,440	
	To Equity Share Allotment A/c			53,440
	Equity Share Final Call A/c	Dr.	2,40,000	
	To Equity Share Capital A/c			2,40,000
	Bank A/c	Dr.	2,36,560	
	To Equity Share Final Call A/c			2,36,560

	Equity Share Capital A/c Dr.		8,600	
	To Equity Share Allotment A/c			60
	To Equity Share Final Call A/c			3,440
	To Forfeited Shares A/c			5,100
	Bank A/c Dr.		5,280	
	Forfeited Shares A/c Dr.		3,320	
	To Equity Share Capital A/c			8,600
	Forfeited Share A/c Dr.		1,780	
	To Capital Reserve A/c			1,780

Working note:

1. Ascertainment of no of shares allotted to Sanjay

No of shares applied	70000
No of shares allotted	42000
Therefore No of shares for ₹100 = (42000/70000) ×100	60 shares

2.

	₹
Application money paid	450
Less adjusted with application 60 × 4.50 =	270
Excess application money	180
Allotment money due	240
Less excess application money	180
Money due on allotment by Sanjay	60

3.

	₹
Money due on allotment	2,40,000
Less: Excess application money	1,86,500
	53,500
Less: Amount not paid by Sanjay	60
Actual amount received in allotment	53,440

4.

	₹	₹
Money received from Sanjay	450	
Less: Adjusted for premium (60×2.5)	150	
	300	
Less: loss on re issue (60×2)	120	
Transferred to Capital Reserve	180	
Money received from Vivek (800×8.50)		6,800
Less: premium (800 x 2.50)		2,000
		4,800
Less: loss on reissue		3,200
Transfer to capital reserve		1,600

Total transfer to capital reserve = ₹ 180 + ₹ 1,600 = ₹ 1,780

1.1.3 Follow-on public offer (FPO) and 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. 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

a. IPO is made when company seeks to raise capital via public investment while FPO is subsequent public contribution.

b. 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.

- **Rights Issue of Shares**

The term 'rights issue' has not been defined in the Companies Act, 2013. As per Regulation 2(1) (zg) of SEBI (Issue of Capital and Disclosure Requirements), 2009, "rights issue" means an offer of specified securities by a listed issuer to the shareholders of the issuer as on the record date fixed for the said purpose. The provisions relating to issue of rights shares are, however, covered in Section 62(1)(a) of the Companies Act, 2013.

Accordingly, 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.

Such issue of shares shall be done subject to the following conditions:

a. the offer shall be made by notice specifying the number of shares offered;

b. The time limit shall be not less than 15 days and shall be not exceeding thirty days from the date of the offer within which the offer;

c. 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;

d. 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.

- **Accounting for Rights Issue**

The accounting entries for issue of rights shares will be as follows:

(i) On receipt of application money

Bank A/c ………………………………….Dr.

To Share Application A/c

(ii) On allotment of shares

Share Application A/c ………………………Dr.

To Share Capital A/c (Face Value x no. of shares allotted)

To Securities Premium A/c (Premium x no. of shares allotted)

Consider the following illustrations

Illustration 22

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, 2/5×100 = 40%

Illustration 23

NT Limited has an issued capital of 20000 equity shares of ₹10 each fully called up.

The following decisions are taken by the company:

To forfeit 100 shares on which `5 per share has been paid up and to be issue at ₹15 per share as fully paid up.

To issue right shares in the ratio of 1 fully paid up shares for every 4 existing shares held, at ₹ 15 per share.

Assuming that the company has sufficient to general reserve, the above through journal entries.

Solution:

Journal

Date	Particulars		Dr. (₹)	Cr. (₹)
	Equity Share Capital (100 × 10)A/c	Dr.	1,000	
	To Calls in Arrear A/c			500
	To Forfeited Shares A/c			500
	Bank A/c	Dr.	1,500	
	To Equity Share Capital A/c			1,000
	To Securities Premium A/c			500
	Forfeited Shares A/c	Dr.	500	
	To Capital Reserve A/c			500
	Bank A/c	Dr.	75,000	
	To Equity Share Application A/c			75,000
	Equity Share Application A/c	Dr.	75,000	
	To Equity Share Capital A/c			50,000
	To Securities Premium			25,000

1.1.4 Bonus Issue of Shares

Bonus shares are shares which are issued by a company free of cost to its existing members on a pro-rata basis. Established companies that have already built-up reserves sometimes decides to capitalize a part of these reserves by issuing bonus shares to existing shareholders, without requiring the shareholders to pay any consideration.

Since bonus shares requires capitalization of reserves, it leads to decrease in Reserve & Surplus and increase in the issued capital but does not bring any change in cash flow and net worth.

- **Ways 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.

- **Companies Act, 2013 on Issue of Bonus Shares**

  As per Section 63 of the Companies Act, 2013, provisions relating to bonus issue are as follows:

  (1) A company may issue fully paid-up bonus shares to its members, in any manner whatsoever, out of —

  (i) its free reserves;

  (ii) the securities premium account; or

  (iii) the capital redemption reserve account:

  Provided that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

  (2) No company shall capitalise its profits or reserves for the purpose of issuing fully paid-up bonus shares under sub-section (1), unless—

  (a) it is authorised by its articles;

  (b) it has, on the recommendation of the Board, been authorised in the general meeting of the company;

  (c) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;

  (d) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;

  (e) the partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;

  (f) it complies with such conditions as may be prescribed.

  (3) 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. (a) 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.

⊙ 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.

Thus, the following are excluded from free reserves:

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

b. 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.

⊙ Conversion of partly paid-up share to fully paid-up shares

A company may utilize its reserves to convert its partly paid shares into fully paid without asking the shareholders to contribute further against the call money due. This may be termed as bonus dividend.

Unlike issue of fully paid bonus shares, the sources for bonus dividend shall be, however, free reserves only as Section 52 of Companies Act, 2013 allows utilization of 'Securities Premium' for issuing fully paid bonus shares only. Similarly, Section 55(4) of the Act prohibits the use of 'Capital Redemption Reserve' for purposes other than issue of fully paid-up bonus shares.

Note: Capital Reserve realized in cash can be a source of bonus dividend as well as issue of fully paid-up bonus shares.

⊙ Accounting for Bonus Issue

The accounting entries for issue of rights shares will be as follows

a. Conversion of partly paid-up share to fully paid-up shares by bonus dividend

(i) On declaration of bonus

Free Reserves A/c ……………………Dr.

To Bonus to Shareholders A/c

(ii) On making final call

Share Final Call A/c ………………. Dr.

To Share Capital A/c

(iii) On adjustment of final call

Bonus to Shareholders A/c …………. Dr.

To Share Final Call A/c

b. Issue of fully paid-up bonus shares

(i) On declaration of bonus

Capital Redemption Reserves A/c ……………………Dr.

Securities Premium A/c ………………………………. Dr.

Free Reserves A/c ……………………………………. Dr.

To Bonus to Shareholders A/c

(ii) On issue of fully paid-up bonus shares

Bonus to Shareholders A/c …………. Dr.

To Share Capital A/c

To Securities Premium A/c (if any)

Consider the following illustrations.

Illustration 24

Following items appear in the Trial Balance of M Ltd. as at 31st March, 2023:

Particulars	(₹)
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:

In the books of M Ltd.

Journal

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

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 25

Following is the extract of the Balance Sheet of YY Ltd. as at 31st March, 2023:

	₹
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	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, 2023 the Company has made final call @ 2 each on 1,35,000 equity shares. The call money was received by 20th April, 2023. 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 2023.

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:

In the books of YY Ltd.

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
2023 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
April 20	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 Dr. 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, 2021 (after bonus issue):

Particulars	Note No.	₹
EQUITY AND LIABILITIES		
(1) Shareholders' Fund		
(a) Share Capital	1	18,07,500
(b) Reserve 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 June, 2023	
Total	7,50,000

Working Notes:

1. Capital Reserve realised in cash can be utilised for issue of fully paid bonus shares.
2. As per SEBI guidelines, securities premium collected in cash can only be utilised for bonus issue.
3. 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.
4. 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

Illustration 26

The following is the balance sheet of RR Company Ltd as on 31.12.2023

Liabilities:	**(₹)**
Issued and paid up capital: 225000 equity shares of ₹10 each fully called up	22,50,000
Less: Calls in arrear (25000 shares of ₹2 each)	50,000
100000 equity shares of ₹10 each, ₹4 paid up	4,00,000
P/L A/c	12,50,000
Dividend Equalization Reserve	1,00,000
General Reserve	1,50,000
Development Rebate reserve	2,50,000
Capital reserve	1,50,000
Securities premium	2,50,000
Capital redemption reserve	4,00,000
Current liability	10,00,000
Total	6,15,0000
Assets:	**(₹)**
Non current assets	
Fixed assets	30,00,000
Current assets	10,00,000
Cash at bank	21,50,000
Total	61,50,000

The board of directors of the company took the following decisions.

a. To forfeit the shares on which final call of ₹ 2 each is due.

b. To issue fully paid bonus shares @ 1 fully paid up share for every 2 fully paid shares held.

c. to pay bonus to the partly paid shares at an equivalent rate as in (b)above without collecting any amount from the related shareholders.

d. to reissue the forfeited shares @ ₹ 12 each fully paid up.

e. To pay dividend equivalent to 10% on share capital including bonus shares.

f. To issue right shares in the ratio of 1 fully paid up share for every four existing fully paid up shares held at ₹15 per share.

g. To use minimum balance of profit and loss account.

Note:

1. All Capital Reserve are realised in cash.
2. One fifth of the development rebate reserve is free.

Pass necessary journal entries in the books of the company including cash transaction after the above decisions are implemented.

Solution:

In The Books of RR Company Ltd.

Journal

Date	Particulars		Dr. (₹)	Cr. (₹)
	Equity Share Capital A/c	Dr.	2,50,000	
	To Calls in arrear A/c			50,000
	To Share forfeiture A/c			2,00,000
	Capital Redemption Reserve A/c	Dr.	4,00,000	
	Securities Premium A/c	Dr.	2,50,000	
	Capital Reserve A/c	Dr.	1,50,000	
	Development Rebate Reserve A/c	Dr.	50,000	
	General Reserve A/c	Dr.	1,50,000	
	To Bonus to Shareholders A/c			10,00,000
	Bonus to Shareholders A/c	Dr.	10,00,000	
	To Equity Share Capital A/c			10,00,000
	Equity Share Call A/c	Dr.	2,00,000	
	To Equity Share Capital A/c			2,00,000
	Dividend Equalization Reserve A/c	Dr.	1,00,000	
	Profit and Loss A/c	Dr.	1,00,000	
	To Bonus to Shareholders A/c			2,00,000

	Bonus to Shareholders A/c	Dr.	2,00,000	
	To Equity Share Call A/c			2,00,000
	Bank (12 × 25000) A/c	Dr.	3,00,000	
	To Equity Share Capital A/c			2,50,000
	To Securities Premium A/c			50,000
	Share Forfeiture A/c	Dr.	2,00,000	
	To Capital Reserve A/c			2,00,000
	Profit and Loss A/c	Dr.	3,85,000	
	To Equity Dividend A/c			3,85,000
	Equity Dividend A/c	Dr.	3,85,000	
	To Bank A/c			3,85,000
	Bank A/c	Dr.	12,18,750	
	To Equity Share Capital A/c			8,12,500
	To Securities Premium A/c			4,06,250

Illustration 27

MG Limited was registered on 1st January 2023 with an authorised capital of ₹3,00,000 divided into 30000 equity shares of ₹10 each. During the next 12 months to 31st November 2023 following events occurred which related to the share capital of the company.

On 1st January 2023 the company offered for subscription of 10,000 equity shares at a price of rupees 19 each, to be paid as follows:

At the date of issue including premium	₹10
On allotment	₹4
On first and final call	₹5

On 30th June 2023 the company made right issue on 1 for 2 basis at ₹22.50 per share, payable in full on 10th July 2023.

Only 80% of the issue was subscribed for by the shareholders with a payment being made on the due date.

On 30th November 2023 Company decided to make a bonus issue of shares at par by utilising the entire balance of securities premium account.

Prepare the equity share capital account and the securities premium account of the company for the year ended 31st December 2023.

A share holder who had subscribed initially for 140 shares had subsequently taken up 80% of the right issue and then received the bonus shares to which he was entitled.

Calculate the ultimate number of shares owned by him and the total price paid by him for those shares.

Solution:

In the books of MG Limited

Equity Share Capital Account

Dr. **Cr.**

Particulars	(₹)	Particulars	(₹)
		By Share Application A/c	10,000
		By Share Allotment A/c	40,000
		By Share First and Final Call A/c	50,000
		By Bank (right issue) A/c	40,000
To Balance c/d	2,80,000	By Bonus to Shareholders A/c	1,40,000
	2,80,000		**2,80,000**

Securities Premium Account

Dr. **Cr.**

Particulars	(₹)	Particulars	(₹)
To Bonus to Shareholders	1,40,000	By Share Application	90,000
		By Bank	50,000
	1,40,000		**1,40,000**

Working notes:

a. Securities premium per share on original issue = ₹(19-10) = 9. Securities premium per share on right issue = ₹(22.50 -10) = ₹12.50.

Number of right shares issued = 80% (1/2×10000) = 4000 shares.

Total securities premium available =(10000×9)+(4000×12.50) = ₹(90,000+50,000) = ₹1,40,000.

b. So number of bonus share to be issued at par = ₹1,40,000 / ₹10 = 14000, i.e., rate of bonus issue is 14000: 14000 = 1:1, i.e., 1 bonus share issued for every share held after right issue.

c. Number of right shares purchased by the shareholder = 80% x (1/2 × 140) = 56 shares. So number of bonus shares to be received by him @ 1:1 = (140+56)= 196 shares.

d. It is remembered that no amount is payable by the shareholders against bonus issue of shares.

e. **Calculation of ultimate number of equity shares owned by :**

Particulars	No of Shares	₹
Main issue of shares in Jan 2023:		
a. As application money 140x10	140	1,400
b. As allotment money 140x4		560
c. As first and final money 140x 5		700
		2,660
For right issue @1:2 (80% of 140 shares x1/2 x 22.50)	56	1,260
For bonus issue of shares @ 1:1 for total 196 shares held	196	nil
	392	3,920

Question Number:1

A Ltd. with a share capital of ₹30,00,000 in 1,00,000 share of ₹30 each fully paid has an accumulated free reserve of ₹5,00,000.It intends to distribute out of this reserve, ₹4,00,000 to the existing shareholders in the form of bonus shares of ₹30 each at par as fully paid. Give journal entries.

Solution:

Reserve A/C…. Dr.	400,000	
To Bonus to Shareholders A/C		400,000
(On the declaration of bonus out of reserve)		
Bonus to Shareholders A/C… … Dr.	400,000	
To Share Capital A/C		400,000
(On issue of bonus shares)		

Question Number:2

A Ltd. had the following balance as on 31-3-2023;

9% Preference share capital	₹9,00,000
Equity share capital(₹10 each fully paid)	₹3,00,000
Capital redemption reserve	₹50,000
General reserve	₹5,00,000

The directors of the company declared bonus issue in the ratio of 4 fully paid bonus shares of ₹10 each at ₹13 per share for every 5 fully paid shares held. Pass journal entries to record the above transactions.

Solution:

Capital Redemption Reserve A/C…. ….. Dr.	50,000	
General Reserve A/C ………..Dr.	2,62,000	
To Bonus to Shareholders A/C		3,12,000
(On the declaration of bonus out of reserve)		
(300,00 /5 *4*13)		
Bonus to Shareholders A/C… …Dr.	3,12,000	
To Share Capital A/C		2,40,000
To Securities Premium A/C		72,000
(On issue of bonus shares at premium)		

Question Number: 3

The paid-up share capital of AB Ltd. Consisted of 1,00,000 Equity shares of ₹10 each fully paid and 50,000 equity shares of ₹10 each, ₹6 called up and paid-up. The company had a General Reserve of ₹20,00,000. It decided to utilize this reserve for issuing bonus shares at a premium of 50% for every fully paid share held and for making partly paid shares as fully paid. Give journal entries to record the above transactions.

Solution:

Particulars	Dr. (₹)	Cr. (₹)
General Reserve A/c ………..Dr. To, Bonus to Shareholders A/c (50000 × ₹4) (Being declaration of bonus out of reserve to convert partly paid shares fully paid.)	2,00,000	 2,00,000
Share Final Call A/c …………Dr. To Share Capital A/c (Being final call money due @ ₹4 per share as per Board's Resolution no. … dated…)	2,00,000	 2,00,000
Bonus to Shareholders A/c ……Dr. To Share Final Call A/c (Being final call money adjusted.)	2,00,000	 2,00,000
General Reserve A/c ………..Dr. To Bonus to Shareholders A/c (1,00,000 × ₹15) (Being the declaration of fully paid-up bonus shares out of reserve)	15,00,000	 15,00,000
Bonus to Shareholders A/c ……Dr. To Equity Share Capital A/c To Securities Premium A/c (Being issue of fully paid-up bonus shares of Rs.10 each at a premium of 50% as per Board's Resolution no. …dated…)	15,00,000	 10,00,000 5,00,000

1.1.5 Issue of Sweat Equity Shares

When a company issues shares to its employees or directors for providing knowhow, intellectual properties etc., such an issue of shares is termed as issue of sweat equity shares.

As per Section 2(88) of the Companies Cat, 2013, "sweat equity shares" means such equity shares as are issued by a company to its Directors or employees at a discount or for consideration, other than cash, for providing their know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

- **Provisions Relating to Issue of Sweat Equity Shares**

  The provisions relating to issue of sweat equity shares are covered under Section 54 of the Companies Act, 2013 and Rule 8 of the Companies (Share Capital and Debentures) rules, 2014.

  Section 54 of the Act states that –

(1) 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;

(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.

(2) 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.

Rule 8 of the Companies (Share Capital and Debentures) Rules, 2014 further states that –

(1) A company other than a listed company, which is not required to comply with the Securities and Exchange Board of India Regulations on sweat equity, shall not issue sweat equity shares to its directors or employees at a discount or for consideration other than cash, for their providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called, unless the issue is authorised by a special resolution passed by the company in general meeting.

(2) The explanatory statement to be annexed to the notice of the general meeting pursuant to Section 102 shall contain the specified particulars.

(3) The special resolution authorising the issue of sweat equity shares shall be valid for making the allotment within a period of not more than twelve months from the date of passing of the special resolution.

(4) The company shall not issue sweat equity shares for more than fifteen percent of the existing paid-up equity share capital in a year or shares of the issue value of rupees five crores, whichever is higher.

(5) The sweat equity shares issued to directors or employees shall be locked in/non-transferable for a period of three years from the date of allotment.

(6) The sweat equity shares to be issued shall be valued at a price determined by a registered valuer as the fair price giving justification for such valuation.

In addition to the above, SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 provides the terms of conditions for issue of sweat equity shares by listed companies.

⊙ Accounting for Issue of Sweat Equity Shares

I. Issue of sweat equity shares for cash consideration at a discount

When sweat equity shares are issued for cash consideration at a discount, the difference between cash consideration and nominal value of sweat equity shares shall be considered as the value of intellectual property provided by the employee or director. The accounting entry shall be as follows:

Bank A/c …………………Dr.

Intellectual Property A/c ……Dr.

To Equity Share Capital A/c

Note: The details of issue of sweat equity shares shall be disclosed in the Notes to Balance Sheet on Equity Share Capital.

II. Issue of sweat equity shares for consideration other than cash

According to Rule 8(9) of Companies (Share Capital and Debentures) rules, 2014 –

Where 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 accounting standards; or

(b) where clause (a) is not applicable, it shall be expensed as provided in the accounting standards.

Accordingly, the accounting entries for issue of sweat equity shares for consideration other than cash will be as follows:

(i) Sweat equity shares issued in pursuant to acquisition of an asset

Intellectual Property A/c ……………………………………. Dr. (Value of asset)

Employee/Director's Compensation Expenses A/c …………Dr. (Difference)

To Equity Share Capital A/c

(ii) Sweat equity shares issued not in pursuant to acquisition of an asset

Employee/Director's Compensation Expenses A/c …………Dr.

To Equity Share Capital A/c

Note: Employee/Director's Compensation Expenses will be included in Employee Benefit Expenses in the Statement of Profit and Loss. The details of issue of sweat equity shares shall be disclosed in the Notes to Balance Sheet on Equity Share Capital.

Illustration 28

Show the accounting entries for the following.

a. Tinku Ltd. allotted 500 sweat equity shares of ₹100 each to its directors at a discount of 6%.

b. 800 sweat equity shares of ₹100 allotted to employees at par in consideration of technical know-how.

Solution:

In the books of ……………….

Journal **Dr.** **Cr.**

Date	Particulars	₹	₹
(a)	Bank A/c …………………..…Dr. Intellectual Property A/c ……..Dr. To Equity Share Capital A/c (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)	47,000 3,000	 50,000
(b)	Technical Know-how A/c ……..Dr. To Equity Share Capital A/c (Being allotment of 800 sweat equity shares of ₹100 each to employees at par, in consideration of technical know-how)	80,000	 80,000

1.1.6 Employee Stock Option Plan (ESOP) and Employee Stock Purchase Plan (ESPP)

Now-a-days established companies, in order to retain quality human resources in the organisation, offer innovative compensation strategies to their employees including directors. One of such categories of innovative strategies involve paying compensation the value which is based on the value of the company's stock (i.e., bundle of shares). This category of compensation scheme is popularly known as Stock Based Employee Benefit Scheme/Plan. The most common form of Stock Based Employee Benefit Scheme/Plans are (a) Employee Stock Option Plan/ Scheme (ESOP/ESOS) and (b) Employee Stock Purchase Plan/ Scheme (ESPP/ESPS).

I. Employee Stock Option Plan/ Scheme (ESOP/ESOS)

As per section 2(37) of the Companies Act, 2013, "employees' stock option" means the option given to the Directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such Directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price.

The general features of ESOP are as follows:

a. It is an innovative tool for employee compensation.

b. It is an employee stock-based benefit scheme/plan.

c. It provides the employees a right to acquire company's stock at a predetermined price.

d. It is exercised on a future date.

e. It ensures employee participation in profits.

⊙ **Important Terminologies**

a. Option: A right (but not the obligation) which is granted to an employee pursuant to an ESOP to buy company's shares on the future date at a predetermined price.

b. Grant: It refers to the issuance of option to the employee under an ESOP.

c. Vesting: It refers to the requirement to be satisfied by the employee to apply the right to exercise the option. Conditions may include certain period of service, meeting any performance standard etc.

d. Vesting Period: It is the period during which the vesting has been granted to the employee under the ESOP.

e. Exercise: It is the act of subscribing the shares under ESOP.

f. Exercise Period: The time period within which the option shall be exercised.

g. Exercise Price: It is the price payable to subscribe the shares under ESOP.

h. Intrinsic Value: It is the excess of market price over the exercise price of shares.

⊙ **ESOP Process Flow**

The sequential steps under an ESOP are depicted in the following diagram.

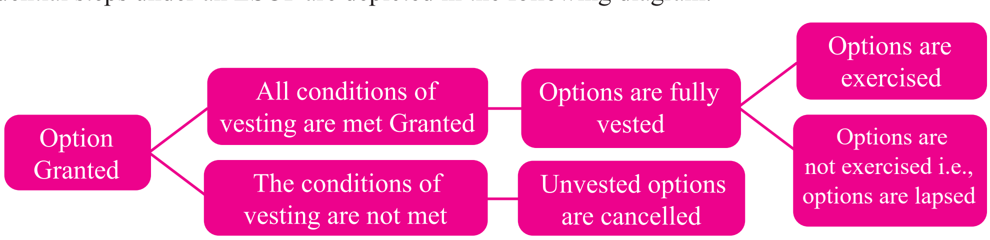

Figure 1.2: ESOP Process Flow

As explained in the above diagram, a company initially grants the eligible employees the option to buy a stated number of shares/stocks for a pre-determined price at a future date. After granting the options are vested over a period of time or once the specific performance goal is achieved. If all the conditions are satisfied, the options are fully vested and the employee becomes eligible to exercise the option. Otherwise, the unvested options are cancelled at once. The employees get a maximum period for exercising the option. This is known as the exercise period. If the employee exercise ethe option, he or she get the share/stock at the predetermined price even if the actual market is much higher on such date of exercise. If the employee does not exercise the option, it is lapsed.

- **Provisions Regarding Employee Stock Option Plan**

The statutory provisions relating to ESOP are governed by Section 62(1)(b) of the Companies Act, 2013 and Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014.

According to Section 62(1)(b) of the Companies Act, 2013, any company having a share capital may proposes to increase its subscribed capital by the issue of further shares to employees under a scheme of employees' stock option, subject to special resolution passed by company and subject to such conditions as may be prescribed.

In addition, Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014 provides the terms and conditions subject to which an unlisted company can issue shares to its employees under ESOP.
Additionally, SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 provides terms and conditions for a number of share-based employee benefit schemes including ESOP and ESPP and also for issue of sweat equity shares by listed companies.

- **Accounting for ESOP**

The accounting for ESOP (and also for ESPP discussed later in this Module) is guided by the Guidance Note on Accounting for Employee Share-based Payments issued by The Institute of Chartered Accountants of India.

The accounting entries at various stages of implementing the ESOP are as follows:

Stage	Accounting Entries
a. Granting of Stock Option At the end of every year the company will estimate the number of options to be granted to the employees.	At this stage no accounting entry is required.
b. Recognition of ESOP Expense This further involves the following steps: (i) Determination of Intrinsic Value Intrinsic Value = Market price per share – Exercise price per share (ii) Determination of Gross Value of employee compensation expenses GV = No. of options expected to vest × Intrinsic vale $\times \dfrac{\text{Expired Period}}{\text{Total Vesting Period}}$ (iii) Determine expenses to be recognized Expenses to be recognized = GV – Cumulative expenses recognized up to earlier accounting period	⅄ On recognition of Stock Option Expenses Employee Stock Option Expenses A/c ……Dr. To Employee Stock Option Outstanding A/c ⅄ On transfer at the end of the period Profit and Loss A/c ……………………Dr. To Employee Stock Option Expenses A/c

c. Cancellation of options during the vesting period	⅄ If cumulative expenses recognized up to earlier accounting period < GV No Journal Entry is required ⅄ If cumulative expenses recognized up to earlier accounting period > GV Employee Stock Option Outstanding A/c …Dr. To Employee Stock Option Expenses A/c ------------------- Employee Stock Option Expenses A/c…Dr. To Profit and Loss A/c
d. Exercising of Stock Options	Bank A/c …………………………Dr. To Employee Stock Option Outstanding A/c -------- Employee Stock Option Outstanding A/c …Dr. To Equity Share Capital A/c To Securities Premium A/c
e. Lapse of unexercised option	Employee Stock Option Outstanding A/c …Dr. To General Reserve A/c

Note:

(1) The amount of Employees Stock Option Expenses will be reflected under the sub-head Employee Benefit Expenses in the Statement of Profit and Loss.

(2) Balance of Employee Stock Option Outstanding A/c should be shown under Reserve and Surplus in the Balance Sheet.

(3) Upon exercise of the stock options, the shares issued under ESOP should be included in the Share Capital in the Balance Sheet and securities premium thereon should be included in Securities Premium.

(4) The Notes to Accounts must provide the details of ESOP.

Consider the following Illustrations.

Illustration 29

ABC Ltd., a listed company, granted 2,000 options on 01.04.2020 at an exercise price of ₹50 per share. The market price at that time was of ₹100 per option (face value of each share being ₹10). The maximum exercise period and the vesting period are 1 year and 2 years respectively. On 01.04.2021, 600 unvested options were lapsed while 1,200 options were exercised on 30.06.2022. The remaining options were lapsed at the end of the exercise period. Show the journal entries to record the above transactions.

Solution:

In the books of ABC Ltd.

Journal **Dr.** **Cr.**

Date	Particulars	₹	₹
31.03.2021	Employees Stock Option Expenses A/c ……………...........Dr.	1,00,000	
	To Employees Stock Option Outstanding A/c		1,00,000
	(Being expenses on 2,000 stock options recognized)		

31.03.2021	Profit and Loss A/c ………………………..........................Dr. To Employees Stock Option Expenses A/c (Being Employees Stock Options Expenses transferred to P/ L A/c)	1,00,000	 1,00,000
31.03.2022	Employees Stock Option Expenses A/c ………….......... Dr. To Employees Stock Option Outstanding A/c (Being expenses on 1400 stock options recognized)	40,000	 40,000
31.03.2022	Profit and Loss A/c ………………………..........................Dr. To Employees Stock Option Expenses A/c (Being Employees Stock Options Expenses transferred to P/ L A/c)	40,000	 40,000
30.06.2022	Bank A/c [1200x50] ………………………......................Dr. To Employees Stock Option Outstanding A/c (Being amount received on 1200 stock options at ₹50 each)	60,000	 60,000
30.06.2022	Employees Stock Option Outstanding A/c [1200 x 150] .... Dr. To Equity Share Capital A/c [1200 x 10] To Securities Premium A/c [1200 x (150 - 10)] (Being 1200 options having market value of ₹150, exercised at ₹50 each)	1,80,000	 12,000 1,68,000
31.03.2023	Employees Stock Option Outstanding A/c [200 x 100] ...... Dr. To General Reserve A/c (Being 200 options lapsed at the end of exercisable period)	20,000	 20,000

Working Notes

Employee Compensation Expenses to be recognized:

Particulars	2020-21 (₹)	2021-22 (₹)
Gross Value of employee compensation expenses	1,00,000	1,40,000
[No. of options expected to be vest x Fair value x Expired Period/ Vesting period]	[2,000 x 100 x 1/2]	[(2,000-600) x 100 x 2/2]
Less: Expenses already recognized up to preceding accounting period	---	1,00,000
Expenses to be recognized	1,00,000	40,000

Illustration 30

K Ltd. granted option for 16,000 equity shares on 01.10.17 at ₹80 when the market price was ₹170. the vesting period is 4 ½ years. 8,000 unvested options lapsed on 01.12.2022. 6,000 options are exercised on 30.09.22 and 2,000 vested options lapsed at the end of the exercise period. Pass journal entries to record the above transactions.

Solution:

In the books of K Ltd.

Journal

Date	Particulars	Dr. ₹	Cr. ₹
31.03.18	Employees Stock Option Expenses A/c …………............. Dr. To Employees Stock Option Outstanding A/c (Being expenses on 16,000 stock options recognized)	1,60,000	1,60,000
31.03.18	Profit and Loss A/c ……………………...........................Dr. To Employees Stock Option Expenses A/c (Being Employees Stock Options Expenses transferred to P/ L A/c)	1,60,000	1,60,000
31.03.19	Employees Stock Option Expenses A/c …………............. Dr. To Employees Stock Option Outstanding A/c (Being expenses on 16,000 stock options recognized)	3,20,000	3,20,000
31.03.19	Profit and Loss A/c ……………………...........................Dr. To Employees Stock Option Expenses A/c (Being Employees Stock Options Expenses transferred to P/ L A/c)	3,20,000	3,20,000
31.03.20	Employees Stock Option Outstanding A/c ………….......... Dr. To Employees Stock Option Expenses A/c (Being expenses on 8,000 stock options recognized)	80,000	80,000
31.03.20	Employees Stock Option Expenses A/c …………...................Dr. To Profit and Loss A/c (Being Employees Stock Options Expenses transferred to P/ L A/c)	80,000	80,000
31.03.21	Employees Stock Option Expenses A/c ……………... Dr. To Employees Stock Option Outstanding A/c (Being expenses on 8,000 stock options recognized)	1,60,000	1,60,000
31.03.21	Profit and Loss A/c ……………………....................Dr. To Employees Stock Option Expenses A/c (Being Employees Stock Options Expenses transferred to P/ L A/c)	1,60,000	1,60,000
31.03.22	Employees Stock Option Expenses A/c ……………... Dr. To Employees Stock Option Outstanding A/c (Being expenses on 8,000 stock options recognized)	1,60,000	1,60,000
31.03.22	Profit and Loss A/c ……………………...................Dr. To Employees Stock Option Expenses A/c (Being Employees Stock Options Expenses transferred to P/ L A/c)	1,60,000	1,60,000
30.09.22	Bank A/c [6000×80] ……………………….............Dr. To Employees Stock Option Outstanding A/c (Being amount received on 6000 stock options at ₹80 each)	4,80,000	4,80,000

30.09.22	Employees Stock Option Outstanding A/c [6000 × 170] .... Dr. To Equity Share Capital A/c [6000 × 10] To Securities Premium A/c [6000 × (170 - 10)] (Being 6000 options having market value of ₹170, exercised at ₹80 each)	10,20,000	 60,000 9,60,000
31.03.23	Employees Stock Option Outstanding A/c [2000 × 90] .... Dr. To General Reserve A/c (Being 200 options lapsed at the end of exercisable period)	1,80,000	 1,80,000

Working Notes:

Employee Compensation Expenses to be recognized:

Particulars	2017-18 (₹)	2018-19 (₹)	2019-20 (₹)	2020-21 (₹)	2021-22 (₹)
Gross Value of employee compensation expenses	1,60,000	4,80,000	4,00,000	5,60,000	7,20,000
[No. of options expected to be vest x Fair value × Expired Period/Vesting period]	[16,000 × 90 × 0.5/4.5]	[16,000 × 90 × 1.5/4.5]	[(16,000 – 8,000) × 90 2.5/4.5]	[(16,000 – 8,000) × 90 × 3.5/4.5]	[(16,000 – 8,000) × 90 × 4.5/4.5]
Less: Expenses already recognized up to preceding accounting period	-----	1,60,000	4,80,000	4,00,000	5,60,000
Expenses to be recognized	1,60,000	3,20,000	(80,000)	1,60,000	1,60,000

II. Employee Stock Purchase Plan/ Scheme (ESPP/ESPS)

Employee Stock Purchase Scheme (ESPS) refers to a scheme under which the company offers shares to employees as part of a public issue or otherwise.

⦿ **Accounting for Employee Stock Purchase Scheme**

The fair value of ESPP shall be treated as a form of employee compensation in the financial statements of the company.

The fair value of ESPP = No. of shares to be issued under ESPP x (Fair value per share – issue price)

The accounting entries will be as follows:

(i) For shares purchased under ESPP

Bank A/c ……………………………………………Dr.

Employee Compensation Expense A/c ………………Dr.

To Equity Share Capital Account

To Securities Premium Account

(ii) For transfer of the balance Employee Compensation Expense A/c

Profit and Loss A/c …………………………..Dr.

To Employee Compensation Expense A/c

Note:

(1) The amount of Employees Compensation Expenses will be reflected under the sub-head Employee Benefit Expenses in the Statement of Profit and Loss.

(2) Upon purchase of shares under ESPP, the shares issued should be included in the Share Capital in the Balance Sheet and securities premium thereon should be included in Securities Premium.

(3) The Notes to Accounts must provide the details of ESPP.

Consider the following Illustrations.

Illustration 31

Y Ltd issued 2,000 shares on 1st April, 2023 under ESPP at ₹50 when the market price was ₹150 (face value being ₹10).

Pass necessary journal entries to record the above transactions.

Solution:

In the books of Y Ltd
Journal

Date	Particulars	Dr. ₹	Cr. ₹
2023 April 1	Bank A/c (2,000 × 50) ………………….....……Dr.	1,00,000	
	Employee Compensation Expense A/c …………Dr.	2,00,000	
	To Equity Share Capital A/c (2,000 × 10)		20,000
	To Securities Premium A/c [2,000 × (150-10)]		2,80,000
	(Being the issue of 2,000 shares under ESPP at a price of ₹50 each when the market price is ₹150 each)		

Illustration 32

On 1st April, 2023, X Ltd. offered 200 shares to each of its 400 employees at ₹25 per share. The employees are given a month to accept the shares. The shares issued under the plan shall be subject to lock-in to transfer for three years from the grant date, i.e., 30th April, 2023. The market price of shares of the company on the grant date is ₹30 per share. Due to post-vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at ₹28 per share.

Up to 30th April, 2023, 50% of employees accepted the offer and paid ₹25 per share purchased. Nominal value of each share is ₹10. Record the issue of shares in the books of the company under the aforesaid plan.

Solution:

Number of employees accepting the offer: 400 x 50% = 200.

Total number of shares to be issued: 200 x 200 = 40,000.

Fair value of the option: ₹28 – ₹25 = ₹3.

Total value of options: 20,000 x ₹3 = ₹60,000.

In the books of X Ltd

Journal **Dr.** **Cr.**

Date	Particulars	₹	₹
2023 April 30th	Bank A/c (40,000 x 25) ………………………...…Dr. Employee Compensation Expense A/c …………Dr To Equity Share Capital A/c (40,000 x 10) To Securities Premium A/c [40,000 x (28-10)] (Being the issue of 40,000 shares under ESPP at a price of ₹25 each when the fair value is ₹150 each)	10,00,000 1,20,000	 4,00,000 7,20,000

1.1.7 Buy-back of Equity Shares

In case of companies, equity shares represent the share of ownership of net worth and hence are supposed to be perpetual. However, over time this basic feature of equity shares has also been changed. Companies, across the globe are now allowed to return back the equity shares subject to certain conditions specified in the relevant statutes. This process is known as buy-back of equity shares. Technically, it is a means of capital restructuring.

A company generally undertakes buy-back of equity shares for varied reasons. Following are a few important reasons for adopting a buy-back strategy.

a. Cash rich companies may resort to buy-back when they have only a few projects to invest in.

b. At times, buy-backs may be a more tax-effective means of rewarding shareholders.

c. Theoretically buy-backs tend to improve the valuation of a companies as the capital base is reduced.

d. By showing the confidence to use its reserves to buy-back its own shares, companies give a hint that the management perceives it as undervalued.

e. Buy-back can help the promoters to consolidate their stake in the company.

A company may buy-back its equity shares at par or at a premium or even at a discount. However, in most of the cases, buy-backs are found to be made at premium. Hence, in such cases, buy-back involves ‘payment of capital’ as well as ‘payment of premium’.

- **Buy-back under Companies Act, 2013**

The regulatory framework of buy-back is provided by following three sources:

a. Companies Act, 2013 (Section 67, 68, 69 and 70);

b. Companies (Share Capital and Debentures) Rules, 2014; and

c. SEBI (Buy-back) Regulations, 2018

Section 67 of the Companies Act, 2013 states that 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.

As per Section 68 of the Act,

a. a company may purchase its own shares or other specified securities hereinafter referred to as buy-back) out of—

(i) its free reserves;

(ii) the securities premium account; or

(iii) 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.

b. The buyback must be authorised by its articles.

c. A special resolution must be passed at a general meeting of the company authorising the buy-back unless –

(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

d. The buy-back should be twenty-five per cent. or less of the aggregate of paid-up capital and free reserves of the company. Moreover, buy-back of equity shares in any financial year, shall not be more than twenty-five per cent. of the total paid-up equity capital.

e. The ratio of the aggregate of secured and unsecured debts owed by the company after buy-back is shall not be more than twice the paid-up capital and its free reserves.

f. All the shares or other specified securities for buy-back must be fully paid-up.

g. The buy-back of the shares or other specified securities listed on any recognized stock exchange should be done in accordance with the regulations made by the Securities and Exchange Board in this behalf.

h. The buy-back in respect of shares or other specified securities other than those specified shall be made in accordance with such rules as may be prescribed.

i. No offer of buy-back under section 68(2) 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.

j. 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.

k. The buy-back under section 68(1) may be made -

(i) from the existing shareholders or security holders on a proportionate basis;

(ii) from the open market;

(iii) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

l. Before making such buy-back, the company needs to file with the Registrar and the Securities and Exchange Board, a declaration of solvency signed by at least two Directors of the company. However, unlisted companies need not to file any such declaration to SEBI.

m. 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.

n. Where a company completes a buy-back of its shares or other specified securities under section 68, 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.

o. 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.

p. 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. This is, however, not required for unlisted companies.

As per Section 69 of the Act,

(1) Where a company purchases its own shares out of free reserves or securities premium account, 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 shall be disclosed in the balance sheet.

(2) The capital redemption reserve account may be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

Section 70 of the Act further states that –

(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.

  Note: A company cannot utilize any borrowed fund for the purpose of buy-back. Such type of buy-backs are called leveraged buy-back which are not allowed in India.

Major provisions of SEBI (Buy-back) Regulations, 2018

1. A company may buy-back its shares or other specified securities by any one of the following methods:

   a) from the existing shareholders or other specified securities holders on a proportionate basis through the tender offer;

   b) from the open market through—

      i) book-building process,

      ii) stock exchange;

   c) from odd-lot holders:

   Provided that no offer of buy-back for fifteen per cent or more of the paid-up capital and free reserves of the company shall be made from the open market.

2. The 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)

Accounting for Buy-back

I. Important Issues relating to accounting of buy-back

a. Sources for payment on buy-back

The sources for payment of capital on buy-back are –

a. Its free reserves, or

b. The securities premium account, or

c. The proceeds of any shares or other specified securities like employees' stock option

The sources for payment of premium on buy-back are –

a. Securities Premium Account; or

b. Other Free Reserves

Note: 'Free Reserves' include Surplus of Statement of Profit and Loss, General Reserve, Reserve Fund, Dividend Equalization Reserve, Capital reserve (if realized) and free portion of Workmen Compensation fund etc. Hence, it does not include Securities Premium, Capital reserve (unrealized), Reevaluation reserve, Capital redemption Reserve and any other statutory reserve.

Note: Companies that do not have adequate reserves may buy-back shares or other specified securities by making fresh issue of shares for this purpose. The fresh issue may be of equity shares or of preference shares. However, buy-back of any kind of shares or other specified securities shall not be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

b. 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.

The tests are discussed below:

(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 shareholders' fund (Aggregate Paid-up Capital + Free Reserves)

  (b) No. of shares held for buyback = Shareholders funds/ Buy-back price

(3) The number of shares to be bought back should be such that the debt-equity ratio does not exceed 2:1.

The number of shares to be bought-back will be the least of the above three.

II. Accounting Entries for Buy-back

(i) Due entry for buy-back

Share Capital A/c …………………Dr.

Premium on Buy-back A/c ………. Dr. (if at premium)

To Shareholders A/c

To Gain on Buy-back A/c (if at discount)

(ii) Payment made for buy-back

Shareholders A/c …………………….Dr.

To Bank A/c

(iii) Provision for premium on buy-back

Securities Premium A/c ……………….Dr.

Free Reserves A/c …………………..Dr.

To Premium on Buy-back A/c

(iv) Transfer of gain on buy-back (if any)

Gain on Buy-back A/c ……………Dr.

To Capital Reserve A/c

(v) Transfer to Capital Redemption Reserve

Securities Premium A/c ……………….Dr.

Free Reserves A/c …………………..Dr.

To Capital Redemption Reserve A/c

(vi) Expenses on Buy-back

Expenses on Buy-back A/c …………Dr.

To Bank A/c

(vii) Transfer of expense on buy-back

Profit and Loss A/c ……………Dr.

To Expenses on Buy-back A/c

Consider the following illustrations.

Illustration 33

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

Date	Particulars	Dr. (₹)	Cr. (₹)
	Equity Share Capital A/c Dr. To Bank A/c (Buying-back 2,00,000 equity shares of ₹ 10 each, at par)	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 34

(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.

Journals

Date	Particulars	Dr. (₹)	Cr. (₹)
	Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Final call of ₹2 per share due on 2,00,000 equity shares as per Board resolution)	4,00,000	4,00,000
	Bank A/c Dr. To Equity Share Final Call A/c (Final call money on 2,00,000 shares received)	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 35

(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

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

Illustration 36

(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

Date	Particulars		Dr. (₹)	Cr. (₹)
	Equity Share Capital A/c To Equity Shareholders A/c To Capital Reserve A/c (Amount due to equity shareholders for buy-back of 20,000 shares @ ₹9)	Dr.	2,00,000	1,80,000 20,000
	Equity Shareholders A/c To Bank A/c (Payment to equity shareholders the amount due to them)	Dr.	1,80,000	1,80,000
	General Reserve A/c To Capital Redemption Reserve A/c (Transfer of nominal amount of shares bought-back)	Dr.	2,00,000	2,00,000

Illustration 37

(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

Date	Particulars	Dr. (₹)	Cr. (₹)
	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 38

The following was the balance sheet of Diamond Ltd. as at 31st March, 2023.

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, 2023 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

	Particulars	Dr. ₹	Cr. ₹
1.	Bank A/c Dr. To Investment A/c To Profit and Loss A/c (Being sale of investments and profit thereon)	3,150	 3,000 150
2.	Bank A/c Dr. To Bank Loan A/c (Being loan taken from bank)	2,000	 2,000
3.	10% Redeemable Preference Share Capital A/c Dr. Premium on Redemption of Preference Share A/c Dr. To Preference Shareholder A/c (Being redemption of preference shares)	2,500 250	 2,750
4.	Preference Shareholders A/c Dr. To Bank A/c (Being payment of amount due to preference shareholders)	2,750	 2,750
5.	Securities Premium A/c Dr. To Premium on Redemption of Preference Share A/c (Being use of securities premium to provide premium on redemption of preference shares)	250	 250
6.	Equity Share Capital A/c Dr. Premium on Buy-back A/c Dr. To Equity Shareholders A/c (being buy back of equity shares)	2,000 1,000	 3,000

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 01.04.2023 (6,000 – 450 - 4,500)		
9.	Equity Shareholders A/c Dr.	3,000	
	To Bank A/c		3,000
	(Being payment of amount due to equity shareholders).		
	Note : Cash at Bank [1650+3150+2000-2750-3000] = ₹ 1,050		

Balance Sheet of Diamond Ltd.
as on 01.04.2023

(₹ 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 5 Tangible Assets	Current Year (₹)	Previous Year (₹)
Fixed Assets	14,000	
Total	14,000	

Illustration 39

XYZ Ltd. has the following capital structure on of 31st March 2023.

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 2023 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.	180		90	
	To Bank A/c			180		90
	[Being purchase of shares from public]					
b.	Share capital A/c	Dr.	60		30	
	Security premium A/c	Dr.	100		60	
	General reserve A/c (balancing figure)	Dr.	20		—	
	To Shares bought back A/c			180		90
	[Being cancellation of shares bought on buy back]					
c.	General reserves A/c	Dr.	60		30	
	To Capital redemption reserve A/c			60		30
	[Being transfer of reserves to capital redemption reserve to the extent capital is redeemed]					

Note: Under situation III, the company does not qualify the debt equity ratio test. Therefore the company cannot perform the buyback of shares

Working Notes :

WN # 1: Shares outstanding test

Particulars	(₹)
a. No. of shares outstanding	30 crores
b. 25% of shares outstanding	7.5 crores

WN # 2: Resources test **(₹ in Crores)**

Particulars	
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**

Solved Case 1 (Buyback of Equity Shares – Determination of Maximum Limit)

R Ltd. wants to buy back 100000 equity shares of ₹10 each at a price of ₹20 each on 01.04.2023. The buy back is allowed in its articles of association and the company has obtained necessary approval from the shareholders. The company has sufficient bank balance to make the payment for buy back of shares.

The following information is available as on 31.03.2023:

	₹
Equity Share Capital (₹10 each fully paid)	50,00,000

General Reserve	60,00,000
Dividend Equalization Reserve	10,00,000
Balance of Profit and Loss (Cr.)	5,00,000
10% Debentures (₹100 each)	75,00,000
Bank Loan	40,00,000
Current Liabilities	66,00,000

You have been appointed as a legal expert to supervise the buyback process. Verify whether the buyback plan of the company meets the conditions specified by the Companies Act 2013 as regards to the maximum amount of buyback.

Solution:

Determination of maximum buyback permissible as per Companies Act 2013:

1. **Shares Outstanding Test:** Max. Permissible Limit = 25% of Outstanding Shares

Particulars	₹
Total number of shares outstanding	5,00,000
25% of the shares outstanding	1,25,000

2. **Resource Test:** Max. Permissible Limit = 25% of Paid up Capital plus Free Reserves

Particulars	₹
Equity share capital (₹)	50,00,000
Free Reserve (₹) (General Reserve + DER +P/L)	75,00,000
Paid up Capital plus Free Reserves (₹)	1,25,00,000
25% of Paid up Capital plus Free Reserves (₹)	31,25,000
Buy back price per share (₹)	20
No. of shares that can be bought back (3125000/20)	1,56,250

3. **Debt Equity Ratio Test:** Debt after buyback cannot exceed twice the paid up capital plus free reserves.

Particulars	₹
Total Debt (₹) (75,00,000+40,00,000+66,00,000)	1,81,00,000
Minimum Equity to be maintained after buyback in the ratio 2:1 (₹)	90,50,000
Paid up capital plus free reserves before buyback (₹)	1,25,00,000
Future Paid up capital plus free reserves (₹) (**see working note:1**) (1,25,00,000 – 11,50,000)	1,13,50,000
Maximum permissible buyback (₹) (1,13,50,000 - 90,50,000)	23,00,000
Buy back price per share (₹)	20
No. of shares that can be bought back	1,15,000

Summary of three test results:

Particulars	No. of Shares

Permissible Buyback as per –	
Share Outstanding Test	125000
Resource Test	156250
Debt-Equity Ratio Test	115000
Maximum permissible buyback (least of the three)	115000
Actual buyback plan	100000

Since actual buyback proposed is below the permissible limit, the company can buy back 100000 shares at ₹20 each.

Redemption of Preference Shares, Issue and Redemption of Debentures

1.2

1.2.1 Redemption of Preference Shares

Redeemable preference shares have a fixed term and hence are redeem at the end of such period. On redemption the shareholders are repaid the capital that they had invested in those shares.

The redemption may occur either 'at par' or 'at premium'. When the company repays an amount equal to the face value or nominal value of the preference shares, it is called 'redemption at par'. On the other hand, when a company repays more than the face value or nominal value of the preference shares, it is known as 'redemption at premium'. Thus, under redemption at premium, the company makes payment for (a) preference share capital as well as for (b) premium.

- **Provisions Regarding Issue and Redemption of Preference Shares**

The issue and redemption of preference shares are governed by Companies Act, 2013 and Companies (Share Capital and Debentures) Rules, 2014.

Section 55 of the Act states that –

(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.

Rule 10 of the Companies (Share Capital and Debentures) Rules, 2014 further states that 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.

Moreover, as per Rule 9(6), a company may redeem its preference shares only on the terms on which they were issued or as varied after due approval of preference shareholders under section 48 of the Act and the preference shares may be redeemed:

(a) at a fixed time or on the happening of a particular event;

(b) any time at the company's option; or

(c) any time at the shareholder's option.

⊙ Conditions for Redemption of Preference Shares

Section 55(2) of the Companies Act, 2013, provides that –

(a) no such shares shall be redeemed except out of the profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purposes of such redemption;

(b) no such shares shall be redeemed unless they are fully paid;

(c) where such shares are proposed to be redeemed out of the profits of the company, there shall, out of such profits, be transferred, a sum equal to the nominal amount of the shares to be redeemed, to a reserve, to be called the Capital Redemption Reserve Account, and the provisions of this Act relating to reduction of share capital of a company shall, except as provided in this section, apply as if the Capital Redemption Reserve Account were paid-up share capital of the company; and

(d) (i) in case of such class of companies, as may be prescribed and whose financial statement comply with the accounting standards prescribed for such class of companies under section 133, the premium, if any, payable on redemption shall be provided for out of the profits of the company, before the shares are redeemed:

Provided also that premium, if any, 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, the premium, if any, 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.

Note: Deemed Redemption u/s 55(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:

⊙ Important Points on Redemption of Preference Shares (Other than Deemed Redemption)

Based on the above provisions, the following important points can be noted:

a. Only fully paid-up preference shares can be redeemed. Partly paid-up preference shares must be converted into fully paid-up by calling up the remaining instalment(s) before they can be eligible for redemption.

b. The repayment of capital portion can be done out of two sources –

(i) Profits of the company (which would otherwise be available for dividend payment)

(ii) Proceeds of fresh issue of shares.

c. The premium on redemption, if any, shall be provided as follows:

(i) In case of the prescribed class of companies and whose financial statements comply with the accounting standards prescribed u/s 133 of the Companies Act, 2013 –

- If the preference shares were issued on or before 01.04.2014 (date of commencement of the Companies Act, 2013), premium can be provided out of Securities Premium as well as out of Profits of the Company.

- If the preference shares were issued after 01.04.2014, premium can be provided only out of Profits of the Company.

(ii) For other companies, there can be two sources of premium i.e., Securities Premium and Profits of the Company.

Note: For the purpose of payment of capital, the term 'Profits of the Company which would otherwise be available for dividend' shall mean 'free reserves'. Hence, Securities Premium, Revaluation Reserve, Capital Reserve (unrealized) or any Statutory Reserve will not be eligible for this purpose. But free portion of Investment Allowance Reserve, Development Rebate Reserve, Workmen Compensation Fund will be allowed.

Note: For the purpose of payment of premium, the term 'Profits of the Company' (excluding the expression 'which would otherwise be available for dividend') means all profits of the company whether realized or not. Hence, Capital Reserve (whether released or not), all Statutory Reserve (free portion only), free portion of Investment Allowance Reserve, Development Rebate Reserve, Workmen Compensation Fund will be allowed.

d. Companies may also issue fresh equity or preference shares for redemption of existing preference shares. In such a case –

(i) If the shares are issued at par, proceeds from fresh issue = Nominal Value of shares;

(ii) If the shares are issued at premium, proceeds from fresh issue = Nominal Value of shares (i.e., excluding premium on issue)

e. A sum equal to the nominal amount of the shares to be redeemed out of profits should be transferred tom Capital Redemption Reserve (CRR). The balance of CRR so created shall only be utilized for issue of fully paid-up bonus shares.

⊙ Accounting for Redemption of Preference Shares

(i) On issue of new shares for the purpose of redemption

Bank A/c …………………… Dr.

To Equity Share Application A/c

(Being application money received on ... shares @ ₹ ... each)

Equity Share Application A/c ……Dr.

To Share Capital A/c

To Securities Premium A/c (if new shares are issued at premium)

(Being the issue of... shares of ₹ ...each at a premium of ₹ ...each for the purpose of redemption of preference shares as per Board's Resolution No ... dated ...)

(ii) Redemption due entry

Redeemable Preference Share Capital A/c …...…… Dr.

Premium on Redemption of Preference Shares A/c …Dr. (if redeemable at premium)

To Preference Shareholders A/c

(iii) When payment is made to preference shareholders

Redeemable Preference Shareholders A/c ………. Dr.

To Bank A/c

(iv) Adjustment of premium on redemption

Profit and Loss A/c …………… Dr.

To Premium on Redemption of Preference Shares A/c

(Being the premium on redemption adjusted against profit and loss balance)

Note: In addition, the company may need to undertake transactions such as 'sale of investment' 'sale of idle assets' etc. at profit or at loss. The effect of such transaction shall also be taken into consideration while determining the required amount of fresh issue or profits to be transferred to CRR.

Consider the following illustrations.

Illustration 40

T Ltd. furnishes you with the following Balance Sheet as at 31st March, 2023 : (₹ 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 2023 at a premium of 10%. You are required to pass journal entries to record the above.

Solution :

In the books of T Ltd
Part I - Journal

(₹ in Lakhs)

	Particulars		Dr. ₹	Cr. ₹
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.

Illustration 41

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 42

The Balance Sheet of Pixel Ltd. as on 31.12.2022 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
1,00,000 Redeemable Pref. shares of ₹100 each	100	Stock	46
Less: Call-in-arrears on 20,000 shares	(4)	Debtors	30
Security premium account	15	Bank	30
Reserve	30		
Profit and Loss account	15		
Creditors	30		
	286		286

On 1st Jan 2023, fixed assets costing ₹40 Lakh were sold for ₹32 Lakh. It was decided that on 1st Feb 2023, 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 31.12.2022. 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

Particulars		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)			

Illustration 43

The balance sheet of G Ltd as on 31.12.2022

Liabilities:	(₹)
Equity shares of ₹10 each	2,00,000
Less: Calls in arrear @ ₹2	10,000
14% Preference Shares of ₹100	1,00,000
Securities Premium	10,000
Investment Allowance Reserve	40,000
Development Rebate Reserve	20,000
Workmen Compensation Fund	10,000
Dividend Equalization Reserve	12,000
Profit and Loss Account	38,000
Unsecured Loans	80,000
	5,00,000
Assets	
Non Current Assets	4,00,000
Current Assets(including Bank balance ₹10,000)	1,00,000
	5,00,000

The board of directors decided to redeem the preference shares on 1st January 2023 on the following conditions.

Issue 4000 equity shares and ₹50,000 10% debentures.

Redeem preference shares at a premium of 10%.

Raise necessary bank loan to provide funds for redemption and to have ₹15,000 as balance.

Admit claim of ₹40,00 for workmen compensation.

Utilise ₹10,000 out of development rebate reserve for the purpose.

Necessary journal entries assuming that holders of 100 reference shares could not be traced by the company.

Solution:

In the books of G Ltd.

Journal

Remarks	Particulars		Dr. ₹	Cr. ₹
Arrangement of fund	Bank A/c	Dr.	40,000	
	To Equity Share Capital A/c			40,000
Arrangement of fund	Bank A/c	Dr.	50,000	
	To 10% Debentures A/c			50,000
Amount payable	14% Preference Share Capital A/c	Dr.	1,00,000	
	Premium on redemption A/c	Dr.	10,000	
	To Preference Shareholders A/c			1,10,000

Arrangement of fund	Securities Premium A/c	Dr.	10,000	
	To Premium on Redemption A/c			10,000
Arrangement of fund	Development Rebate Reserve A/c	Dr.	10,000	
	Workmen Compensation Fund A/c	Dr.	6,000	
	Dividend Equalization Reserve A/c	Dr.	12,000	
	Profit and Loss A/c	Dr.	32,000	
	To Capital Redemption Reserve A/c			60,000
Arrangement of fund	Bank A/c	Dr.	25,000	
	To Bank Loan A/c			25,000
Payment made except 100 shareholders who could not be traced.	Preference Shareholders A/c	Dr.	99,000	
	To Bank A/c			99,000
	Workmen Compensation Fund A/c	Dr.	4,000	
	To Claim for Workmen Compensation A/c			4,000

Note:

Amount to be transferred to CRR:	₹
Nominal value of shares to be redeemed	1,00,000
Less : Fresh issue of equity shares	40,000
CRR	60,000

Illustration 44

Books of M Limited show the following balances on 31st December 2022	₹
15000 present equity shares of ₹10 each fully paid	1,50,000
2500 10% preference shares of ₹100 each fully paid	2,50,000
500 8% redeemable preference shares pop ups ₹108, what is ₹70 paid up	₹35,000
General Reserve	75,000
Profit and Loss Account	1,60,000
Securities Premium	15,000
Investment	1,20,000
Cash at Bank	39,600

On 1st January 2023 the board of directors decided to redeem the preference shares at a premium of 8%. In order to pay of preference shareholders the company also decided to sell the Investments and use companies fund and to raise the balance by issue of sufficient number of equity shares of ₹10 each at a premium of rupee 1 per share subject to leaving a minimum bank balance of ₹9,000 after search Redemption.

Investments web sold at ₹1,08,000

Show the necessary journal entries (without narration) to record the transactions.

Solution:

In the books of M Ltd.

Journal

Remarks	Particulars	Dr. (₹)	Cr. (₹)
Arrangement of fund	Bank A/c To Equity Share Capital A/c To Securities Premium A/c	1,32,000	 1,20,000 12,000
Arrangement of fund	Bank A/c Profit and Loss A/c To Investment A/c	1,08,000 12,000	 1,20,000
Amount payable	14% Preference Share Capital A/c Premium on Redemption A/c To Preference Shareholders A/c	2,50,000 20,000	 2,70,000
Arrangement of fund	Securities Premium A/c To Premium on Redemption A/c	20,000	 20,000
Arrangement of fund	General Reserve A/c Profit and Loss A/c To Capital Redemption Reserve A/c	75,000 55,000	 1,30,000
Payment made	Preference Shareholders A/c To Bank A/c	2,70,000	 2,70,000

Note:

Amount to be transferred to CRR:	₹
Nominal value of shares to be redeemed	2,50,000
Less : fresh issue of equity shares	1,20,000
CRR	1,30,000

Note :

Amount of cash to be collected from new issue of equity shares = amount payable in redemption + minimum closing cash balance – (opening bank balance + sale of investment) = ₹ [2,70,000 + 9,600 - (39,600 + 1,08,000)] = ₹ (2,79,600 - 1,47,600) = ₹ 1,32,000.

Therefore, number of shares to be issued will be = 132000/ (10+1) = 12,000

Value per share = 10+1 (including premium of ₹1)

1.2.2 Issue and Redemption of Debentures

Share capital is the primary source of finance for every company. However, companies are often found to raise debt capital for additional financing requirement. A company raises the debt capital either through institutional financing i.e., loans from banks and other financial institutions or may issue structured debt instruments (such as debentures and bonds). Debentures happens to be the most popular debt instruments issued by a company to raise borrowed capital.

As per Section 2(30) of the Companies Act, 2013, "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.

Following are the features of debentures as a debt instrument.

a. Debenture is a financial instrument used to raise debt capital.

b. It is written document issued under the seal of the company.

c. It normally carries a rate of interest payable at regular interval. Such rate is termed as coupon rate.

d. Debenture may be redeemable or irredeemable.

Types of Debentures

The various types of debentures are shown in the following diagram.

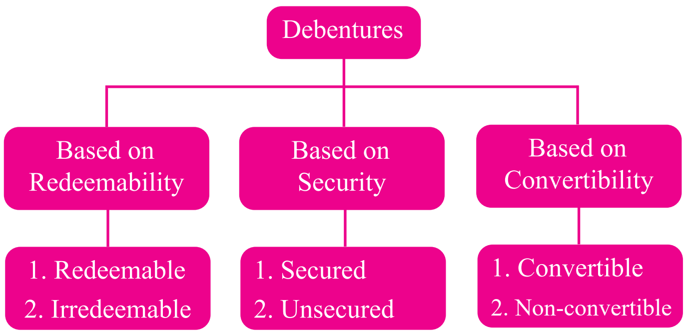

Figure 1.3: Types of Debentures

a. Redeemable vs. Irredeemable Debentures

Redeemable Debentures are debentures that are repayable by a company at the end of the pre-specified time period. Irredeemable debentures are not repayable during the life-time of the company.

b. Secured vs. Unsecured Debentures

Secured Debentures are those debentures which create a charge on the assets of the company. These are also called Mortgage Debentures. Unsecured debentures are issued without the support of a collateral security. These are also called Naked Debentures.

c. Convertible vs. Non-convertible Debentures

Debentures which are convertible into other securities viz. equity shares, preference shares or new debentures after a specified period are referred to as Convertible Debentures. They may fully convertible or partly convertible. On the other hand, Debentures which are not convertible into any other security are referred to as Non-convertible Debentures.

Note: In all the above cases, the debentures may be issued at par or at premium or at discount to the issue price.

Provisions Relating to Issue and Redemption of Debentures

The provisions relating to issue and redemption of debentures are covered by Section 71 of the Companies Act, 2013 and Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014.

Section 71 of the Companies Act, 2013 states that -

(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.

(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.

Additional conditions[2] have been provided by the Companies (Share Capital and Debentures) Rules, 2014.

In addition to the above, SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021 also provides important guidelines for debt securities[3] to be issued by listed entities.

1.2.2.1 Accounting for Issue of Debentures – General Cases

Debentures can be issued at par or at premium or at discount. Moreover, the money can be collected in lump-sum or in instalments. The accounting entries for issue of debentures are as follows:

a. Debentures issued in lump sum

(i) On receipt of application money

Bank A/c ....Dr.

To Debenture Application A/c

(ii) For excess debenture application money refunded

Debenture Application A/c .... Dr.

To Bank A/c

(iii) On allotment of debentures

Debenture Application A/c ....Dr.

Discount on Issue of Debentures A/c .... Dr. (if issued at discount)

To Debentures A/c

To Securities Premium A/c (if issued at premium)

b. Debentures issued in instalments

(i) On receipt of application money

Bank A/c ....Dr.

To Debenture Application A/c

(ii) For excess debenture application money refunded

Debenture Application A/c .... Dr.

To Bank A/c

(iii) For debenture application money transferred to share capital

Debenture Application A/c ....Dr.

To Share Capital A/c

(iv) For debenture allotment money due

Debenture Allotment A/c ....Dr.

Discount on Issue of Debentures A/c .... Dr. (if issued at discount)

To Debenture Capital A/c

To Securities Premium A/c (if issued at premium)

(v) For debenture allotment money received

Bank A/c ....Dr.

To Debenture Allotment A/c

(vi) For debenture call money due

Debenture Call A/c .... Dr.

To Share Capital A/c

(vii)For debenture call money received

Bank A/c ………………………………..Dr.

To Debenture Call A/c

Note: In case of issue of debentures at discount, the Discount will always be accounted in allotment. However, premium will be accounted with the instalment in which it is included. If nothing is mentioned specifically, it is accounted with allotment money.

Note: The premium on issue of debenture is included in Securities Premium A/c and the same is reflected under Reserve and Surplus in the Balance Sheet. The discount on issue of debentures is amortized over the life of the debentures on a proportionate basis. Accordingly, the amount amortized during the year is shown under Depreciation and Amortization in the Statement of Profit and Loss. The remaining amount is shown in the assets section of the Balance Sheet. The portion to be amortized over next 12 months is included in Other Current Assets while the portion that will not be amortized over next 12 months is shown in Other Non-current Assets. (Refer to illustration 58)

Consider the following illustration.

Illustration 45

P Ltd. issued 50,000, 8% Debentures of ₹100 each at a premium of ₹20 payable as follows:

₹30 on application; ₹40 on allotment (including premium); and ₹50 on first and final call.

Applications were received for all the debentures along with the application money and allotment was made Call money was also received on due date. Pass necessary journal entries to record the issue of debentures.

What will be the entries if the entire amount is received on application?

Solution:

(a) When debentures were issued in instalment

In the books of P Ltd.

Journal

Date	Particulars	Dr. ₹	Cr. ₹
	Bank A/c …………………Dr.	15,00,000	
	To Debenture Application A/c		15,00,000
	(Being application money received)		
	Debenture Application A/c ……………………. Dr.	15,00,000	
	To Debentures A/c		15,00,000
	(Being application money transferred to Debentures as per board's resolution no ….. dated…)		
	Debenture Allotment A/c …………………………Dr.	20,00,000	
	To Debenture Capital A/c		10,00,000
	To Securities Premium A/c		10,00,000
	(Being allotment money due as per board's resolution no ….. dated…)		

	Bank A/c ………………………..Dr.	20,00,000	
	To Debenture Allotment A/c		20,00,000
	(Being allotment money received)		
	Debenture First and Final Call A/c…………… Dr.	25,00,000	
	To Share Capital A/c		25,00,000
	(Being first and final call money due as per board's resolution no ….. dated…)		
	Bank A/c ………………………..Dr.	25,00,000	
	To Debenture First and Final A/c		25,00,000
	(Being first and final call money received)		

(b) When debentures were issued at lumpsum

In the books of P Ltd.
Journal

Date	Particulars	Dr. ₹	Cr. ₹
	Bank A/c …………………Dr.	60,00,000	
	To Debenture Application A/c		60,00,000
	(Being application money received)		
	Debenture Application A/c …………………… Dr.	60,00,000	
	To Debenture Capital A/c		50,00,000
	To Securities Premium A/c		10,00,000
	(Being application money transferred to Debentures as per board's resolution no ….. dated…)		

1.2.2.2 Accounting for Issue of Debentures – Special Cases

I. When terms of redemption are known and debentures are redeemable at premium

In this case the premium payable on redemption may be provided at the time of issue itself, by passing the following additional entry –

Loss on Issue of debentures A/c……………….... Dr.

To Premium on Redemption of Debentures A/c

Students may pass a combined entry at the time of allotment to record the above. Consider the following alternative situations (other entries remain the same).

[2] See Rule 18 of Companies (Share Capital and Debentures) Rules, 2014
[3] See Chapter III of SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021

Situation	Combined entry on allotment
Issue at par, redemption at premium	Debenture Application A/c …………Dr. Loss on Issue of debentures A/c……….... Dr. To Debentures A/c To Premium on Redemption of Debentures A/c
Issue at premium, redemption at premium	Debenture Application A/c …………Dr. Loss on Issue of debentures A/c……….... Dr. To Debentures A/c To Securities Premium A/c To Premium on Redemption of Debentures A/c
Issue at discount, redemption at premium	Debenture Application A/c ………………………Dr. Loss on Issue of Debentures A/c …………..... Dr. To Debentures A/c To Premium on Redemption of Debentures A/c Note: Here, Loss on Issue of Debentures A/c includes both discount on issue of debentures and premium on redemption of debentures

Consider the following illustration.

Illustration 46

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		Dr. ₹ '000	Cr. ₹ '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.

II. Issue of Debenture for Consideration other than Cash

Debentures may also be issued for consideration other than cash. Examples include allotment of debentures for purchase of asset or for technical services received. The accounting entries in such a case will be as follows:

(i) On purchase of assets

Sundry Assets A/c …………………Dr.

To Vendor A/c

(ii) On issue of debentures

Vendor A/c …………………………Dr.

Discount on Issue of Debentures A/c …………... Dr. (if issued at discount)

To Debenture Capital A/c

To Securities Premium A/c (if issued at premium)

Consider the following illustration.

Illustration 47

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

Working Notes:

(i) The amount by which the purchase consideration exceeds the value of the net assets (i.e. the difference between the agreed value of the assets taken over and the agreed amount of liabilities taken over) has been debited to Goodwill Account.

(ii) Calculation of No. of Debentures to be issued in each case.

Particulars	(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

III. Debentures Issued as Collateral Security

The term 'collateral' means additional or secondary. When debentures are issued as additional security against a loan (for which there exists a primary security) it is called issue of debentures as collateral security. This type of issue is generally made when the lender feels that the primary security is inadequate. The borrower company, however, is not required to pay any interest on the debenture which are issued as collateral security. On full repayment of the loan, the debentures issued as collateral security are returned by the lender. However, if the company fails to repay the loan, the lender exercises its right on the debentures issued as collateral security.

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.

b. Second method

Sometimes issue of debentures as collateral security is recorded by making a journal entry as follows:

Debenture Suspense A/c ……………. Dr.

To Debenture A/c

Note: Debenture Suspense A/c is shown as a deduction from Debenture A/c in the balance sheet. When the loan is paid the above entry is cancelled by means of a reverse entry.

IV. Interest on Debentures

The periodical interest paid on debentures is included in the Finance Cost in the Statement of Profit and Loss as it is a charge against profit. The accounting entries are:

(i) On payment of interest

Interest A/c …………………Dr.

To Bank A/c

(ii) On issue of debentures

Profit and Loss A/c ………………………. Dr.

To Interest A/c

Note: When the due dates for payment of debenture interest does not match with the accounting period, the following two concepts emerge:

(1) Debenture interest accrued and due: The portion of the total amount of debenture interest for which due date(s) has/have fallen within the accounting period is referred to as 'Debenture interest accrued and due; and

(2) Debenture interest accrued but not due: The portion of the total amount of debenture interest that has arisen but for which due date(s) has/have not fallen within the accounting period is referred to as 'Debenture interest accrued but not due'.

In the Balance Sheet, both 'Debenture interest accrued and due' as well as 'Debenture interest accrued but not due' are shown under 'Other current liabilities'.

Consider the following illustration

Illustration 48

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:

1. **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		

2. **Second Method**

In the books of C Ltd.

Journal

Particulars	Dr. (₹)	Cr. (₹)
Debentures Suspense A/c Dr.	10,00,000	
To 12% Debentures A/c		10,00,000
(Being the issue of 1,000, 12% debentures of ₹1000 each as collateral security for a loan from a bank as per Board's resolution dated...)		

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

Liabilities	₹	Assets	₹
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		

1.2.2.3 Accounting for Redemption of Debentures

Redemption of debentures refers to the repayment of borrowed capital raised by a company through debentures. The condition of redemption is clearly specified in the prospectus inviting application for the issuance of debentures.

The common sources that may be utilized by the companies for the purpose of redemption of debentures are –

a. Redemption out of proceeds of fresh issue of shares/ debentures: Here the company issues fresh equity/ preference shares or debentures or bonds for raising the money required for redemption of debentures. This may amount tom change in the capital structure.

b. Redemption out of profits: A company may utilize a portion of its profit which otherwise were available for distribution of dividend to redeem the debentures. This may be done by transferring a portion of profits to Debenture Redemption Reserve. The profits so transferred may be retained within the company or may be invested outside in readily marketable securities.

c. Redemption out of capital: Here the company does not set aside any profits for redemption purpose. Thus, eventually, the amount is paid out of capital.

In India, redemption of debenture is guided by Section 71 of the Companies Act, 2013 and Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014 which require mandatory creation of Debenture Redemption Reserve. Hence, the redemption happens to be partly out of profits and partly out of capital.

⊙ Provisions on Creation of Debenture Redemption Reserve (DRR)

As per Section 71(4) of the Companies Act, 2013, 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 utilized by the company except for the redemption of debentures.

As per Rule 18 of The Companies (Share Capital and Debentures) Rules 2014, the company shall create a Debenture Redemption Reserve for the purpose of redemption of debentures, in accordance with the conditions given below-

(a) the Debenture Redemption Reserve shall be created out of the profits of the company available for payment of dividend;

(b) the limits with respect to adequacy of Debenture Redemption Reserve and investment or deposits, as the case may be, shall be as under;-

(i) Debenture Redemption Reserve is not required for debentures issued by All India Financial Institutions regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures;

(ii) For other Financial Institutions within the meaning of clause (72) of section 2 of the Companies Act, 2013, Debenture Redemption Reserve shall be as applicable to Non - Banking Finance Companies registered with Reserve Bank of India.

(iii) For listed companies (other than All India Financial Institutions and Banking Companies as specified in sub-clause (i)), Debenture Redemption Reserve is not required in the following cases -

(A) in case of public issue of debentures -

A. for NBFCs registered with Reserve Bank of India under section 45- IA of the RBI Act, 1934 and for Housing Finance Companies registered with National Housing Bank;

B. for other listed companies;

(B) in case of privately placed debentures, for companies specified in sub items A and B.

(iv) for unlisted companies, (other than All India Financial Institutions and Banking Companies as specified in sub-clause (i))-

(A) for NBFCs registered with RBI under section 45-IA of the Reserve Bank of India Act, 1934 and for Housing Finance Companies registered with National Housing Bank, Debenture Redemption Reserve is not required in case of privately placed debentures.

(B) for other unlisted companies, the adequacy of Debenture Redemption Reserve shall be ten percent, of the value of the outstanding debentures;

(c) every company required to create Debenture Redemption Reserve shall on or before the 30th day of April in each year, invest or deposit, as the case may be, a sum which shall not be less than fifteen percent, of the amount of its debentures maturing during the year ending on the 31st day of March of the next year, in any one or more of the following methods, namely:-(i) in deposits with any scheduled bank, free from any charge or lien; (ii) in unencumbered securities of the Central Government or of any State Government; (iii) in unencumbered securities mentioned in sub-clauses (a) to (d) and (ee) of section 20 of the Indian Trusts Act, 1882; (iv) in unencumbered bonds issued by any other company which is notified under sub-clause (f) of section 20 of the Indian Trusts Act, 1882; (v) the amount invested or deposited as above shall not be used for any purpose other than for redemption of debentures maturing during the year referred above:

Provided that the amount remaining invested or deposited, as the case may be, shall not at any time fall below fifteen per cent of the amount of the debentures maturing during the year ending on the 31st day of March of that year;

(d) in case of partly convertible debentures, Debenture Redemption Reserve shall be created in respect of non-convertible portion of debenture issue in accordance with this sub-rule.

(e) the amount credited to the Debenture Redemption Reserve shall not be utilized by the company except for the purpose of redemption of debentures.

The above provisions may be summarized in the following points:

a. DRR is required to be created only in case of 'Non-convertible Debentures' and 'Non-convertible portion of Partly Convertible Debentures'.

b. The DRR shall be created out of the profits of the company that are available for payment of dividend i.e., out of the divisible profits of the company.

c. A company shall create DRR before starting the redemption of debentures.

d. An eligible company (i.e., an unlisted company other than AIFI, Banking Compnaies and NBFCs registered with RBI and Housing Finance Companies registered with NHB) shall create DRR of an amount equal to at least 10% of the nominal (face) value of the outstanding debentures.

e. Listed Companies (other than AIFIs and Banking companies) are not required to create DRR for publicly and privately placed debentures.

f. NBFCs and other financial institutions covered u/s 2(72) of Companies Act, 2013 are not required to create DRR for publicly and privately placed debentures.

g. Every company which is required to create DRR shall on or before April 30 each year, must invest or deposit a specified sum of not less than 15% of the amount of debentures maturing during the year ending on the March 31, in any of the specified modes.

h. After the redemption of debentures, such DRR a/c is closed by transfer to General Reserve A/c.

Note: It is to be noted that a company only requires to create DRR to the extent of 10% of the nominal value of the debentures. Then, effectively 90% of the nominal value of debentures is redeemed out of capital. In short, Investment of Debenture Redemption Fund requirement is needed in the case of following types of companies:

i. All listed NBFCs

ii. All listed HFCs

iii. All other listed companies (Other than AIFIs, Banking Companies and other FIs); and

iv. All unlisted companies which are not NBFCs and HFCs.

⊙ Methods of Redemption of Debentures

I. Redemption of Debentures in Lump Sum

Here debentures are redeemed at the expiry in one lump-sum. The redemption can be made at par, at premium or at discount. The company, as per the statutory provisions discussed earlier, needs to make statutory transfer to DRR and also to make necessary investment. After redemption DRR A/c should be closed to General Reserve.

The accounting entries are as follows:

Particulars	Journal Entries	Remarks
Before Redemption		
Transfer to DRR	Surplus A/c …………………Dr. To DRR A/c Note: Here Surplus refers to profits under Statement of Profit and Loss	At least 10% of face value of debentures issued at any time before expiration
Making Investment	Deb. Red. Investment A/c ………Dr. To Bank A/c	At least 15% of the face value debentures to be redeemed. The investment has to be made on or before 30th April of the financial year in which the debentures are redeemed.
On redemption		
Sale of Investment	Bank A/c ……………………..Dr. To Deb. Red. Investment A/c	
Due entry for redemption	Debenture A/c…………………..Dr. Premium on Redemption of Debentures A/c ………………..Dr. To Debenture-holders A/c	Face value Premium payable Total amount payable
Payment entry	Debenture-holders A/c …………Dr. To Bank A/c	
Transfer of DRR	DRR A/c ………………………Dr. To General Reserve A/c	

Note: When the company maintains a Sinking Fund (for redemption of debentures)

Sometimes companies maintain a Sinking Fund for the purpose of repayment of the liability and invest the amount in readily marketable securities. The fund (called Sinking Fund) is created by annual contribution out of profits. The annual contribution is determined based on Annuity Table. The investment out of the fund is termed as Sinking Fund Investment.

This method is in practice for many years. Section 71(4) of the Companies Act, 2013 has provided a statutory recognition to it.

The accounting process, in this case, is as follows:

Transaction	Journal Entry	Remarks
In the year of Debenture issue		
Annual contribution	Surplus A/c ....Dr To Sinking Fund A/c	Annual Contribution is calculated with the help of the Annuity Table.
Investment of the amount	Sinking Fund Investment A/c ....Dr. To Bank A/c	Either equal to or less the amount of contribution.
In all subsequent years (except the last year)		
Receipt of Interest on Investment	Bank A/c ....Dr. To Interest on Sinking Fund Investment A/c	Interest is earned on the 'Nominal (Face) Value' of Sinking Fund Investment.

Transferring of interest to Sinking Fund	Interest on Sinking Fund Investment A/c ....Dr. To Sinking Fund A/c	
Providing Annual contribution	Surplus A/c ....Dr. To Sinking Fund A/c	
Investment of the amount	Sinking Fund Investment A/c .... Dr. To Bank A/c	Amount invested in Sinking Fund Investment = Annual Contribution + Interest on Sinking Fund Investment
In the year of redemption		
Receipt of Interest	Bank A/c ....Dr. To Interest on Sinking Fund Investment A/c	This is reinvested as it is the last year.
Annual contribution	Surplus A/c ....Dr. To Sinking Fund A/c	The balancing figure to get the required amount of fund.
Disposal of Sinking Fund Investment	Bank A/c ....Dr. To Sinking Fund Investment A/c	The sale proceeds
	Sinking Fund Investment A/c …………..Dr. To Sinking Fund A/c	Profit on sale
	Bank A/c ……………………Dr. Sinking Fund A/c ……………..Dr. To Sinking Fund Investment A/c	Sale at a loss
Due entry for redemption	Debenture A/c…………………..Dr. Premium on Red. of Debentures A/c…..Dr. To Debenture-holders A/c	
Payment entry	Debenture-holders A/c …………Dr. To Bank A/c	
Transfer of Sinking Fund balance	Sinking Fund A/c …………..Dr. To General Reserve A/c	Face value of debentures redeemed

Consider the following illustrations.

Illustration 49 (Redemption out of profits)

P Ltd. had issued ₹15,00,000, 10% Debentures which are due to be redeemed out of profits on Nov. 1, 2023 at a premium of 5%. The company had a Debenture Redemption Reserve of ₹6,21,000. It was decided to invest the required amount in Debenture Redemption Investment on 15.4.2023. Pass necessary journal entries for recording the transactions relating to redemption of debentures.

Solution:

In the books of P Ltd.

Journal

Date	Particulars	Dr. ₹	Cr. ₹
31.03.23	Surplus A/c …………………Dr.	8,79,000	
	To Debenture Redemption Reserve A/c		8,79,000
	(Being amount of profits transferred to DRR as per Board's Resolution no…. Dated…)		

15.04.23	Debenture Redemption Investment A/c .... Dr. To Bank A/c (15,00,000 x 15%) (Being statutory minimum investment made in DRI)	2,25,000	 2,25,000
01.11.23	Bank A/c ....Dr. To DRI A/c (Being amount encashed from DRI for redemption)	2,25,000	 2,25,000
01.11.23	10% Debentures A/c.....................Dr. Premium on Redemption of Debentures A/c ....Dr. To 10% Debenture-holders A/c (Being amount due on redemption.)	15,00,000 75,000	 15,75,000
01.11.23	10% Debenture-holders A/c To Bank A/c (Being payment made.)	15,75,000	 15,75,000
01.11.23	DRR A/c ....Dr. To General Reserve A/c (Being DRR transferred on redemption.)	15,75,000	 15,75,000

Working Note:

Transfer of profits to DRR = Face value of debentures redeemed – Existing DRR

= 15,00,000 – 6,21,000 = ₹8,79,000

Illustration 50 (Redemption of debentures of capital)

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:

In the books of ....

Journal

Date	Particulars		Dr. ₹ '000	Cr. ₹ '000
1st year	Bank A/c	Dr.	10,000	
	Loss on issue of debentures A/c	Dr.	1,500	
	To 15% Debentures A/c			10,000
	To Premium on redemption A/c			1,500
8th year end	15% Debentures A/c	Dr.	10,000	
	Premium on redemption A/c	Dr.	1,500	
	To Debenture Redemption A/c			11,500
	Debenture redemption A/c	Dr.	11,500	
	To Bank A/c			11,500

Illustration 51 (Redemption partly out of profit and partly out of capital)

The Balance Sheet of AB Ltd. as on March 31, 2022 reflected 10,000, 12% Debentures of ₹100 each outstanding. These debentures were due for redemption on July 31, 2023. The company decided to transfer ₹5,00,000 to Debenture Redemption Reserve on March 31, 2023 and invest ₹1,50,000 in fixed deposits with Bank of India on April 8, 2023. The investment was encashed as the debentures were redeemed on due date. Pass journal entries to record the above transactions (Ignore transactions relating to interest on debentures).

Solution:

In the books of AB Ltd.

Journal

Date	Particulars	Dr. ₹	Cr. ₹
31.03.2023	Surplus A/c …………………Dr.	5,00,000	
	To Debenture Redemption Reserve A/c		5,00,000
	(Being amount of profits transferred to DRR as per Board's Resolution no…. Dated…)		
08.04.2023	Debenture Redemption Investment A/c …………. Dr.	1,50,000	
	To Bank A/c		1,50,000
	(Being statutory minimum investment made in DRI)		
31.07.2023	Bank A/c …………………………Dr.	1,50,000	
	To DRI A/c		1,50,000
	(Being amount encashed from DRI for redemption)		
31.07.2023	12% Debentures A/c…………………..Dr.	10,00,000	
	To 12% Debenture-holders A/c		10,00,000
	(Being amount due on redemption.)		
31.07.2023	12% Debenture-holders A/c	10,00,000	
	To Bank A/c		10,00,000
	(Being payment made.)		
31.07.2023	DRR A/c ……………………Dr.	5,00,000	
	To General Reserve A/c		5,00,000
	(Being DRR transferred on redemption.)		

Illustration 52 (Issue and Redemption at premium, Redemption partly out of profit and partly out of capital)

K Ltd. issued ₹6,00,000,13% Debentures of ₹100 each on April 1, 2019 at a premium of 6% redeemable at a premium of 10% on March 31, 2023. The debentures were redeemed on due date. Assume that the required minimum investment was made by the company in 10% Government Securities on the last due date meant for the purpose of this redemption. Pass journal entries to record the issue and redemption of debentures. (Ignore transactions relating to interest on debentures and writing-off loss on issue of debentures).

Solution:

In the books of K Ltd.

Journal

Date	Particulars	Dr. ₹	Cr. ₹
01.04.2019	Bank A/c ……………………Dr. Loss on Issue of Debentures A/c To 13% Debentures A/c To Securities Premium A/c (600000 x 6%) To Premium on Redemption of Debentures A/c (Being issue of debentures at premium and premium on redemption is provided for.)	6,36,000 60,000	 6,00,000 36,000 60,000
30.04.2022	Debenture Redemption Investment A/c ………… Dr. To Bank A/c (Being statutory minimum investment made in DRI)	90,000	 90,000
31.03.2023	Surplus A/c …………………Dr. To Debenture Redemption Reserve A/c (Being amount of profits transferred to DRR as per Board's Resolution no…. Dated…)	60,000	 60,000
31.03.2023	Bank A/c …………………………Dr. To DRI A/c To Interest on DRI A/c (90000 x 10% x 11/12) (Being amount encashed from DRI for redemption)	98,250	 90,000 8,250
31.03.2023	13% Debentures A/c…………………..Dr. Premium on Redemption of Debentures A/c …….Dr. To 13% Debenture-holders A/c (Being amount due on redemption.)	6,00,000 60,000	 6,60,000
31.03.2023	13% Debenture-holders A/c To Bank A/c (Being payment made.)	6,60,000	 6,60,000
31.03.2023	DRR A/c ……………………Dr. To General Reserve A/c (Being DRR transferred on redemption.)	60,000	 60,000
31.03.2023	Interest on DRI A/c …………Dr. To Profit and Loss A/c (Being interest on DRI transferred.)	8,250	 8,250

Illustration 53 (Redemption at lump-sum with Sinking Fund)

On 1st April 2019. 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 2023, 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

Debenture Redemption Fund Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31.03.2020	To Balance c/d	1,00,000	31.03.2020	By P&L App.A/c	1,00,000
31.03.2021	To Balance c/d	2,10,000	01.04.2020	By Balance b/d	1,00,000
			31.03.2021	By Interest on DRFI A/c	10,000
				By P&L App. A/c	1,00,000
		2,10,000			2,10,000
31.03.2022	To Balance c/d	3,31,000	01.04.2021	By Balance b/d	2,10,000
			31.03.2022	By Interest on DRFI A/c	21,000
			31.03.2022	By P&L App. A/c	1,00,000
		3,31,000			3,31,000
31.03.2023	To Loss on issue of Debentures/ Premium on redemption of Debentures A/c	22,100	01.04.2022	By Balance b/d	3,31,000
	To Debenture Redemption Reserve A/c	4,51,000	31.03.2023	By Interest on DRFI A/c	33,100
			31.03.2023	By P&L App. A/c	1,00,000
				By Debenture Redemption Fund Investment A/c (Profit)	
		4,73,100			4,73,100

Debentures Redemption Fund Investment (DRFI) Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31.03.2020	To Bank A/c	1,00,000	31.03.2020	By Balance c/d	1,00,000
01.04.2020	To Balance b/d	1,00,000	31.03.2021	By Balance c/d	2,10,000
31.03.2021	To Bank A/c	1,10,000			
		2,10,000			2,10,000
01.04.2021	To Balance b/d	2,10,000	31.03.2022	By Balance c/d	3,31,000
31.03.2022	T Bank A/c	1,21,000			
		3,31,000			3,31,000
01.04.2022	To Balance b/d	3,31,000	31.03.2023	By Bank A/c (Sales)	3,40,000
31.03.2023	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 ₹ 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
2019-20	—	—	1,00,000	1,00,000	1,00,000
2020-21	1,00,000	10,000	1,00,000	1,10,000	2,10,000
2021-22	2,10,000	21,000	1,00,000	1,21,000	3,31,000
2022-23	3,31,000	33,100	1,00,000	—	—

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

II. Redemption of Debentures in Instalments by Drawing Lots

Under this method redemption is done in parts. When it is done in every year, it is called Redemption by Annual Drawing. Redemption may be done at par, at premium or at discount.

Under this approach, the statutory requirements are exactly similar to that discussed under lump-sum method.

The recording of transactions is also similar to that explained under lump-sum method.

Consider the following illustration.

Illustration 54

X Ltd., a pharmaceutical company, has 20,000, 9% Debentures of ₹100 each outstanding. These are due for redemption in lots as follows:

On March 31, 2021 – 4,000 debentures; On March 31, 2022 – 6,000 debentures; On March 31, 2023 – Balance debentures.

You are required to ascertain the amount of balance that is required to be maintained in DRR A/c for each redemption. Also state the balance required to be transferred from DRR to General Reserve after each redemption.

Solution:

X Ltd., assuming an eligible unlisted company, is mandatorily required, to create Debenture Redemption Reserve (DRR) as per Sec, 71(4) of Companies Act, 2013. A company is required to create DRR of an amount equal to at least 10% of the nominal (face) value of the debentures issued. In this case, face value of outstanding 9% Debentures = 20,000 x ₹100 = ₹20,00,000.

The time limit and amount of DRR required is presented below:

Date	Time limit for creating DRR	Minimum DRR required	Number of debentures redeemed	Transfer of DRR to General Reserve
On 31.3.21	Before 31.3.21	20,000 x ₹100 x 10% = ₹2,00,000	4,000 debentures [Given]	₹40,000 (2,00,000x4,000/20,000)

On 31.3.22	Before 31.3.22	(20,000 - 4,000) x ₹100 x 10% = ₹1,60,000	6,000 debentures [Given]	₹60,000 (2,00,000 x 6,000/ 20,000)
On 31.3.23	Before 31.3. 21	(16,000- 6,000) x ₹100 x 10% = ₹1,00,000	10,000 debentures [20,000-4,000-6,000]	₹1,00,000 (2,00,000 x 10,000/ 20,000)

Note: Alternatively, entire balance of Debenture Redemption Reserve A/c (₹2,00,000) may be transferred to General Reserve after all the debentures have been redeemed i.e., after 31.3.2023.

Note: For each debenture redemption, the entries to be passed are:

a. Creation of DRR

b. Creation of DRI

c. Realization of DRI

d. Redemption due entry

e. Redemption payment entry

f. Transfer of DRR to General Reserve

III. Redemption of Debentures by Conversion

Under this method debentures are converted into new debentures or equity shares or preference shares. However, in most of the cases, they are convertible into equity shares. Debentures may be fully convertible or partly convertible. New securities may be issued at par, at premium or at discount.

Since, DRR is required only for non-convertible debentures or non-convertible part of partly convertible debentures, under this method the provisions for DRR and DRI are not applicable.

The accounting entries are as follows:

Particulars	Journal Entry	Remarks
Redemption due entry	Debentures A/c . ... Dr. Prem. on redemption of Debentures A/c ....Dr. To Debenture-holders A/c	Face value Premium payable, if any Total amount due
On issue of new securities 'at Par'	Debenture-holders A/c ...Dr. To Eq. Shares/ Pref. Shares/ Debentures A/c	Total amount redeemed FV of new securities issued
On issue of new securities 'at a premium'	Debenture-holders A/c ....Dr. To Eq. Shares/ Pref. Shares/ Debentures A/c To Securities Premium A/c	Total amount redeemed FV of new securities issued Premium on issue
On issue of new debentures at a discount'	Debenture-holders A/c ....Dr. Discount on issue of Debentures A/c ....Dr. To (New) Debentures A/c	Total amount redeemed Discount on issue FV of new securities issued

Consider the following illustration.

Illustration 55

B Ltd. issued notice of its intention to redeem its outstanding ₹12,00,000, 8% Debentures at 102% and offered the holders the following options to apply for the redemption moneys:

(i) 6% Cumulative Preference shares of ₹20 each at ₹22.50 per share; and

(ii) 10% Debentures of ₹100 each at ₹96.

The holders of ₹4,80,000 debentures accepted proposal (i), and ₹7,20,000 debenture-holders accepted proposal (ii).

Pass necessary journal entries to record the above-mentioned transactions.

Solution:

In the books of B Ltd.

Journal **Dr.** **Cr.**

Date	Particulars	₹	₹
	8% Debentures A/c ... .Dr. Premium on Redemption of Debentures A/c . . . .Dr. To 8% Debenture-holders A/c [12,00,000 × 102%] (Being amount due to 8% Debenture-holders on redemption at 2% premium)	12,00,000 24,000	 12,24,000
	8% Debenture-holders A/c . . .Dr. To 6% Cumulative Preference Share Capital A/c [21,760 × 20] To Securities Premium A/c [21,760 × 2.50] (Being holders of ₹4,80,000, 8% Debentures discharged by issue of 21,760, 6% Cumulative Preference Shares of ₹20 each, at ₹22.50 per share)	4,89,600	 4,35,200 54,400
	8% Debenture-holders A/c . . . .Dr. Discount on issue of Debentures A/c [7,650 × 4] ....Dr. To 10% Debentures [7,650 × 100] (Being holders of ₹7,20,000, 8% Debentures discharged by issue of 7,650, 10% Debentures of ₹100 each, at ₹96 per debenture)	7,34,400 30,600	 7,65,000

Working Notes:

1. Conversion of ₹4,80,000, 8% Debentures into 6% Cumulative Preference shares

   Face value of 8% Debentures opting for Proposal (i) = ₹4,80,000 (Given)

   Amount due on redemption – ₹4,80,000 × 102% = ₹4,89,600.

   Value of each 6% Cumulative Preference share issued on conversion = ₹22.50 (Given)

   No. of 6% Cumulative Preference shares issued on conversion = 4,89,600/ 22.5 = 21,760 shares.

2. Conversion of ₹7,20,000, 8% Debentures into 10% Debentures

   Face value of 9% Debentures opting for Proposal (ii) = ₹7,20,000 (Given)

   Amount due on redemption = 7,20,000 × 102% = ₹7,34,400.

Value of each 6% Cumulative Preference share issued on conversion = ₹96 (Given)

No. of 6% Cumulative Preference shares issued on conversion = 7,34,400/ 96 = 7,650 debentures.

Note: In the absence of specific information, accounting regarding writing off amount of Premium on Redemption of Debentures A/c has been ignored.

IV. Redemption of Debentures by Purchase in the Open Market

A company may redeem the debentures by buying them form the open market (i.e., from the existing debenture-holders). The debentures so purchased may be immediately cancelled or may be held as investment and cancelled later. In the former, the debentures are immediately redeemed while in case of the latter they are redeemed after some time. Till the redemption, the debentures are considered as Investment.

If debentures are redeemed under this method, Debenture Redemption Investment (DRI), proportionate to the number of debentures purchased should be encashed. On cancellation of own debentures, minimum DRR associated with number of debentures cancelled should be transferred to General Reserve.

Note: Ex-interest and Cum-interest purchase price

If price quotation in the open market is available in form of ex-interest or cum-interest and debentures are purchased by the company on dates other than the interest date, consideration paid on purchase shall be segregated into price and interest and shall be recorded accordingly.

The accounting entries will be as follows.

a. When own debentures are purchased and immediately cancelled

(i) Own debentures purchased and cancelled

Debentures A/c …………………….............Dr.

Loss on Cancellation of Debentures A/c ……..Dr. (if there is a loss)

To Bank A/c

To Profit on Cancellation of Debentures A/c (if there is a profit)

(ii) Transfer of profit or loss on cancellation

Profit on Cancellation of Debentures A/c ……………..Dr.

To Capital Reserve A/c

Or

Profit and Loss A/c …………………….Dr.

To Loss on Cancellation of Debentures A/c

Note: Profit or loss on cancellation is the difference between the face value of debentures cancelled and the purchase price of the debentures.

b. When own debentures are purchased and held as investment

(i) Purchase of own debentures

Investment in Own Debentures A/c ………………..Dr.

To Bank A/c

(ii) Interest payment on debentures including own debentures

Debenture Interest A/c ………………..Dr.

To Bank A/c

To Interest on Own Debentures A/c

(iii) Resale of own debentures held as investment

Bank A/c ………………………………………….Dr.

Loss on Sale of Own Debentures A/c …………….Dr.

To Investment in Own Debentures A/c

To Profit on Sale of Own Debentures A/c

(iv) Cancellation of own debentures

Debentures A/c ………………………………….Dr.

Loss on Cancellation of Debentures A/c ……..Dr.

To Investment in Own Debentures A/c

To Profit on Cancellation of Own Debentures A/c

(v) Transfer of profit or loss on cancellation

Profit on Cancellation of Debentures A/c ……………..Dr.

To Capital Reserve A/c

Or

Profit and Loss A/c …………………….Dr.

To Loss on Cancellation of Debentures A/c

Note: When the company maintains a Sinking fund for redemption of debentures

A company which maintains a sinking fund and investment the proceeds to a Sinking Fund Investment may consider its own debentures as an investment avenue. The own debentures purchased may again be either retained as investment or cancelled immediately.

Illustration 56 (Purchase of own debentures and immediate cancellation)

A company purchased its own 12% Debentures in the open market for ₹25,00,000 (cum-interest). The interest amount included in the purchase price is ₹75,000. The face value of the debentures purchased is ₹26,00,000. The company immediately cancelled the debentures so purchased. Pass journal entries to record the purchase and immediate cancellation (ignoring transactions relating to Debenture Redemption Reserve and Debenture Redemption Investment).

Solution:

In the books of ………..

Journal **Dr.** **Cr**

Date	Particulars	₹	₹
	Debenture Interest A/c . . . .Dr.	75,000	
	To Bank A/c		75,000
	(Being debenture interest paid)		
	12 % Debentures A/c . . . .Dr.	26,00,000	
	To Bank A/c (25,00,000 -75,000)		24,25,000
	To Profit on Cancellation of Debentures A/c [Bal. Fig.]		1,75,000
	(Being ₹26,00,000 own 12% Debentures purchased @ ₹24,25,000 for immediate cancellation and profit on cancellation recognized)		
	Profit on Cancellation of Debentures A/c . . . .Dr.	1,75,000	
	To Capital Reserve A/c		1,75,000
	(Being profit on cancellation of debentures transferred to Capital Reserve)		

Illustration 57 (Purchase of own debentures and cancellation on a later date)

Draft journal entries in respect of the following since March 1, 2023:

In 2014 XY Ltd had issued 5,000, 7.5% Debentures of ₹100 each. On 1st March, 2020, the company purchased 500 of its own 7.5% Debentures at ₹ 47,500 cum-interest.

The debentures were held as investment until 30th June, 2023 when it was decided to cancel them. Interest is payable half yearly on 30th June and 31st December and the books are closed on 30th June each year. Assume absence of sinking fund.

Solution:

In the books of XY Ltd.

Journal **Dr.** **Cr**

Date	Particulars		₹	₹
	Investment in Own Debentures A/c (Note 1)	Dr.	46,875	
	Debenture Interest A/c	Dr.	625	
	To Bank A/c			47,500
	(Being the purchase of 500 debentures for ₹47,500 cum-interest which will be held as investment)			

	Debenture Interest A/c (Note 2) To Bank A/c (Being interest paid to outside debenture-holders for 4,500 debentures for 6 months)	Dr.	16,875	 16,875
	Debenture Interest A/c To Interest on Own Debentures A/c (Being adjustment for interest on 500 own debentures for 4 months)	Dr.	1,250	 1,250
	7.5% Debentures A/c To Investment in Own Debentures A/c To Profit on Cancellation of Debentures A/c (Being cancellation of 500 own debentures)	Dr.	50,000	 46,875 3125
	Profit on Cancellation of Debentures A/c To Capital Reserve A/c (Being profit on cancellation of debentures transferred to capital reserve)	Dr.	3,125	 3,125
	Profit and Loss A/c To Debenture Interest A/c (Being debenture's interest transferred to Statement of Profit and Loss)	Dr.	18,750	 18,750
	Interest on Own Debentures A/c To Profit and Loss A/c (Being interest on own debentures transferred to Statement of Profit and Loss)	Dr.	1,250	 1,250
	Profit and Loss A/c To General Reserve A/c (Being the amount equal to the face value of debentures transferred to general reserve)	Dr.	50,000	 50,000

Working Notes:

(1) Total amount paid ₹ 47,500; Less Interest for 2 months ₹ 625, Therefore, amount to be debited to Own Debentures Account = ₹46,875.

(2) Interest payable to outside Debenture-holders = ₹ 4,50,000 × 7.5/100 × ½ = ₹16,875.

Illustration 58

On 01.01.2020 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

Loss on Issue of Debentures Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.2020	To 10% Debentures A/c	5,000	31.12.2020	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
01.01.2021	To Balance b/d	7,500	31.12.2021	By P&L A/c	2,500
				By Balance c/d	5,000
		7,500			7,500
01.01.2022	To Balance b/d	5,000	31.12.2022	By P&L A/c	2,500
				By Balance c/d	2,500
01.01.2023	To Balance b/d	2,500	31.12.2023	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
31.03.20	1,00,000	12 months	6,00,000	4	4,000
31.03.21	75,000	12 months	4,50,000	3	3,000
31.03.22	50,000	12 months	3,00,000	2	2,000
31.03.23	25,000	12 months	1,50,000	1	1,000

Discount on Issue of Debentures Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
01.01.2020	To 10% Debentures A/c	5,000	31.12.2020	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
01.012021	To Balance b/d	6,000	31.12.2021	By P&L A/c	3,000
				By Balance c/d	3,000
		6,000			6,000
01.01.2022	To Balance b/d	3,000	31.12.2022	By P&L A/c	2,000
				By Balance c/d	1,000
01.01.2023	To Balance b/d	1,000	31.12.2023	By P& L A/c	1,000
		1,000			1,000

Underwriting of Securities

1.3

A company issuing securities to the potential investors cannot completely rule out the possibility of an under-subscription where the number of shares applied falls short of the shares offered for issue. Whatever be the cause, this may lead to serious consequences for the company as its plan of raising capital may be jeopardized. Thus, companies, while issuing securities, often take help of a specialized service providers who guarantee that no security remains unsubscribed. These service providers are known as Underwriters and their service is termed as Underwriting of Securities.

Underwriting of securities is an agreement, entered into by a company (issuing the security) with a financial agency to ensure that the entire issue of securities (shares, debentures etc.) gets fully subscribed. The concerned financial agency is known as 'underwriter'. The underwriters provide their services against certain fees known as 'underwriting commission'.

⊙ Types of Underwriting

Underwriting agreements can be classified into various types on different basis. These are:

I. Based on the extent of underwriting

Based on the extent, underwriting can be of two types – full underwriting and partial underwriting.

When the entire issue is underwritten by the underwriters, it is called Full Underwriting or Complete Underwriting. On the other hand, when only a part of the total issue is underwritten by the underwriters, it is called partial underwriting. Here, the issuing company needs to take the responsibility of the remaining securities.

II. Based on the number of underwriters

Based on the number of underwriters involved, underwriting can be of two types – single underwriting and multiple underwriting.

When the entire issue is underwritten by a single underwriter, it is called a Single Underwriting. On the other hand, when entire issue is underwritten jointly by more than one financial agency, it is referred to as syndicate or Multiple Underwriting.

III. Based on the Degree of Commitment

Based on the commitment of underwriters, underwriting can be of two types – firm underwriting and regular underwriting.

In case of firm underwriting, the underwriter gives a specific commitment to take a specified number of shares, irrespective of the number of shares subscribed by the public. On the other hand, regular underwriting refers to the usual underwriting agreement in which the underwriters would be liable to take up the securities in the event of under-subscription.

Note: Sub-underwriting

In order to spread the risk of under-subscription, the principal underwriters may enter into subsidiary agreements in which the underwriter further gets a part of his commitment underwritten by another agency. This is known as Sub-underwriting. 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. Sub-underwriting is not a separate type of underwriting but rather an extension of an existing underwriting arrangement.

- **Marked vs. 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 is more than one underwriter, the unmarked applications are divided amongst underwriters. Again, when the issue is fully subscribed, the distinction between marked and unmarked applications becomes immaterial.

- **Underwriter's Liability**

The liability of an underwriter is the number of securities that has to be taken up by him.

This liability may be of two types - Gross Liability and Net Liability.

Gross Liability refers to the total commitment of the underwriter as per the underwriting agreement.

Net Liability refers to the liability of taking up the unsubscribed securities after taking into consideration the gross liability as per the agreement of underwriting and applications received (both, marked applications and unmarked applications).

Thus, Net Liability = Gross Liability - (Marked applications + Proportion of Unmarked applications for which the underwriter has been given credit).

- **Underwriting Commission**

The price charged by the underwriter for his underwriting services rendered to the issuer company is called Underwriting Commission. It is payable to the underwriter for bearing the risk of under subscription, and not for subscribing the unsubscribed shares. The securities are eventually issued at the same price at which they are issued to other shareholders. This is why, the underwriters are entitled to commission even when the issue is fully subscribed by the public. The commission may be paid in cash or in fully paid-up shares or debentures or a combination of all these.

Underwriting commission is calculated on their total commitment, also known as gross liability, based on the issue price of the securities to the public. Accordingly,

Underwriting Commission = [Gross Liability (in no.) x Issue Price per security] x Rate of Commission.

Illustration 59 (Determination of underwriting commission)

XYZ Ltd. is issuing 20,00,000 shares of ₹10 each to the public. N Ltd. has been appointed as the underwriter for 5% of the issue size. The commission payable to the underwriter is 5% of the issue price. Calculate the amount of underwriting commission payable to N Ltd. if the shares are issued at par. How will your answer change if the shares are issued at 20% premium?

Solution:

When shares have been issued at par:

Gross Liability = 5% of 20,00,000 = 1,00,000 shares.

Issue price = Face value = ₹ 10 per share

Underwriting Commission = [Gross Liability (in shares) x Issue Price per share] x Rate of Commission

= [1,00,000 x 10] x 5% = ₹50,000.

When shares have been issued at a premium of 20%:

Gross Liability = 5% of 20,00,000 = 1,00,000 shares.

Issue price = ₹ 10 x 120% = ₹ 12 per share

Underwriting Commission = [Gross Liability (in shares) x Issue Price per share] x Rate of Commission

= [1,00,000 shares x 12] x 5% = ₹60,000

Legal Provisions Regarding Underwriting Commission

As per the provision of Section 40 (6) of the Companies Act, 2013, read with Rule 13 of Companies (Prospectus and Allotment of Securities) Rules, 2014, a company may pay commission to any person in connection with the subscription or procurement of subscription to its securities, whether absolute or conditional, subject to the following conditions, namely:

(a) the payment of such commission shall be authorized in the company's articles of association;

(b) the commission may be paid out of proceeds of the issue or the profit of the company or both;

(c) the rate of commission paid or agreed to be paid shall not exceed, in case of shares, five percent of the price at which the shares are issued or a rate authorised by the articles, whichever is less, and in case of debentures, shall not exceed two and a half per cent of the price at which the debentures are issued, or as specified in the company's articles, whichever is less;

(d) the prospectus of the company shall disclose -

  (i) the name of the underwriters;

  (ii) the rate and amount of the commission payable to the underwriter; and

  (iii) the number of securities which is to be underwritten or subscribed by the underwriter absolutely or conditionally.

(e) there shall not be paid commission to any underwriter on securities which are not offered to the public for subscription;

(f) a copy of the contract for the payment of commission is delivered to the Registrar at the time of delivery of the prospectus for registration.

Determination of Underwriter's Liability

The determination of liability of an underwriter in an issue of securities depend on the extent of underwriting arrangement i.e., whether the issue is underwritten in full or in part and the number of underwriters involved – single or multiple. Accordingly, there can be the following four possibilities:

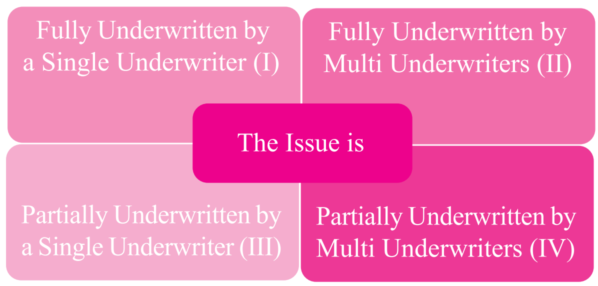

Figure 1.4: Determination of Underwriter's Liability – Alternative Possibilities

I. When the Issue is Fully Underwritten by a Single Underwriter

Here, the underwriter is responsible for 100% of the unsubscribed issue. Since, the entire issue is underwritten by him, the distinction between marked and unmarked applications is irrelevant here. Further, the concept of firm underwriting is also not relevant in this case.

Underwriter's liability is simply calculated as follows:

Underwriter's liability = No. of Shares Issued (-) No. of shares subscribed by the public.

Consider the following illustration.

Illustration 60 (Single Underwriter – Full Underwriting)

A Ltd. issued 1,00,000 equity shares of ₹100 each at par to the public, underwritten only by B & Co. The company received applications for 90,000 shares of which 80,000 shares were marked. Determine the liability of the B & Co.

Solution:

Underwriting liability of M/s U & Co.

= No. of Shares Issued (-) No. of shares subscribed by the public

= 1,00,000 (-) 90,000

= 10,000 shares.

II. When the Issue is Fully Underwritten by Multiple Underwriters

Under this situation, the underwriters are jointly responsible for subscription of 100% of the issue size. Thus, individual uunderwriters are given credits for respective marked applications. The unmarked applications are shared between all the underwriters. The sharing is normally done in proportion of their 'Gross Liability'. However, if the underwriting arrangement so provides, the same can be shared based on 'Gross Liability (-) Marked Application' also.

Thus, the distinction between marked applications and unmarked applications becomes relevant here.

Treatment of Firm Underwriting: The treatment of Firm Underwriting becomes significant as the underwriter must take up the number of securities underwritten 'firm' irrespective of its liability under the regular underwriting agreement.

For determining the liability of the underwriters, the shares underwritten firm may be treated in either of the following two ways:

(a) Firm underwriting treated as Marked applications: Here, the benefit of firm underwriting is given to each individual underwriter i.e., number of shares underwritten firm is deducted from each underwriter's respective liability; or

(b) Firm underwriting is treated as Unmarked applications: Here, the benefit is given to all underwriters in the ratio of Gross Liability.

Note: Students should note that unless otherwise stated, firm underwriting should preferably be treated as either 'Marked applications' or 'Unmarked applications' by stating the assumption clearly.

Thus, Underwriter's Liability is finally calculated as –

Underwriter's liability = Gross Liability (-) No. of Marked applications (-) Shares of Unmarked applications (+) Firm Underwriting.

Consider the following illustrations.

Illustration 61 (Full Underwriting, Multiple Underwriters, Without Firm Underwriting, Alternative Treatment w.r.t Unmarked Applications)

A Ltd. issued 4,00,000 equity shares. The whole issue was underwritten as: X - 40%; Y - 30%; and Z - 30%.

Applications for 3,20,000 shares were received in all, out of which applications for 80,000 shares had the stamp of X, those for 40,000 shares had that of Y and 80,000 shares had that of Z. The remaining applications for 1,20,000 shares did not bear any stamp.

Calculate the liability of underwriters.

Find out the liability of the individual underwriters in each of the following situations:

(a) Unmarked applications are apportioned in the ratio of "Gross Liability"; and

(b) Unmarked applications are apportioned in the ratio of "Gross Liability Less. Marked Applications".

Solutions:

(i) When Unmarked applications are apportioned in the ratio of "Gross Liability"

Calculation of Liability of the underwriters (No. of shares)

Particulars	X	Y	Z
Gross Liability	1,60,000	1,20,000	1,20,000
Less: Marked Applications	80,000	40,000	80,000
	80,000	80,000	40,000
Less: Unmarked Applications	48,000	36,000	36,000
Net Liability	32,000	44,000	4,000

Working:

Unmarked applications = 1,20,000

Unmarked applications are apportioned in the ratio of "Gross Liability" i.e., 4:3:3

(ii) When Unmarked applications are apportioned in the ratio of "Gross Liability (-) Marked Applications"

Calculation of Liability of the underwriters (No. of shares)

Particulars	X	Y	Z
Gross Liability	1,60,000	1,20,000	1,20,000
Less: Marked Applications	80,000	40,000	80,000
	80,000	80,000	40,000
Less: Unmarked Applications	48,000	48,000	24,000
Net Liability	32,000	32,000	16,000

Working:

Unmarked applications = 1,20,000

Unmarked applications are apportioned in the ratio of "Gross Liability (-) Marked Applications" i.e., 80,000:80,000:40,000 = 2:2:1

Illustration 62 (Full Underwriting, Multiple Underwriters, Without Firm Underwriting, Alternative Treatment w.r.t Unmarked Applications, adjustment of surplus)

M Ltd., incorporated on April 1, 2023, issued a prospectus inviting applications for 5,00,000 equity shares of ₹10 each. The issue was fully underwritten by A, B, C and D as follows:

A - 2,00,000; B - 1,50,000; C - 1,00,000; and D - 50,000.

The applications were received for 4,50,000 shares of which marked applications were as follows:

A - 2,20,000; B- 90,000; C - 1,10,000; and D - 10,000.

Find out the liability of the individual underwriters in each of the following cases:

(i) Unmarked applications are apportioned in the ratio of "Gross Liability"; and

(ii) Unmarked applications are apportioned in the ratio of "Gross Liability (-) Marked Applications".

Solution:

(i) When Unmarked applications are apportioned in the ratio of "Gross Liability"

Calculation of Liability of the underwriters (No. of shares)

Particulars	A	B	C	D
Gross Liability	2,00,000	1,50,000	1,00,000	50,000
Less: Marked Applications	2,20,000	90,000	1,10,000	10,000
	(20,000)	60,000	(10,000)	40,000
Less: Unmarked Applications	8,000	6,000	4,000	2,000
	(28,000)	54,000	(14,000)	38,000
Surplus of A & C apportioned between B & D in the ratio of Gross Liability	28,000	(31,500)	14,000	(10,500)
Net Liability	Nil	22,500	Nil	27,500

Working:

Unmarked applications = Total applications received – Marked applications

= 4,50,000 – (2,20,000 + 90,000 + 1,10,000 + 10,000) = 20,000

Unmarked applications are apportioned in the ratio of "Gross Liability" i.e., 4:3:2:1

(ii) When Unmarked applications are apportioned in the ratio of "Gross Liability (-) Marked Applications"

Calculation of Liability of the underwriters (No. of shares)

Particulars	A	B	C	D
Gross Liability	2,00,000	1,50,000	1,00,000	50,000
Less: Marked Applications	2,20,000	90,000	1,10,000	10,000
	(20,000)	60,000	(10,000)	40,000
Surplus of A & C apportioned between B & D in the ratio of Gross Liability	20,000	22,500	10,000	7,500
	Nil	37,500	Nil	32,500
Less: Unmarked Applications	Nil	10,714	Nil	9,286
Net Liability	Nil	26,786	Nil	23,214

Working:

Total surplus = 20,000 + 10,000 = 30,000

This is to be apportioned between B and D in 150000:50000 = 3:1

Unmarked applications = Total applications received – Marked applications

= 4,50,000 – (2,20,000 + 90,000 + 1,10,000 + 10,000) = 20,000

Unmarked applications are apportioned between B and D in the ratio of "Gross Liability (-) Marked Applications " = i.e., 37,500: 32,500 = 15:13

Illustration 63 (Full Underwriting, Multiple underwriters, Firm underwriting with Alternative Treatment, Adjustment of Surplus)

The following underwriting took place for P Ltd. which invited applications for 10,000 shares of ₹ 10 each:

X: 6,000 shares Y: 2,500 shares Z: 1,500 shares

In addition, there were firm underwriting as follows:

X: 800 shares Y: 300 shares Z: 1,000 shares

Total subscription including firm underwriting was 7,100 shares, and the forms included the following marked forms:

X: 1,000 shares Y: 2,000 shares Z: 500 shares

Show the allocation of liability of the underwriters, if –

(i) Firm underwriting is treated as unmarked applications.

(ii) Firm underwriting is treated as marked applications

Solution:

(i) When firm underwriting is treated as unmarked applications.

Calculation of Liability of the underwriters (No. of shares)

Particulars	X	Y	Z
Gross Liability	6,000	2,500	1,500
Less: Marked Applications	1,000	2,000	500
	5,000	500	1,000
Less: Unmarked Applications	2,160	900	540
	2,840	(400)	460
Surplus of Y apportioned between X & Z in the ratio of Gross Liability (12:3 or 4:1)	(320)	400	(80)
Net Liability under contract	2,520	Nil	380
Add: Firm Underwriting	800	300	1,000
Net Liability	3,320	300	1,380

Working:

(1) Allocation of unmarked applications

Total Applications (including marked and firm underwriting) = 7,100

Marked applications = 1000 + 2000 + 500 = 3,500

Unmarked applications including firm underwriting = 7,100 – 3,500 = 3,600 to be shared in Gross Liability i.e., 6000:2500:1500 = 12:5:3.

(ii) When firm underwriting is treated as marked applications.

Calculation of Liability of the underwriters (No. of shares)

Particulars	X	Y	Z
Gross Liability	6,000	2,500	1,500
Less: Marked Applications including firm underwriting	1,800	2,300	1,500
	4,200	200	Nil
Less: Unmarked Applications	900	375	225
	3,300	(175)	(225)

Surplus of Y and Z apportioned to X	(400)	175	225
Net Liability under contract	2,900	Nil	Nil
Add: Firm Underwriting	800	300	1,000
Net Liability	3,700	300	1,000

Working:

(1) Marked Applications including firm underwriting

Particulars	X	Y	Z
Marked applications	1,000	2,000	500
Add: Firm underwriting	800	300	1,000
	1,800	2,300	1,500

(2) Allocation of unmarked applications

Total applications (including marked and firm underwriting) = 7,100

Marked applications (including firm underwriting) = 1800 + 2300 + 1500 = 5,600

Unmarked applications = 7,100 – 5,600 = 1,500 to be shared in Gross Liability i.e., 6000:2500:1500 = 12:5:3

III. When the Issue is Partially Underwritten by a Single Underwriter

In this situation, the concerned underwriter shall be responsible only for the agreed portion of the total issue. For the balance portion of the issue, the company itself shall be responsible.

The liability of the underwriter will be determined in the following manner:

Step 1: Gross Liability = Total Issue Size x % of underwriting

Step 2: No. of shares unsubscribed = Total no. of shares offered (–) No. of shares subscribed (including marked applications)

Step 3: Deficit of the underwriter = Gross Liability (-) Marked Applications

Note: the deficit can never be negative

Step 4: Net Liability = Step 2 or Step 3 – whichever is lower.

Treatment of Firm Underwriting: In case the underwriter has underwritten 'firm', the liability of the underwriter should be determined by adding the number of shares underwritten 'firm' to the 'Net Liability under the underwriting contract' mentioned above.

In this context, there can be two possibilities as follows:

(i) No abatement is allowed for the shares taken up 'firm': This means that the shares underwritten 'firm' will not be adjusted against 'Net Liability under the underwriting contract' and the underwriter will have to subscribe them additionally. Therefore, here, number of shares to be taken up by the underwriter = 'Net Liability under the underwriting contract' + Firm Underwriting.

(ii) **Abatement is allowed for the shares taken up 'firm':** This means that the shares underwritten 'firm' will be adjusted against 'Net Liability under the underwriting contract'. Hence, in this case, number of shares to be taken up by the underwriter = 'Net Liability under the underwriting contract' or Firm Underwriting – whichever is higher.

Consider the following illustration.

Illustration 64 (Partial underwriting, Sole underwriter, Abatement allowed)

Mr. X underwrites 60% of an issue of 20,000 shares of ₹100 each of ABC Ltd. He has also agreed for a firm underwriting for 1,600 shares. The company received applications for 13,600 shares out of which were 8,000 marked applications. Determine the number of shares to be taken up by Mr. X:

a) If the underwriting contract provides that no abatement would be allowed in respect of shares taken up 'firm'.

b) If the underwriting contract provides that abatement would be allowed in respect of shares taken up 'firm'.

Solution:

Gross Liability = 20,000 x 60% = 12,000 shares

No. of unsubscribed shares = Total no. of shares offered (–) No. of shares subscribed (including marked applications) = 20,000 – 13,600 = 6,400 shares.

Deficit of the underwriter = Gross Liability (-) Marked Applications

= 12,000 – (8,000 + 1,600) = 2,400.

Net Liability under the underwriting contract = 6,400 or 2,400 – lower of the two = 2,400

Case (a) When no abatement would be allowed in respect of shares taken up 'firm'

Number of shares to be taken up by the underwriter = 'Net Liability under the underwriting contract' + Firm Underwriting = 2,400 + 1,600 = 4,000 shares

Case (b) When abatement would be allowed in respect of shares taken up 'firm'

Number of shares to be taken up by the underwriter = 'Net Liability under the underwriting contract' or Firm Underwriting – whichever is higher. = 2,400 or 1,600 – higher of the two = 2,400 shares.

IV. When the Issue is Partially Underwritten by Multiple Underwriters

Here, the underwriters together take the responsibility of a part of the total issue and the for the remining portion, the company itself is held responsible. The credit for marked applications is given to the individual underwriters. However, the credit for unmarked applications does not go to the underwriters.

Consider the following illustrations.

Illustration 65 (Partial underwriting, Multiple underwriters, Without Firm underwriting)

C Ltd. offered for the issue of 3,00,000 equity shares of ₹ 10 each. The issue was partially underwritten by M, N and O as follows: M - 40%; N - 30%; O - 20%. Applications were received for 2,40,000 shares of which marked applications were as follows: M – 1,05,600 shares; N - 78,000 shares; O - 50,000 shares. There was no firm underwriting.

Required: (a) Compute the liability of the underwriters, (b) Determine how many share-remain unissued.

Solution:

(a) Calculation of Liability of the underwriters (No. of shares)

Particulars	M	N	O
Gross Liability	1,20,000	90,000	60,000
Less: Marked Applications	1,05,600	78,000	50,000
Net Liability	14,400	12,000	10,000

(b) Shares remained unissued = 3,00,000 – 2,40,000 – (14,400 + 12,000 + 10,000) = 23,600 shares.

Illustration 66 (Partial underwriting, Multiple underwriters, With Firm underwriting)

H Ltd. issued 1,50,000 shares which are underwritten as follows: A - 50%; B - 20%; and C - 20%. The underwriters made applications for firm underwriting as under: A - 6,000 shares, B - 3,000 shares, and C - 3,000 shares.

The total subscriptions including firm underwriting was 1,45,500 shares and they included the following marked forms: A - 78,000 shares, B - 27,000 shares, and C – 28,500 shares.

Compute the liability of each underwriter assuming shares underwritten 'firm' are treated as marked applications.

Solution:

Calculation of Liability of the underwriters (No. of shares)

Particulars	A	B	C
Gross Liability	75,000	30,000	30,000
Less: Marked Applications including firm underwriting	78,000	27,000	28,500
	(3,000)	3,000	1,500
Surplus of A apportioned between B and C in the ratio of gross liability i.e., 20%: 20% or 1:1	3,000	(1,500)	(1,500)
Net Liability under contract	Nil	1,500	Nil
Add: Firm Underwriting	6,000	3,000	3,000
No. of shares to be taken up	6,000	4,500	3,000

Accounting for Underwriting

Following are the accounting entries required for underwriting transactions.

Particulars	Journal Entries	Remarks
For shares taken up by the underwriters	Underwriters A/c ……..Dr. To Share Capital A/c To Securities Premium A/c	Issue Price Face Value Premium on issue
Underwriting commission	Underwriting Commission A/c …..Dr. To Underwriters A/c	Commission payable
Final Settlement	Bank A/c ………………………..Dr. Underwriters A/c Or Underwriters A/c…………………Dr. To Bank A/c	Difference between Net liability under underwriting contract and commission payable.

Note: Underwriting commission written off during the year will be included in Finance Cost in the Statement of Profit and Loss. The portion of underwriting commission yet to be written off will appear in the balance sheet as follows –

(i) The portion to be written off within 12 months will be shown in Other Current Assets;

(ii) The portion to be written off after 12 months will be shown in Other Non-Current Assets.

The details of each underwriting contract should be disclosed in the Notes to Accounts.

Consider the following illustration.

Solved Case 2 (Accounting in the books of the company)

M Ltd., incorporated on April 1, 2023, issued a prospectus inviting applications for 2,50,000 equity shares of ₹10 each. The issue was fully underwritten by A, B, C and D as follows:

A - 1,00,000; B - 75,000; C - 50,000; and D - 25,000.

The applications were received for 2,25,000 shares of which marked applications were as follows:

A – 1,10,000; B- 45,000; C - 55,000; and D - 5,000.:

Unmarked applications are apportioned in the ratio of "Gross Liability".

Underwriters' commission: 4% of the issue price.

Required:

(a) Determine the underwriters' liability in shares;

(b) Determine the underwriters' liability in amount;

(c) Pass journal entries in the books of M Ltd. to record the above transactions.

Solution:

(a) Calculation of Liability of the underwriters (No. of shares)

Particulars	A	B	C	D
Gross Liability	1,00,000	75,000	50,000	25,000
Less: Marked Applications	1,10,000	45,000	55,000	5,000
	(10,000)	30,.000	(5,000)	20,000
Less: Unmarked Applications	4,000	3,000	2,000	1,000
	(14,000)	27,000	(7,000)	19,000
Surplus of A & C apportioned between B & D in the ratio of Gross Liability	14,000	(15,750)	7,000	(5,250)
Net Liability	Nil	11,250	Nil	13,750

Working:

Unmarked applications = Total applications received – Marked applications

= 2,25,000 – (1,10,000+45,000+55,000+5,000) = 10,000

Unmarked applications are apportioned in the ratio of "Gross Liability" i.e., 4:3:2:1

(b) Calculation of Liability of the underwriters (in amount)

Particulars	A	B	C	D
Net Liability	Nil	11,250	Nil	13,750
Total amount receivable on shares @ ₹10	Nil	1,12,500	Nil	1,37,500
Less: Underwriting Commission @ 4% on (Issue price x Gross Liability)	40,000	30,000	20,000	10,000
(Amount Payable or Amount Receivable	(40,000)	82,500	(20,000)	1,27,500

(c) Accounting entries in the books of the issuer company

In the books of M Ltd.

Journal

Date	Particulars	Dr. ₹	Cr ₹
	B A/c ……………………….Dr.	1,12,500	
	D A/c ……………………….Dr.	1,37,500	
	To Share Capital A/c		2,50,000
	(Being shares allotted to underwriters as per Board's resolution no…. dated….)		
	Underwriting Commission A/c ……………………….Dr.	1,00,000	
	To A A/c		40,000
	To B A/c		30,000
	To C A/c		20,000
	To D A/c		10,000
	(Being underwriting commission payable to underwriters)		
	Bank A/c ……………………….Dr.	2,10,000	
	To B A/c		82,500
	To D A/c		1,27,500
	(Being amount received from B and D)		
	A A/c ……………………….Dr.	40,000	
	C A/c……………………….Dr.	20,000	
	To Bank A/c		60,000
	(Being amount paid to A and C)		

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. The balance of Securities Premium A/C cannot be utilized for

   A. Writing off preliminary expenses

   B. Payment of dividend

   C. Buyback of shares

   D. Discount on issue of shares

2. Which of the following is not a Free Reserve?

   A. General Reserve

   B. Dividend Equalization Reserve

   C. Revaluation Reserve

   D. Revenue Reserve

3. Which of the following reserves cannot be used for the purpose of issuing bonus shares?

   A. Revaluation Reserve

   B. Dividend Equalization Reserve

   C. Capital Redemption Reserve

   D. General Reserve

4. Which of the following is not a condition of buy-back of securities?

   A. Both fully and partly paid-up securities can be bought back.

   B. Buy-back must be authorised by the Articles of Association.

   C. Buy-back must be authorised by passing a special resolution in general meeting.

   D. Buy-back should be completed within 1 year from the state of passing of special resolution

5. Which of the following is correct?

   A. Debenture carries a fixed rate of dividend.

   B. A company limited by shares may issue irredeemable preference shares.

   C. Unmarked applications are those applications that bear the stamp of the underwriter

   D. Except as provided in Section 54, a company shall not issue shares at a discount.

6. At present, a company can issue preference shares which is:

   A. Irredeemable

   B. Redeemable after the expiry of 20 years from the date of issue

   C. Redeemable before the expiry of 20 years from the date of issue

   D. Redeemable after the expiry of 25 years from the date of issue

7. Partly paid-up preference shares can be redeemed

   A. After the permission from Company Law Board

   B. After making them fully paid up

   C. After passing a special resolution

   D. After the permission from the BOD

8. _________of the Companies Act, 2013 prohibits issue of shares at a discount.

   A. Section 53

   B. Section 54

   C. Section 61

   D. Section 62

9. The net profit on forfeiture and reissue of equity shares is transferred to _________.

   A. Capital Reserve

   B. General Reserve

   C. Dividend Equalization Reserve

   D. Revaluation Reserve

10. Which of the following is/are statutory book(s) of a company?

    A. Register of charges

    B. Register of Members

    C. Register of debenture holders

    D. All of the above

[Answer: 1-B; 2-C; 3-A; 4-A; 5-C; 6-C; 7-B; 8-B; 9-A; 10-D]

State True or False

1. 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.

2. 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.

3. A Company cannot buy-back its shares from any person through a negotiated deals whether on or off the stock exchange.

4. 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.

5. 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.

6. Debenture carries a fixed rate of dividend.

7. 'Unmarked' applications are those applications which bear the stamp of an underwriter.

8. The sum which is still to be paid to the Company for a share is known as calls in arrears.

9. An infrastructure company can issue preference shares with a maximum tenure of 20 years.

10. A company limited by shares shall not issue any preference shares which are irredeemable.

[Answer: True; False; True; False; False; True; False; False; True; True]

Fill in the blanks:

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

[Answer: 1. Statutory; 2. Issued Capital; 3. subscription; 4. Premium; 5. Discount; 6. Reserves & Surplus; 7. Buy-back; 8. Own Debentures; 9. Two; 10. independent]

Short Essay Type Questions

1. State the provisions of Companies Act, 2013 in respect of use of Securities Premium
2. State the provisions of Companies Act, 2013 in respect of issue of shares at discount
3. Write a short note on Sources of Buy-back of Equity Shares
4. Write a short note on Sources of Redemption of Preference Shares
5. Differentiate Marked and Unmarked Applications
6. What do you mean by Regular Underwriting and Firm Underwriting?

Essay Type Questions

1. State the Conditions for Buy-back of Equity Shares by a company.
2. State the Conditions for Redemption of Preference Shares by a company.
3. Discuss different types of preference shares.
4. Discuss various types of debentures.
5. How will you account for issue of bonus shares by a company?

B. Numerical Questions

Multiple Choice Questions

1. If Total issue size is 2,00,000 and the underwriter commits for 100% underwriting at a commission of 4%, what will be the commission payable if no. of applications received is 1,40,000. The issue price of shares is ₹12 for each ₹10 face value shares.

   A. ₹28,800

   B. ₹28,000

   C. ₹30,000

   D. ₹30,800

2. Given, paid -up share capital ₹10,00,000 and free reserves ₹2,00,000, what is the maximum amount permissible for buy-back of shares?

   A. ₹2,00,000

   B. ₹2,50,000

   C. ₹2,80,000

   D. ₹3,00,000

[Answer: 1-A; 2-D]

Comprehensive Numerical Problems

1. A joint stock company resolved to issue 5 lakh equity shares of ₹10 each at a premium of ₹1 per share. 50000 of these shares were taken up by the directors and their relatives, 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 of 2% of the issue price. 65% of the issue was underwritten by P, while Q and R's share were 25% and 10% respectively.

   Their firm underwriting was as follows:

   P 15000 shares, Q 10000 shares and R 5000 shares. The underwriters were to submit unmarked applications for shares underwritten firm with full application money along with the members of the general public.

   Marked applications were as follows: P 59750 shares, Q 28750 shares and R 5250 shares.

   Unmarked applications totaled 350000 shares.

   Accounts with the underwriters were promptly settled.

   You are required to:

   (i) Prepare a statement calculating underwriters' liability for shares other than shares underwritten firm.

   (ii) Pass necessary journal entries (narration not required) for all the transactions including the cash transactions.

   [Answer: (i) Net Liability: P -2,000, Q – Nil, R – 4,250]

2. On 31.03.2023, the books of ABC Ltd showed the following balances:

	₹
30000 Equity shares of ₹10 each fully paid	3,00,000
5000, 10% Redeemable Preference Shares of ₹100 each fully paid	5,00,000
1000, 8% Redeemable Preference Shares of ₹100 each, ₹ 70 paid up	70,000
General Reserve	1,50,000
Balance of Profit	3,20,000
Securities Premium	30,000

Investment	2,40,000
Cash at Bank	79,200

On 1st April 2023 the Board decided to redeem the preference shares at a premium of 8%. In order to pay off the preference shareholders the company also decided to dispose of the investments, use company's fund and to raise the balance by the issue of sufficient number of Equity Shares of ₹10 each at a premium of ₹1 per share subject to leaving a minimum bank balance ₹19,200 after such redemption. Investments were sold at ₹2,16,000.

Show the necessary journal entries to record the transactions.

[Answer: No. of new shares to be issued 24,000]

3. The following balances appeared in the books of P Ltd. As on 31.03.2022:

   13% Debentures Account ₹14,00,000

   Debenture Redemption Fund Account ₹10,00,000

   13% Debenture Redemption Fund Investment Account (Nominal = Cost) ₹10,00,000

   The annual contribution to the Debenture Redemption Fund was ₹1,40,000. the company sold its investments for ₹14,00,000and redeemed the debentures on 31.03.2023. Prepare 13% Debentures Account, Debenture Redemption Fund Account and Debenture Redemption Fund Investment Account up to 31.03.2023.

   [Answer: Transfer to General Reserve ₹16,70,000; Profit on sale od DRFI ₹4,00,000]

4. S Ltd. issued 50,000 equity shares of ₹10 each at a premium of ₹2 per share. The share money is payable as follows:

   On application: ₹5 per share; On allotment: ₹3 per share (including premium) and On Call: ₹4 per share. Applications were received for 70,000 shares. Allotment was made pro-rata to the applicants for 65,000 shares, the remaining applications being refused. Excess amounts paid on application are to be adjusted against amounts due on allotment.

   Mr. X to whom 300 shares were allotted failed to pay the allotment money and call money and Mr. Y to whom 400 shares were allotted failed to pay the call. These shares were forfeited after the call was made. Subsequently only 500 shares (including all the shares held by Mr. X) were re-issued to Mr. Z as fully paid up at ₹9 per share. Pass the journal entries to record the above transactions.

   [Answer: Transfer to Capital Reserve ₹2,500]

5. K Ltd. granted option for 16,000 equity shares on 01.10.19 at ₹80 when the market price was ₹170. the vesting period is 4 ½ years. 8,000 unvested options lapsed on 01.12.2021. 6,000 options are exercised on 30.09.24 and 2,000 vested options lapsed at the end of the exercise period. Pass journal entries to record the above transactions.

Unsolved Case

Fast Forward Ltd. (a non-listed company) has the following capital structure as on March 31, 2023:

Particulars	₹	₹
Equity Share Capital (Shares of ₹10 each fully paid) Reserves & Surplus:		60,00,000
General Reserve	65,00,000	
Security Premium Account	12,00,000	
Surplus in Statement of Profit and Loss	8,60,000	
Revaluation Reserve	12,40,000	98,00,000
Loan Funds		42,00,000

The company is contemplating to undertake a buyback program for its equity shares. You have been appointed as a legal expert in this respect.

You are required to compute by Debt-Equity Ratio Test, the maximum number of shares that can be bought back in the light of above information, when the offer price for buy back is ₹30 pershare.

[Answer: Maximum no. of shares buy-back 2,59,000 shares]

References

1. The Companies Act, 2013
2. The Companies (Share Capital and Debentures) Rules, 2014
3. Companies (Prospectus and Allotment of Securities) Rules, 2014
4. SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021
5. SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021
6. SEBI (Issue of Capital and Disclosure Requirements), 2009
7. Corporate Accounting by Mukherjee & Mukherjee; Oxford Publication (1e)
8. Fundamentals Corporate Accounting by Hanif & Mukherjee; McGraw Hill Publication

Preparation of the Statement of Profit and Loss and Balance Sheet (as per Schedule III of Companies Act, 2013)

2

This Module includes:

Preparation of the Statement of Profit and Loss and Balance Sheet (as per Schedule III of Companies Act, 2013)

SLOB Mapped against the Module

To develop detail understanding on preparation of mandatory financial statements by companies (including Banking, Insurance and Electricity companies) in an Ind AS environment. (CMLO 4 c)

Module Learning Objectives:

After studying this module, the students will be able to –

- Understand the form and contents of the Statement of Profit and Loss as per Division I of Schedule III of the Companies Act, 2013.
- Understand the form and contents of the Balance Sheet as per Division I of Schedule III of the Companies Act, 2013.
- Develop an idea about the major changes prescribed under Division II vis-à-vis Division I of Schedule III of the Companies Act, 2013.

Introduction

2

Financial statements are compilation of financial data, collected and classified in a systematic manner according to the accounting principles, to assess the financial performance and financial position of an enterprise. These 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 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 that is useful to a wide range of users in making economic decisions. They show the results of the stewardship of management, or the accountability of management for the resources entrusted to it.

Types of Financial Statement

The following are the major types of financial statements prepared by entities.

(a) Statement of Financial Performance or Income Statement

(b) Statement of Financial State of Affairs or Balance Sheet

(c) Statement of Changes in Equity if applicable

(d) Statement of Inflow and Outflow of Cash

Regulatory Framework Related to Preparation of Financial Statements

In India, preparation and presentation of financial statements is guided by –

(a) The Companies Act, 2013;

(b) The Companies (Accounts) Rules 2014;

(c) Accounting Standards (AS or Ind AS as applicable)

The relevant provisions under the above three regulatory sources are mentioned below.

a. Meaning of Financial Statements

According to Section 2(40) of Companies Act, 2013, financial statement in relation to a company, includes—

(i) a balance sheet as at the end of the financial year;

(ii) a profit and loss account, or in case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;

(iii) cash flow statement for the financial year; and

(iv) any explanatory note annexed to, or forming part of, any document referred to in sub-clause (i) to sub-clause (iv).

However, the financial statement, with respect to one person company, small company and dormant company (Section 455) may not include cash flow statement.

b. Meaning of Financial Year

According to Section 2(41), financial year, in relation to any company or body corporate, means the period ending on the 31st day of march every year. Where a company has been incorporated on or after 1st day of January of a year, the first financial year will end on 31st day of March of the following year. If a company or body corporate which is a holding company or a subsidiary or associate company of a company incorporated outside India and is required to follow a different financial year for consolidation of its accounts outside India, the Tribunal may, if it is satisfied, allow any period as its financial year, whether or not that period is a year.

c. Frequency of Financial Statements

Financial statements are prepared as -

(i) Annual financial statements (i.e., once a financial year)

(ii) Quarterly financial statements which are prepared by listed companies on quarterly basis as per SEBI requirements.

d. Preparation of Financial Statements by Entities

Companies Act, 2013

Section 129(1): The financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III:

Provided that the items contained in such financial statements shall be in accordance with the accounting standards:

Provided further that nothing contained in this sub-section shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company:

Section 129(2): At every annual general meeting of a company, the Board of Directors of the company shall lay before such meeting financial statements for the financial year.

Section 129(3): Where a company has one or more subsidiaries, it shall, in addition to financial statements provided under sub-section (2), prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own which shall also be laid before the annual general meeting of the company along with the laying of its financial statement under sub-section (2):

Provided that the company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in such form may be prescribed:

Section 129(4): The provisions of this Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, apply to the consolidated financial statements referred to in sub-section (3).

Section 129(5): Without prejudice to sub-section (1), where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

Section 137(1): A copy of the financial statements, including consolidated financial statement, if any, along with all the documents which are required to be or attached to such financial statements under this Act, duly adopted at the annual general meeting of the company, shall be filed with the Registrar within thirty days of the date of annual general meeting in such manner, with such fees or additional fees as may be prescribed.

Companies (Accounts) Rules, 2014

Rule 4A: The financial statements shall be in the form specified in Schedule III to the Act and comply with Accounting Standards or Indian Accounting Standards as applicable:

Provided that the items contained in the financial statements shall be prepared in accordance with the definitions and other requirements specified in the Accounting Standards or the Indian Accounting Standards, as the case may be.

Rule 12(1): Every company shall file the financial statements with Registrar together with Form 2AOC-4 and the consolidated financial statements, if any, with form 2AOC-4 CFS.

Rule 12(2): The class of companies as may be notified by the Central Government from time to time, shall mandatorily file their financial statement in Extensible Business Reporting Language (XBRL) format and the Central Government may specify the manner of such filing under such notification for such class of companies.

⊙ Form and Content of Financial Statements

The form and content of Financial Statements have been specified in Schedule III of the Companies Act, 2013. The objective of such specification is to improve the comparability of financial information across entities.

Schedule III of the Companies Act, 2013 comprises of three divisions as follows:

(a) **Division I:** General Instructions for Preparation of Balance Sheet and Statement of Profit and Loss of a company whose Financial Statements are required to comply with the Companies (Accounting Standards) Rules, 2021.

(b) **Division II:** General Instructions for Preparation of Financial Statements of a company whose Financial Statements are drawn up in compliance of the Companies (Indian Accounting Standards) Rules, 2015.

(c) **Division III:** General Instructions for Preparation of Financial Statements for a Non-Banking Financial Company (NBFC) whose financial statements are drawn up in compliance of the Companies (Indian Accounting Standards) Rules, 2015.

Note: In this Module, preparation of financial statements has been discussed primarily as per Division I i.e., for whom Financial Statements are required to comply with the Companies (Accounting Standards) Rules, 2021.

⊙ Division I of Schedule III of Companies Act, 2013

Relevant provisions under 'General Instructions for Preparation of Balance Sheet and Statement of Profit and Loss of a Company' as specified in Schedule III, Division I are given below:

a. Where compliance with the requirements of the Act including Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head or sub-head or any changes, inter se, in the financial statements or statements forming part thereof, the same shall be made and the requirements of this Schedule shall stand modified accordingly.

b. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 2013. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the notes to accounts in addition to the requirements set out in this Schedule.

c. (i) Notes to accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required

   (a) narrative descriptions or disaggregations of items recognised in those statements; and

   (b) information about items that do not qualify for recognition in those statements.

   (ii) Each item on the face of the Balance Sheet and Statement of Profit and Loss shall be cross-referenced to any related information in the notes to accounts. In preparing the Financial Statements including the notes to accounts, a balance shall be maintained between providing excessive detail that may not assist users of financial statements and not providing important information as a result of too much aggregation.

d. (i) Depending upon the Total Income of the company, the figures appearing in the Financial Statements shall be rounded off as given below:

   - When total income is less than one hundred crore rupees, rounding off shall be done to the nearest hundreds, thousands, lakhs or millions, or decimals thereof.

   - When total income is one hundred crore rupees or more, rounding off shall be done to the nearest lakhs, millions or crores, or decimals thereof.

   (ii) Once a unit of measurement is used, it should be used uniformly in the Financial Statements.

e. Except in the case of the first Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes shall also be given.

f. For the purpose of this Schedule, the terms used herein shall be as per the applicable Accounting Standards. Division I of Schedule III comprises of two parts as follows:

   (a) Part I, which provides the minimum disclosure requirements for the Balance Sheet; and

   (b) Part II, which provides the minimum disclosure requirements for the Statement of Profit and Loss.

   These have been discussed in detail in the following sections.

Statement of Profit and Loss (as per Division I of Schedule III)

2.1

Statement of Profit and Loss (as per Division I of Schedule III)

The Statement of Profit and Loss of a company is the statement of financial performance of the entity and is also known as the Income Statement. The objective of preparing this statement is to determine the profit (or loss) of a company for a particular reporting period.

Following is the pro-forma of the Statement of Profit and Loss suggested in Part II of Division I of Schedule III.

Name of the Company: ………………………………………………………

Statement of Profit and Loss for the year ended:……………………………………….. (Amount in ₹)

	Particulars	Note No.	Figures for the Current Reporting Period	Figures for the Previous Reporting Period
	1	2	3	4
I	Revenue from Operations		XXX	XXX
II	Other Income		XXX	XXX
III	Total Income (I+II)		XXX	XXX
IV	Expenses:			
	Cost of Materials Consumed		XXX	XXX
	Purchases of Stock-In-Trade		XXX	XXX
	Changes in Inventories of Finished Goods / Work- in- progress and Stock-In-Trade		XXX	XXX
	Employee Benefits Expense		XXX	XXX
	Finance Costs		XXX	XXX
	Depreciation and Amortization Expense		XXX	XXX
	Other Expenses		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:		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 Profit and Loss

<table>
<tr><th>Item</th><th colspan="2">Description</th></tr>
<tr><td>1. Sec.25 Companies</td><td colspan="2">The provisions of this Part shall apply to the Income and Expenditure Account referred to in Sec. 129 of the Act, in like manner as they apply to a Statement of Profit and Loss.</td></tr>
<tr><td>2. Revenue from Operations</td><td>For Company other than a Finance Company: Revenue from Operations shall disclose separately in the Notes, Revenue from –
(a) Sale of Products
(b) Sale of Services
(c) Grants or Donations received (relevant for Section 8 companies)
(d) Other Operating Revenues
(e) Less: Excise Duty</td><td>For Finance Company: Revenue from Operations shall include Revenue from:
(a) Interest &
(b) Other Financial Services
Revenue under each of the above heads shall be disclosed separately by way of Notes to Accounts to the extent applicable.</td></tr>
<tr><td>3. Finance Costs</td><td colspan="2">Finance Costs shall be classified as –
(a) Interest Expenses,
(b) Other Borrowing Costs,
(c) Applicable Net Gain / Loss on Foreign Currency Transactions and Translation.</td></tr>
<tr><td>4. Other Income</td><td colspan="2">Other Income shall be classified as –
(a) Interest Income (in case of a Company other than a Finance Company),
(b) Dividend Income,
(c) Net Gain/Loss on Sale of Investments,
(d) Other Non-Operating Income (Net of Expenses directly attributable to such income).</td></tr>
</table>

Note: Other operating revenues include Discount Received, Bad Debt Recovery etc.

5. **Additional Information:** A Company shall disclose, by way of Notes, additional information regarding Aggregate Expenditure and Income on the following items.

   (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) In case of Companies covered under Section 135, amount of expenditure incurred on corporate social responsibility activities;

(l) Details of items of Exceptional and Extraordinary Nature;

(m) 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.

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.

(d) 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 material, 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) Insurance;

(g) Rates and Taxes, excluding, Taxes on Income,

(h) 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.

(ix) Undisclosed income

The Company shall give details of any transaction not recorded in the books of accounts that has been surrendered or disclosed as income during the year in the tax assessments under the Income Tax Act, 1961 (such as, search or survey or any other relevant provisions of the Income Tax Act, 1961), unless there is immunity for disclosure under any scheme and also shall state whether the previously unrecorded income and related assets have been properly recorded in the books of account during the year.;

(x) Corporate Social Responsibility (CSR)

Where the company covered under section 135 of the Companies Act, 2013, the following shall be disclosed with regard to CSR activities:

(a) amount required to be spent by the company during the year,

(b) amount of expenditure incurred,

(c) shortfall at the end of the year,

(d) total of previous years shortfall,

(e) reason for shortfall,

(f) nature of CSR activities,

(g) details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per relevant Accounting Standard,

(h) where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year should be shown separately.

(xi) Details of Crypto Currency or Virtual Currency

Where the Company has traded or invested in Crypto currency or Virtual Currency during the financial year, the following shall be disclosed:

(a) profit or loss on transactions involving Crypto currency or Virtual Currency

(b) amount of currency held as at the reporting date,

(c) deposits or advances from any person for the purpose of trading or investing in Crypto Currency/ virtual currency.

Balance Sheet (as per Division I of Schedule III)

2.2

The Balance Sheet of a company is the statement of financial affairs of the entity. The objective of preparing this statement is to determine the financial position of a company for a particular reporting period.

Following is the pro-forma of the Balance Sheet suggested in Part I of Division I of Schedule III.

Name of the Company: ………………………………………………….

Balance Sheet as at: …………………………………………………… (₹ in……)

	Particulars	Note No.	Figures as at the end of Current Reporting Period	Figures as at the end of the Previous Reporting Period
	1	2	3	4
I.	EQUITY AND LIABILITIES			
(1)	Shareholders' Funds			
	(a) Share Capital			
	(b) Reserves & Surplus			
	(c) Money Received against Share Warrants			
(2)	Share Application money pending allotment			
(3)	Non-Current Liabilities			
	(a) Long Term Borrowings			
	(b) Deferred Tax Liabilities (Net)			
	(c) Other Long-Term Liabilities			
	(d) Long Term Provisions			
(4)	Current Liabilities			
	(a) Short Term Borrowings			
	(b) Trade Payables			
	(c) Other Current Liabilities			
	(d) Short Term Provisions			
	Total			
II	ASSETS			
(1)	Non-Current Assets			

	(a) PPE and Intangible Assets			
	(i) Property, Plant and Equipment			
	(ii) Intangible Assets			
	(iii) Capital WIP			
	(iv) Intangible Assets under Development			
	(b) Non-Current Investment			
	(c) Deferred Tax Assets (Net)			
	(d) Long Term Loans & Advances			
	(e) Other Non-Current Assets			
(2)	Current Assets			
	(a) Current Investments			
	(b) Inventories			
	(c) Trade Receivables			
	(d) Cash & Cash Equivalents			
	(e) Short Term Loans & Advances			
	(f) Other Current Assets			
	Total			

General Instructions for preparation of Balance Sheet

1. An asset shall be classified as current when it satisfies any of the following criteria:
   (a) it is expected to be realised in, or is intended for sale or consumption in, the company's normal operating cycle;
   (b) it is held primarily for the purpose of being traded;
   (c) it is expected to be realised within twelve months after the reporting date; or
   (d) it 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.

   All other assets shall be classified as non-current.
2. An operating cycle is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of twelve months.
3. A liability shall be classified as current when it satisfies any of the following criteria:
   (a) it is expected to be settled in the company's normal operating cycle;
   (b) it is held primarily for the purpose of being traded;
   (c) it is due to be settled within twelve months after the reporting date; or
   (d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

   All other liabilities shall be classified as non-current.
4. A receivable shall be classified as a "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.

5. A payable shall be classified as a "trade payable" if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.
6. Disclosure Requirement

Schedules Forming Part of Financial Statements/Annual Report

A. DISCLOSURE REQUIREMENT 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):	
(i) 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.
(ii) 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
(iii) Face/Par Value per Share	Face/Par Value, as per Capital Clause in Memorandum of Association should be disclosed
(iv) Reconciliation of No. of Shares outstanding at the beginning and at the end	• 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
(v) 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.

(vi) Shares in respect of each class 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 each class of Shares, (for both Equity and Preference Shares)
(g) List of shareholders holding more than 5% shares as on the Balance Sheet Date	• Date for computing the 5% limit should be taken as the Balance Sheet date. So, if during the year, any Shareholder held more than 5% Equity Shares but does not hold as much at the Balance Sheet date, disclosure is not required. • Companies should disclose the Shareholding for each class of Shares, both within Equity and Preference Shares. So, such % should be computed separately for each class of Shares. • This information should also be given for comparative previous period.
(h) Shares reserved for issue under options and contracts/ commitments for the sale of shares/ disinvestment, including the terms and amounts	• Shares under options generally arise under Promoters or Collaboration Agreements, Loan Agreements or Debenture Deeds (including Convertible Debentures), agreement to convert Preference Shares into Equity Shares, ESOPs or Contracts for supply of Capital Goods, etc. • Disclosure is required for the number of shares, amounts and other terms for shares so reserved. such options are in respect of unissued portion of share capital
(i) For the period of 5 years immediately preceding the date as at which the Balance Sheet is prepared- • Aggregate number & class of shares allotted as fully paid and up pursuant to 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 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 Balance Sheet.
(l) Forfeited shares (amount originally paid up)	-------
(m) A company shall disclose Shareholding of Promoters	The information shall be disclosed in the format specified in Schedule III.

Illustration 1

(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 be 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	

D. 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	

E. Reconciliation of Number and Amount of Shares

(1) For Equity Shares

Particulars	Current Year		Previous Year	
	No. of Shares	(₹)	No. of Shares	(₹)
Opening Balance	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	49,800	45,84,000	Nil	Nil

(2) For Preference Shares

(i) For 15% Redeemable Preference Shares of ₹100 each

Particulars	Current Year		Previous Year	
	No. of Shares	Amount (₹)	No. of Shares	Amount (₹)
Opening Balance	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	10,000	10,00,000	Nil	Nil

(ii) For 18% Convertible Preference Shares of ₹100 each

Particulars	Current Year		Previous Year	
	No. of Shares	Amount (₹)	No. of Shares	Amount (₹)
Opening Balance	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	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	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 The Institute of Chartered Accountants of India, Guidance Note on ESOP, Share Options Outstanding should be shown as separate line item. Under Sch III, this line item should be shown separately under Reserves & Surplus.
(g) Other Reserves (specify the nature & purpose of each Reserve and the amount in respect thereof)	This includes any other Statutory Reserves, e.g., Tonnage Tax reserve to be created under the Income Tax Act, 1961.
(h) Surplus, i.e., balance in Statement of P&L disclosing allocations & appropriations such as dividend, bonus shares and transfer to/from reserves etc. (additions & deductions since last Balance Sheet to be shown under each of specified heads)	Appropriations to the Profit for the year (including carried forward balance) is to be presented under the main head 'Reserves and Surplus'. Under Sch. III, the Statement of P&L will no longer reflect any appropriations, like Dividends transferred to Reserves, Bonus Shares, etc.

Notes:

1. Fund: A Reserve specifically represented by Earmarked Investments shall be termed as a 'Fund'.
2. Profit and Loss Account (Dr.): Debit balance of 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

(a) LONG TERM BORROWINGS

Sch. III Disclosure Requirement	Points
Long-Term Borrowings shall be classified as – (i) Bonds/Debentures,	------
(ii) Terms Loans – ● from Banks; and ● 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".

(iii) 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.
(iv) Deposits,	Deposits classified under Borrowings would include Deposits accepted from Public and Inter – Corporate Deposits which are in the nature of Borrowings.
(v) 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.
(vi) Long-Term Maturities of Finance Lease Obligations,	
(vii) 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 Presentation: 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. Redemption by Installment: 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. Powers to Re-issue: Particulars of any redeemed Bonds/ Debentures which the Company has power to reissue shall be disclosed.	-----

6. Terms of Repayment: Terms of repayment of Repayment of Term Loans and Other Loans shall be stated.	Other loans should be interpreted to mean all categories listed under the heading 'Long-Term Borrowings' as per Sch. VI (R). Disclosure of terms of repayment should be made preferably for each Loan unless the repayment terms of individual loans within a category are similar, in which case, they may be aggregated.
7. Default: Period and amount of continuing default as on the Balance Sheet date in repayment of Loans and Interest, shall be specified separately in each case.	The term "Continuing Default" is used w.r.t. Long Term Borrowings, whereas the term "Default" is used w.r.t. Short Term Borrowings. • Under CARO, the auditor shall report on the default made and the period of default. • 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 Balance Sheet Date in repayment of Loans and Interest shall be separately disclosed in each case. 5. Current maturities of long term borrowings shall be disclosed separately.	• Short-Term Borrowings will include all Loans within a period of 12 months from the date of the loan, Loans payable on demand, etc. • 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 a 4-year Operating Cycle will be categorized only as Short Term Borrowings, and not as Long Term Borrowings.

(4) (b) TRADE PAYABLES

Sch. III Disclosure Requirement	Points
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 is 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.

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.

Note: The entity shall prepare an ageing schedule for Trade Payable due for payment as per the format given under Schedule III.

(4) (C) Other Current Liabilities

Sch. III Disclosure Requirement	Points
It shall be classified as – (a) Current Maturities of Finance Lease Obligations, (b) Interest Accrued but not due on Borrowings, (c) Interest Accrued and due on Borrowings, (d) Income Received in Advance, (e) Unpaid Dividends, (f) Application Money received for allotment of Securities and due for Refund and Interest Accrued thereon (Refer Note below) (g) Unpaid Matured Deposits and Interest Accrued thereon, (h) Unpaid Matured Debentures and Interest Accrued thereon, (i) Other Payables (specify nature).	• The portion of 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.
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'.	• Other Payables under this head may be in the nature of statutory dues such as Withholding Taxes, GST, etc. • **Current Year Classification as Current Liability and Previous Year Non-Current Liability:** Current/Non-Current Classification of Assets/ Liabilities is determined on 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 Taxation, Provision for Warranties, etc.

B. DISCLOSURE REQUIREMENTS FOR "ASSETS" ITEMS

(i) NON-CURRENT ASSETS

(1) (a) (i) Property, Plant and Equipment (Also Refer AS 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 PPE. 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, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment) and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.	(i) 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 (ii) Similar disclosures should also be made for Impairment, if any, as applicable. (iii) 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. (iv) 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).	• Intangible Assets under development should also be disclosed separately, if AS-26 criteria are met.

Note: Points 3 and 4 of PPE 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. • An ageing schedule must be given as per the prescribed format in Schedule III. • For Intangible assets under development, whose completion is overdue or has exceeded its cost compared to its original plan, completion schedule shall also be given in the Notes.

(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. • An ageing schedule must be given as per the prescribed format in Schedule III. • For Intangible assets under development, whose completion is overdue or has exceeded its cost compared to its original plan, completion schedule shall also be given in the Notes.

(1) (b) NON CURRENT INVESTMENTS (Also Refer AS – 13)

Schedule III Disclosure Requirement	Points
Non-Current Investments shall be classified as Trade Investments and Other Investments, and further classified as Investments in – (a) Property, (b) Equity Instruments, (c) Preference Shares (d) Government / Trust Securities, (e) Debentures or Bonds, (f) Mutual Funds, (g) Partnership Firms, and (h) Other Non-Current Investments (specify nature).	• If a Debenture is to be redeemed partly within 12 months and balance after 12 months, the amount to be redeemed within 12 months should be disclosed as current, and balance as Non-Current. • "Trade Investment" is normally understood as an Investment made by a company in shares or debentures of another company, to promote the trade or business of the first company.
Notes: 1. Under each classification, details shall be given of names of the 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.	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) Investment in LLP:** A LLP is a Body Corporate, and not a Partnership Firm as envisaged under the Partnership Act, 1932. Hence, disclosures pertaining to Investments, in Firms will not include LLPs. Investments in LLPs will be disclosed separately under "Other Investments". **(b) Change in Constitution:** In case of change in constitution of the Firm during the year, the names of the Other Partners should be disclosed based on the position existing as on the date of Company's B/s. **(c) Capital:** • The Total Capital of the Firm, to be disclosed, should be with reference to the Amount of Capital on the date of the Company's Balance Sheet.

	• If the Partnership Firm has separate accounts for Partner's Capital, Drawings or Current, Loans to or from Partners, etc. disclosure must be made with regard to the Total of Capital Accounts alone, since this is what constitutes the capital of the Partnership Firm. • Where, however, such Accounts have not been segregated, or where the Partnership Deed Provides that the Capital or each Partner is to be calculated by reference to the Net Amount at his credit after merging all the Accounts, the disclosure relating to the Partnership Capital must be made on the basis of the total effect of such accounts taken together. **(d) Share of each Partner:** Share of each Partner means share in the Profits of the Firm, rather than the share in the Capital.
	(e) Different Reporting Dates: If it is not practicable to draw up the Financial Statements of the Partnership up to such date and, are drawn up to 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) Loans and Advances to Related Parties (giving details thereof), (c) 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 received. 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, 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 Loans and Advances: 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 – (i) Long-term Trade Receivables (including Trade Receivables on Deferred Credit Terms) (ii) Security Deposits (iii) Others (specify nature)	• A Receivable shall be classified as 'Trade Receivable' if it is in respect of the amount due on account of goods sold or

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 Loans and Advances:** 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. **5. Ageing Schedule:** For trade receivables outstanding, ageing schedule shall be prepared as per the format prescribed in Schedule III.	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.	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. 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.	

(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: (i) Goods-in-Transit shall be disclosed under the relevant sub-head of Inventories. (ii) 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 Loans and Advances: Allowance for Bad and Doubtful Loans and Advances shall be disclosed under the relevant heads separately. 4. Debts due by Directors: 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 Outstanding 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 Loans and Advances: 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.

(2) (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.

- **Additional Disclosures in the Notes to Accounts:**

I. Contingent liabilities and commitments (to the extent not provided for)

(i) Contingent liabilities shall be classified as:

(a) Claims against the company not acknowledged as debt;

(b) Guarantees;

(c) Other money for which the company is contingently liable.

(ii) Commitments shall be classified as:

(a) Estimated amount of contracts remaining to be executed on capital account and not provided for;

(b) Uncalled liability on shares and other investments partly paid;

(c) Other commitments (specify nature).

- The amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share shall be disclosed separately and not to be shown in the Balance Sheet.
- Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of note how such unutilised amounts have been used or invested.
- Where the company has not used the borrowings from banks and financial institutions for the specific purpose for which it was taken at the balance sheet date, the company shall disclose the details of where they have been used.
- If, in the opinion of the Board, any of the assets other than fixed assets and non-current investments do not have a value on realisation in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion, shall be stated.

II. Additional Regulatory Information

(i) The company shall provide the details of all the immovable property whose title deeds are not held in the name of the company in the prescribed format.

(ii) Where the Company has revalued its Property, Plant and Equipment, the company shall disclose as to whether the revaluation is based on the valuation by a registered valuer as defined under rule 2 of the Companies (Registered Valuers and Valuation) Rules, 2017.

(iii) Disclosures shall be made where Loans or Advances in the nature of loans are granted to promoters, Directors, KMPs and the related parties (as defined under Companies Act, 2013,) either severally or jointly with any other person that are (a) repayable on demand or (b) without specifying any terms or period of repayment.

III. Details of Benami Property held

Where any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, the company shall disclose details such as year of acquisition, amount, details of beneficiaries, reference to the item in the Balance Sheet etc.

IV. Borrowing based on security of current assets

The company shall disclose whether the quarterly returns or statements of current assets filed by the Company with banks or financial institutions are in agreement with the books of accounts. if not, summary of reconciliation and reasons of material discrepancies, if any to be adequately disclosed.

V. Willful Defaulter

Where a company is a declared willful defaulter by any bank or financial institution or other lender, the company shall disclose the details of the date of such declaration and details of default.

VI. Relationship with Struck Off Companies

Where the company has any transactions with companies struck off under section 248 of the Companies Act, 2013 or section 560 of Companies Act, 1956, the Company shall disclose details such as name of the struck off company, nature of transactions with the company, balance outstanding and relationship with the struck off company, if any.

VII. Registration of charges or satisfaction with Registrar of Companies

Where any charges or satisfaction yet to be registered with Registrar of Companies beyond the statutory period, details and reasons thereof shall be disclosed.

VIII. Compliance with number of layers of companies

Where the company has not complied with the number of layers prescribed under clause (87) of section 2 of the Act read with Companies (Restriction on number of Layers) Rules, 2017, the name and CIN of the companies beyond the specified layers and the relationship/extent of holding of the company in such downstream companies shall be disclosed.

IX. Certain ratios are to be disclosed

The company shall disclose ratios such as (a) Current Ratio, (b) Debt-Equity Ratio, (c) Debt Service Coverage Ratio, (d) Return on Equity Ratio, (e) Inventory turnover ratio, (f) Trade Receivables turnover ratio, (g) Trade payables turnover ratio, (h) Net capital turnover ratio, (i) Net profit ratio, (j) Return on Capital employed, (k) Return on investment. explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

Among the other compliance requirements are:

X. Compliance with approved Scheme(s) of Arrangements; and

XI. Utilisation of Borrowed funds and share premium.

[Please refer to Schedule III, Division I for further details]

- **Accounting Standard 1, Disclosure of Accounting Policies**

In addition to the disclosure requirements specified in Division I of Schedule III, companies who are required to comply with Companies (Accounting Standards) Rules, 2006 shall also follow the requirements of AS 1, Disclosure of Accounting Policies while preparing and presenting the financial statements. Following are the important provisions of this Standard.

a. All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

b. The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.

c. Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

d. If the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

e. There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable.

f. Examples of the areas in which different accounting policies may be adopted by different enterprises are: method of depreciation, treatment of expenditure during construction, conversion or translation of foreign currency items, valuation of inventories etc.

g. The primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit or loss for the period ended on that date. For this purpose, the major considerations governing the selection and application of accounting policies are – prudence, substance over form and materiality.

h. Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts.

- **Preparation of the Statement of Profit and Loss and Balance Sheet – Some Typical Adjustments**

a. Classification of Items of Assets and Liabilities as Current or Non-current Current assets

An entity shall classify an asset as current when:

(i) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;

(ii) it holds the asset primarily for the purpose of trading;

(iii) it expects to realise the asset within twelve months after the reporting period; or

(iv) the asset is cash or a cash equivalent unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

An entity shall classify all other assets as non-current.

Note: The term 'non-current' shall include tangible, intangible and financial assets of long-term nature.

Note: The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents.

An entity shall classify a liability as current when:

(i) it expects to settle the liability in its normal operating cycle;

(ii) it holds the liability primarily for the purpose of trading;

(iii) the liability is due to be settled within twelve months after the reporting period; or

(iv) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

Note: An entity shall classify all other liabilities as non-current.

Consider the following illustration.

Illustration 2

While preparing the Balance Sheet as on 31.03.2023, the Accountant of ABC Ltd. is confused regarding classification of following Trade Payables into current and non-current.

Sl. No.	Amount due (₹)	Due from	To be settled on
1	3,10,000	01.04.2022	18.05.2023
2	1,80,000	01.06.2022	15.09.2024
3	40,000	01.08.2022	15.07.2024
4	15,000	01.01.2023	30.04.2024
5	2,30,000	06.03.2023	05.07.2024
6	1,08,000	15.03.2023	31.12.2023

The normal operating cycle of the company is 15 months. Advice the Accountant on classification with reason.

Solution:

Classification of Trade Payables as Current and Non-current Liabilities

Sl. No.	Amount Due (₹)	Date of settlement	Due from	Cut of period based on operating cycle	Whether due within the cut of date	Whether Current or non- current
1	3,10,000	18.05.2023	01.04.2022	01.07.2023	Before	Current Liabilities
2	1,80,000	15.09.2024	01.06.2022	01.09.2023	After	Non-current Liabilities
3	40,000	15.07.2024	01.08.2022	01.11.2023	After	Non-current Liabilities
4	15,000	30.04.2024	01.01.2023	01.04.2024	After	Non-current Liabilities
5	2,30,000	05.07.2024	06.03.2023	06.06.2024	After	Non-current Liabilities
6	1,08,000	31.12.2023	15.03.2023	15.06.2024	Before	Current Liabilities

Note: An item of liability is considered as a current liability is the same is due to be settled within the normal operating cycle which is calculated from the date of recording the asset in the books. It may also be noted that item no. 2, 3, 4 and 5 are also not likely to be settled within 12 months from the end of the reporting period.

b. Closing balance of inventories:

The changes in the inventories of finished goods, WIP and Stock-in-trade is shown under Expenses in the Statement of Profit and Loss and the closing balance of inventories appear under Current Assets in the Balance Sheet.

Consider the following illustration.

Illustration 3

X Ltd., a manufacturer-cum trader, provides you the following details for the financial year ended on 31.03.2023.

Item of Inventory	Balance on 01.04.2022 (₹)	Balance on 31.03.2023 (₹)	Purchases during the year (₹)
Raw Materials	2,00,000	2,50,000	5,00,000
WIP	1,20,400	1,50,200	--
Finished Goods	5,10,000	3,50,000	--
Stock-in-trade	59,000	1,25,000	--

You are required to draft an extract of the Statement of Profit and Loss and also show the relevant Notes to Accounts.

Solution:

X Ltd.

Statement of Profit and Loss for the year ended on 31.03.2023

	Particulars	Note No.	Figures for the Current Reporting Period	Figures for the Previous Reporting Period
	1	2	3	4
IV.	Expenses			
	Cost raw materials consumed	1	4,50,000	
	Changes in inventories	2	64,200	

Workings:

1. Cost raw materials consumed = 2,00,000 +5,00,000 – 2,50,000 = ₹4,50,000
2. Changes in inventories

Item of Inventory	Balance on 01.04.2022 (₹)	Balance on 31.03.2023 (₹)	Changes (₹) = Opening Balance – Closing Balance
WIP	1,20,400	1,50,200	(29,800)
Finished Goods	5,10,000	3,50,000	1,60,000
Stock-in-trade	59,000	1,25,000	(66,000)
Total			64,200

c. Provision for doubtful debt

The provision for doubtful debt is usually estimated as a percentage on Sundry Debtors (after necessary adjustments).

The amount of provision for doubtful debt as at the end of the accounting period is shown as an expense under Other Expenses in the Statement of Profit and Loss. The amount is also shown as a deduction from Sundry Debtors within Trade Receivables under Current Assets.

Note: Balance of provision as at the beginning of the accounting year is shown as a deduction from closing provision under Other Expenses in the Statement of Profit and Loss.

d. Interest on Debenture or Bonds

Interest on debenture is shown as a part of Finance Cost in the Statement of Profit and Loss.

Interest accrued and due is shown as a part of Other Current Liabilities within the line-item Current Liabilities.

Interest accrued and not due is also shown as a part of Other Current Liabilities within the line-item Current Liabilities.

Note: There exists no difference in the treatment of interest on debenture 'interest accrued and due' and 'interest accrued but not due'. However, they must be disclosed separately.

e. Depreciation

The amount of depreciation on tangible assets is included under the sub head Depreciation and Amortization under the head Expenses in the Statement of Profit and Loss.

It is also deducted from the carrying amount of respective assets while preparing the Notes to Property, Plant and Equipment.

f. Amortization

Amortization of intangible assets is included under the sub head Depreciation and Amortization under the head Expenses in the Statement of Profit and Loss.

It is also deducted from the carrying amount of respective assets while preparing the Notes to Intangible Assets.

f. Calls-in Arrear

The balance of Calls-in-Arrear is shown as a deduction from Share Capital under Shareholders' Fund in the Balance Sheet. For this purpose, in the Notes to Accounts section, the share capital is split between 'Shares fully paid up' and Shares not fully paid up'.

g. Calls-in-advance

The amount of Calls-in-Advance not yet adjusted till the Balance Sheet date is shown under Other Current Liabilities under the head Current Liabilities. It is never reflected under Share Capital.

h. Transfer to Reserves from Profits

It is an appropriation of profit. No appropriation item is reflected in the Statement of Profit and Loss. The final balance of Reserves and Surplus (after appropriation) is shown under Shareholders Fund in the Balance Sheet.

The individual appropriation items are to be shown in the Notes to Reserves and Surplus under Notes to Accounts section.

i. Interim Dividend Paid

The interim dividend already appearing in the Trial Balance is deducted from current year's Surplus while preparing the Notes on reserve and Surplus.

No entry is required in the Statement of Profit and Loss.

j. Proposed Dividend

It is treated as a Contingent Liabilities and is shown as a deduction in Reserve and Surplus. It is disclosed in the Notes to Accounts section as a contingent liability.

i. Writing -off Share Issue Expenses, Underwriting Commission etc.

The amount to be written-off is included in the Other Expenses under the head Expenses in the Statement of Profit and Loss.

It is also deducted from the corresponding item in Other Non-Current Assets under the head Non-Current Assets.

Note: The portion of expenses to be written-off within the next 12 months is to be shown as current assets under Other Current Assets.

j. Payment to Auditors

It is shown under the sub-head Other Expenses under the head Expenses in the Statement of Profit and Loss. Disclosure of various items should be made in the Notes to Accounts section.

k. Provision for Income Tax, Advance Tax and Assessed Tax of Prior Year

There may be following three situations:

(i) When Assessed Tax Liability = Provision for Income Tax

Here, no further provision is required to be created. Now –

If Advance tax paid = Assessed Tax Liability, Provision for Income Tax and Advance Tax squared off.

If Advance tax paid < Assessed Tax Liability, Provision for Income Tax and Advance Tax squared off and their difference is treated as Income Tax Payable to appear under Other Current Liabilities.

If Advance tax paid > Assessed Tax Liability, Provision for Income Tax and Advance Tax squared off and their difference is treated as Income Tax Refund to appear under Other Current Assets.

(ii) When Assessed Tax Liability > Provision for Income Tax

Here, further provision is required to be created by debiting Profit & Loss A/c. The additional Provision for income tax will appear under the line-item Tax Expense in the Statement of Profit and Loss as Prior Period Tax.

Further, adjustment of Advance tax and Provision for Income Tax shall be done in the same way as explained in situation (i).

(iii) When Assessed Tax Liability < Provision for Income Tax

Here, excess provision is required to be written back by crediting it to Profit & Loss A/c. The excess Provision for income tax will appear under the line-item Tax Expense in the Statement of Profit and Loss as Prior Period Excess Provision.

Further, adjustment of Advance tax and Provision for Income Tax shall be done in the same way as explained in situation (i).

l. Provision for Income Tax and Advance Tax of Current Year

The Provision for Income Tax will appear in the line-item Tax Expenses as 'Current Tax' in the Statement of Profit and Loss. It will also appear under the sub-head Short-term Provisions under Current Labilities in the Balance Sheet.

The Advance Tax will appear under Short-term Loans and Advances under Current Assets in the Balance Sheet.

Illustration 4

The following are the extracts from the Trial Balance of Y Ltd. on March 31, 2023: (figures in ₹)

Provision for current tax (2021-22)	4,00,000	Tax deducted at source (2022-23)	20,000
Advance tax paid (2021-22)	3,60,000	Advance tax paid (2022-23)	2,00,000

The assessment for the year 2021-22 was finalized during the year 2022-23. The total tax liability for that year was fixed at ₹4,40,000 and the net amount payable for the year 2021-22 has not yet been paid. The net profit before tax for the year 2022-23 amounted to ₹8,00,000. Balance of Profit & Loss A/c at the end of 2021-22 was ₹4,00,000. Assume corporate income tax @ 35% (inclusive of surcharge and education cess) You are required to draft:

(a) Extract of Statement of Profit and Loss for the year ended March 31, 2023 along with the relevant Notes; and

(b) Extract of Balance Sheet as on March 31, 2023 along with the relevant Notes.

Solution:

Y Ltd.

Statement of Profit and Loss for the year ended on 31.03.2023

	Particulars	Note No.	Figures for the Current Reporting Period (₹)	Figures for the Previous Reporting Period
	1	2	3	4
I.	Profit before tax (given)		8,00,000	
II.	Tax Expenses: Current Tax	1	3,20,000	
III.	Profit from Continuing operations (I- II)		4,80,000	
IV.	Profit from dis-continuing operations		Nil	
V.	Profit for the period (III +IV)		4,80,000	

Notes to Statement of Profit and Loss:

1. Current tax	₹
Provision for income tax (2022-23) [8,00,000 × 35%]	2,80,000
Prior period tax (further provision for 2021-22 (Working 1)	40,000
Total	3,20,000

Y Ltd.

Balance Sheet as on 31.03.2023

	Particulars	Note No.	Figures for the Current Reporting Period	Figures for the Previous Reporting Period
I.	Equity and Liabilities			
	(1) Shareholders' Fund'			
	Reserves and Surplus	1	8,80,000	
	(2) Current liabilities			
	Other current liabilities: I.T Payable (2021-22)		80,000	
	Short term Provisions: Provision for tax (2022-23)		2,80,000	
II.	Assets			
	(1) Current Assets			
	Short term loans and advances: Advance Tax (2022-23)	2	2,20,000	

Notes to Balance Sheet

1. Reserves and Surplus	₹
Surplus: Balance on 01.04.2022	4,00,000
Add: Profit (2022-23)	4,80,000
Total	8,80,000

2. Short term loans and advances	₹
Advance tax (2022-23)	2,00,000
TDS (2022-23)	20,000
Total	2,20,000

Workings:

Tax assessment (2021-22)

Provision for tax (2021-22) = ₹4,00,000, and Assessed tax = ₹4,40,000

So, further provision required = ₹4,40,000-4,00,000 = ₹40,000

Income tax payable = Assessed tax – advance tax = 4,40,000 – 3,60,000 = ₹80,000

Comprehensive Problems on Preparation of Statement of Profit and Loss and Balance Sheet

Illustration 5

The following information has been extracted from the books of account of Hero Ltd. as at 31st March, 2023:

Particulars	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, 2022)		260
Distribution Costs	102	
Factory Closure Costs	60	
Fixtures, Fittings, Tools and Equipment at Cost	680	
Profit & Loss Balance (at 1st April, 2022)		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, 2022)	140	
Trade Creditors		80
Trade Debtors	780	
	4,500	4,500

Additional Information:

1. The stock at 31st March, 2023 (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, 2023, 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. Profits transferred to reserves ₹30,000.

Prepare Hero Ltd.'s Statement of Profit and Loss for the year to 31st March, 2023 and balance Sheet as at that date in accordance with the Companies Act, 2013 as per Division I of schedule III 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, 2023 (₹ in '000)

Ref No.	Particulars	Note No.	As at 31st March, 2023	As at 31st March, 2022
	I EQUITY AND LIABILITIES			
	1 Shareholder's Fund			
	(a) Share capital	1	1,000	
	(b) Reserves and surplus	2	350	
	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	270	
	Total (1+2+3+4)		1,770	
	II ASSETS			
	1 Non-current assets			
	(a) PPE and Intangibles			
	(i) PPE	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.

Statement of Profit and Loss for the year ended: 31st March, 2023 **(₹ in ....)**

		Note No.		As at 31st March, 2023	As at 31st March, 2022
I	REVENUE FROM OPERATION	11		3,000	
	Less: Excise duty				
				3,000	
II	OTHER INCOME				
III	TOTAL REVENUE(I+II)			3,000	
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 FROM 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	
XVI	Earning per equity share:				
	(1) Basic				
	(2) Diluted				

(₹ In ‘000)

Note 1. Share Capital	As at 31st March, 2023	As at 31st March, 2022
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, 2023		As at 31st March, 2022	
	Nos.	(₹)	Nos.	(₹)
Opening Balance as on 01.04.22 (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, 2023	As at 31st March, 2022
General Reserve	30	
Profit and loss Balance	320	
Total	350	

Note 3. Long term borrowings	As at 31st March, 2023	As at 31st March, 2022
Long term loan	70	
Total	70	

Note 4. Trade Payables	As at 31st March, 2023	As at 31st March, 2022
Sundry Creditors	80	
Total	80	

Note 5. Short- term provisions	As at 31st March, 2023	As at 31st March, 2022
Provision for Taxation	270	
Total	270	

Note 6. PPE		As at 31st March, 2023	As at 31st March, 2022
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, 2023	As at 31st March, 2022
Investments	200	
Total	200	

Note 8. Inventories	As at 31st March, 2023	As at 31st March, 2022
Stock	200	
Total	200	

Note 9. Trade Receivables	As at 31st March, 2023	As at 31st March, 2022
Trade Debtors (more than six months considered good) –	780	
Total	780	

Note 10. Cash and cash equivalents	As at 31st March, 2023	As at 31st March, 2022
Cash at Bank and on hand	228	
Total	228	

Note 11. Revenue from operation	As at 31st March, 2023	As at 31st March, 2022
Sales (net of Excise Duty)	3,000	
Total	3,000	

Note 12. Other Expenses	As at 31st March, 2023	As at 31st March, 2022
Administrative Expenses	480	
Distribution Expenses	102	
Loss on sale of Fixed Assets	20	
Total	602	

Note 13: Profit and Loss Balance	As at 31st March, 2023	As at 31st March, 2022
Balance brought forward from previous year	80	
Profit during the year	270	
Profit available for appropriation	350	
Appropriation:		
Transfer to General Reserve	30	
Balance carried forward	320	

Note 14. Contingent Liabilities for Proposed dividend	As at 31st March, 2023	As at 31st March, 2022
Proposed divided (20% of ₹1,000)	200	

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. 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, 2023

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 year 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	₹ in '000
(1) PPE: Furniture and Fixture: Gross block As on 01.04.2022 Add: addition during the year	 680 120	
	800	
Less: Deductions during the year	60	

As on 31.03.2023		740
Depreciation: As on 01.04.2022 Add: For the year (20% on 740)	 260 148	
	408	
Less: Deduction during the year	30	
As on 31.03.2023		378
Net Block as on 31.03.2023		362
(2) Provision for Taxation: Profit for the year Add: Loss on sale of asset (short term capital loss) Depreciation	 20 148	 540 168
		708
Less: Depreciation under Income-tax Act		168
		540
Provision for tax @50%		270

Note: It has been assumed that depreciation calculated under Income-tax Act amounts to ₹ 1,68,000.

Illustration 6

The following balances are extracted from the books of Supreme Ltd., a real estate company, on 31st March, 2023:

(₹ '000)

Particulars	Dr.	Cr.
Sales		13,800
Purchases of materials	6,090	
Share capital fully paid		500
Land purchased in the year as stock	365	
Leasehold premises	210	
Creditors		2,315
Debtors	3,675	
Directors' salaries	195	
Wages	555	
Work in progress on 01.04.2022	1,050	
Sub-contractors' cost	4,470	
Equipment, Fixtures and Fittings at cost on 01.04.2022	1,320	
Stock on 01.04.2022	295	
Profit and Loss Account, Credit Balance on 01.04.2022		640
Secured Loan		560
Bank Overdraft		525

Interest on Loan and Overdraft	110	
Depreciation on Equipment on 01.04.2022		820
Administration Expenses	735	
Office Salaries	90	
	19,160	19,160

You also obtain the following information:

a. On 31st March, 2023, 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, 2023 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:

a. to prepare the company's financial statements for the year ended 31st March, 2023 as near as possible to proper form of company final accounts; and

b. 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, 2023 **(₹ in '000)**

Ref No.		Particulars	Note No.	As at 31st March, 2023	As at 31st March, 2022
	I	EQUITY AND LIABILITIES			
	1	Shareholder's Fund			
		(a) Share capital	1	500	
		(b) Reserves and surplus	2	1070	

	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	770	
		Total (1+2+3+4)		5,840	
	II	ASSETS			
	1	Non-current assets			
		(a) PPE and Intangible Assets			
		(i) PPE	8	1,000	
	2	Current assets			
		(a) Inventories	9	1,410	
		(b) Trade receivables	10	3,430	
		Total (1+2)		5,840	

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.

Statement of Profit and Loss for the year ended: 31st March, 2023 **(₹ in '000)**

Ref. No.	Particulars	Note No.	As at 31st March, 2023	As at 31st March, 2022
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	10170	
	(b) Purchase of products for sale (land)		365	
	(c) changes in inventories of finished goods, work-in- progress and products for sale	12A	(65)	
	(d) Employees cost/ benefits expenses	13	960	
	(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 CONTINU- ING 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	
XVI	Earning per equity share:			
	(1) Basic			
	(2) Diluted			

(₹ In ‘000)

Note 1. Share Capital	As at 31st March, 2023	As at 31st March, 2022
Authorized, Issued, Subscribed and paid-up Share capital:		
50,000 Equity share of ₹10 each	500	
Total	500	

FOR EQUITY SHARE	As at 31st March, 2023		As at 31st March, 2022	
	Nos.	(₹)	Nos.	(₹)
Opening Balance as on 01.04.22 (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, 2023	As at 31st March, 2022
General Reserve	45	
Profit and loss A/c (See working)	1025	
Total	1070	

Note 3. Long term borrowings	As at 31st March, 2023	As at 31st March, 2022
Secured Loan	560	
Total	560	

Note 4. Short-term borrowings	As at 31st March, 2023	As at 31st March, 2022
Bank Overdraft	525	
Total	525	

Note 5. Trade Payables	As at 31st March, 2023	As at 31st March, 2022
Sundry Creditors	2,315	
Total	2,315	

Note 6. Other Current Liabilities	As at 31st March, 2023	As at 31st March, 2022
Audit fees	100	
Total	100	

Note 7. Short- term provisions	As at 31st March, 2023	As at 31st March, 2022
Provision for Taxation	650	
Provision for bonus	120	
Total	770	

Note 8. PPE		As at 31st March, 2023	As at 31st March, 2022
Equipment, Fixtures & Fittings at cost- Opening	1,320		
Less: Depreciation	895	425	
Leasehold premises (210+200+190)	600		
Less: Witten off	25	575	
Total		1,000	

Note 9. Inventories	As at 31st March, 2023	As at 31st March, 2022
Stock – Finished stock	710	
Work in progress	700	
Total	1410	

Note 10. Trade Receivables	As at 31st March, 2023	As at 31st March, 2022
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, 2023	As at 31st March, 2022
Sales (net of Excise Duty)	13,800	
Total	13,800	

Note 12. Cost of materials Consumed	As at 31st March, 2023	As at 31st March, 2022
Purchase of materials (6,090-190)	5,900	
Sub-contract Cost (4,470-200)	4,270	
Total	10170	

Note 12A. Changes in inventories	As at 31st March, 2023	As at 31st March, 2022
Changes in WIP (1050-700)	350	
Changes in FG (295-710)	(415)	
	(65)	

Note 13. Employees benefit expenses	As at 31st March, 2023	As at 31st March, 2022
Wages	555	
Salary- office staff (90+195)	285	
Bonus	120	
Total	960	

Note 14. Other Expenses	As at 31st March, 2023	As at 31st March, 2022
Administrative Expenses	735	
Provision for doubtful debts	245	
Auditor's remuneration	100	
Total	1,080	

Working Note: Balance of P/L	As at 31st March, 2023	As at 31st March, 2022
Balance brought forward from previous year	640	
Profit for the year	430	
Profit available for appropriation	1,070	
Appropriation:		
Transfer to General Reserve	45	
Balance carried forward	1,025	

NOTES ON ACCOUNTS FOR THE YEAR ENDED 31ST MARCH, 2023

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 price and other attributable expenses.

c. **Depreciation:** Depreciation on fixed assets is provided using the written down method. Lease-hold premises/improvements are being amortized 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)	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	(1410)
	Total		11,025
1(b)	Administration Expenses		735
	Director's Salaries		195
	Provision for Doubtful Debts [175 + 2% of (3675 – 175)]		245
	Audit Fees		100
	Other Expenses		1,275
(c)	Employee benefits:		
	Office Salaries		90
	Bonus		120
	Bonus calculation		210
(2)	Sales		13,800
	Less: Manufacturing Expenses	11,025	
	Other Exp. (excluding bonus) (1275 + 90)	1,365	
	Depreciation	100	
	Interest	110	12,600
	Pre-tax profit		1,200
	Bonus (10%)		120
(3)	Fixed Asset:		
	Tangible Asset		
	(a) Gross block		
	(b) Furniture and Fixture		1,320
	(c) Leasehold premises (210 + 200 + 190)		600
			1,920

(b)	Depreciation		
	(e) Furniture and fixture (01.04.22)	820	
	(f) For the year [15% on (1,320 – 820)]	75	895
	(g) Cost of Leasehold Premises written of (h) [(210+200+190) × 1/12 × ½]		25
			920
(4)	(i) 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 ₹1,25,000)		650

Illustration 7

PQR Ltd. was registered with a nominal capital of ₹20,00,000 divided into shares of ₹100 each. The following Trial Balance is extracted from the books on 31st March, 2023:

Particulars	₹	Particulars	₹
Buildings	11,60,000	Sales	20,80,000
Machinery	4,00,000	Outstanding Expenses	8,000
Closing Stock	3,60,000	Provision for Doubtful Debts (1-4-2022)	12,000
Loose Tools	92,000	Equity Share Capital	8,00,000
Purchases (Adjusted)	8,40,000	General Reserve	1,60,000
Salaries	2,40,000	Profit and Loss A/c (31.03.2022)	1,00,000
Directors' Fees	40,000	Creditors	3,68,000
Rent	1,04,000	Provision for depreciation:	
Depreciation	80,000	On Building	2,00,000
Bad Debts	24,000	On Machinery	2,20,000
Investment	4,80,000	14% Debentures	8,00,000
Interest accrued on investment	8,000	Interest on Debentures accrued but not due	56,000
Debenture Interest	1,12,000	Interest on Investments	48,000
Advance Tax	2,40,000	Unclaimed dividend	20,000
Sundry expenses	72,000		
Debtors	5,00,000		
Bank	1,20,000		
	48,72,000		48,72,000

You are required to prepare Statement of Profit and Loss for the year ending 31st March, 2023 and Balance sheet as at that date after taking into consideration the following information:

(i) Closing stock is more than opening stock by ₹3,20,000.

(ii) Provide to doubtful debts @ 4% on Debtors.

(iii) Make a provision for income tax @30%.

(iv) Depreciation expense included depreciation of ₹32,000 on Building and that of ₹48,000 on Machinery.

(v) Transfer to General Reserve @ 10%.

(vi) The directors proposed a dividend @ 25%.

(vii) Bills Discounted but not yet matured ₹ 40,000.

Solution:

PQR Ltd.

Statement of Profit and Loss for the year ended 31st March, 2023

Particulars	₹
I. Revenue from operations	20,80,000
II. Other income (interest on investment)	48,000
III. Total Revenue [I + II]	21,28,000
IV. Expenses:	
Cost of purchase [8,40,000+3,20,000]	11,60,000
Changes in inventories [40,000-3,60,000]	(3,20,000)
Employee Benefits Expense	2,40,000
Finance Costs (debenture interest)	1,12,000
Depreciation and Amortisation Expenses	80,000
Other Expenses	2,48,000
Total Expenses	15,20,000
V. Profit before Tax (III-IV)	6,08,000
VI. Tax Expenses @ 30%	1,82,400
VII. Profit for the period	4,25,600

Balance Sheet as on 31.03.2023

Particulars		₹
I EQUITY AND LIABILITIES		
(1) Shareholders' Funds		
Share Capital	1	8,00,000
Reserves and Surplus	2	6,85,600
(2) Non Current Liabilities		
Long-term Borrowings (14% debentures)		8,00,000
(3) Current Liabilities		
Trade Payable (Sundry Creditors)		3,68,000
Other Current Liabilities	3	84,000

Short-Term Provisions	4	1,82,400
Total		29,20,000
II ASSETS		
(1) Non Current Assets		
(a) PPE and Intangible Assets		
PPE	5	11,40,000
(b) Non-current Investments		4,80,000
(2) Current Assets		
Inventories	6	4,52,000
Trade Receivables	7	4,80,000
Cash and bank balances		1,20,000
Short Term Loans and Advances		
(Advance Payment of Tax)		2,40,000
Other Current Assets		
(Interest accrued on investments)		8,000
Total		29,20,000

Note: Contingent Liability for bills discounted but not yet matured ₹ 40,000.

Note: Contingent Liability for Proposed dividend ₹ 2,00,000

Notes to Accounts:

Sl. No.	Particulars	₹	₹
1.	Share Capital		
	Authorized Capital		
	20,000 Equity Shares of ₹100 each		20,00,000
	Issued Capital		
	8000 Equity Shares of ₹100 each		8,00,000
	Subscribed and Paid up Capital		
	8000 Equity Shares of ₹100 each		8,00,000
2.	Reserve and Surplus		
	General Reserve [₹1,60,000 + ₹42,560]		2,02,560
	Balance of Statement of Profit & Loss Account		
	Opening Balance	1,00,000	
	Add: Profit for the period	4,25,600	
		5,25,600	
	Appropriations		
	Transfer to General Reserve @ 10%	(42,560)	
			4,83,040
			6,85,600

3.	Other Current Liabilities		
	Unclaimed Dividend	20,000	
	Outstanding Expenses	8,000	
	Interest accrued on Debentures	56,000	
		84,000	
4.	Short Term Provision		
	Provision for Tax	1,82,400	
5.	Tangible Assets		
	Buildings	11,60,000	
	Less: Provision for Depreciation	2,00,000	
			9,60,000
	Plant and Equipment	4,00,000	
	Less; Provision for Depreciation	2,20,000	
			1,80,000
			11,40,000
6.	Inventories		
	Closing Stock of Finished Goods	3,60,000	
	Loose Tools	92,000	
			4,52,000
7.	Trade Receivables		
	Sundry Debtors	5,00,000	
	Less: Provision for Doubtful Debts	20,000	
			4,80,000
8.	Other Expenses		
	Rent		1,04,000
	Directors' Fees		40,000
	Bad Debts		24,000
	Provision for Doubtful Debts (4% of ₹5,00,000 less. ₹12,000)		8,000
	Sundry Expenses		72,000
			2,48,000
9.	Proposed Dividend (8,00,000 × 25%)		2,00,000

Note: Total purchase is obtained by adding back the changes in inventory to Adjusted Purchase.

An Introduction to Division II of Schedule III 2.3

Since its inception, the Companies Act, 2013 has been undergoing changes from time to time through various amendments to the Act, Rules and through notifications and circulars of the Ministry of Corporate Affairs which aim to keep the law at commensurate with various developments in the economic and regulatory environment and policy requirements. Moreover, the Government of India also decided to converge Indian Accounting Standards with certain carve outs from International Financial Reporting Standards, in a phased manner to accomplish its commitment in G-20 summit with the objective of achieving high quality global accounting and reporting standards.

At this backdrop, the Ministry of Corporate Affairs vide its notification dated 6th April, 2016 notified amendments to Schedule III of the Companies Act, 2013, thereby inserting Division II to Schedule III for preparation of financial statements by those entities who are covered under Companies (Indian Accounting Standards) Rules, 2015.

Similar to Division I, this also comprises of two parts – Part I explaining the general instructions for preparation of Balance Sheet and Part II explaining the general instructions for preparation of the Statement of Profit and Loss.

The formats for the Statement of Profit and Loss and Balance Sheet as per Division II are described below.

- **Format of the Statement of Profit and Loss**

Name of the Company.........................

Statement of Profit and Loss for the period ended................ **(₹ in.........)**

	Particulars	Note No.	Figures as at the end of current reporting period	Figures for the previous reporting period
I	Revenue From operations			
II	Other Income			
III	Total Income (I + II)			
IV	Expenses:			
	Cost of materials consumed			
	Purchases of Stock-in-Trade			
	Changes in inventories of finished goods, Stock-in -Trade and work-in-progress			

	Employee benefits expense			
	Finance costs			
	Depreciation and amortization expenses			
	Other expenses			
	Total expenses (IV)			
V	Profit/(loss) before exceptional items and tax (I-IV)			
VI	Exceptional Items			
VII	Profit/ (loss) after exceptions items and tax(V-VI)			
VIII	Tax expense: (1) Current tax (2) Deferred tax			
IX	Profit (Loss) for the period from continuing operations (VII-VIII)			
X	Profit/(loss) from discontinued operations			
XI	Tax expenses of discontinued operations			
XII	Profit/(loss) from Discontinued operations (after tax) (X-XI)			
XIII	Profit/(loss) for the period (IX+XII)			
XIV	Other Comprehensive Income A. (i) Items that will not be reclassified to profit or loss (ii) Income tax relating to items that will not be reclassified to profit or loss B. (i) Items that will be reclassified to profit or loss (ii) Income tax relating to items that will be reclassified to profit or loss			
XV	Total Comprehensive Income for the period (XIII+XIV) comprising Profit (Loss) and Other comprehensive Income for the period			
XVI	Earnings per equity share (for continuing operation): (1) Basic (2) Diluted			
XVII	Earnings per equity share (for discontinued operation): (1) Basic (2) Diluted			
XVIII	Earning per equity share (for discontinued & continuing operation) (1) Basic (2) Diluted			

Format of the Balance Sheet

Name of the Company....................

Balance Sheet as at .... **(₹ in.........)**

Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
ASSETS			
Non-current assets			
(a) Property, Plant and Equipment			
(b) Capital work-in-progress			
(c) Investment Property			
(d) Goodwill			
(e) Other Intangible assets			
(f) Intangible assets under development			
(g) Biological Assets other than bearer plants			
(h) Financial Assets			
(i) Investments			
(ii) Trade receivables			
(iii) Loans			
(i) Deferred tax assets (net)			
(j) Other non-current assets			
Current assets			
(a) Inventories			
(b) Financial Assets			
(i) Investments			
(ii) Trade receivables			
(iii) Cash and cash equivalents			
(iv) Bank balances other than(iii) above			
(v) Loans			
(vi) Others (to be specified)			
(c) Current Tax Assets (Net)			
(d) Other current assets			
Total Assets			

EQUITY AND LIABILITIES			
EQUITY			
(a) Equity Share capital			
(b) Other Equity			
LIABILITIES			
Non-current liabilities			
(a) Financial Liabilities			
(i) Borrowings			
(ii) Trade Payables:			
(A) total outstanding dues of micro enterprises and small enterprises; and			
(B) total outstanding dues of creditors other than micro enterprises and small enterprises.			
(iii) Other financial liabilities (other than those specified in item (b), to be specified)			
(b) Provisions			
(c) Deferred tax liabilities (Net)			
(d) Other non-current liabilities			
Current liabilities			
(a) Financial Liabilities			
(i) Borrowings			
(ii) Trade Payables:			
(A) total outstanding dues of micro enterprises and small enterprises; and			
(B) total outstanding dues of creditors other than micro enterprises and small enterprises.			
(iii) Other financial liabilities (other than those specified in item (c)			
(b) Other current liabilities			
(c) Provisions			
(d) Current Tax Liabilities (Net)			
Total Equity and Liabilities			

Format of the Statement showing Changes in Equity

STATEMENT OF CHANGES IN EQUITY

Name of the Company..............

A. Equity Share Capital

Balance at the beginning of the current reporting period	Changes in Equity Share Capital due to prior period errors	Restated balance at the beginning of the current reporting period	Changes in equity share capital during the current year	Balance at the end of the current reporting period

B. Other Equity

	Share application on money pending allotment	Equity component of compound financial instrument	Reserve and Surplus				Debt Instrument through other Compre-hensive Income	Equity Instrument through Other Comprehen-sive Income	Effective portion of Cash Flow Hedges	Revaluation Surplus	Exchange difference on translating the financial statement	Other items of Other Compr-ehensive Income	Money received against share capital	Total
			Capital Reserve	Securities Premium	Other Reserve (Specify nature)	Retained Earning								
Balance at the beginning of the reporting period														
Changes in accounting policy or prior period errors														
Restated balance at the beginning of the reporting period														
Total comprehensive Income for the year														
Dividends														
Transfer to retained earnings														
Balance at the end of the reporting period														

⦿ Division II vs. Division I – Major Differences in Format

The major differences between Division II vs. Division I of Schedule III are as follows:

a. **Applicability:** Division II of Schedule III is applicable for a company whose financial statements are prepared in compliance with IND AS per Companies (Indian Accounting Standards) Rules, 2015. On the other hand, Division I of Schedule III is applicable for a company whose financial statements are prepared in compliance with Accounting Standards as per Companies (Accounting Standards) Rules, 2006.

b. **Other Equity:** In Division II, the head Equity Share Capital is followed by 'Other Equity' which comprises of (i) Share application money pending allotment, (ii) Equity component of compound financial instruments, (iii) Reserves and Surplus including Capital Reserve, Securities Premium, Other Reserves and Retained Earnings (i.e., Balance of Profit and Loss), (iv) Debt instruments through Other Comprehensive Income (OCI), (v) Equity instruments through OCI, (vi) Effective portion of Cash Flow Hedges, (vii) Revaluation Surplus and (viii) Exchange differences on translation, (ix) Other OCI items; and (x) Money received against share warrants. In Division I these items either had separate heads or were included in Reserves and Surplus.

c. **Statement Showing Changes in Equity:** In addition to the formats of the Statement of Profit and Loss and Balance Sheet, Division II additionally provides the format of the Statement of Changes in Equity.

d. **Order of Assets and Liabilities in the Balance Sheet:** In Division II, assets have been placed first followed by Equity and Liabilities. This was opposite in Division I.

e. **Bifurcation of Balance Sheet Items:** In addition to the Current and Non-Current Classification in Division I, Division II further bifurcates assets and liabilities in Financial and Non-Financial.

f. **Retrospective Change in Accounting Policy:** As per Division II, when there is retrospective change in accounting policy or restatement or reclassification of an item in financial statement, Balance Sheet at the beginning the earliest comparative period shall be presented. There is no such requirement in Division I.

g. **Disclosure of Preference Shares including Premium Received:** In Division II, non- redeemable preference shares are disclosed as part of equity and redeemable preference shares are disclose as Non- Current Liabilities.

h. **Disclosure of Compound Financial Instruments:** In Division II, compound financial instruments are split into equity and liability component per Ind AS requirements. The equity component is included in Other Equity while the debt component is reflected in Non-current Liabilities.

i. **Disclosure of EPS:** Division II requires EPS for discontinued operation and EPS discontinued & continuing operation to be reported separately.

j. **Dividend on Redeemable Preference Shares:** Division II requires the Dividend on Redeemable Preference Shares to be included in Finance Cost.

k. **Extraordinary Items:** Division II does not have any concept of extraordinary items to be included in the Statement of Profit and Loss.

l. **Other Comprehensive Income:** Division II requires Other Comprehensive Income to be a part of the Statement of Profit and Loss.

⦿ Comprehensive Problems on Preparation of the Statement of Profit and Loss and Balance Sheet under Division II of Schedule III of the Companies Act, 2013 (These illustrations are for knowledge purpose only).

Illustration 8

Please refer to Illustration 7. Prepare the Statement of Profit and Loss for the year ending 31st March, 2023 and Balance sheet as on that date as per Division II of Schedule III of the Companies Act, 2013.

Solution:

Name of the Company: PQR Ltd.

Statement of Profit and Loss for the period ended 31.03.2023

(Fig. in ₹)

	Particulars	Note No.	31.03.2023	31.03.2022
I	Revenue From operations		20,80,000	
II	Other Income (interest on investment)		48,000	
III	Total Income (I + II)		21,28,000	
IV	Expenses:			
	Cost of materials consumed		--	
	Purchases of Stock-in-Trade (8,40,000 + 3,20,000)		11,60,000	
	Changes in inventories of finished goods, Stock-in -Trade and work-in-progress (40,000 – 3,60,000)		(3,20,000)	
	Employee benefits expense		24,000	
	Finance costs (Debenture Interest)		1,12,000	
	Depreciation and amortization expenses		80,000	
	Other expenses		2,48,000	
	Total expenses (IV)		15,20,000	
V	Profit/(loss) before exceptional items and tax (I-IV)		6,08,000	
VI	Exceptional Items		--	
VII	Profit/ (loss) after exceptions items and tax(V-VI)		6,08,000	
VIII	Tax expense:			
	(1) Current tax (Provision @ 30%)		1,82,400	
	(2) Deferred tax			
IX	Profit (Loss) for the period from continuing operations (VII-VIII)		4,25,600	
X	Profit/(loss) from discontinued operations		--	
XI	Tax expenses of discontinued operations		--	
XII	Profit/(loss) from Discontinued operations (after tax) (X-XI)		--	
XIII	Profit/(loss) for the period (IX+XII)		4,25,600	
XIV	Other Comprehensive Income A. (i) Items that will not be reclassified to profit or loss (ii) Income tax relating to items that will not be reclassified to profit or loss B. (i) Items that will be reclassified to profit or loss (ii) Income tax relating to items that will be reclassified to profit or loss		NIL	
XV	Total Comprehensive Income for the period (XIII+XIV) comprising Profit (Loss) and Other comprehensive Income for the period		4,25,600	

XVI	Earnings per equity share (for continuing operation): (1) Basic (2) Diluted		53.20	
XVII	Earnings per equity share (for discontinued operation): (1) Basic (2) Diluted		--	
XVIII	Earning per equity share (for discontinued & continuing operation) (1) Basic (2) Diluted		53.20	

Name of the Company: PQR Ltd.

Balance Sheet as at 31.03.2023

(Fig. in ₹)

Ref No.	Particulars		Note No.	As at 31st March, 2023	As at 31st March, 2022
I		**ASSETS**			
	1	**Non-current assets**			
		(a) Property, Plant and Equipment	5	11,40,000	
		(b) Financial Assets			
		(i) Investments		4,80,000	
	2	**Current assets**			
		(a) Inventories		4,52,000	
		(b) Financial Assets			
		(i) Trade receivables		4,80,000	
		(ii) Cash and cash equivalents		1,20,000	
		(c) Current Tax Assets (Advance Tax)		2,40,000	
		(d) Other Current Assets (Interest Accrued)		8,000	
		Total		29,20,000	
II		**EQUITY AND LIABILITIES**			
	1	**Equity**			
		(a) Equity Share capital	1	8,00,000	
		(b) Other Equity	2	6,85,600	
	2	**Liabilities**			
		Non-current liabilities			
		(a) Financial Liabilities			
		(i) Borrowings (14% Debentures)		8,00,000	

		Current Liabilities			
		(a) Financial Liabilities			
		(a) Trade payables		3,68,000	
		(b) Other Current Labilities	3	84,000	
		(b) Provisions	4	1,82,400	
		Total		29,20,000	

STATEMENT OF CHANGES IN EQUITY

Name of the Company..............

A. Equity Share Capital

Balance at the beginning of the current reporting period	Changes in Equity Share Capital due to prior period errors	Restated balance at the beginning of the current reporting period	Changes in equity share capital during the current year	Balance at the end of the current reporting period
8,00,000	Nil	8,00,000	Nil	8,00,000

B. Other Equity (Applicable column only are shown)

	Reserve and Surplus				Total
	Capital Reserve	Securities Premium	Other Reserve (General Reserve)	Retained Earning	
Balance at the beginning of the reporting period			1,60,000	1,00,000	2,60,000
Changes in accounting policy or prior period errors			Nil	Nil	
Restated balance at the beginning of the reporting period			1,60,000	1,00,000	
Total comprehensive Income for the year				4,25,600	4,25,600
Dividends					
Transfer to/from retained earnings			42,560	(42560)	
Balance at the end of the reporting period			2,02,560	4,83,040	

Notes to Accounts:

(Fig. in ₹)

1.	Share Capital		
	Authorized Capital		
	20,000 Equity Shares of ₹100 each		20,00,000
	Issued Capital		
	8000 Equity Shares of ₹ 100 each		8,00,000
	Subscribed and Paid-up Capital		
	8000 Equity Shares of ₹100 each		8,00,000

2.	Other Equity		
	General Reserve [₹1,60,000 + ₹42,560]		2,02,560
	Balance of Statement of Profit & Loss Account		
	Opening Balance	1,00,000	
	Add: Profit for the period	4,25,600	
		5,25,600	
	Appropriations		
	Transfer to General Reserve @ 10%	(42,560)	4,83,040
			6,85,600
3.	Other Current Liabilities		
	Unclaimed Dividend		20,000
	Outstanding Expenses		8,000
	Interest accrued on Debentures		56,000
			84,000
4.	Provision		
	Provision for Tax		1,82,400
5.	PPE		
	Buildings	11,60,000	
	Less: Provision for Depreciation	2,00,000	9,60,000
	Plant and Equipment	4,00,000	
	Less; Provision for Depreciation	2,20,000	1,80,000
			11,40,000
6.	Inventories		
	Closing Stock of Finished Goods	3,60,000	
	Loose Tools	92,000	4,52,000
7.	Trade Receivables		
	Sundry Debtors	5,00,000	
	Less: Provision for Doubtful Debts	20,000	4,80,000
8.	Other Expenses		
	Rent		1,04,000
	Directors' Fees		40,000
	Bad Debts		24,000
	Provision for Doubtful Debts (4% of ₹5,00,000 less. ₹12,000)		8,000
	Sundry Expenses		72,000
			2,48,000
9.	Contingent Liabilities for Proposed Dividend		
	8,00,000 × 25%		2,00,000

Note: Total purchase is obtained by adding back the changes in inventory to Adjusted Purchase.

Illustration 9

MNP Ltd. has a nominal capital of ₹ 800,000 divided into shares of ₹ 10 each. The following Trail Balance was extracted from the books as on 31-12-2023

Particulars	Amount (₹)	Particulars	Amount (₹)
Calls-in-arrears.	7,500	6% Debentures	3,00,000
Premises (₹ 60,000 added on 1-7-2023)	3,60,000	Profits and loss statement (1-1-2023)	14,500
Interim dividend paid	7,500	Creditors	50,000
Machinery	300,000		
Purchases	1,85,000	General reserve	25,000
Preliminary expenses	5,000	Share capital (called up)	4,60,000
Freight	13,100	Bills payable	38,000
Director's fees	5,740	Sales	4,16,000
Bad debts	2,110	Reserve for bad debts	3,500
4% Govt. securities	60,000		
Stock 1-1-2023	75,000		
Furniture	12,200		
Sundry debtors	87,000		
Goodwill	20000		
Cash at bank	39,900		
Bank	750		
Wages	84,800		
General expenses	16,900		
Salaries	15,500		
Debenture interest	9,000		
	13,07,000		13,07,000

Prepare final accounts for the year ending 31-12-2023 as per Division II of Schedule III of the Companies Act 2013 after taking into account the following adjustment:

i) Depreciate Machinery 5% and Furniture 10%
ii) Write off half of the preliminary expenses
iii) Wages include ₹ 10,000 paid for the construction of a compound wall to the premises and no adjustment was made;
iv) Reserve 5% for bad debts;
v) Transfer ₹ 10,000 to general reserve
vi) Provide for income tax ₹ 25,000;
vii) Stock on 31-12-2023 was ₹1,01,000

Solution:

I. Statement of Profit and Loss for the year ended on 31 December 2023.

Particulars	Note No	Amount (₹)
Income Revenue from Operations		416,000
Other Income		2400
Total Income		**418,400**
Expenses		
Purchase of Stock-in-Trade	5	198,100
Changes in Inventories of Finished Goods, Work-in-Progress and Stock-in-Trade		(26,000)
Employee Benefits Expense	6	90,300
Finance Costs	7	18,000
Depreciation Expenses	8	16,220
Other Expenses	9	28,100
Total Expenses		**324,720**
Profit Before Tax.		**93,680**
Current Tax		25,000
Profit for the Year		68,680
Other Comprehensive Income		
A i. Items that will not be reclassified to Profit or Loss		--------
ii. Income tax relating to items that will not be reclassified to Profit or Loss		--------
Biii. Items that will be reclassified to Profit or Loss		-------------
iv. Income tax relating to items that will be reclassified to Profit or Loss		------------
Total Other Comprehensive Income/(Loss) for the Year (Net of Tax)		------------
Total Comprehensive Income for the Year		68,680
Earnings Per Equity Share of Face Value of ₹ 10 each		1.49

II. Statement of Changes in Equity

A. Equity Share Capital

Balance at the beginning of the current reporting period	Changes in equity share capital during the current year	Balance at the end of the current reporting period
460,000-7500	----	452,500

B. Other Equity

	Balance as on 01/01/2023	Total Comprehensive Income of the year	Transfer (to)/ from Retained Earnings	Transfer (to)/from General Reserve	Dividends	Balance as on 31/12/2023
General Reserve	25,000			10,000		35,000
Retained Earnings	14,500	68680	(10,000)		(7500)	65,680
Total	**39,500**	**68680**	**(10,000)**	**10,000**	**(7500)**	**100,680**

III. Balance sheet as on 31 December 2023

Particulars	Note No	Amount (₹)
Assets		
Non-Current Assets		
Property, Plant and Equipment	2	665,980
Goodwill		20,000
4% Govt. Securities		60,000
Total Non-Current Assets		**745,980**
Current Assets		
Inventories		101,000
Trade Receivables	3	82,650
Cash and Cash Equivalents.(cash+ bank)		40,650
Preliminary expenses not written off Interest on 4% Govt. Securities		2500 2400
Total Current Assets		**229,200**
Total Assets		**975,180**
Equity and Liabilities		
Equity		
Equity Share Capital		452500
Other Equity		100,680
Liabilities		
Non-Current Liabilities		
Financial Liabilities		
Borrowings 6% Debentures		300,000

Particulars	Note No	Amount (₹)
Total Non-Current Liabilities		**300,000**
Current Liabilities Financial Liabilities Trade Payables:-		38,000
Other Current Liabilities	4	59,000
Provisions		25,000
Total Current Liabilities		122,000
Total Liabilities		422,000
Total Equity and Liabilities		975,180

Notes:

Note 1: Share Capital

Nominal Capital		
80,000 shares of ₹ 10 each		**800,000**
Called up Capital		
46,000 shares of ₹ 10 each		460,000
Less: Calls in arrears		7,500
Share Capital		**452,500**

Note 2: Property, Plant and Equipment.

Premises (300,000+60,000)		360,000.
Add: Wages relating to the Construction		10,000
Total		**370,000**
Machinery	300,000	
Less: Depreciation	15,000	285,000
Furniture	12,200	
Less: Depreciation	1,220	10,980
Total		**665,980**

Note 3: Trade Receivables

Sundry Debtors	87,000
Less: New provision for bad debts	4,350
Total	**82,650**

Note 4: Other Non-Current Liabilities

Creditors	50,000
Debenture Interest outstanding	9,000
Total	**59,000**

Note No: 5 Purchases

Particulars	**Amount**
Purchases	185,000
Add: Freight	13,100
Total	**198,100**

Note No: 6 Employee benefit expenses

Wages 84,800-10,000	74,800
Salaries	15,500
Total	**90,300**

Note No: 7 Finance Cost

Debenture interest	9,000
Add: Outstanding	9,000
Total	**18,000**

Note No: 8 Depreciation Expenses

Depreciation on Machinery	15,000
Depreciation on Furniture	1,220
Total	**16,200**

Note No:9 Other Expenses

General Expenses		16,900
Directors fees		5,740
Preliminary expenses Written off		2,500
Bad debts	2,110	
Add: New Provision for		
Bad debts	4,350	
Less: Old Provision for		
Bad debts	3,500	2,960
Total		**28,100**

Illustration 10

The following is the trail balance of X Ltd. As on 31st March 2023.

Particulars	Amount (₹)	Amount (₹)
Stock 1st April,2022	85,000	-
Purchases returns	-	10,000
Purchase and sales	2,45,000	3,50,000
Wages	30,000	-
Discount	-	3,000
Carriage inward	950	-
Furniture and fittings	17,000	-
Salaries	7,500	-
Rent	4,000	-
Sundry expenses	16,950	-
Share capital	-	1,00,000
General reserve	-	15,500
Surplus A/c	-	15,000
Debtors and creditors	27,500	17500
Plant and machinery	29,000	-
Cash at bank	45,300	-
Patents and trade mark	4,800	-
Bills receivable and bills payable	8,000	10,000
	5,21,000	5,21,000

Prepare Statement of Profit & Loss as per Division II of Schedule III of the Companies Act 2013 for the year ended 31-03-2023 and Balance sheet at that date. Take into consideration the following adjustments:

(a) Stock on 31st March, 2023 was valued at ₹ 88,000

(b) Make a provision for income tax @ 30%

(c) Depreciate plant and machinery @ 15%, furniture and fittings @ 10% and patents and trademarks @ 5%

(d) On 31-03-2023, outstanding rent amount to ₹ 800 while total of outstanding salaries ₹900

(e) The Board of Directors propose a dividend @15% per annum for the year ended 31st March,2023, after transfer to general reserve ₹10,000.

(f) Make a provision for doubtful debts amounting to ₹ 1,510.

Solution:

I. Statement of Profit and Loss for the year ended on 31 March 2023.

Particulars	Note No	Amount (₹)
Income Revenue from Operations		350,000
Other Income		3000
Total Income		353,000
Expenses		
Purchase of Stock-in-Trade	6	235,950
Changes in Inventories of Finished Goods, Work-in-Progress and Stock-in-Trade		(3,000)
Employee Benefits Expense	7	38,400
Finance Costs		-------
Depreciation and Amortization Expenses	8	6290
Other Expenses	9	23,260
Total Expenses		**300,900**
Profit Before Tax		**52,100**
Current Tax		15,630
Profit for the Year		36,470
Other Comprehensive Income		
A i. Items that will not be reclassified to Profit or Loss		--------
ii. Income tax relating to items that will not be reclassified to Profit or Loss		--------
B.iii. Items that will be reclassified to Profit or Loss		-------------
iv. Income tax relating to items that will be reclassified to Profit or Loss		------------
Total Other Comprehensive Income/(Loss) for the Year (Net of Tax)		------------
Total Comprehensive Income for the Year		36,470
Earnings Per Equity Share of Face Value of ₹10 each		---------

II. Statement of Changes in Equity

A. Equity Share Capital

Balance at the beginning of the current reporting period	Changes in equity share capital during the current year	Balance at the end of the current reporting period
100,000	----	100,000

B. Other Equity

	Balance as on 01/04/2022	Total Comprehensive Income of the year	Transfer (to)/ from Retained Earnings	Transfer (to)/from General Reserve	Dividends	Balance as on 31/03/2023
General Reserve	15,500			10,000		25,500
Retained Earnings	15,000	36470	(10,000)		-----	41,470
Total	30,500	36,470	(10,000)	10,000	-----	66,970

III. Balance sheet as on 31 March 2023

Particulars	Note No	Amount (₹)
Assets		
Non-Current Assets		
Property, Plant and Equipment	2	39,950
Patents and trade marks		4560
4% Govt. Securities		-------
Total Non-Current Assets		44,510
Current Assets		
Inventories		88,000
Trade Receivables	3	33,990
Cash and Cash Equivalents.(cash+ bank)		45,300
Preliminary expenses not written off		----------
Total Current Assets.		167,290
Total Assets		211,800
Equity and Liabilities		
Equity		
Equity Share Capital		100,000
Other Equity		66,970
Liabilities		
Non-Current Liabilities		
Financial Liabilities		
Borrowings		-----
Total Non-Current Liabilities		-------

Particulars	Note No	Amount (₹)
Current Liabilities Financial Liabilities Trade Payables:-		10,000
Other Current Liabilities	4	19,200
Provisions		15,630
Total Current Liabilities		44830
Total Liabilities		44830
Total Equity and Liabilities Contingent Liabilities and Commitments	 5	211,800 15,000

Notes:

Note 1: Share Capital

Share Capital		100,000

Note 2: Property, Plant and Equipment.

Plant and Machinery		29,000
Less: Depreciation	4,350	24,650
Furniture	17,000	
Less: Depreciation	1,700	15,300
Total		**39,950**

Note 3: Trade Receivables

Sundry Debtors		27,500
Less: New provision for bad debts	1,510	
Bills Receivable		8000
Total		**33,990**

Note 4: Other Non-Current Liabilities

Creditors	17,500
Outstanding Rent	800
Outstanding Salaries	900
Total	**19,200**

Note 5: Contingent Liabilities and Commitments

Proposed Dividend	15,000
Total	**15,000**

Note No: 6 Purchases

Particulars		**Amount**
Purchases		245,000
Add: Carriage inward		950
Less: Purchase returns	10,000	
Total		**235,950**

Note No: 7 Employee benefit expenses

Wages		30,000
Salaries	7,500	
Add: Outstanding	900	8,400
Total		**38,400**

Note No: 8 Depreciation and Amortization Expenses.

Depreciation on Plant Machinery	4,350
Depreciation on Furniture	1,700
Amortization on patents and trademarks	240
Total	**6,290**

Note No: 9 Other Expenses

Sundry Expenses	16,950
Rent	4000
Add: Outstanding Rent	800
Provision for bad debt	1510
Total	**23,260**

Illustration 11

Siva Ltd. Was registered with a nominal capital of 60,000 divided into shares of ₹ 10 each. The following is the trail balance of the company as at March 31, 2023:

Trail Balance of Siva Ltd as at March 31, 2023.

Particulars	Dr. (₹)	Cr. (₹)
Buildings	29,000	-
Machinery	10,000	-
Closing stock	9,000	-
Purchase (adjusted)	21,000	-

Particulars	Dr. (₹)	Cr. (₹)
Salaries	6,000	-
Director's fees	1,000	-
Rent	2,600	-
Depreciation	7000	-
Bad debts	600	-
Interest accrued on investment	200	-
1,200 shares of Y Ltd. of ₹10 each, ₹ 8 paid up	12,000	-
Debenture interest	2,800	-
Loose tools	2,300	-
Advance tax	1000	-
Sundry expenses	1,800	-
Debtors	12,500	-
Bank balance	14000	-
Sales	-	63000
Outstanding expenses	-	200
Provision for doubtful debts (April 1,2022)	-	300
Equity share capital	-	20,000
General reserve	-	4,000
Profit and loss a/c (April 1,2022)	-	2,500
Creditors	-	9,200
Provision for depreciation-building	-	5,000
Provision for depreciation- machinery	-	5,500
14% Debentures	-	20,000
Interest on debentures accrued but not due	-	1,400
Interest on investments	-	1,200
Unclaimed dividend	-	500
Total	1,32,800	1,32,800

Prepare Statement of Profit & Loss as per Division II of Schedule III of the Companies Act 2013 for the year ended 31-03-2023 and Balance sheet at that date. Take into consideration the following adjustments:

(a) Bills discounted but not yet matured -₹ 1,000

(b) Closing stock is more than opening stock by ₹ 8,000

(c) Provide for doubtful debt @ 4% on debtors

(d) Make a provision for income tax @ 30%

(e) Depreciation includes depreciation of ₹ 1800 on buildings and that of ₹ 5,200 on machinery

(f) The directors recommend a dividend @ 25% and transfer to general reserve @ 10%

Solution:

I . Statement of Profit and Loss for the year ended on 31 March 2023.

Particulars	Note No	Amount (₹)
Income Revenue from Operations		63,000
Other Income		1200
Total Income		64,200
Expenses		
Purchase of Stock-in-Trade(21000+9000-1000)	7	29000
Changes in Inventories of Finished Goods, Work-in-Progress and Stock-in-Trade		(8000)
Employee Benefits Expense	8	6000
Finance Costs	9	2800
Depreciation Expenses.	10	7000
Other Expenses.	11	6200
Total Expenses		43,000
Profit Before Tax.		21,200
Current Tax		6360
Profit for the Year		14,840
Other Comprehensive Income		
A i. Items that will not be reclassified to Profit or Loss		--------
ii. Income tax relating to items that will not be reclassified to Profit or Loss		--------
B.iii. Items that will be reclassified to Profit or Loss		-------------
iv. Income tax relating to items that will be reclassified to Profit or Loss		------------
Total Other Comprehensive Income/(Loss) for the Year (Net of Tax)		------------
Total Comprehensive Income for the Year		
Earnings Per Equity Share of Face Value of ₹ 10 each		7.42

II. Statement of Changes in Equity

A. Equity Share Capital

Balance at the beginning of the current reporting period	Changes in equity share capital during the current year	Balance at the end of the current reporting period
20000	----	20000

B. Other Equity

	Balance as on 01/04/2022	Total Comprehensive Income of the year	Transfer (to)/ from Retained Earnings	Transfer (to)/from General Reserve	Dividends	Balance as on 31/03/2023
General Reserve	4,000			1484		5484
Retained Earnings	2,500	14840	(1484)		-----	15856
Total	6,500	14840	(1484)	1484	-----	21,340

III. Balance sheet as on 31 March 2023

Particulars	Note No	Amount
Assets		
Non-Current Assets		
Property, Plant and Equipment	2	28500
1200 shares of Y Ltd		12000

Total Non-Current Assets		**40500**
Current Assets		
Inventories	3	11,300
Trade Receivables(12,500-500)		12,000
Cash and Cash Equivalents.		14000
Advance Tax		1000
Other Current Assets	4	200
Total Current Assets.		**38500**
Total Assets		**79000**
Equity and Liabilities		
Equity		
Equity Share Capital		20000

Particulars	Note No	Amount
Other Equity		21,340
Liabilities		
Non-Current Liabilities		
Financial Liabilities		
Borrowings 14% Debentures		20,000
Total Non-Current Liabilities		**20,000**
Current Liabilities Financial Liabilities Trade Payables:-		9200
Other Current Liabilities	**5**	**2100**
Provisions		6360
Total Current Liabilities		**17,660**
Total Liabilities		**37,660**
Total Equity and Liabilities		**79000**
Contingent Liabilities and Commitments	**6**	**8400**

Notes:

Note 1: Share Capital

Nominal capital of 60,000 divided into shares of ₹ 10 each		**600,000**
Equity Share Capital		**20,000**

Note 2: Property, Plant and Equipment.

Plant and Machinery		10,000
Less: Accumulated Depreciation	5500	4500
Buildings		29000
Less: Accumulated Depreciation	5000	24000
Total		**28,500**

Note 3: Inventories

Closing stock		9000
Loose tools	2300	
Total		**11,300**

Note 4: Other Current Assets

Interest Accrued on Investments		200
Total		**200**

Note 5: Other Current Liabilities

Unpaid dividend		500
Outstanding expenses		200
Interest on Debentures accrued but		
Not due	1400	
Total		**2100**

Note 6: Contingent Liabilities and commitments

Proposed dividend		5000
Bills discounted but not matured		1000
Uncalled liability on partly paid		
shares (1200 × 2 = 2400)		2400
Total		**8400**

Note No: 7 Purchases

Particulars		**Amount**
Purchases (adjusted)		21,000
Add: Closing stock		9000
Less: Opening stock	1000	
Purchases		**29,000**

Note No: 8 Employee benefit expenses

Salaries		6000
Total		**6000**

Note No: 9 Finance Costs

Debenture Interest		2800
Total		**2800**

Note No: 10 Depreciation Expenses

Depreciation on Plant Machinery		5200
Depreciation on Buildings		1800
Total		**7000**

Note No: 11.Other Expenses

Directors fees	1000
Rent	2600
Bad debts	600
Sundry expenses	1800
Provision for Bad debts (500-300)	200
Total	**6200**

Illustration 12

KHJ Ltd. presents you the summarized Trail balance for the year 31-03-2023.

Debit items	Amount (₹cr.)	Credit items	Amount (₹cr.)
Employee cost	40.45	Share capital (₹ 1)	100.00
Depreciation	56.30	P/L (1-4-2022)	10.00
Cost of materials	110.44	Securities premium	16.41
Other expenses	14.33	Revaluation reserve	7.33
Current assets	130.42	Current liabilities	75.64
Fixed assets	455.60	Debentures	20.00
		Sales and services	578.16
Total	**807.54**		**807.54**

Prepare Statement of Profit & Loss as per Division II of Schedule III of the Companies Act 2013 for the year ended 31-03-2023 and Balance sheet at that date. Take into consideration the following adjustments:

(a) Employee cost includes ₹ 2.30 on account of actuarial loss.

(b) On 31st March, fixed assets were upward revalued by 20% (not yet accounted).

(c) Dividend declared 13% (not yet accounted).

Solution

I. Statement of Profit and Loss for the year ended on 31 March 2023.

Particulars	Note No	Amount (₹cr.)
Revenue from Operations		578.16
Other Income		--------
Total Income		578.16
Expenses		
Cost of materials consumed		110.44
Employee Benefits Expense(40.45-2.30=38.15)		38.15

Particulars	Note No	Amount (₹cr.)
Depreciation Expenses.		56.30
Other Expenses.		14.33
Total Expenses		219.22
Profit Before Tax.		358.94
Current Tax		---------
Profit for the Year		358.94
Other Comprehensive Income		
A i. Items that will not be reclassified to Profit or Loss Actuarial loss Revaluation Surplus		-------- (2.30) 91.12
ii. Income tax relating to items that will not be reclassified to Profit or Loss		--------
B.iii. Items that will be reclassified to Profit or Loss		-------------
iv. Income tax relating to items that will be reclassified to Profit or Loss		------------
Total Other Comprehensive Income/(Loss) for the Year (Net of Tax)		------------
Total Comprehensive Income for the Year		447.76
Earnings Per Equity Share of Face Value of ₹ 10 each		3.5894

II. Statement of Changes in Equity

A. Equity Share Capital (Amount ₹ in Crores)

Balance at the beginning of the current reporting period	Changes in equity share capital during the current year	Balance at the end of the current reporting period
100	----	100

B. Other Equity (Amount ₹ in Crores)

	Balance as on 01/04/2022	Total Comprehensive Income of the year	Transfer to Retained Earnings	On Equity Shares	Balance as on 31/03/2023
Securities Premium	16.41				16.41
Retained Earnings Other Comprehensive Income Revaluation Reserve	10 7.33	358.94 (2.30) 91.12			368.94 (2.30) 98.45
Total	**33.74**	**447.76**			**481.50**

III. Balance sheet as on 31 March 2023 (Amount Rs.in Crores)

Particulars	Note No	Amount
Assets		
Non-Current Assets		
Property, Plant and Equipment		546.72
Total Non-Current Assets		546.72
Current Assets		130.42
Total Current Assets.		130.42
Total Assets		677.14
Equity and Liabilities.		
Equity		
Equity Share Capital		100
Other Equity		481.50
Liabilities		
Non-Current Liabilities		
Financial Liabilities		
Borrowings Debentures		10
Total Non-Current Liabilities		10
Current Liabilities		75.64
Total Current Liabilities		75.64
Total Liabilities		85.64
Total Equity and Liabilities Contingent Liabilities and Commitments(Dividend Proposed)		677.14 13

Illustration 13

Trial Balance of Balu Ltd

Debit balances

Opening stock	–	30,000
Rent and Taxes	–	6000
Purchases	–	60,900
Wages	–	55,200
Discount	–	1,500

Fuel	–	2570
Building	–	70,000
Carriage inward	–	1175
Sundry Debtors	–	20,000
Goodwill	–	28,000
Plant and Machinery	–	25,000
Loose Tools	–	6,000
Advertisemen	–	3,000
General expenses	–	4,400
Bad debts	–	1030
Debenture interest	–	625
(Half year interest up to 30/9/2022)		
Miscellaneous Expenses	–	3,000
Insurance	–	1,000
Cash and bank	–	5,000
Total	**–**	**324,400**

Credit Balances

Equity share capital	–	100,000
(1000 shares of 100 each)		
5% Debentures	–	25,000
Sales	–	175,000
Sundry creditors	–	10,000
Bank overdraft	–	12,000
Discount	–	2,200
Transfer fee	–	100
Return outward	–	100
Total	**–**	**324,400**

Prepare Statement of Profit & Loss as per Division II of Schedule III of the Companies Act 2013 for the year ended 31-03-2023 and Balance sheet at that date. Take into consideration the following adjustments:

A. The authorized capital of the company is 200,000
B. Stock on 31/03/2023 was 35,000
C. Depreciate plant and machinery by 9% and revalue loose tools at 4,400
D. Provide 2%as bad debt reserve and 2.5% discount on debtors
E. Final dividend at 10% was proposed by the Board of Directors.

Solution:

I. Statement of Profit and Loss for the year ended on 31 March 2023.

Particulars	Note No	Amount
Income Revenue from Operations		1,75,000
Other Income (2200 + 100)		2,300
Total Income		1,77,300
Expenses		
Purchase of Stock-in-Trade (60900 + 1175 - 100)		61,975
Changes in Inventories of Finished Goods, Work-in-Progress and Stock-in-Trade		(5,000)
Employee Benefits Expense		55,200
Finance Costs	5	1,250
Depreciation Expenses	6	2,250
Other Expenses	7	24,990
Total Expenses		1,40,665
Profit Before Tax.		36,635
Current Tax		------
Profit for the Year		36,635
Other Comprehensive Income		
A i. Items that will not be reclassified to Profit or Loss		--------
ii. Income tax relating to items that will not be reclassified to Profit or Loss		--------
B.iii. Items that will be reclassified to Profit or Loss		-------------
iv. Income tax relating to items that will be reclassified to Profit or Loss		------------
Total Other Comprehensive Income/(Loss) for the Year (Net of Tax)		------------
Total Comprehensive Income for the Year		36,635
Earnings Per Equity Share of Face Value of ₹ 10 each		36.635

II. Statement of Changes in Equity

A. Equity Share Capital

Balance at the beginning of the current reporting period	Changes in equity share capital during the current year	Balance at the end of the current reporting period
100,000	----	100,000

B. Other Equity

	Balance as on 01/04/2022	Total Comprehensive Income of the year	Transfer (to)/ from Retained Earnings	Transfer (to)/from General Reserve	Dividends	Balance as on 31/03/2023
General Reserve	-			-		-
Retained Earnings		36,635			-	36,635
Total		36,635			-	36,635

III. Balance sheet as on 31 March 2023

Particulars	Note No	Amount (₹)
Assets		
Non-Current Assets		
Property, Plant and Equipment	1	92,750
Goodwill		28,000
		-
Total Non-Current Assets		1,20,750
Current Assets		
Inventories	2	39,400
Trade Receivables	3	19,110
Cash and Cash Equivalents		5,000
Other Current Assets		--------
Total Current Assets.		63,510
Total Assets		1,84,260
Equity and Liabilities		
Equity		
Equity Share Capital		100,000

Particulars	Note No	Amount (₹)
Other Equity		36,635
Liabilities		
Non-Current Liabilities		
Financial Liabilities		
Borrowings 5% Debentures		25,000
Total Non-Current Liabilities		25,000
Current Liabilities Financial Liabilities Bank Overdraft Trade Payables :-		 12,000 --------
Other Current Liabilities	4	10,625
Provisions		--------
Total Current Liabilities		22,625
Total Liabilities		45,625
Total Equity and Liabilities		184260
Contingent Liabilities and Commitments (Dividend)		10,000

Notes:

Note No-1 Property, Plant and Equipment

Particulars	**Amount**
Building	70,000
Plant and Machinery	22,500
	92,750

Note 2-Inventories

Particulars	**Amount**
Closing stock	35,000
Loose Tools	4,400
	39,400

Note 3-Trade receivables

Particulars	**Amount**
Debtors	20,000
Less: Provision for bad debts	400
Less: Provision for discount on debtors	490
	19,110

Note 4: Other Current Liabilities

Particulars	**Amount**
Sundry Creditors	10,000
Debenture Interest outstanding	625
Total	**10,625**

Note 5: Finance Cost

Interest on Debentures	1250

Note 6: Depreciation Expenses.

Particulars	**Amount**
Depreciation on Plant and Machinery - 25,000 × 0.09	2250
Total	**2,250**

Note-7: Other Expenses

Particulars	**Amount**
Rent and taxes	6,000
Discount	1,500
Fuel	2,570
Advertisement	3000
General expenses	4400
Bad debts	1030
Depreciation of loose tools	1,600
Miscellaneous expenses	3000
Insurance	1000
Provision for bad debts	400
Provision for discount on debtors 19,600 × 2.5 / 100	490
Total	**24,990**

Illustration 14

The following is the trial balance of Reliance Company Ltd, Chennai as at 31 March 2023.

Particulars	Dr.	Cr.
Authorised Capital		
50,000 shares of ₹ 10 per share		
Subscribed capital:		
10,000 shares of ₹ 10 per share		100,000
Calls in arrears		6400
Land		10,000
Buildings		25,000
Plant and Machinery		15,000
Furniture and fixtures		3200
Carriage inward		2300
Wages		21,400
Salaries		4600
Bad debts reserve		1400
Sales		80,000
Sales Returns		1700
Bank charges		100
Coal, Gas and water		700
Rates and taxes		800
Purchases		50,000
Purchases Returns		3400
Bills Receivable		1200
General Expenses		1900
Sundry Debtors		42,800
Sundry Creditors		13,200
Stock		40,000
Fire Insurance		400
Cash at Bank		13,000
Cash in Hand		2500

Particulars	Dr.	Cr.
Security Premium Reserve		6000
General Reserve		39,000
	243,000	**243,000**

Prepare Statement of Profit & Loss as per Division II of Schedule III of the Companies Act 2013 for the year ended 31-03-2023 and Balance sheet at that date. Take into consideration the following adjustments: (Avoid Notes)

1. Charge depreciation on building @5%, on plant and machinery @10% and on furniture and fixtures @10%.
2. Make a reserve at 5% on sundry debtors for bad debts.
3. Carry forward following unexpired amount: Fire insurance ₹ 120.
4. Provide the following outstanding liabilities: Wages ₹ 3200; Salaries ₹ 1500; Rent, Rates and Taxes ₹ 200.
5. The value of stock as on 31 March ,2023 was 45,000.

I. Statement of Profit and Loss for the year ended 31st March

Particulars	Note No	Amount
Revenue from Operations		78,300
Other Income		
Total Income		78300
Expenses		
Cost of Material Consumed		
Purchase of Stock-in-Trade		48900
Changes in Inventories of Finished Goods, Work-in-Progress and Stock-in-Trade		(5000)
Employee Benefits Expense		30,700
Finance Costs		
Depreciation/Amortization and Depletion Expense		3070
Other Expenses.		4720
Total Expenses		82390
Loss Before Exceptional Item and Tax		4090
Exceptional Item (Net of Tax)		-------
Loss Before Tax.		4090
Tax Expenses		
Current Tax		--------
Deferred Tax		

Particulars	Note No	Amount
Profit From Continuing Operations		
Profit From Discontinued Operations (Net of Tax)		
Loss for the Year		4090
Other Comprehensive Income		
A.i. Items that will not be reclassified to Profit or Loss		
ii. Income tax relating to items that will not be reclassified to Profit or Loss		
B.iii. Items that will be reclassified to Profit or Loss		
iv. Income tax relating to items that will be reclassified to Profit or Loss		
Total Other Comprehensive Income/(Loss) for the Year (Net of Tax)		
Total Comprehensive Income for the Year		(4090)
Earnings Per Equity Share of Face Value of --- each		
Basic		
Diluted		
Significant Accounting Policies		
See accompanying Notes to the Financial Statements		

Statement of Changes in Equity For the year ended 31st March.

A. Equity Share Capital.

Balance at the beginning of the current reporting period	Changes in Equity Share Capital due to prior period errors	Restated balance at the beginning of the current reporting period	Changes in equity share capital during the current year	Balance at the end of the current reporting period
100,000 - 6400	------	------	------	93,600

B. Other Equity.

	Balance as at 1st April --	Total Comprehensive Income for the year	Dividend	Transfer (to)/from Retained Earnings	Transfer (to)/from General Reserve	On Rights Issue#	On Employee Stock Options	Others	Balance as at 31st March, 2023
As at 31st March, 2023 Reserves and Surplus									
Capital Reserve									

	Balance as at 1st April --	Total Comprehensive Income for the year	Dividend	Transfer (to)/from Retained Earnings	Transfer (to)/from General Reserve	On Rights Issue#	On Employee Stock Options	Others	Balance as at 31st March, 2023
Securities Premium	6000								6000
Debenture Redemption Reserve									
Share Based Payments Reserve									
General Reserve	39000								39000
Other Comprehensive Income	(4090)								(4090)
Total	**40,910**								**40,910**

Balance sheet as at 31st March, 2023

Particulars	Note No	Amount
Assets		
Non-Current Assets		
Property, Plant and Equipment		50,130
Capital Work-in-Progress		
Goodwill		
Other Intangible Assets		
Intangible Assets Under Development		
Financial Assets.		
Investments		
Loans		
Deferred Tax Assets (Net)		
Other Non-Current Assets		
Total Non-Current Assets		
Current Assets		

Particulars	Note No	Amount
Inventories		45,000
Financial Assets		
Investments		
Trade Receivables		40,660
Cash and Cash Equivalents.		15,500
Bills Receivables		1200
Other current Assets		120
Total Current Assets.		102,480
Assets Held for Sale.		
Total Assets		152,610
Equity and Liabilities		
Equity		
Equity Share Capital		93600
Other Equity		40910
Liabilities		
Current Liabilities Financial Liabilities (i) Borrowings. (ia) Lease liabilities (ii) Trade Payables:-		13,200
Other Financial Liabilities		
Other Current Liabilities		4900
Provisions		
Total Current Liabilities		18,100
Liabilities directly associated with Assets Held for Sale		
Total Liabilities		
Total Equity and Liabilities		152,610
Significant Accounting Policies See accompanying Notes to the Financial Statements		

Solved Case

XYZ Pharmaceuticals is a pharma start-up established in 2017. The company has registered significant growth over the last two years. To further expand its business, the company wants to mop up additional capital. Motivated by the recent success of a number of IPOs, the BOD has decided to go for a public issue rather than accessing institutional loan.

In order to apply for the IPO to SEBI, the company requires to submit, along with all other documents, its restated financial statements in prescribed format. The company, therefore, has hired you as an expert to assist its accountant in preparing the financial statements so that the statements conform, in all respect, to the relevant legislation and can be used to prepare restated financial statements for the purpose of filing for an IPO.

You have been given the following information for the financial year 2022-2023.

Particulars	Dr. (₹)	Cr. (₹)
Stock on 1st April, 2022	1,60,000	-
Purchases & Sales	5,00,000	8,00,000
Purchase returns	-	10,000
Carriage inward	2,100	-
Wages	50,000	-
Salaries	20,000	-
Discount Received	-	8,000
Furniture & Fittings	40,000	-
Rent	10,000	-
Sundry expenses	16,500	-
Balance of Profit & Loss (1.4.2022)	-	50,000
Share Capital (Subscribed & Paid-up; ₹10 each)	-	2,00,000
Interim Dividend	16,000	-
Debtors & Creditors	52,400	31,000
Plant & Machinery	2,46,000	-
General Reserve	-	20,000
Cash at bank	8,000	-
Bills Receivable & Bills Payable	6,000	8,000
Total	11,27,000	11,27,000

Additional information:

(i) Stock on March 31, 2023 was valued at ₹ 98,000

(ii) Depreciate: Plant & Machinery @ 15%, Furniture & Fitting @ 10%.

(iii) On 31st March, 2023 outstanding rent amounted to ₹ 800 while outstanding salaries totalled ₹ 1,200.

(iv) Make a provision for doubtful debts @ 5%.

(v) Provision for tax is to be made @ 30%.

(vi) The directors proposed a dividend @ 10% for the year ended March 31, 2023 excluding interim dividend and decided to transfer ₹ 10,000 to General Reserve.

a. You are required to prepare the Notes to Accounts to support preparation of the Statement of Profit and Loss for the year ended on 31.03.2023.

b. You are required to prepare the Statement of Profit and Loss for the year ended on 31.03.2023.

c. You are required to prepare the Notes to Accounts to support preparation of the Balance Sheet as on 31.03.2021.

d. You are required to prepare the Balance Sheet as on 31.03.2023.

The company follows Division I of Schedule III of the Companies Act, 2013.

Solution:

a. Notes to Accounts supporting the Statement of Profit and Loss:

(1) Cost of purchase

Particulars	Amount (₹)
Purchase less. Returns (5,00,000-10,000)	4,90,000
Add: carriage inward	2,100
	4,92,100

(2) Employee benefit expenses

Particulars	Amount (₹)	Amount (₹)
Wages		50,000
Salaries	20,000	
Add: Outstanding	1,200	21,200
		71,200

(3) Depreciation and Amortization

Particulars	Amount (₹)
On Plant and Machinery (2,46,000 × 15%)	36,900
On Furniture and Fittings (40,000 × 10%)	4,000
	40,900

(4) Other expenses

Particulars	Amount (₹)	Amount (₹)
Rent	10,000	
Add: Outstanding	800	
		10,800
Sundry expenses		16,500
Provision for doubtful debt (52,400 × 5%)		2,620
		29,920

b.

XYZ Pharmaceuticals Ltd.

Profit and Loss Statement for the year ended 31st March, 2023

Particulars		Amount (₹)
I. Revenue from operations		8,00,000
II. Other income (Discount received)		8,000
III. Total Revenue [I + II]		8,08,000
IV. Expenses:		
Cost of purchase	1	4,92,100
Changes in inventories [1,60,000-98,000]		62,000
Employee Benefits Expense	2	71,200
Finance Costs		Nil
Depreciation and Amortization Expenses	3	40,900
Other Expenses	4	29,920
Total Expenses		6,96,120
V. Profit before Tax (III-IV)		1,11,880
VI. Tax Expenses @ 30%		33,564
VII. Profit for the period		78,316

c. Notes to Accounts supporting Balance Sheet:

1.	Share Capital	Amount (₹)	Amount (₹)
	Subscribed and Paid-up Capital		
	20000 Equity Shares of ₹ 10 each	2,00,000	
2.	Reserve and Surplus		
	General Reserve (20,000+10,000)	30,000	
	Balance of Statement of Profit & Loss Account		
	Opening Balance	50,000	
	Add: Profit for the period	78,316	
		1,28,316	
	Appropriations		
	Interim dividend Transfer to General Reserve	(16,000) (10,000)	1,02,316
	Closing balance		1,32,316
3.	Trade payables		
	Creditors	31,000	
	Bills payables	8,000	
		39,000	

4.	Other Current Liabilities		
	Outstanding Salaries Outstanding rent	1,200 800	2,000
5.	Tangible Assets		
	Plant and Machinery	2,46,000	
	Less: Depreciation	36,900	2,09,100
	Furniture and Fittings	40,000	
	Less: Depreciation	4,000	36,000
			2,45,100
6.	Trade Receivables		
	Bills receivable		6,000
	Sundry Debtors	52,400	
	Less: Provision for Doubtful Debts	2,620	49,780
			55,780

d. XYZ Pharmaceuticals Ltd.

Balance Sheet as on 31.03.2023

I EQUITY AND LIABILITIES	Note	Amount (₹)
(1) Shareholders' Funds		
Share Capital	1	2,00,000
Reserves and Surplus	2	1,32,316
(2) Non-Current Liabilities		
(3) Current Liabilities		
Trade Payable	3	39,000
Other Current Liabilities	4	2,000
Short term provisions (Provision for tax)		33,564
Total		4,06,880
II ASSETS		
(1) Non-Current Assets		
(a) PPE and Intangible Assets		
PPE	5	2,45,100
(b) Non-current Investments		
(2) Current Assets		
Inventories		98,000
Trade Receivables	6	55,780
Cash and Cash Equivalent (Bank balance)		8,000
Total		4,06,880

Foot Note:

Contingent Liabilities for Proposed Dividend = 2,00,000 × 10% = ₹ 20,000

Exercise

A. Theoretical Questions:

Multiple Choice Questions:

1. As per Schedule III Current Maturities of Long-term Borrowings should be shown under –

   A. Current Assets in Balance Sheet

   B. Non-current Liability in Balance Sheet

   C. Current Liabilities in Balance Sheet

   D. Other Expenses in Statement of Profit and Loss

2. As per Schedule III of Companies Act 2013, while preparing the financial statements in case of a Finance Company, interest received from borrowers should be shown under

   A. Revenue from operation

   B. Other Income

   C. Current assets

   D. Non-current assets

3. Installment of principal amount of long-term loan payable within next 12 months is shown under Balance Sheet of a company under the heading

   A. Non-current Assets

   B. Non-current Liabilities

   C. Current Assets

   D. Current Liabilities

4. In case of purchase of assets under instalment payment system, instalments due after 12 months from the reporting date are shown as

   A. Current liability

   B. Current assets

   C. Non-current liability

   D. Non-current assets

5. For the issuer, unpaid matured debentures and interest accrued thereon will be shown under the head

   A. Non-current liabilities

   B. Current liabilities

   C. Non-current assets

   D. Current assets

6. Which of the following is not a financial statement as per Division II of Schedule III of the Companies Act 2013.

   A. Statement of Profit and Loss

   B. Trial Balance

   C. Balance sheet

   D. Statement of Changes in Equity

7. As per Division II of Schedule III of the Companies Act 2013, the Statement of Changes of Equity has ----------parts

   A. One

   B. Two

   C. Three

   D. Four

8. Basic EPS and Diluted EPS are the same.

   A. True

   B. False

   C. Cannot say

   D. Not 100% Sure

9. Eps is calculated on the basis of which amount?

   A. Profit as per Statement of Profit or loss

   B. Total Comprehensive Income

   C. Gross Profit

   D. Fixed Assets

10. As per Division II of Schedule III of the Companies Act 2013, the Statement of Financial position is to be prepared.

    A. True

    B. False

    C. Cannot say

    D. Not 100% Sure

[Answer: 1-C; 2-A; 3-D; 4-C; 5-B; 6-B; 7-B; 8-B; 9-A; 10-B]

State True and False:

1. Interest accrued and due should be shown under the head Other Current Liabilities in a Balance Sheet of a Company. (T)
2. Interest on loan is included in 'other operating expenses' under the Statement of Profit and Loss. (F)
3. As per Schedule III of Companies Act 2013, interest received on convertible debentures is shown under Finance Cost in the Statement of Profit and Loss. (F)
4. Part I of Schedule III is related to preparation of Profit and Loss Statement. (F)
5. Interest income in case of a Finance Company is treated as a part of revenue from Operation. (T)
6. Schedule III deals only with presentation and disclosure requirements. (T)
7. The aggregate amount of the balance of 'Reserve and Surplus', is to be shown after adjusting negative balance of surplus/ Loss, if any. (T)
8. 2,00,000 8% Preference Shares of ₹100 each will come under: Equity and Liabilities –Shareholders' funds - Share Capital (Schedule III). (F)

[Answer: True; False; False; False; True; True, False]

Fill in the Blanks:

1. Interest expenses are ______________ costs.
2. Investment of ₹ 45,00,000 in 40,000 12% Debenture of ₹100 each of Amrit Ltd. will come under: Assets - Non-current Assets _________________________.
3. Provision for taxation of ₹88,000 will come under: Equity and Liabilities under ______________ ___________ Short-term Provision.
4. Short-Term Borrowings will include all Loans within a period of _____ months from the date of the loan.
5. Stock-in-Trade (in respect of goods acquired for Trading) are classified as ___________.

[Answer: 1. Finance; 2. Non-current Investments; 3. Current Liabilities; 4. 12; 5. Inventories.]

Short Essay Type Questions:

1. Write short note on: Applicability of various divisions of Schedule III of Companies Act 2013
2. Write short note on: Schedule III disclosure requirement for Trade Receivables
3. Write short note on: Schedule III disclosure requirement for Cash and Cash Equivalent
4. Write short note on: Schedule III disclosure requirement for Trade Payables

B. Numerical Questions

Comprehensive Numerical Problems

1. Elixir Ltd. provides the following Trial Balance as on 31st March 2023:

Particulars	Dr. Balances (₹)	Cr. Balances (₹)
Equity Share Capital: 300000 shares of ₹ 10 each fully paid		30,00,000
12% Bank Loan		2,00,000
Furniture	2,25,000	
Machinery	7,50,000	
Building	12,50,000	
Non-current Investment	2,00,000	
Sales		48,00,000
Sales Return	4,00,000	
Interest Received on Investment		20,000
Interest on Bank Loan	20,000	
Purchase	33,20,000	
Purchase Returns		4,20,000
Opening Stock	2,00,000	
Discount	6,250	
Carriage on Goods Sold	1,39,000	
Rent and Taxes	60,000	
Trade Receivables	12,00,000	
Trade Payables		80,000
Advertisement	1,20,000	
Bad Debt	10,000	
Salaries	4,00,750	
Audit fees	27,000	
Contribution to P. F	60,000	
Cash at Bank and in hand	1,32,000	
Total	85,20,000	85,20,000

Additional Information:

(i) Closing Stock as on 31st March 2023 was ₹ 2,12,500

(ii) Depreciation Rates: Furniture 10%; Machinery 20% and Building 10%

(iii) Outstanding salaries as on 31st march 2023 was ₹ 62,250

(iv) Trade receivables include a sum of ₹25,000 due from Mr. B. Reddy and trade payables include ₹15,000 due to him.

(v) Create a provision for doubtful debt @ 5% on trade receivables.

(vi) Provide for income tax ₹ 80,000

Prepare a Statement of Profit and Loss for the year ended on 31st March 2023 and a Balance Sheet as on that date as per the format provided in Division I of Schedule III.

[Answer: Balance Sheet Total ₹ 35,97,750]

2. ABC Ltd provides the following Trial Balance as on 31st March 2023.

Particulars	Dr. Balances (₹)	Cr. Balances (₹)
Equity Share Capital: 350000 shares of ₹10 each fully paid		35,00,000
10% Debentures		3,00,000
Motor Van	4,00,000	
Machinery	20,00,000	
Land and Building	12,00,000	
12% Long Term Govt. Securities	2,00,000	
Sales		60,00,000
Sales Return	3,00,000	
Interest on Debenture	22,500	
Purchase	36,00,000	
Purchase Returns		4,00,000
Opening Stock	3,00,000	
Discount	7,500	
Carriage Outward	1,50,000	
Rent and Rates	50,000	
Income from Govt. Securities		24,000
Trade Receivables	10,00,000	
Trade Payables		2,00,000
Advertisement	1,50,000	

Particulars	Dr. Balances (₹)	Cr. Balances (₹)
Bad Debt	20,000	
Salaries	6,72,000	
Misc. Expenditure	30,000	
Contribution to P.F and Gratuity Funds	1,00,000	
Cash at Bank and in hand	2,22,000	
Total	1,04,24,000	1,04,24,000

Additional Information:

(i) Closing Stock as on 31st March 2023 was ₹3,50,000

(ii) Depreciation Rates: Motor Vehicle 10%, Machinery 20% and Land & Building 5%

(iii) Misc. expenditure includes ₹20,000 as audit fees.

(iv) Interest on debenture is payable quarterly and the last quarter's interest is yet to be paid.

(v) Trade receivables include a sum of ₹25,000 due from Mr. X who has become insolvent and only 25 paisa in a rupee is expected to be recoverable from him.

(vi) Create a provision for doubtful debt @ 2% on trade receivables.

(vii)Provide for income tax ₹1,50,000

Prepare a Statement of Profit and Loss for the year ended on 31st March 2023 and a Balance Sheet as on that date as per the format provided in Division I of Schedule III.

[Answer: Balance Sheet Total ₹48,04,500]

3. PQR Ltd. was registered with a nominal capital of ₹20,00,000 divided into shares of ₹100 each. The following Trial Balance is extracted from the books on 31st March, 2023:

Particulars	₹	Particulars	₹
Buildings	11,60,000	Sales	20,80,000
Machinery	4,00,000	Outstanding Expenses	8,000
Closing Stock	3,60,000	Provision for Doubtful Debts (1-4-2020)	12,000
Loose Tools	92,000	Equity Share Capital	8,00,000
Purchases (Adjusted)	8,40,000	General Reserve	1,60,000
Salaries	2,40,000	Profit and Loss A/c (1-4-2020)	1,00,000
Directors' Fees	40,000	Creditors	3,68,000
Rent	1,04,000	Provision for depreciation:	
Depreciation	80,000	On Building	2,00,000

Particulars	₹	Particulars	₹
Bad Debts	24,000	On Machinery	2,20,000
Investment	4,80,000	14% Debentures	8,00,000
Interest accrued on investment	8,000	Interest on Debentures accrued but not due	56,000
Debenture Interest	1,12,000	Interest on Investments	48,000
Advance Tax	2,40,000	Unclaimed dividend	20,000
Sundry expenses	72,000		
Debtors	5,00,000		
Bank	1,20,000		
	48,72,000		48,72,000

You are required to prepare statement of Profit and Loss for the year ending 31st March, 2023 and Balance Sheet as per Division I of Schedule III of the Companies Act 2013 as at that date after taking into consideration the following information:

(i) Closing stock is more than opening stock by ₹3,20,000.

(ii) Provide to doubtful debts @ 4% on Debtors.

(iii) Make a provision for income tax @30%.

(iv) Depreciation expense included depreciation of ₹32,000 on Building and that of ₹48,000 on Machinery.

(v) The directors declared a dividend @ 25% and transfer to General Reserve @ 10%.

(vi) Bills Discounted but not yet matured ₹40,000.

[Answer: Balance Sheet total ₹ 29,20,000]

4. The following is the trial balance of Alpha Ltd. as on 31.03.2023:

Particulars	₹	Particulars	₹
Stock in trade on 01.04.22	1,50,000	Purchase returns	20,000
Purchases	4,90,000	Sales	6,80,000
Salaries	60,000	Discount received	6,000
Freight, carriage etc.	1,900	Balance of Profit and Loss (Cr.)	30,000
Furniture	34,000	Share capital (₹10)	2,00,000
Contribution to P.F	10,000	Trade payables	49,000
Rent and Rates	8,000	General reserve	31,000
Stationary	3,800		
Repairs	4,000		
Insurance	6,000		

Particulars	₹	Particulars	₹
Misc. expenses	300		
Interim dividend paid	18,000		
Staff welfare expenses	5,000		
Plant and machinery	58,000		
Cash at bank	92,400		
Patents	9,600		
Trade receivables	65,000		
	10,16,000		10,16,000

You are required to prepare statement of Profit and Loss for the year ending 31st March, 2023 and Balance Sheet as at that date after taking into consideration the following information:

(i) Closing stock as at 31.03.2023 is ₹1,76,000.

(ii) Make a provision for income tax @ 40%.

(iii) Depreciate plant and machinery @ 15%, furniture @ 10% and patents @ 5%.

(iv) Outstanding rent ₹1,600 and outstanding salaries ₹1,800.

(v) The directors recommended a dividend @ 15% after transfer to General Reserve ₹4,000.

(vi) Provide ₹1,020 for doubtful debts.

The authorized capital of the company is ₹4,00,000 divided into 40,000 equity shares of ₹10 each of which 20000 shares have been issued and fully paid up.

[Answer: Balance Sheet Total ₹4,21,400]

Unsolved Cases

1. As per the present regulations in India, financial statements of companies must strictly adhere to the format prescribed in the relevant legislation for being acceptable to regulators as well as to various stakeholders.

   PQR Ltd. registered as a company on 30.06.2020 and commenced operation with effect from 01.04.2019. The authorized capital of the company is 10,00,000 equity shares of ₹10 each. The paid-up capital of the company is, however, 6,00,000 equity shares of ₹10 each.

   On 10.04.2023, the BOD has decided to undertake an expansion programme for which the capital expenditure is estimated at ₹15,00,000. The BOD has decided to apply for an institutional loan to arrange the funds. The lender however, requires the financial statements of the company to be submitted in prescribed format along with the loan application.

   The directors, being novice in this respect, have asked your help as an expert in drafting the financial statements of the company for the financial year 2022-23.

   In this respect, the following information is available.

Particulars	Dr. Balances (₹)	Cr. Balances (₹)
Equity Share Capital: 6,00,000 shares of ₹10 each fully paid		60,00,000
12% Bank Loan		4,00,000
Furniture	4,50,000	
Machinery	15,00,000	
Building	25,00,000	
Non-current Investment	4,00,000	
Sales		96,00,000
Sales Return	8,00,000	
Interest Received on Investment		40,000
Interest on Bank Loan	40,000	
Purchase	66,40,000	
Purchase Returns		8,40,000
Opening Stock	4,00,000	
Discount	12,500	
Carriage on Goods Sold	2,78,000	
Rent and Taxes	1,20,000	
Trade Receivables	24,00,000	
Trade Payables		1,60,000
Advertisement	2,40,000	
Bad Debt	20,000	
Salaries	8,01,500	
Audit fees	54,000	
Contribution to P.F.	1,20,000	
Cash at Bank and in hand	2,64,000	
Total	1,70,40,000	1,70,40,000

Additional Information:

(i) Closing Stock as on 31st March 2023 was ₹4,25,000

(ii) Depreciation Rates: Furniture 10%, Machinery 20% and Building 10%

(iii) Outstanding salaries as on 31st march 2023 was ₹1,24,500

(iv) Trade receivables include a sum of ₹50,000 due from Mr. B. Reddy and trade payables include ₹ 30,000 due to him.

(v) Create a provision for doubtful debt @ 5% on trade receivables.

(vi) Provide for income tax ₹1,60,000

a. You are required to prepare the Notes to Accounts (Employee Benefit Expenses, Finance Cost, Other Expenses and Depreciation) to support preparation of the Statement of Profit and Loss for the year ended on 31.03.2023.

b. You are required to prepare the Statement of Profit and Loss for the year ended on 31.03.2023.

c. You are required to prepare the Notes to Accounts (Fixed Assets and Trade Receivable) to support preparation of the Balance Sheet as on 31.03.2023.

d. You are required to prepare the Balance Sheet as on 31.03.2023.

[Answer: Balance Sheet Total ₹71,95,500]

References

1. Fundamentals of Corporate Accounting by Hanif and Mukherjee; Mc Graw Hill Publications.
2. Corporate Accounting by Mukherjee and Mukherjee; Oxford Publications.
3. The Companies Act, 2013
4. The Companies (Accounts) Rules, 2014

Cash Flow Statement 3

This Module includes:

Cash Flow Statement 3

SLOB Mapped against the Module

To develop detail understanding on preparation of mandatory financial statements by companies (including Banking, Insurance and Electricity companies) in an Ind AS environment. (CMLO 4 c)

Module Learning Objectives:

After studying this module, the students will be able to –

- Understand the meaning of cash flow statement
- Form an idea about the various types of cash flows
- Prepare a Cash Flow Statement under Direct Method as well as Indirect Method
- Know major changes in Ind AS 7, Statement of Cash Flow from AS 3, Cash Flow Statement

Introduction

3

In addition to the Statement of Profit and Loss and Balance Sheet, companies also prepare a Cash Flow Statement as a part of its complete set of financial statements. Cash flow statement is an additional information source to the users of financial statements. This statement exhibits the flow of incoming and outgoing cash and cash equivalents. It assesses the ability of the enterprise to generate and utilize cash. In other words, this statement is an important tool for assessing the liquidity position and the sources of liquidity.

As per SFAS 95, Statement of Cash Flows, issued by Financial Accounting Standards Board (FASB) of USA, 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.

In India, the preparation and presentation of Cash Flow Statements for eligible entities is guided by Ind AS 7, Statement of Cash Flows (and by AS 3 for companies to which Ind AS is still not applicable).

AS 3 - Cash Flow Statements 3.1

3.1.1 Objective of the Standard

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 and the needs of the entity to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation.

Accordingly, 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.

3.1.2 Scope or Applicability

As per AS 3, all AS compliant entities shall prepare a statement of cash flows in accordance with the requirements of this Standard and shall present it as an integral part of its financial statements for each period for which financial statements are presented.

3.1.3 Benefits of Cash Flow Information

A Cash Flow Statement, when used in conjunction with the rest of the financial statements, provides information that enables users to evaluate the changes in net assets of an entity, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the entity to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different entities. It also enhances the comparability of the reporting of operating performance by different entities because it eliminates the effects of using different accounting treatments for the same transactions and events.

Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

3.1.4 Presentation of a Statement of Cash Flows

The statement of cash flows shall report cash flows during the period classified under the following three categories –

a. Cash flow from operating activities;

b. Cash flow from investing activities; and

c. Cash flow from financing activities.

Sum of these three types of cash flows reflects the net change in cash and cash equivalent of the entity.

In this context,

a. Cash shall consist of cash in hand and demand deposits; and

b. Cash equivalent consist of 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.

The following points shall be kept in mind with respect to Cash Equivalents:

1. Cash equivalents are held for the purpose of meeting short-term cash commitments.
2. 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.
3. Equity investments are excluded unless they are, in substance, cash equivalents.
4. 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.
5. 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 1

M Ltd. had a cash balance of ₹1,50,000 as on 30.09.2023. On 15.10.2023, 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 31.12.2023?

Solution:

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.

a. Cash flow from 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:

(i) cash receipts from the sale of goods and the rendering of services;

(ii) cash receipts from royalties, fees, commissions and other revenue;

(iii) cash payments to suppliers for goods and services;

(iv) cash payments to and on behalf of employees;

(v) cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;

(vi) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(vii)cash receipts and payments from contracts held for dealing or trading purposes.

Note: Cash received on account of sale of an item of plant is a cash flow from investing activities.

Again, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial institutions are usually classified as operating activities since they relate to the main revenue-producing activity of that entity.

b. Cash flow from investing activities

The activities of acquisition and disposal of long-term assets and other investments not included in cash and cash equivalents are investing activities. However, only expenditures that result in a recognized asset in the balance sheet are eligible for classification as investing activities. Examples of cash flows arising from investing activities are:

(i) 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;

(ii) cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

(iii) cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);

(iv) cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(v) cash advances and loans made to other parties (other than advances and loans made by a financial enterprise);

(vi) cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial enterprise);

(vii) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(viii) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

c. Cash from financing activities

These are activities that result into change in size and composition of owner's capital and borrowing of the organisation. Accordingly, it includes receipts from issue of shares, bonds and other instruments, borrowing and repayment of loans. Examples of cash flows arising from financing activities are:

(i) cash proceeds from issuing shares or other similar instruments;

(ii) cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings;

(iii) cash repayments of amounts borrowed; and

3.1.5 Reporting of 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.

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:

  (i) changes during the period in inventories and operating receivables and payables;

  (ii) other non-cash items; and

  (iii) 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:

  (i) changes during the period in inventories and operating receivables and payables;

  (ii) non-cash items such as depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses, and undistributed profits of associates; and

  (iii) all other items for which the cash effects are investing or financing cash flows.

  Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the revenues and expenses disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

3.1.6 Reporting of cash flows from investing and financing activities

An entity shall report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities.

Note: However, 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, such as –

  (i) the acceptance and repayment of demand deposits of a bank;

  (ii) funds held for customers by an investment entity; and

  (iii) rents collected on behalf of, and paid over to, the owners of properties.

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

  (i) principal amounts relating to credit card customers;

  (ii) the purchase and sale of investments; and

  (iii) other short-term borrowings, for example, those which have a maturity period of three months or less.

In addition, Cash flows arising from each of the following activities of a financial institution may be reported on a net basis:

(i) cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;

(ii) the placement of deposits with and withdrawal of deposits from other financial institutions; and

(iii) cash advances and loans made to customers and the repayment of those advances and loans.

Illustration 2

Classify the following cash receipts and payments of a furniture company into cash from operating, investing and financing activities:

a. Receipt from sale of furniture
b. Purchases of furniture from various suppliers
c. Wages paid
d. Advertisement expenses paid
e. Credit sales of furniture
f. Misc. charges received from customers for repairs of furniture
g. Warranty claims received from the suppliers
h. Loss due to decrease in market value of the closing stock of furniture
i. Payment to suppliers of furniture
j. Depreciation on furniture of sales showrooms
k. Interest paid on bank loan
l. Profit on sale of equipment, in exchange of new equipment
m. Advance received from customers
n. GST paid
o. Equity dividend paid for the current financial year

Solution:

Classification of cash received and paid

Transaction	Nature of Cash Flow	Inflow/Outflow
a. Receipt from sale of furniture	C/F from operating activities	Inflow
b. Purchases of furniture from various suppliers	C/F from operating activities	Outflow
c. Wages paid	C/F from operating activities	Outflow
d. Advertisement expenses paid	C/F from operating activities	Outflow
e. Credit sales of furniture	Not a cash flow	N. A
f. Misc. charges received from customers for repairs of furniture	C/F from operating activities (supplementary revenue)	Inflow
g. Loss due to decrease in market value of the closing stock of furniture	Not a cash flow	N. A
h. Payment to suppliers of furniture	C/F from operating activities	Outflow
i. Depreciation on furniture of sales showrooms	Not a cash flow	N. A
j. Interest paid on bank loan	C/F from financing activities	Outflow
k. Profit on sale of equipment, in exchange of new equipment	Not a cash flow	N. A
l. Advance received from customers	C/F from operating activities	Inflow
m.GST paid	C/F from operating activities	Outflow
n. Equity dividend paid for the current financial year	C/F from financing activities	Outflow

Illustration 3

Classify the following transactions into cash flow from operating, investing and financing activities in respect of a pharmaceutical company:

a. Issued equity shares

b. Bonus shares issued

c. Right shares issued

d. Purchased 90% shares of subsidiary company

e. Dividend received from subsidiaries

f. Dividend received from investment in other companies

g. Payment of license fees

h. Royalty received from the goods patented

i. Rent received from the letting out of free space

j. Interest received on loans to Y Ltd.

k. Preference Dividend paid

l. Interest paid on security deposits

m. Acquired the assets of a company through issue of equity shares

n. Purchased goodwill

o. Interim dividends paid

p. Sale of investment in subsidiary

Solution:

Classification of cash received and paid

Transaction	Nature of Cash Flow	Inflow/Outflow
a. Issued equity shares	a. C/F from financing activities	Inflow
b. Bonus shares issued	b. Not a Cash flow at all.	N. A
c. Right shares issued	c. C/F from financing activities	Inflow
d. Purchased 90% shares of subsidiary company	d. C/F from investing activities	Outflow
e. Dividend received from subsidiaries	e. C/F from investing activities	Inflow
f. Dividend received from investment in other companies	f. C/F from investing activities	Inflow
g. Payment of license fees	g. C/F from investing activities	Outflow
h. Royalty received from the goods patented	h. C/F from operating activities	Inflow
i. Rent received from the letting out of free space	i. C/F from investing activities	Inflow
j. Interest received on loans to Y Ltd.	j. C/F from investing activities	Inflow
k. Preference Dividend paid	k. C/F from financing activities	Outflow
l. Interest paid on security deposits	l. C/F from financing activities	Outflow

m. Acquired the assets of a company through issue of equity shares	m. No cash flow	N. A
n. Purchased goodwill	n. C/F from investing activities	Outflow
o. Interim dividends paid	o. C/F from financing activities	Outflow
p. Sale of investment in subsidiary	p. C/F from investing activities	Inflow

3.1.7 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. A rate that approximates the actual rate may be used if the result is substantially the same as it would arise if the rates at the dates of the cash flows were used. The effect of changes in exchange rates on cash and cash equivalents held in a foreign currency shall be reported as a separate part of the reconciliation of the changes in cash and cash equivalents during the period.

Illustration 4

On 01.01.2023, P Ltd., an Indian company, bought goods from USA for $1000 to be sold within India. The exchange rate on that date was ₹76 = 1$. On 31.03.2023, the exchange rate moved to ₹78 = 1 $. How will you report the above in the Cash Flow Statement?

Solution:

P Ltd. would account for the purchase of inventory at (1000 x 76) = ₹76,000 on 01.01.2023. On 31.03.23, the payables will be recorded at ₹ (1000 x 78) = ₹78,000 resulting into an unrealised loss of ₹2,000 on exchange fluctuation.

Under Indirect Method of determining Operating Cash Flow, this will be reported as follows:

Profit	(-) ₹2,000
Add: Increase in payables (78,000-76,000)	₹2,000
Net impact on cash flow from operating activities	Nil

3.1.8 Interest and Dividends

Cash flows from interest and dividends received and paid shall each 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.

Illustration 5

X Ltd. provides you the following information of its cash inflow and outflow for the financial year 2022-23:

a. Dividend paid to equity and preference shareholders ₹50,000

b. Interest paid ₹10,000

c. Interest received on loan ₹ 20,000

d. Dividend received from Y Ltd. ₹15,000

How will you classify the above in the Cash Flow Statement of X Ltd. if –

(i) X Ltd. is a financial institution and

(ii) X Ltd. is a manufacturing concern.

Solution:

The treatment of the items has been shown below:

Cash Receipt/ Payment	If X Ltd. is a financial institution	If X Ltd. is a manufacturing concern
Dividend paid to equity and preference shareholders ₹50,000	C/F from financing activities	C/F from financing activities
Interest paid ₹10,000	C/F from operating activities	C/F from financing activities
Interest received on loan ₹ 20,000	C/F from operating activities	C/F from investing activities
Dividend received from Y Ltd. ₹15,000	C/F from operating activities	C/F from investing activities

Illustration 6

B Ltd., a manufacturing concern, invested ₹3,00,000 in a five-year bond with an effective interest rate of 10% for 4 years. It received ₹4,40,000 on maturity. During the four years it recognised the interest income based on the effective interest rate in its income statement. How will you treat the transactions over four years and on maturity?

Solution:

Over the four years lifetime, the company did not receive any cash payment. Hence, nothing will be reflected in the Cash Flow Statement. On maturity, the entire amount of ₹4,40,000 will appear in cash flow from investing activities with appropriate disclosure on the interest and principal part.

3.1.9 Treatment of 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.

Illustration 7

A Ltd. paid an advance tax amounting to ₹3,65,000 out of which ₹15,000 is relating to a short-term capital gain on sale of securities. How will A Ltd. report the payment of advance tax in its Cash Flow Statement?

Solution:

As per Ind AS 7, cash flows arising from taxes on income shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. Thus, in this case, ₹3,50,000 should be treated as operating cash outflow while ₹15,000 should be treated as investing cash outflow.

3.1.10 Investment in subsidiaries, associates and joint ventures

When accounting for an investment in an associate, a joint venture or a subsidiary is accounted for by use of the equity or cost method, an investor restricts its reporting in the statement of cash flows to the cash flows between itself and the investee, for example, to dividends and advances.

The aggregate cash flows arising from acquisitions and from disposal of subsidiaries or other businesses shall be presented separately and classified as investing activities. The entity, in this context, shall disclose

(i) the total purchase or disposal consideration;

(ii) the portion of the consideration consisting of cash and cash equivalents;

3.1.11 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. Such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities. Examples of non-cash transactions are:

(i) the acquisition of assets by assuming directly related liabilities

(ii) the acquisition of an entity by means of an equity issue; and

(iii) the conversion of debt to equity.

3.1.12 Disclosure

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.

An entity shall disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by it. For example, when cash and cash equivalent balances held by a subsidiary that operates in a country where exchange controls or other legal restrictions apply, the balances are not available for general use by the parent or other subsidiaries.

In addition, management shall also disclose additional information regarding –

(i) the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities;

(ii) the aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity;

Cash Flow Statement under AS 3 and Ind as 7 - A Comparative View

3.2

The provisions of AS 3 are largely similar to that of Ind AS 7. However, they differ on the following aspects:

AS 3	Ind AS 7
Existing AS 3 is not mandatory for Small and Medium Sized Companies, as defined in the Notification. However, it encourages such entities to comply with the standard.	Ind AS 7 does not offer any exclusion with regard to its applicability for certain concerns. All Ind AS compliant entities are required to prepare Cash Flow Statement.
Repayment of overdraft as demand is silent in existing AS 3.	Ind AS 7 specifically includes bank overdrafts which are repayable on demand as a part of cash and cash equivalents.
AS 3 uses the term "Reporting Currency"	Ind AS 7 uses the term "functional currency" instead of "Reporting Currency".
AS 3 does not deal with cash flows arising from foreign subsidiaries.	Ind AS 7 deals with translation of cash flows arising from foreign subsidiaries.
AS 3 does not contain any requirement in the treatment of cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale in the ordinary course of business as cash flows from operating activities.	Ind AS 7 requires the treatment of cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale in the ordinary course of business as cash flows from operating activities. Further, treatment of cash receipts from rent and subsequent sale of such assets as cash flow from operating activity is also provided is also provided.
	Ind AS 7 provides some new examples of cash flows from financing activities like: (i) Cash payments to the owners to acquire or redeem entity's shares. (ii) Cash receipts from mortgages (iii) Cash payments made by lessee, for reduction of the outstanding liability, in a finance lease.
AS 3 is silent in adjusting profit or loss for the effects of: undistributed profits of associates, and non-controlling interests.	Under Ind AS 7, the net cash flow from operating activities, using the indirect method, is determined by adjusting profit or loss for the effects of: undistributed profits of associates, and non-controlling interests
AS 3 requires classification under cash flow from investing activities.	Under Ind AS 7, cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control shall be classified as cash flows from financing activities.

AS 3 requires cash flows associated with extraordinary activities to be separately classified as arising from operating, investing and financing activities.	Ind AS 7 does not have any such requirement.
AS 3 does not have any requirements in cash flows arising from changes in ownership interests in a subsidiary.	Ind AS 7 requires to classify cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control as cash flows from financing activities.
AS 3 does not require any disclosures as required in Ind AS 7.	Ind AS 7 requires the following additional disclosures: (i) the amount of cash and cash equivalents in the subsidiaries or other businesses over which control is obtained or lost; and (ii) the amount of the assets and liabilities other than cash or cash equivalents in the subsidiaries or other businesses over which control is obtained or lost, summarised by each major category.

Proforma of Cash Flow Statement under AS 3

3.3

Proforma of Cash Flow Statement under Direct Method

Cash Flow Statement of ____________________ for the period ended on ___

Particulars	₹	₹	₹
A. Cash Flows from Operating Activities:			
Cash receipts from Customers		– –	
Less: Cash paid to Suppliers and Employees and for other expenses		– –	
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 of Fixed assets including Investments		– –	
Less: Purchase of 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.

⦿ **Proforma of Cash Flow Statement under Indirect Method**

Cash Flow Statement of _________for the period ended on ____

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 8:

Name of the Company: MZ Ltd.

Statement of Profit and Loss for the year ended 31st March, 2023

	Particulars	Note No.	As at 31st March, 2023	As at 31st March, 2022
I	REVENUE FROM OPERATION		10,000	
II	OTHER INCOME		1,200	
III	**TOTAL INCOME (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	
	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 FOR THE YEAR FROM CONTINUING OPERATION (IX -X)		800	
XII	Profit (loss) from discontinued operations		-	
XIII	Tax expenses from discontinued operations		-	
XIV	Profit(loss) from discontinued operations (XII-XIII)		-	
XV	PROFIT (LOSS) FOR THE PERIOD (XI + XIV)		800	
	Balance brought forward from previous year		550	
	Profit available for appropriation		1350	
	Appropriation:			
	Dividend paid		450	
	Transfer to General Reserve		250	
	Distribution Tax		-	
	Total		700	
	Balance carried forward		650	
XVI	Earning per equity share:			
	(1) Basic			
	(2) Diluted			

Name of the Company: MZ Ltd.

Balance Sheet as at 31st March, 2023

(₹ in lakhs)

Ref No.		Particulars	Note No.	As at 31st March, 2022	As at 31st March, 2023
I		EQUITY AND LIABILITIES			
	1	Shareholders' Fund			
		(a) Equity Share capital		3,000	4,000
		(b) Reserve and Surplus		1300	1,650
	2	Liabilities			
		Non-current liabilities			
		(a) Long-term borrowings		4,000	6,000
		Current Liabilities			
		(a) Trade payables		4,650	4,200

		(b) Short-term provisions		300	250
		Total		13,250	16,100
II		ASSETS			
	1	Non-current assets			
		(a) Property, Plant and Equipment		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,2022**	**As at 31st March,2023**
Sales (net of Excise Duty)	10,000	
Total	**10,000**	

2. Other Income	**As at 31st March,2022**	**As at 31st March,2023**
Income from Investments	1,200	
Total	**1,200**	

3. Raw Material Consumed	**As at 31st March,2022**	**As at 31st March,2023**
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,2022**	**As at 31st March,2023**
Closing stock	4,000	
Less: Opening Stock	3,000	
Total	**1,000**	

5. Employees Benefits	**As at 31st March,2022**	**As at 31st March,2023**
Salaries and Contribution to Retirement Benefit Schemes	2,500	
Total	**2,500**	

6. Other Equity (Reserve & Surplus)	As at 31st March,2022	As at 31st March,2023
General Reserve	750	1,000
Profit & Loss A/c	550	650
Total	1300	1650

7. Long Term Borrowings	As at 31st March,2022	As at 31st March,2023
Secured Loan	4,000	6,000
Total	**4,000**	**6,000**

8. PPE	As at 31st March,2022	As at 31st March,2023
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,2022	As at 31st March,2023
Advance tax	150	100
	150	100

10. Short Term Provisions	As at 31st March,2022	As at 31st March,2023
Tax Provision	150	100
Other Provisions	150	150
	300	250

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:

1. Cash inflows from sale of goods and services are given by cash sales plus collection from debtors.
2. Cash outflows on account of purchase of materials are given by cash purchases plus payment to creditors.
3. 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
Profit for the year		800
Add: Tax provision		100
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 block the cash flows, whereas decrease in current assets releases cash.

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 outflow 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 9:

Taking the data given in Illustration 8, 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			
Increase in gross block			(2,000)
Purchase of long-term investments			
	31-03-2022	31-03-2023	
	1,000	1,500	
Less: cash equivalents	100	150	
	900	1,350	(450)
			(2,450)
Income from Investments			1,200
			(1,250)

Thus, there were net cash outflows for investing activities.

Illustration 10:

Take the information given in Illustration 8 & 9 (a) and derive cash flow from financing activities:

Cash flows from financial activities	₹ In lakhs
Issue of share	1,000
Loans raised	2,000
Interest	(800)
Dividend paid	(450)
	1,750

Illustration 10 (a):

Use the data given in Illustration 9 & 10(a) and find out change in cash and cash equivalents:

Particulars	31-03-2022	31-03-2023	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 10 (b):

Now using data given in Illustration 8-10(a), prepare a cash flow statements:

Cash Flow Statement	₹ in lakh
Cash flows from operating activities	(550)
Cash flows from investment activities	(1,250)
Cash flows from financing activities	1,750
Decrease in cash and cash equivalents:	(50)

Illustration 11:

The following is the income statement XYZ Company for the year 2022 – 23.

			(₹)
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 amortization		900	
Interest		10,650	
Bad debts		2,050	
Income tax:			
Current	6,600		
Deferred	1,550		
Total expenses		8,150	1,54,650
Net income			14,050

Additional information is:

1. 70% of gross revenue from sales were on credit.
2. Merchandise purchases amounting to ₹ 92,000 were on credit.
3. Salaries payable totalled ₹ 1,600 at the end of the year.
4. Amortisation of premium on bonds payable was ₹1,350.
5. No dividends were received from the other company.
6. XYZ Company declared cash dividend of ₹ 4,000.
7. Changes in Current Assets and Current Liabilities were as follows:

	Increase (Decrease) ₹
Cash	500
Marketable securities	1,600
Accounts receivable	(7,150)
Allowance for bad debt	(1,900)
Inventory	2,700
Prepaid insurance	700
Accounts payable (for merchandise)	5,650
Salaries payable	(2,050)
Dividends payable	(3,000)

Prepare a statement showing the amount of cash flow from operations.

Solution:

Statement showing cash flow from operations

Cash flow from operations	₹	₹
Cash sales (30% 1,62,700)	48,810	
Collection from debtors	1,20,890	
Total cash from operations		1,69,700
Uses of cash from operations		
Payment to suppliers	86,350	
Salaries expense	36,450	
Payment for insurance	1,200	
Research and development	1,250	
Interest payment	12,000	
Income tax payment	6,600	
Total operating cash payment		1,43,850
Net cash flow from operations		25,850

Notes:

(1)

Collection from debtors	**₹**
Credit sales (70% × 1,62,700)	1,13,890
Less: Bad debts (2,050 less 1,900)	150
	1,13,740
Add: decrease in accounts receivables	7,150
Collection from debtors on credit sales	1,20,890

(2) Dividends earned ₹6,000 on equity of ABC Company has not been considered as it has not been received in cash.

(3)

Payment to suppliers	**₹**
Cost of goods sold	89,300
Add: Increase in inventory	2,700
Purchases	92,000
Less: increase in accounts payable	5,650
Payment to suppliers	86,350

(4)

Calculation of salaries payment	**₹**
Salary expense	34,400
Add: decrease in salary payable	2,050
Payment of salaries	36,450

(5)

Insurance payments	**₹**
Insurance	500
Add: increase in prepaid insurance	700
Payment for insurance	1,200

(6)

Interest 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 12

From the information contained in Income Statement and Balance Sheet of 'A' Ltd., prepare Cash Flow Statement:

Income statement for the year ended March 31,2023

		₹
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, 2023		16,38,000

Name of the company: A Ltd.

Balance Sheet as at: 31.03.2023 (₹)

Ref No.		Particulars	Note No.	As at 31.03.23	As at 31.03.22
I		**EQUITY AND LIABILITIES**			
	1	**Shareholders' Fund**			
		(a) Share capital		44,40,000	36,00,000
		(b) Reserve & Surplus		16,38,000	15,18,000
	2	Liability			
		Non-current liabilities		NIL	NIL
		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) Property, Plant and Equipment		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. PPE	**31.03.23**		**31.03.22**	
Land		9,60,000		4,80,000
Building and Equipment	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	**31.03.23**	**31.03.22**
Income Tax Payable	1,32,000	1,20,000
Total	1,32,000	1,20,000

3. Other Current Liabilities	**31.03.23**	**31.03.22**
Outstanding Expenses	4,80,000	2,40,000
Total	4,80,000	2,40,000

4. Short Term Loans and Advances	**31.03.23**	**31.03.22**
Advances	90,000	78,000
Total	90,000	78,000

The original cost of equipment sold during the year 2022-23 was ₹7,20,000.

Solution:

Cash Flow Statement of Company A Ltd. for the year ending March 31,2023

Cash flows from Operating Activities

Particulars	**₹**
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

Particulars	₹
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

Particulars	₹
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

Dr. Building and Equipment Account Cr.

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

Dr. Accumulated Depreciation on Building and Equipment Account Cr.

Particulars	₹	Particulars	₹
To Sale of Asset (Accumulated depreciation)	4,80,000	By Balance b/d	12,00,000
To Balance c/d	13,20,000	By Profit and Loss (Provisional)	6,00,000
	18,00,000		18,00,000

Sale of Asset

Particulars	₹
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 13:

Name of the Company:

Balance Sheet as at 31-12-2022 and 31- 12- 2023

(₹ in thousands)

Ref No.		Particulars	Note No.	31.12.2023	31.12.2022
I		**EQUITY AND LIABILITIES**			
	1	**Equity**			
		(a) Equity Share capital		1,500	1,250
		(b) Reserve & Surplus		3,410	1,380
	2	**Liability**		NIL	
		Non-current liabilities		NIL	
		(a) Long-term borrowings		1,110	1,040
		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) PPE		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	**31.12.2023**	**31.12.2022**
Interest Payable	230	100
Total	230	100

2. Short Term Provision	**31.12.2023**	**31.12.2022**
Income Tax Payable	400	1,000
Total	400	1,000

3. PPE	31.12.2023	31.12.2022
Fixed Assets at cost	2,180	1,910
Less: Accumulated Depreciation	1,450	1,060
Total	730	850

4. Other Current Assets	31.12.2023	31.12.2022
Interest Receivable	100	-
Total	100	-

Statement of profit and Loss for the year ended 31–12–2023

	(₹ 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 and 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)**

Particulars	₹	₹
Cash Flows from Operating Activities:		
Cash receipts from customers	30,150	
Cash paid to suppliers and employees	(27,600)	
Cash generated from operations	2,550	
Income taxes paid	(860)	
Cash flow before extraordinary item:	1,690	
Proceeds from earthquake disaster settlement	180	
Net cash from operating activities (a)		1,870
Cash Flows from Investing Activities:		
Purchase of fixed assets	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividend received	160	
Net cash from investing activities (b)		30
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)

Particulars	₹	₹
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	2023	2022
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

2. Total tax paid during the year (including tax deducted at source on dividends received) amounted to ₹900.

3. Cash receipt from customers

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

4. Cash paid to supplies and employees

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

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

Income tax expenses for the year (including tax)	
deducted at source from dividends received)	300
Add: Income tax liability at the beginning of the year	1,000
	1300
Less: Income tax liability at the end of the year	400
	900

Out of ₹900, tax deducted at source on dividends received (amounting to ₹40) is included in cash flows from investing activities and the balance of 860 is included in cash flows from operating activities.

6. Repayment of long-term borrowing

Long-term debt at the beginning of the year	1,040
Add: Long-term borrowings made during the year	250
	1,290
Less: Long-term borrowings at the end of the year	1,110
	180

7. Interest Paid

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

Illustration 14

Sumangal Ltd. finds on 31st December, 2022 that it is short of funds with which to implement its branch expansion programme. On 1st January, 2022, 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, 2023 has arisen:

Sumangal Ltd.
Figures as per Balance Sheet
(as on 31st December)

	2022 (₹)	2023 (₹)
PPE	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, 2023 before charging depreciation and taxation amounted to ₹2,50,000. The 5,000 shares were issued on 1st January, 2023 at a premium of ₹5 per share. ₹1,37,500 was paid in March 2020 by way of income tax including tax on distribution of dividend. Dividend was paid as follows: for 2023 (final) on the capital on 31-12-2022 @ 10% less tax 25%. For 2023 (interim) 5% on capital on 31st March, 2023 free of tax.

Solution:

Sumangal Ltd.

Cash Flow Statement

For the period 1st January 2022 to 31st December 2022

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 (1)		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 (2021)	(18,750)	
Payment of interim dividend (2022)	(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)

Illustration 15

From the following figures of LK Ltd. prepare a Cash Flow Statement:

Particulars	31.03.2022	31.03.2023
Equity and Liabilities	(₹)	(₹)
Equity Share Capital	12,00,000	16,00,000
10% Preference Share Capital	4,00,000	2,80,000
Capital Reserve		40,000
General Reserve	6,80,000	8,00,000
Profit and Loss Account	2,80,000	4,04,000
9% Debentures	4,00,000	2,80,000
Current Liabilities	4,80,000	5,36,000
Provision for Tax	3,60,000	3,40,000
	38,00,000	42,80,000
Fixed Assets	32,00,000	38,00,000
Less Depreciation	9,20,000	11,60,000
	22,80,000	26,40,000
Investments	4,00,000	3,20,000
Cash	10,000	10,000
Other Current Assets	11,10,000	13,10,000
	38,00,000	42,80,000

Additional information:

1. The company sold one fixed asset for ₹1,00,000 the cost of which was ₹ 2,00,000 and the depreciation provided on it was ₹ 80,000.
2. The company also decided to right off another fixed asset costing ₹ 56,000 on which depreciation amounting to ₹ 40,000 has been provided.
3. Depreciation on fixed assets provided ₹3,60,000.
4. Company sold some investment at a profit of ₹ 40,000, which was credited to Capital Reserve.
5. Debentures and preference share capital where redeemed at 5% premium.
6. Company decided to value stock at cost, whereas previously, the practice was to Value stock at cost less 10%. The stock according to book on 31st March 2022 was ₹ 2,16,000. The stock as on 31st March 2023 was correctly valued at ₹ 3,00,000.

Solution:

NET CASH FROM OPERATING ACTIVITIES:	₹	₹
Cash Flow from Operating Activities Net Profit (Note 1)	1,00,000	
Add: Transfer to General Reserve	1,20,000	
Provision for Tax	3,40,000	
Loss on Sale of Fixed Assets	20,000	
Depreciation	3,60,000	
Loss on Disposal of Fixed Assets	16,000	
Premium on Redemption of Preference Shares	6,000	
Premium on Redemption of Debenture	6,000	
Cash Generated from operation before WC changes	9,68,000	
Increase in other Current Assets	(1,76,000)	
Increase in other Current Liabilities	56,000	
Cash Generated from Operations	8,48,000	
Income Tax paid	(3,60,000)	4,88,000
NET CASH FLOW FROM INVESTING ACTIVITIES:		
Purchase of Fixed Assets	(8,56,000)	
Sale of Fixed Assets	1,00,000	
Sale of Investments	1,20,000	(6,36,000)
NET CASH FLOW FROM FINANCING ACTIVITIES:		
Issue of Share Capital	4,00,000	
Redemption of Pref. Shares including premium	(1,26,000)	
Redemption of Debentures including premium	(1,26,000)	1,48,000
NET INCREASE IN CASH AND CASH EQUIVALENT		Nil
Cash and cash equivalent at the beginning of the period		10,000
Cash and cash equivalent at the end of the period		10,000

Workings:

A. Up to 31.03.2022 company valued stock at cost less 10 %. Revised value of stock on 31.03.2022 will be 2,16,000 x100/90 = 2,40,000.

   Net effect will be –

   1. Opening stock will be increased by ₹ 24,000
   2. Opening balance of P/L A/c will be increased by ₹ 24,000

   Therefore, the revised figure of current assets will be ₹ (11,10,000 + 24,000) = ₹ 11,34,000 The revised figure of P/L A/c will be = ₹ (2,80,000 + 24,000) = ₹ 3,04,000

   Net profit for the year 2022-23: ₹ 4,04,000 – ₹ 3,04,000 = ₹ 1,00,000

B. Increase in the value of other CA: ₹13,10,000 – ₹11,34,000 = ₹ 1,76,000

Dr. **Fixed Assets Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	32,00,000	By Asset Disposal A/c	2,00,000
To Bank A/c(bal fig)	8,56,000	By Asset discarded A/c	56,000
		By Balance c/d	38,00,000
	40,56,000		40,56,000

Dr. **Accumulated Depreciation Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Asset Disposal A/c	80,000	By Balance b/d	9,20,000
To Asset Discarded A/c	40,000	By Depreciation A/c	3,60,000
To Balance c/d	11,60,000		
	12,80,000		12,80,000

Dr. **Asset Disposal Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Fixed Assets A/c	2,00,000	By Accumulated Depreciation A/c	80,000
		By Bank A/c	1,00,000
		By Loss on Sale A/c (bal fig)	20,000
	2,00,000		2,00,000

Dr. **Asset Discarded Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Fixed Assets A/c	56,000	By Accumulated Depreciation A/c	40,000
		By Loss on Disposal A/c	16,000
	56,000		56,000

Solved Case Study

Given below is the Statement of Profit and Loss Account of ABC Ltd. and relevant Balance Sheet information:

Statement of Profit and Loss for the year ended 31st March, 2023 **(₹ in lakhs)**

	Particulars	Note No.	As at 31st March, 2023	As at 31st March, 2022
I	Revenue from Operation		4,150	
II	Other Income		100	
III	**TOTAL INCOME (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
	(h) Other expenses		200	
	TOTAL EXPENSES		3,540	
V	PROFIT BEFORE EXCEPTIONAL ITEMS AND TAX (III-IV)		710	
VI	EXCEPTIONAL ITEMS		-	
VII	PROFIT BEFORE TAX FROM CONTINUING OPERATIONS (V-VI)		710	
VIII	Tax expenses:			
	(1) Current Tax		200	
	(2) deferred tax		-	
IX	PROFIT FOR THE YEAR FROM CONTINUING OPERATION (VII – VIII)		510	
X	Profit (loss) from discontinued operations			
XI	Tax expenses from discontinued operations			
XII	Profit(loss) from discontinued operations (after tax) (XII-XIII)			
XIII	PROFIT (LOSS) FOR THE PERIOD (XI+XIV)			
XIV	Other Comprehensive Income		--	
XV	Total Comprehensive Income (XIII + XIV)		510	
XVI	Earning per equity share:			
	(1) Basic			
	(2) Diluted			
	Balance brought forward from previous year		50	
	Profit available for appropriation		560	
	Appropriation:			
	Dividend		300	
	Transfer to General Reserve		200	
	Total		500	
	Balance carried forward		60	

Notes on Accounts

(₹ in lakhs)

1. Revenue from operation	**As at 31st March,2023**	**As at 31st March,2022**
Sales (net of Excise Duty)	4,150	
Total	4,150	

2. Other Income	As at 31st March,2023	As at 31st March,2022
Interest and Dividend	100	
Total	100	

3. Employees Cost/ Benefits Expenses	As at 31st March,2023	As at 31st March,2022
Wages and Salaries	800	
Total	800	

4. Finance Expenses	As at 31st March,2023	As at 31st March,2022
Interest	60	
Total	60	

Relevant Balance Sheet information	31-03-2023 (₹ in lakhs)	31-03-2022 (₹ 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

Prepare the Cash Flow from Operating Activities of the company under (a) Direct Method and (b) Indirect Method.

Solution:

Cash Flow from Operating Activities (Direct Method)

Particulars	₹ in lakhs
Cash Receipts (a)	
Cash sales & Collection from debtors	
Sales + Opening Debtors – Closing Debtors (4,150 + 250-400)	4,000
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

Cash Flow from Operating Activities (Indirect Method)

Particulars	₹ in lakhs
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 17

The comparative balance sheets of a company are given below:

Liabilities	2022	2023	Assets	2022	2023
Share Capital	35,000	52,000	Cash at bank	5500	18,900
12%Debentures	7000	3000	Book debts	7450	8850
Creditors	5180	5920	Stocks	24600	21,350
Provision for doubtful Debts	350	400	Land	10000	15,000
Profit and loss A/C	5020	5280	Goodwill	5000	2500
	52,550	**66,600**		**52,550**	**66,600**

Additional Information

i. Dividends paid amounted to 1,750

ii. Land was purchased for 5,000 and amount provided for the amortization of goodwill amounted to ₹ 2,500.

iii. Debentures were repaid to the extent of 4,000.

You are required to prepare Cash flow statement as per AS-3 (Indirect Method)

Solution:

Land A/C

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	10,000	By balance	15,000

Particulars	Amount (₹)	Particulars	Amount (₹)
To cash (Purchase)	5,000		
	15,000		**15,000**

Good will A/C

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	5,000	By P/L a/c	2,500
		By balance c/d	2,500
	5,000		**5,000**

Share Capital A/C

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance c/d	52,000	To balance b/d	35,000
		By Cash	17,000
	52,000		**52,000**

Debentures

Particulars	Amount (₹)	Particulars	Amount (₹)
To Cash	4,000	To balance b/d	7,000
To balance c/d	3,000		
	7,000		**7,000**

Cash Flow Statement (Indirect Method)

I. Cash Flow from Operating Activities	
Net Profit before Tax (5280-5020)	260
Add: Non-Cash and Non-Operating items	
Goodwill written off	2,500
Dividend paid	1,750
Less: Non-Cash and Non-Operating Income	
Operating profit before Working Capital Changes	4,510

Add: Decrease in stock 3,250 Increase in creditors 740 Increase in provision for bad debts 50 Less: Increase in book debts 1,400		2,640
Net Cash from Operating Activities		7,150
II. Cash flow from the Investing activities		
Purchase of Land		(5,000)
Net cash from investing activities		(5,000)
III. Net Cash from Financing activities		
Issue of Shares		17,000
Repayment of Debentures		(4,000)
Dividend Paid		(1,750)
Net Cash from Financing Activities		11,250
Net Increase in cash and cash equivalents		13,400
Add: Opening Cash and Cash Equivalents		5,500
Cash and Cash Equivalents at the end		18,900

Illustration 18

The comparative balance sheets of KZ company are given below:

Liabilities	2022	2023	Assets	2022	2023
Share Capital	200,000	250,000	Building	220,000	160,000
General Reserve	50,000	60,000	Machinery	150,000	169,000
Long-term Loan	150,000	------	Stock	150,000	75,000
Creditors	120,000	100,400	Debtors	50,000	54,200
Profit and loss A/C	30,500	30,600	Cash at bank	500	26,800
Provision for taxation	20,000	49,000	Goodwill		5000
	570,500	**490,000**		**570,500**	**490,000**

Additional Information

1. During the year ended 31/03/2023, a dividend of 23,000 was paid
2. Assets were purchased for 45,000 payable in shares of KZ company Ltd.

   The assets were :

   Stock - 20,000

   Machinery - 25,000

3. Further purchase of machinery for cash 10,000
4. Machinery is depreciated by 15,900
5. There was loss on sale of machinery 3,500 which was written off to general reserve

You are required to prepare Cash flow statement as per AS-3(Indirect Method)

(**Hint:** Tax paid during the year 25,000; Sale of machinery 1,000)

Solution

Buildings A/C

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	2,20,000	By Cash	60,000
		To balance c/d	1,60,000
	2,20,000		**2,20,000**

Machinery A/C

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	1,50,000	By depreciation	15,900
To Cash	14,400	By general reserve	3,500
To Share Capital	25,000	By Cash	1,000
		By balance c/ d	1,69,000
	1,89,400		**1,89,400**

Goodwill A/C

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	---------		
To Cash	5,000	By balance c/d	5,000
	5,000		**5,000**

Stock A/C

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	150,000	By decrease	95,000
To Equity Share Capital	20,000	By balance c/d	75,000
	170,000		**170,000**

Share Capital A/C

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance c/d	250,000	By balance b/d	200,000
		By stock	20,000
		By machinery	25,000
		By cash	5,000
	250,000		**250,000**

General Reserve A/C

Particulars	Amount (₹)	Particulars	Amount (₹)
To machinery	3500	By balance b/d	50,000
To balance c/d	60,000	By P/L A/C	13,500
	63,500		**63,500**

Long –Term Loan A/C

Particulars	Amount (₹)	Particulars	Amount (₹)
To cash	150,000	By balance b/d	150,000
To balance c/d	------		
	150,000		**150,000**

Provision for Taxation A/C

Particulars	Amount (₹)	Particulars	Amount (₹)
To cash	25,000	By balance b/d	20,000
To balance c/d	49,000	BY P/L A/C	54,000
	74,000		**74,000**

Cash Flow Statement (Indirect Method)

I. Cash Flow from Operating Activities	
Net Profit before Tax	100
Add: Non-Cash and Non-Operating items	
Depreciation on Machinery	15,900
Provision for taxation	54,000
Amount to General Reserve	13,500

Dividend		23,000
		106,500
Less: Non-Cash and Non-Operating Income		Nil
Operating profit before Working Capital Changes		106,500
Add: Decrease in stock	95,000	
Less: Decrease in Creditors	19,600	
Less: Increase in Debtors	4,200	71,200
Cash Generated from Operation		1,77,700
Less: income Tax Paid		25,000
Net Cash from Operating Activities		1,52,700
II. Cash flow from the Investing activities		
Sale of building		60,000
Sale of machinery		1,000
Payment to Goodwill		(5,000)
Purchase of Machinery		(14,400)
Net Cash flow from the Investing activities		41,600
III. Net Cash from Financing activities		
Issue of Shares		5,000
Repayment of Long-term Loan		(1,50,000)
Dividend Paid		(23,000)
Net Cash from Financing Activities		(1,68,000)
Net Increase in cash and cash equivalents		26,300
Add: Opening Cash and Cash Equivalents		500
Cash and Cash Equivalents at the end		26,800

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. Which of the following items would be subtracted from net income when using the indirect method of calculating cash flows provided by operating activities?

    A. Depreciation expense

    B. Repayment of bonds payable

    C. A gain on the sale of land

    D. A loss on the sale of equipment

2. Which of the following would be considered a cash-flow item from a “financing” activity?

    A. A cash outflow to the government for taxes

    B. A cash outflow to repurchase the firm’s own common stock

    C. A cash outflow to lenders as interest

    D. A cash outflow to purchase bonds issued by another company

3. The method for presenting Net cash provided by operating activities that starts with net income and adjusts it for items that affected reported net income but that did not affect cash is called as ________.

    A. Direct method

    B. Working capital method

    C. Indirect method

    D. Cost-benefit method

4. Under which activities cash paid for preferred stock dividends should be shown on the statement of cash flows?

    A. Investing activities

    B. Financing activities

    C. Noncash investing and financing activities

    D. Operating activities

5. Which of the following would not be considered a cash flow from “operating” activities?

    A. Payments for the inventory

    B. Collection from customers

    C. Tax payments

    D. Payment of debt principle

6. Under which of the following, a business must generate positive net cash flow for it to survive in the long run?

   A. Investing activities

   B. Financing activities

   C. Operating activities

   D. Non cash activities

7. Depreciation is added back to profit when arriving at the cash flow from operating activities as_______.

   A. Depreciation is a non-cash expenditure

   B. Depreciation does not affect profit

   C. Depreciation only affects the balance sheet, not the profit and loss account

   D. None of Above

8. Which of the following would not represent the cash outflows for the business?

   A. Purchase of building for cash

   B. The sale of land for cash

   C. Retirement of long-term debt

   D. The payment of cash for dividends

9. The statement of cash flows does not include cash inflows and outflows for which of the following activities?

   A. Financing activities

   B. Investing activities

   C. Operating activities

   D. Revenue activities

10. Sale of copyright is concerned with cash flow from _________.

    A. Operating activities

    B. Financing activities

    C. Investing activities

    D. Revenue activities

[Answer: 1-C; 2-B; 3-C; 4-B; 5-D; 6-C; 7-A; 8-B; 9-D; 10-C]

State True or False

1. Dividend received by enterprise other than financial enterprise is shown as cash flow from investing activity.
2. Cash collection from customer is shown as a part of calculation of cash flow from operating activities under direct method.
3. Increase in the amount of bills receivable amounts to increase in cash flow from operating activities.
4. Payment of income tax is classified under cash flow from financing activity.
5. Interest paid by an investment company will come under cash flow from operating activity.

[Answer: False; True; False; False; True]

Fill in the blanks:

1. For a finance company interest income is a Cash Flow from __________.
2. Investing and financing transactions that__________require the use of cash or cash equivalents shall be excluded from a statement of cash flows.
3. Income from dividend and interest is a part of ___________.
4. For a company other than a finance company payment of interest is a ____________ activity.
5. _____________ 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: Operating Activity; do not; Investing Activity; Financing; Cash equivalents]

Short Essay Type Questions

1. State the benefits of cash flow information.
2. How will you treat interest and dividend in cash flow statement?
3. How will you treat taxes on income in cash flow statement?
4. How will you treat foreign currency cash flow in cash flow statement?

Essay Type Questions

1. State the difference between Ind AS 7 and AS 3 with respect to preparation and presentation of cash flow statement.
2. State the disclosure requirements of Ind AS 7.

B. Practical Questions

Numerical Multiple-Choice Questions

1. Net profit for the year ₹15,000, interest received in advance on 1st January 2023 ₹2,000 and 31st December 2023 ₹3,000, cash from operation will be –

   A. ₹16,000

   B. ₹22,000

   C. ₹13,000

   D. ₹15,000

2. X Ltd. purchased machinery of ₹10,00,000 issuing a cheque of ₹2,50,000 and 105 Debentures of ₹7,50,000. In the cash flow statement, the transaction will be shown as _________________.

   A. Outflow under investing activity ₹10,00,000, inflow under financing activity as receipt for debentures ₹7,50,000

   B. Outflow under investing activity ₹2,50,000

   C. Inflow of ₹7,50,000 as financing activity.

   D. None of the above

3. Given salary expenses ₹40,000, Outstanding in the beginning of the year ₹5,000 and outstanding at the end of the year ₹10,000. Cash outflow on salary will be _________________.

   A. ₹55,000

   B. ₹45,000

   C. ₹35,000

   D. ₹15,000

4. If the net profits earned during the year is ₹50,000 and the amount of debtors in the beginning and end of the year is ₹10,000 and ₹20,000 respectively, then the cash from operating activities will be equal to _____________________.

   A. ₹30,000

   B. ₹40,000

   C. ₹50,000

   D. ₹60,000

5. If the net profits earned during the year is ₹50,000 and the bills receivables have decreased by ₹10,000 during the year then the cash flow from operating activities will be equal to __________________.

   A. ₹30,000

   B. ₹40,000

   C. ₹50,000

   D. ₹60,000

[Answer: 1-A; 2-B; 3-C; 4-B; 5-B]

Comprehensive Numerical Problems

1. From the following information provided, prepare a Cash Flow Statement of XYZ Ltd. as per Ind AS-7.

Balance Sheet of XYZ Ltd.

		Particulars	Note No.	As on 31.03.23	As on 31.03.22
I		Assets			
	1.	Non-current Assets			
		(a) PPE	2	704000	648000
		(b) Non-current Investment		296000	440000
	2.	Current Assets			
		(a) Inventories		424000	328000
		(b)Trade Receivables		172000	268000
		(c)Cash and Cash Equivalent		360000	360000
		(d)Short term loan and advances (Prepaid Expenses)		8000	4000
				1964000	2048000
II		Equity and Liabilities			
	1.	Equity			
		(a) Share Capital		920000	920000
		(b) Other Equity	1	332000	304000
	2.	Liability		Nil	Nil
		Non-Current Liability			
		(a) Long Term Borrowings (10% debentures)		280000	360000
		Current Liabilities			
		(a) Trade Payables		384000	412000
		(b) Short term Provisions (Provision for Tax)		48000	52000
		Total		1964000	2048000

Notes to Accounts:

	1.	Reserve & Surplus	As on 31.03.23	As on 31.03.22
		Balance of Profit	92000	64000
		General Reserve	240000	240000
			332000	304000
	2.	PPE		
	(a)	Land	600000	600000
		Machinery (Gross Block)	280000	208000
		Provision for depreciation	176000	160000
	(b)	Machinery (Net Block)	104000	48000
		(a)+(b)	704000	648000

Additional information:

(i) 10% dividend was paid during the year.

(ii) Machinery for ₹ 12,000 was purchased and old machinery costing ₹ 48,000 (accumulated depreciation ₹ 24,000) was sold for ₹ 16,000.

(iii) ₹ 80,000, 8% debentures were redeemed by purchase from open market at ₹96 for a Debenture of ₹100.

(iv) Investments worth ₹1,44,000 were sold at a loss of ₹4,000.

(v) Actual income tax liability for the year amounted to ₹40,000.

[Answer: C/F from Operating activities ₹1,68,800; Investing activities ₹ 36,000; Financing activities ₹ (2,04,800)]

2. The following are the summarized Balance Sheets of ABC Limited as on 31st March 2022 and 2023:

Liabilities	31.3.22 (₹)	31.3.23 (₹)	Assets	31.3.22 (₹)	31.3.23 (₹)
Share Capital	4,60,000	4,60,000	Land & Building	3,00,000	3,00,000
Profit & Loss Balance	32,000	46,000	Machinery	1,04,000	1,40,000
Reserve	1,20,000	1,20,000	Investments	2,20,000	1,48,000
8% Debentures	1,80,000	1,40,000	Stock	1,64,000	2,12,000
Depreciation Fund	80,000	88,000	Debtors	1,34,000	86,000
Creditors	2,06,000	1,92,000	Cash	1,80,000	1,80,000
Outstanding expenses	26,000	24,000	Prepaid expenses	2,000	4,000
	11,04,000	10,70,000		11,04,000	10,70,000

Additional Information:

(1) 10% Dividend was paid during the year.

(2) Old Machinery costing ₹24,000 (accumulated depreciation ₹ 12,000) was sold for ₹ 8,000.

(3) 40,000 8% Debenture were redeemed by purchase from open market at ₹ 96 for a debenture of ₹ 100 on 31.03.2023.

(4) Investments worth ₹ 72,000 were sold at book value.

(5) Bad debt written off during the year ₹ 10,000.

Prepare a Statement of Cash flow for the year ended 31.03.23.

[Answer: C/F from Operating activities ₹78,800; Investing activities ₹20,000; Financing activities ₹ (98,800)]

3. On the basis of the following information provided by X Ltd. prepare a Cash Flow Statement for the year ended on 31st March 2023.

(i) X Ltd. sold all the goods for cash only and purchased the goods in credit only.

(ii) The company earned a Gross Profit of ₹4,00,000 with a Gross Profit Ratio of 25%.

(iii) The closing inventory was higher than the opening inventory by ₹20,000.

(iv) The company paid ₹4,50,000 as wages and ₹90,000 as office expenses during the year.

(v) Balance of Suppliers accounts on 31.03.2022 were higher than the balance on 31.03.2023 by ₹30,000.

(vi) Tax paid by the company amounts to ₹80,000 while provision for taxation was ₹70,000.

(vii) The company repaid bank loan of ₹1,75,000 which included interest of ₹15,000.

(viii)Dividend paid during the year ₹50,000 (including dividend distribution tax).

(ix) X Ltd. sold investments of ₹6,00,000 at a profit of ₹40,000.

(x) Depreciation charged on fixed assets ₹1,20,000.

(xi) Furniture purchased during the year ₹2,00,000.

(xii) Cash and Cash Equivalents as on 31.03.2022 was ₹1,00,000.

(xiii)Cash and Cash Equivalents as on 31.03.2023 was ₹4,95,000.

[Answer: C/F from Operating activities ₹1,80,000; Investing activities ₹4,40,000; Financing activities ₹ (2,25,000)]

4. Following are the summarized Balance Sheets of Beta Ltd.

Liabilities	31.03.22	31.03.23	Assets	31.03.2022	31.03.2023
Equity Share Capital (₹ 10)	4,00,000	5,00,000	Land and Building	4,00,000	3,80,000
General Reserve	1,00,000	1,20,000	Plant and Machinery	3,00,000	3,38,000
Profit and Loss (Cr.)	61,000	61,200	Inventory	2,00,000	1,48,000
Bank Loan	1,40,000	------	Trade Receivable	1,60,000	1,28,400
Trade Payable	3,00,000	2,70,400	Cash in hand	1,000	1,200
Provision for Taxation	60,000	70,000	Cash at Bank	----	16,000
			Goodwill	-----	10,000
	10,61,000	10,21,600		10,61,000	10,21,600

Additional Information:

(i) Dividend paid during the year ₹46,000.

(ii) Net profit for the year ₹1,32,200.

(iii) Depreciation written off on building ₹20,000 and on machinery ₹28,000.

(iv) Income tax paid during the year ₹56,000.

(v) The following assets of another company were purchased for a consideration of ₹1,00,000 and paid in shares. Assets were: Inventory ₹40,000 and Machinery ₹50,000.

(vi) Further machinery was purchased for ₹50,000 during the year.

You are required to prepare a Cash Flow Statement as per Ind AS 7.

[Answer: C/F from Operating activities ₹2,18,200; Investing activities ₹(16,000); Financing activities ₹ (1,86,000)]

5. The following figures have been extracted from the books of M Limited for the year ended on 31.3.2023. You. are required to prepare a Cash Flow Statement.

(i) Net profit, before adjusting income tax but after taking into account the following items, was ₹10 lakhs.

- Depreciation on Assets ₹2,50,000.
- Discount on issue of Debentures written off ₹15,000.
- Interest on Debentures paid ₹1,75,000.
- Book value of investments ₹1,50,000 (Sold for ₹1,60,000).
- Interest received on investments ₹30,000.

(ii) Income tax paid during the year ₹4,80,000.

(iii) 7,500 10% preference shares of ₹100 each were redeemed on 31.3.2023 at a premium of 5%. Further the company issued 25,000 equity shares of ₹10 each at a premium of 20% on 2.4.2020. Dividend on preference shares were paid at the time of redemption.

(iv) Dividends paid for the year 2021-22 ₹2,50,000 and interim dividend paid ₹ 1,50,000 for the year 2022-23.

(v) Land was purchased on 2.4.2020 for ₹ 1,20,000 for which the company issued 10,000 equity shares of ₹10 each at a premium of 20% to the land owner as consideration.

(vi) Current assets and liabilities were as follows:

Particulars	31.03.2022 (₹)	31.03.2023 (₹)
Stock	6,00,000	6,59,000
Sundry Debtors	1,04,000	1,06,550
Cash in hand	98,150	17,650
Bills Receivable	25,000	20,000
Bills Payable	22,500	20,000
Sundry Creditors	83,000	85,650
Outstanding expenses	37,500	40,900

[Answer: C/F from Operating activities ₹8,67,000; Investing activities ₹1,90,000; Financing activities ₹ (11,37,500)]

Unsolved Case

1. Balance Sheet of Y Ltd. as on 31.03.2023 and 31.03.2022 [Figures in ₹ '000]

(₹ in '000)

Particulars	Notes No.	31.03.2023	31.03.2022
I. ASSETS			
1. Non-Current Assets			

(a) Property, Plant and Equipment	4	5,100	5,200
2. Current Assets			
(a) Inventory		1,400	1,550
(b) Trade Receivables		800	650
(c) Cash and Cash Equivalent		400	600
(d) Other Current Assets	5	65	80
TOTAL		7,765	8,080
II. EQUITY AND LIABILITIES			
1. Equity			
(a) Equity Share Capital (₹10 each fully paid)		4,300	4,000
(b) Other Equity	1	640	980
2. Liabilities			
Non-Current Liabilities			
(a) Long-term Borrowing	2	2,050	2,200
Current Liabilities			
(a) Trade Payables		650	800
(b) Short-term Provision	3	125	100
TOTAL		7,765	8,080

Notes to the Financial Statements (₹'000)

Particulars	31.03.2023	31.03.2022
1. Reserve & Surplus		
(a) Profit and Loss	640	980
2. Long-term Borrowings		
(a) 10% Debentures	2,050	2,200
3. Short-term Provision		
(a) Provision for Taxation	125	100
4. Property, Plant and Equipment		
(a) Building	1,900	2,000
(b) Machinery	1,700	1,400
(c) Land	1,500	1,800
	5,100	5,200
5. Other Current Asset		
(a) Prepaid Expenses	65	80

The accountant of Y Ltd. has finalized the accounts and prepared its Balance Sheet with supporting Notes given above. In addition, he has the following information.

1. Dividend paid during the year ₹4,50,000.

2. Land was sold for cash at a profit of ₹50,000.

3. Machinery costing ₹2,00,000 (W.D.V. ₹40,000) was sold for ₹30,000. Also costing ₹6,00,000 was purchased.

4. Amount transferred to provision for taxation during the year ₹1,60,000.

5. Depreciation Funds as on 31.3.2022 and 31.3.2023 on Building were ₹5,00,000 and ₹6,00,000 and on Machinery were ₹2,00,000 and ₹3,00,000.

Assist him in preparing a Cash Flow Statement for the year ended 31.03.2023 as per Ind AS 7.

[Answer: C/F from Operating activities ₹5,40,000; Investing activities ₹(2,20,000); Financing activities ₹(5,20,000)]

References

1. Fundamentals of Corporate Accounting by Hanif and Mukherjee; Mc Graw Hill Publications.
2. Corporate Accounting by Mukherjee and Mukherjee; Oxford Publications.
3. The Companies Act, 2013
4. The Companies (Accounts) Rules, 2014
5. Accounting Standard 3, Cash Flow Statement notified by MCA, India
6. Ind AS 7, Statement of Cash Flow notified by MCA, India

Accounts of Banking, Electricity and Insurance Companies

4

This Module includes:

Accounts of Banking, Electricity and Insurance Companies

SLOB Mapped against the Module

To develop detail understanding on preparation of mandatory financial statements by companies (including Banking, Insurance and Electricity companies) in an Ind AS environment. (CMLO 4 c)

Module Learning Objectives:

After studying this module, the students will be able to –

- Understand the form and contents of financial statements and other accounting issues of Banking Companies.
- Understand the form and contents of financial statements and other accounting issues of Electricity Companies.
- Understand the form and contents of financial statements and other accounting issues of Insurance Companies.

Introduction

4

In India, maintenance of accounts and preparation of financial statements of a company is primarily governed by the provisions Companies Act, 2013 and associated Company Rules. However, there are a few special categories of companies which are additionally governed by some special Acts other than the Companies Act, 2013. Some examples include banking companies governed by the Banking Regulation Act, 1949, electricity companies are governed by the Electricity Act, 2003 and insurance companies are governed by the Insurance Act, 1938. In addition to administrative requirements, these Acts provide definite provisions relating to maintenance of accounts and preparation of financial statements of these companies. Therefore, these aspects need separate and special discussion.

Accounts of Banking Companies

4.1

Application of Indian Accounting Standards With respect to the Banking Companies (Relevant Status is reproduced below).

On 1st April 2019 - Mandatory Basis — (It stands deferred till further notice)

(a) Scheduled commercial Banks, excluding RRBs

(b) India term-lending refinancing institution i.e. Exim bank, NABARD etc. (c) Holding, subsidiary, joint venture or associate companies of scheduled commercial banks

Therefore following are the important Final Accounts of Banking Companies as per Banking Regulation Act 1949 and its latest Amendments and Reserve Bank of India's Circulars including Banking Regulation (Amendment) Act 2020 and Companies Act 2013.

1. Balance Sheet
2. Profit and Loss Account

In an economy, banks play an important role in channelizing the savings of surplus generating units (i.e., households) into investments by deficit generating units (i.e., businesses). These financial institutions manage and maintain the flow of money in the economy and further assist in payment and settlements through various services. In short, today banks are the key to an efficient economic system.

4.1.1 Some Preliminary Concepts and Provisions

- **Meaning of Banking**

  According to Section 5(b) of the Banking Regulation Act, 1949, 'banking' means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise.

- **Meaning of Banking Companies**

  According to Section 5(c) of the Banking Regulation Act, 1949, a 'banking company' means any company which transacts the business of banking in India.

  As per the Explanation to Section 5(c) as above, any company which is engaged in the manufacture of goods or carries on any trade and which accepts 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.

- **Types of Banks in India**

The banking structure in India has many layers and sub-layers as follows:

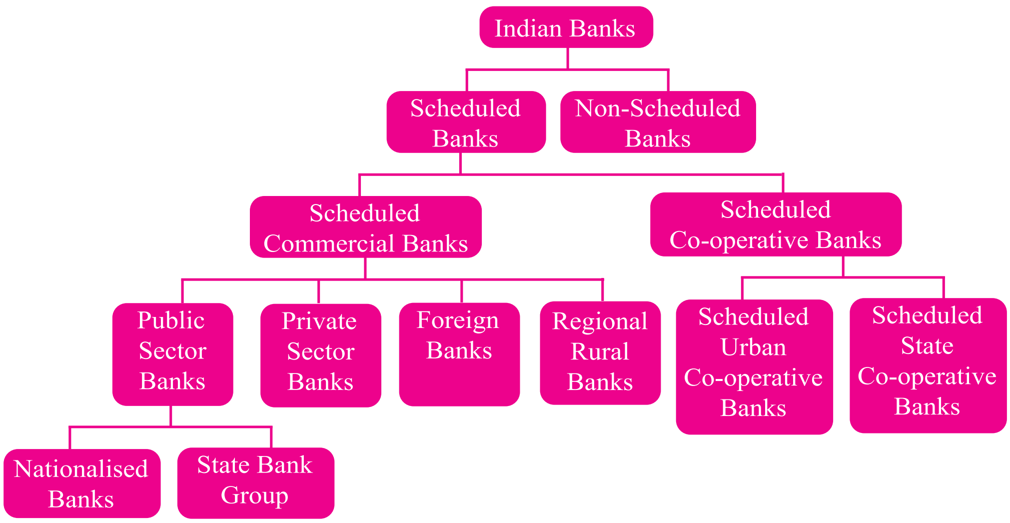

Figure 4.1: Banking Structure in India

Thus, in India, banks are broadly classified as Scheduled and Non-scheduled Banks. Scheduled Banks are those banks which are listed in Schedule II of RBI Act, 1934. In other words, the banks which follow the guidelines of the Schedule II of RBI Act, 1934 are known as Scheduled Banks. The bank's paid-up capital and raised funds must be at least ₹5 to qualify as a scheduled bank. Scheduled banks are liable for low-interest loans from the Reserve Bank of India and membership in clearinghouses. On the other hand, the banks which are not listed in the Schedule II of RBI Act, 1934, is called Non-scheduled banks. These banks are not allowed to deal in foreign exchange. Non- scheduled banks are also known as Local Area Bank although there are only four local area banks in India.

Scheduled banks are further classified into Commercial Banks and Co-operative Banks. The Commercial Banks are those financial institutions which accept deposit and provide services like loans, credit, opening bank accounts, locker facilities, foreign exchange and other digital services like mobile banking, Internet Banking, NEFT, RTGS etc. These are mainly profit-oriented organisations. Co-operative Banks are small scale banking institutions run on no profit no loss basis for mutual cooperation and help.

Scheduled commercial banks include public sector banks (i.e., SBI group banks and other nationalized banks), private sector banks, foreign banks (which are incorporated in a foreign country) and regional rural banks (operating at the regional area to facilitate backward people in society).

In addition, the Reserve Bank of India, acts as the supervisor of the banking institutions and money market regulator.

- **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; Undertaking the administration of estates as executor, trustee or otherwise;

i. 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 dependents 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;

j. The acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purposes of the company;

k. 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;

l. 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;

m. Doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;

n. 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 realization 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.

- **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 capitalized 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 capitalized 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 RBI from 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.

- **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.

- **Accounts and Balance Sheet (Section 29)**

  At the expiration of each calendar year or at the expiration of a period of twelve months ending with such date as the Central Government may, by notification in the Official Gazette, specify in this behalf, every banking company incorporated in India, in respect of all business transacted by it, and every banking company incorporated outside India, in respect of all business transacted through its branches in India, shall prepare with reference to that year or period, as the case may be, a balance-sheet and profit and loss account as on the last working day of that year or the period, as the case may be in the Forms set out in the Third Schedule or as near thereto as circumstances admit.

  The balance sheet and profit and loss account shall be signed by the manager or the principal officer of the company and where there are more than three directors of the company, by at least three of those directors, or where there are not more than three directors, by all the directors in case of a banking company incorporated in India. In the case of a banking company incorporated outside India the same must be signed by the manager or agent of the principal office of the company in India. The disclosure shall be done as per the provisions of the Master Circular issued by RBI.

4.1.2 Accounting in Banking Companies

- **A Bank's Book Keeping System**

  Under bank's Book keeping 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 summarized 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 cleric al 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 c ash-one debit voucher and another credit voucher.

Books of Accounts

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 specialized 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:

1. Principal Books of Accounts

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

2. Subsidiary Books

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

3. Subsidiary Registers

Subsidiary registers are kept for various types of transactions.

a. Demand Drafts, Telegraphic Transfers and Mail Transfers issued on Branches and Agencies.

b. Demand Drafts, Telegraphic Transfers and Mail Transfers received from Branches and Agencies.
c. Letters of Credit.
d. Letters of Guarantee

4. **Memorandum Books**

In addition to the above books and registers, various departments of a bank have to maintain a number of memorandum books to facilitate their work. They include:

1. Departmental Journals	Maintain a record of all the transfer entries originated by each department
2. Cash Department	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	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'	a. Registers for shares and other securities held on behalf of each customer. b. Summary Books of Securities giving details of Government securities, shares of individual companies etc. c. Godown registers maintained by the godown-keeper of the bank. d. Price register giving the wholesale price of the commodities pledged with the bank. e. Overdraft Sanction register. f. Drawing Power book. g. Delivery Order books. h. 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.

5. **Statistical Books**

These are kept in different banks based on their individual requirements. Some of the common purposes are:

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.

- **Forms of Balance Sheet and Profit and Loss Account (Third Schedule of the Banking Regulation Act, 1949)**

Form 'A'
Form of Balance Sheet
Balance Sheet of …………………….. (here enter name of the Banking Company)
Balance Sheet as on 31st March ________________________ (Year)

(₹ in 000')

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

Form 'B'
From of Profit & Loss Account
For the year ended 31st March

	Schedule No.	As on 31.3. (Current Year)	As on 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			

	Schedule No.	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
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			

- **Forms of Various Schedules**

Schedule 1 – Capital

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
I. For Nationalized 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		
Authorized 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 – Reserve 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 others		
II. Savings Bank Deposits		
III. Term Deposits		
(i) From banks		
(ii) From others		
Total (I + II + III)		

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
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		
1. 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 loc al 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		
(i) 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)		

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
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		

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
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		

Particulars	As on 31.3. (Current Year)	As on 31.3. (Previous Year)
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:

A. General

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

B. 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 historic al 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.

C. 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 historic al cost basis.

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

D. 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.

E. Fixed Assets

a. Premises and other fixed assets have been accounted for at their historic al 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.

F. 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.

G. 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".

⊙ Accounting for Some Special Transactions

1. 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 realization 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.

In the next year, if a part of interest is realized and the balance becomes bad, the following entry should be passed

Interest Suspense Account Dr. [Total interest]

To Interest Account [Interest realized]

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.

Consider the following illustration.

Illustration 1

When closing the books of a bank on 31.03.2023 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 2022-23 account?

During the year 2022-23, the bank accepts 75 paise in the rupee on account of the total debt due up to 31.03.2023.

Show the entries and the necessary accounts showing the ultimate effect of the transactions in 2023-24 books of account under Interest Suspense Method.

Solution:

While preparing the 2022-23 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 31.03.23.

In the Books of Bank
Journal

Date	Particulars	Debit (₹)	Credit (₹)
2023 March. 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

Date	Particulars	Debit (₹)	Credit (₹)
	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	₹
2023 Mar. 31	To Balance b/d	2,00,000	2023 Mar. 31		
	To Int. Suspense A/c	20,000		By Balance c/d	2,20,000
		2,20,000			2,20,000
2023 Apr. 1			2024 Mar. 31	By Cash A/c (Dividend @ 75p in the rupee)	1,65,000
				By Int. Suspense A/c (amount of Int. not covered)	5,000
	To Balance b/d	2,20,000		By Bad Debts A/c	50,000
		2,20,000			2,20,000

Dr. **Interest Suspense Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2023 Mar. 31	To Balance c/d	20,000	2023 Mar. 31	By Merchant's A/c	20,000
		20,000			20,000
2024 Mar. 31	To Merchant's A/c	5,000	2023 Apr. 1	By Balance b/d	20,000
	To Profit & Loss A/c	15,000			
		20,000			20,000

Notes:

a. 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.

b. Actual amount of interest which has been received in c ash, i.e., ₹15,000, is transferred to P& L A/c.

2. 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.

Consider the following illustration.

Illustration 2

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

On 1.4.23 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 10.6.23
Q	18,00,000	Party paid off on 30.9.23
R	7,50,000	Party failed to pay and bank had to honour on 30.11.23
S	12,00,000	Not satisfied up to 31.3.24
T	7,50,000	-do-
X	4,05,000	-do-
Total	64,05,000	

Solution:

Acceptances, Endorsements and Other Oblication Account

(₹ in thousand)

Dr. **Cr.**

Date	Particulars	(₹)	Date	Particulars	(₹)
2023-24	To Constituents' liabilities for acceptances/guarantees etc. (Paid off by clients)	3,000	1.4.23	By, Balance b/d	3,345
	To Constituent's liabilities for acceptances/ guarantees etc. (Honoured by bank ₹ 33.45 lakhs less ₹ 30 lakhs)	345	2023-24	By, Constituents' liabilities for Acceptances/ guarantees etc. P 1,500 Q 1,800 R 750 S 1,200 T 750 X 405	6,405
10.6.23	To Constituents' liabilities for acceptances/guarantees etc. (Honoured by bank)	1,500			
30.9.23	To Constituents' liabilities for acceptances/guarantees etc. (Paid off by party)	1,800			
30.11.23	To Constituent's liabilities for acceptances/guarantees etc. (Honoured by bank on party's failure to pay)	750			

Date	Particulars	(₹)	Date	Particulars	(₹)
31.3.24	To Balance c/d (Acceptances not yet satisfied)	2,355			
		9,750			9,750

3. 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. If the entire amount of discount is received during the period, no further adjustment is required. In real world situation, however, the bill may not mature for payment during the accounting period. Thus, an adjustment is required for discounting of those bills which are related to next accounting periods.

The journal entry for adjustment is as follows:

Interest & Discount A/c Dr.

To Rebates on Bill Discount Account

The rebates on bills discounted will be calculated as follows:

Rebate on Bills Discounted = Amount of Bill × Rate of Discount × Unexpired period (in months)/12

Illustration 3

Calculate Rebate on Bills discounted as on 31 December, 2023 from the following data and show journal entries for adjustment.

	Date of Bill	₹	Period	Rate of Discount
(i)	15.10.2023	50,000	5 months	8%
(ii)	10.11.2023	30,000	4 months	7%
(iii)	25.11.2023	40,000	4 months	7%
(iv)	20.12.2023	60,000	3 months	9%

Solution:

Calculation of Rebate on Bills Discounted

Amount of Bill (₹)	Due Date	Days after 31 December, 2023	Discount Rate	Discount (₹)
50,000	18/03/2024	31+ 29 +18 = 78	8%	852.46
30,000	13/03/2024	31+29+13 = 73	7%	418.85

Amount of Bill (₹)	Due Date	Days after 31 December, 2023	Discount Rate	Discount (₹)
40,000	28/03/2024	31+29+28 = 88	7%	673.22
60,000	23/03/2024	31+29+23 = 83	9%	1,224.59
Total				3,169.12

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
Dec. 31 2023	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, 2022 Victory Bank Ltd. had a balance of ₹18 crores in Rebate on Bill Discounted A/c. During the year ended 31st March, 2023, 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, 2023, the average period outstanding after 31st March, 2023 being 36.5 days.

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

a. Discounting of Bills of Exchange; and

b. Rebate on bill Discounted.

Solution:

In the books of Victory Bank Ltd.

Journal **(₹ in Crore)**

Date	Particulars	Dr. (₹)	Cr. (₹)
1.4.23	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 [₹8,000 × 18/100 × 73/365] (Being the discounting of bills during the year)	8,000	 7,712.00 288.00
31.3.23	Discount on bills A/c Dr. To, Rebate on Bills Discounted A/c (Being the Provision for unexpired discount as on 31.03.2022)	21.60	 21.60
31.03.23	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	(₹)	Date	Particulars	(₹)
01.4.22	To, Discount on bills A/c	18.00	01.4.22	By balance b/d	18.00
31.03.23	To balance c/d	21.60	31.3.23	By Discount on bills A/c (Rebate required)	21.60
		39.60			39.60

Discount on Bills Account **(₹ In Crores)**

Dr. **Cr.**

Date	Particulars	(₹)	Date	Particulars	(₹)
31.03.23	To Rebate on Bills Discount A/c	21.60	01.4.22	By Rebate on Bills Discounted A/c	18.00
31.03.23	To Profit and Loss A/c (Transfer)	284.40	2022-23	By Bills Purchased and Discount A/c	288.00
		306.00			306.00

4. Secured and Unsecured Advance

When a bank grants advance to its customers against any tangible security, it is called secured advance. Similarly, where 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 principal 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 31.12.2021, 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 31.03.2023. On 31.03.2023, 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	(₹)
31.12.2023	Balance of Loan (Principal)	5,00,000

Date	Particulars	(₹)
	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

Working:

Calculation of outstanding interest

Quarters ending	Interest (₹)		Closing balance with principal (₹)
31.03.2022	20,000	(₹5, 00, 000 × 16% × 3/12)	5,20,000
30.06.2022	20,800	(₹5, 20, 000 × 16% × 3/12)	5,40,800
30.09.2022	21,632	(₹5,40,800 ×16% × 3/12)	5,62,432
31.12.2022	22,497	(₹5,62,432 ×16% × 3/12)	5,84,929
31.03.2023	23,397	(₹5,84,929 ×16% × 3/12)	6,08,326
	1,08,326		

RBI's Prudential Accounting Norms

RBI's Prudential Accounting Norms are related to:

A. Recognition of Income;

B. Classification of Assets; and Provisions Required

These are discussed below.

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).

An asset becomes non-performing when the bank does not receive income from it for a certain period. In theory, any credit facility turns into a non-performing asset when it ceases to generate income for a bank.

Consider the following illustration.

Illustration 6

Given below are details of interest on advance of a Commercial Bank as on 31.03.2023:

(₹ in Crore)

Particulars	Interest Earned (₹)	Interest Received (₹)
Performing Assets		

Particulars	Interest Earned (₹)	Interest Received (₹)
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 2023.

Solution:

Interest on non-performing assets is considered on Cash Basis whereas interest on performing assets is considered on Accrual Basis.

Statement Showing the Recognition of Income **(₹ in Crore)**

Particulars	(₹)	(₹)
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 Recognized	2,114	

B. Classification of Assets and Provisions Required

A bank's assets are classified as follows:

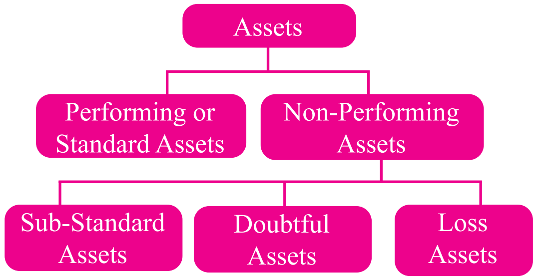

Figure 4.2: Classicization of Bank's Assets

1. Performing or Standard Assets

Practically, these assets bear a little amount of risk like normal risk. They do not create any trouble regarding their realization. Provision required for these assets is @ 0.40%.

2. Non-Performing Assets

(i) Sub-Standard Assets

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.

(ii) Doubtful Advances

Doubtful Advances will continue to attract 100% provision to the extent the advance is not covered by the realizable value of the security to which the bank has a valid recourse and the realizable 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 up to 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%.

(iii) Loss Asset

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

Consider the following summarized table.

Table 4.1 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 up to 1 year	25

Category of Advances	Rate (%)
For Doubtful > 1 year and up to 3 years	40
For Doubtful > 3 years	100

Note: 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:

  i. 3.50 per cent - with effect from March 31, 2014 (spread over the four quarters of 2013-14)

  ii. 4.25 per cent - with effect from March 31, 2015 (spread over the four quarters of 2014-15)

  iii. 5.00 per cent - with effect from March 31, 2016 (spread over the four quarters of 2015-16)

Note: 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

Particulars	₹
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

Particulars	₹
F. Provision required for secured portion of Doubtful Asset @ 25%, /40%/100%	xxx
G. Total Provision required [E+F]	xxx

Consider the following illustration.

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 31.3.2023:

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 (₹ in Lakhs)	Provision (%)	Amount of Provision (₹ 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	(₹)
Total amount of Loans & Advances	120
Advance fully secured	70
Advance overdue for 15 months	20

Particulars	(₹)
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) + 40% of ₹ 5,00,000

= ₹ 5,00,000 + ₹ 2,00,000

= ₹ 7,00,000

Illustration 9 (Provisions covered by Guarantee of DICG/ ECGC in case of advance)

Rajatapeeta Bank Ltd. had extended the following credit lines to a Small-Scale Industry, which had not paid any Interest since March, 2022:

	Term Loan	Export Loan
Balance Outstanding on 31.03.2022	₹ 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, 2022.

Solution:

Calculation for unsecured portion of loan

Particulars	Term loan (₹ in lakhs)	Export credit (₹ in lakhs)
Balance outstanding on 31.3.2022	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

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, 2023:

a. 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.

b. **Other Advances:**

Assets classification	₹ in lacs
Standard	4,500
Sub-standard	3,300
Doubtful:	
For one year	1,350
For two years	900
For three years	600
For more than 3 years	450
Loss assets	900

Solution:

Statement Showing Calculation of Provisions

(₹ in lacs)

Particulars	(₹)	(₹)
Amount outstanding (packing credit)	90.00	
Less: Realizable 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

Particulars	(₹)	(₹)
Provision for secured portion (100%) *		22.50
		56.25

Other advances: **(₹ in lacs)**

Assets	Amount (₹)	% of provision	Provision (₹)
Standard	4,500	0.40*	18
Sub-standard	3,300	15	495
Doubtful:			
For one year	1,350	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		2,800.5

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 31.3.2023.

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		

a. Provision for bad and doubtful debts necessary ₹ 2,00,000.

b. Rebate on bills discounted as on 31.3.2023 ₹ 7,500.

c. Provide ₹3,50,000 for income tax.

d. 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, 2023

	Particulars	Schedule No.	Year ended 31.3.2023 (Current Year) (₹)	Year ended 31.3.2022 (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 31.3.2022 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

	Particulars	₹	₹
I.	Interest and Discount received	20,30,000	
	Less: Rebate on bill discounted as on 31.3.2023	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

	Particulars	₹
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 set up abroad/ in India	—
VIII.	Miscellaneous Income	—
	Total	2,15,000

Schedule 15: Interest Expended

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

Schedule 16: Operating Expenses

	Particulars	₹
I.	Payment to and provision for employees	1,05,000
II.	Rent, taxes and lighting	54,000

	Particulars	₹
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 maintenance	—
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, 2023:

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 c all 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

Debit balance	₹ (in Lakhs)
Current Accounts	780.18
Bills Payable	0.15
Borrowings from other Banks	165.00
	3,882.33

Additional Information:

a. Bills for collection: ₹ 18,10,000

b. Acceptance and endorsements: ₹ 14,12,000

c. Claims against the bank not acknowledged as debts: ₹ 55,000

d. Depreciation charged on premises: ₹ 1,10,000 and Furniture: ₹ 78,000

Solution:

Lakshmi Bank Ltd.
Balance Sheet as on 31.3.2023

Details	Schedule No.	(₹ 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 (29,70,000 @ ₹ 10)	297.00

Schedule 2 - Reserves and Surplus

	₹ (in lakh)	₹ (in lakh)
1. Statutory Reserve		346.50
Add: 25% 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

Illustration 13

Prepare Profit and Loss account for the year ended 31st March, 2023 of Aditya Bank Ltd. from following particulars:

Particulars	Amount (`)	Particulars	Amount (`)
Interest on loan	2,57,000	Salaries and Allowance	1,20,000
Interest on saving A/c	1,50,000	Discount on bills discounted	40,000
Interest on Cash credit	1,60,000	Rent, taxes, insurance &lighting	5,000
Interest on Fixed deposit	1,90,000	Dearness allowance	42,000
Interest on Overdrafts	50,000	Commission, exchange & brokerage	15,000
Amount charged against Current A/c	20,000	Managing director's salary	15,000
Rebate on bills discounted	19,000	Contribution to provident fund	10,000

Solution:

Profit and Loss Account for the year ended 31st March 2023.

	Particulars	Schedule No.	Amount (`)
I.	**Income**		
	Interest earned	13	508,000
	Other Income	14	15,000
	Total		**523,000**
II.	**Expenditure**		
	Interest expended	15	340,000
	Operating expenses	16	192,000
	Provisions and contingencies		
	Total		**532,000**
III.	**Profit**		
	Net Loss for the year		9000
	Add: Profit/ (Loss) brought forward		
	Total		**9000**
IV.	**Appropriations**		
	Transfer to Statutory Reserve		
	Transfer to Capital Reserve		
	Transfer to Investment Fluctuation Reserve		
	Transfer to Revenue and other Reserves		
	Dividend for the current year		
	Balance carried over to Balance Sheet		9000
	Total		
V.	**Earnings Per Equity share (face value 1 per share)**		
	Basic (in ₹)		
	Diluted (in ₹)		

Schedule 13: Interest Earned

Particulars	**Amount**
Interest on loan	257,000
Discount on bills discounted	40,000
Interest on Cash credits	160,000

Interest on Overdrafts	50,000
Amount charged against current A/C	20,000
Less: Rebate on Bills discounted	19,000
Total	**508,000**

Schedule 14: Other Income

Particulars	**Amount**
Commission, Exchange and brokerage	15,000

Schedule 15: Interest Expended

Particulars	**Amount**
Interest on Savings A/C	150,000
Interest on Fixed Deposits	190,000
Total	**340,000**

Schedule 16: Operating Expenses

Particulars	**Amount**
Salaries and Allowances	120,000
Rent, Taxes etc.	5000
Dearness Allowance	42,000
Managing Director's Salary	15,000
Contribution to PF	10,000
Total	**192,000**

(**Hint:** Rebate on Bills discounted may be taken as Closing Rebate on Bills discounted.)

Illustration 14

From the following particulars, prepare Profit and Loss A/c of ABC Bank Ltd. for the year ending 31st March 2023:

Particulars	Amount (`)	Particulars	Amount (`)
Interest on Loans	34,90,000	Rent & taxes	1,80,000
Interest on Fixed deposits	36,50,000	Interest on Overdrafts	12,80,000
Rebate on bills discounted (1-4-2022)	4,80,000	Director's remuneration	42,000
Commission charged to customers	97,000	Interest on savings deposit A/c	6,90,000
Office expenses	15,50,000	Postal expenses	19,000
Discount on bills discounted	19,40,000	Printing and stationary	39,000

Particulars	Amount (`)	Particulars	Amount (`)
Amount charged against Current A/c	1,20,000	Other expenses	18,000
		Interest on cash credit	22,40,000

Adjustments to be made:

(a) Rebate on bills discounted ₹ 485,000.

(b) Provide for taxation @ 30% of the profit.

Solution:

Profit and Loss Account for the year ended 31st March 2023.

Particulars		Schedule No.	Amount (₹ in 000's)
I.	**Income**		
	Interest earned	13	29225
	Other Income	14	97
	Total		**29322**
II.	**Expenditure**		
	Interest expended	15	4340
	Operating expenses	16	1848
	Provisions and contingencies		6940.20
	Total		**13128.20**
III.	**Profit**		
	Net Profit for the year		16193.80
	Add: Profit/ (Loss) brought forward		
	Total		**16193.80**
IV.	**Appropriations**		
	Transfer to Statutory Reserve (25%)		4048.45
	Transfer to Capital Reserve		
	Transfer to Investment Fluctuation Reserve		
	Transfer to Revenue and other Reserves		
	Dividend for the current year		
	Balance carried over to Balance Sheet		12145.35
	Total		**16193.80**
V.	**Earnings Per Equity share (face value 1 per share)**		

Particulars	Schedule No.	Amount (₹ in 000's)
Basic (in ₹)		
Diluted (in ₹)		

Schedule 13: Interest Earned

Particulars	Amount (₹ in 000's)
Interest on loan	3490
Discount on bills discounted	1940
Interest on Cash credits	22,400
Interest on Overdrafts	1280
Amount charged against current A/C	120
Less: Rebate on Bills discounted	485
Add: Rebate on Bills discounted	480
Total	**29,225**

Schedule 14: Other Income

Particulars	Amount (₹ in 000's)
Commission charged to customers	97

Schedule 15: Interest Expended

Particulars	Amount (₹ in 000's)
Interest on Fixed Deposits	3650
Interest on savings deposit A/C	690
Total	**4340**

Schedule 16: Operating Expenses

Particulars	Amount
Director's remuneration	42
Rent, Taxes etc.	180
Office expenses	1550
Postal expenses	19
Printing and stationery	39
Other expenses	18
Total	**1848**

Illustration 15

From the following information prepare Profit and Loss A/c of a bank for the year ended on 31st March 2023:

Particulars	Amount (₹ '000)	Particulars	Amount (₹ '000)
Interest on Loans	2,590	Interest on Overdrafts	1,540
Interest on Fixed deposits	3,170	Director's fees, allowance & expenses	30
Rebate on bills discounted	490	Auditor's fees & expenses	12
Commission	82	Interest on saving bank deposit	680
Payment to employees	540	Postage, telegram & telephones	14
Discount on bills discounted (Gross)	1,550	Printing and stationary	29
Interest on cash credit	2,230	Sundry charges	17
Rent, taxes & lighting	285		

Additional information:

(a) Provide for contingencies ₹ 2,75,000

(b) Transfer ₹ 15,67,000 to Reserves

(c) Transfer ₹ 254,000 to Central Govt.

Solution:

Profit and Loss Account for the year ended 31st March 2023.

Particulars	Schedule No.	Amount (₹ '000)
I. Income		
Interest earned	13	7420
Other Income	14	82
Total		**7502**
II. Expenditure		
Interest expended	15	3850
Operating expenses	16	927
Provisions and contingencies		275
Total		**5052**
III. Profit		
Net Profit for the year		2450
Add: Profit/ (Loss) brought forward		

Particulars		Schedule No.	Amount (₹ '000)
	Total		**2450**
IV.	**Appropriations**		
	Transfer to Statutory Reserve		612.50
	Transfer to Central Govt.		254
	Transfer to Reserve		1567
	Transfer to Revenue and other Reserves		
	Dividend for the current year		
	Balance carried over to Balance Sheet		16.5
	Total		**2450**
V.	**Earnings Per Equity share (face value 1 per share)**		
	Basic (in ₹)		
	Diluted (in ₹)		

Schedule 13: Interest Earned

Particulars	**Amount**
Interest on loan	2590
Discount on bills discounted	1550
Interest on Cash credits	2230
Interest on Overdrafts	1540
Less: Rebate on Bills Discounted	490
Total	**7420**

Schedule 14: Other Income

Particulars	**Amount**
Commission, Exchange and brokerage	82

Schedule 15: Interest Expended

Particulars	**Amount**
Interest on Savings A/C	680
Interest on Fixed Deposits	3170
Total	**3850**

Schedule 16: Operating Expenses

Particulars	Amount
Payment to Employees	540
Rent, Taxes etc.	285
Director's Fees, Allowances and Expenses	30
Auditor's Fees and Expenses	12
Postage, Telegrams & Telephones	14
Printing and stationery	29
Sundry Charges	17
Total	**927**

Illustration 16

While closing the books of accounts, a commercial bank has its advances classified as follows:

Classification of assets	₹ (in lakhs)
Standard Assets	16,010
Substandard Assets	1,300
Doubtful Assets:	
Up to 1 year	700
1 to 3 years	400
More than 3 years	200
Loss Assets	784

You are required to calculate the amount of provisions to be made by the bank.

Solution

Classification of assets	₹ (in lakhs)	% of provision	Amount of provision
Standard Assets	16,010	0.40	64.04
Substandard Assets	1,300	15	195
Doubtful Assets:			
Up to 1 year	700	25	175
1 to 3 years	400	40	160
More than 3 years	200	100	200
Loss Assets	784	100	784

Total Amount of provision = ₹ 1578.04 Lakhs.

Illustration 17

The following figures are extracted from the Trial Balance of a Bank as on 31/3/2023

Discount Received (cr)	480,000
Rebate on Bills Discounted (1/4/2022)	27500

The analysis of the bills discounted revealed the following:

No	Date of Bill	Term	Amount (₹)	Rate
1	02/01/2023	3 months	400,000	5%
2	10/01/2023	4 months	200,000	4%
3	05/02/2023	2 months	100,000	4%
4	03/03/2023	4 months	300,000	5%

Compute the amount of discount to be credited to P/L A/C

Solution:

Rebate on Bills Discounted on 31/03/2023

No	Due Date	Unexpired Days	Amount (₹)	Rebate
1	05/04/2023	5	400,000	274
2	13/05/2023	43	200,000	942
3	08/04/2023	8	100,000	88
4	06/07/2023	97	300,000	3986
			Total	5290

Discount received during the year	480,000
Less: Rebate at the end	5290
	474,710
Add: Rebate at the beginning	27,500
Amount to be credited to P&L A/C	**502,210**

Discount Received A/C

Particulars	Amount (`)	Particulars	Amount (`)
To Rebate on bills discounted	5,290	By Customer	4,80,000
To Profit and loss	5,02,210	By Rebate on Bills discounted	27,500
	5,07,500		**5,07,500**

Illustration 18

From the following information, identify the non-performing assets (NPA) of a commercial bank for the year ending 31 st March 2023

1. Term Loan: ₹ 95 lakhs on which interest remains due for 5 quarters on 30 lakhs, for 2 quarters on 25 lakhs, for 1 quarters on 10 lakhs.
2. CashCredit and Overdrafts: ₹ 500 lakhs on which interest remained past due for 5 quarters on 60 lakhs ,for 3 quarters on 40 lakhs and for 1 month on ₹ 20 lakhs
3. Bills purchased and discounted:

   ₹ 800 lakhs on which interest remained unpaid for 5 quarters for 90 lakhs ,2 quarters for 80 lakhs and for 2 months for 30 lakhs .

Solution:

1.	Term loan	—	30 lakhs + 25 lakhs + 10lakhs	=	65 lakhs
2.	Cash credit and overdrafts	—	60 lakhs + 40 lakhs	=	100 lakhs
3.	Bills purchased and discounted	—	90lakhs + 80 lakhs	=	170 lakhs
			Total NPA	=	335 Lakhs.

Illustration 19

Given Below are the details of interest on advances of a bank for the year ended 31/3/2023.

Advances	ON PA (Interest earned)	ON PA (Interest received)	ON NPA (Interest earned)	ON NPA (Interest received)
1. Term Loans	15,000	7000	5000	3000
2. Cash Credits	35000	20000	7000	4000
3. Bills Purchased	28,000	15000	3000	2000
4. Over drafts	48,000	17000	9000	5500

Calculate the interest income to be recognized for the year ending 31 st March 2023

Solution.

Advances	ON PA	ON NPA	Total
1. Term Loans	15,000	3000	18,000
2. Cash Credits	35000	4000	39,000
3. Bills Purchased	28,000	2000	30,000
4. Over drafts	48,000	5500	53,500

The interest income to be recognized for the year ending 31 st March 2023 = 140,500

Illustration 20

The following are the ledger balances of Global Bank Ltd, from the given Trail Balance prepare Profit and Loss Account and Balance Sheet as at 31-03-2023:

Particulars	Dr. (₹)	Cr. (₹)
Share Capital 20,000 shares of ₹100 each	-	2,00,000
Bad debts	1,28,710	-
Reserve fund investments	10,00,000	-
Reserve fund	-	10,00,000
General expenses	1,82,420	-
Current accounts	-	2,02,44,220
Interest paid	1,60,520	-
Deposit accounts	-	69,20,330
Profit and Loss A/c (Cr) 1-4-2022	-	2,29,340
Acceptance for customers	-	15,42,820
Discount	-	2,43,760
Endorsement and guarantees	-	74,020
Commission	-	44,240
Cash	2,26,540	-
Interest received	-	5,32,260
Cash with RBI	20,12,100	-
Endorsement guarantees (contra)	74,020	-
Owing by foreign correspondents	2,00,440	-
Customers liabilities for acceptance	15,42,820	-
Shorts loans		82,82,060
Loans and advances	1,54,56,700	-
Investments	98,82,640	-
Bills discounted	62,28,240	-
Premises	22,17,900	-
Total	**3,93,13,050**	**3,93,13,050**

Adjustments:

1. Reserve – ₹ 64,380 for rebate on bills discounted
2. Provide for taxation – ₹ 20,000
3. Depreciation on premise @ 10%
4. The Profit and Loss account balance is the balance left on that account after the payment of interim dividend amounting to ₹ 2,00,000

Solution:

Profit and Loss Account for the year ended 31st March 2023.

Particulars	Schedule No.	Amount (₹ '000)
I. Income		

Particulars		Schedule No.	Amount (₹ '000)
	Interest earned	12	711640
	Other Income	13	44,240
	Total		**755,880**
II.	**Expenditure**		
	Interest expended	14	160,520
	Operating expenses	15	532,920
	Provisions and contingencies		20,000
	Total		**713,440**
III.	**Profit**		
	Net Profit for the year		42,440
	Add: Profit/ (Loss) brought forward		429,340
	Total		**471,780**
IV.	**Appropriations**		
	Transfer to Statutory Reserve		10,610
	Transfer to Central Govt.		
	Transfer to Reserve		
	Transfer to Revenue and other Reserves		
	Dividend for the current year		200,000
	Balance carried over to Balance Sheet		261,170
	Total		**471,780**
V.	**Earnings Per Equity share (face value 1 per share)**		
	Basic (in ₹)		23.589
	Diluted (in ₹)		

Schedule 12: Interest Earned

Particulars	Amount
Discount on bills discounted	243,760
Interest received	532,260
Less: Reserve for rebate on bills discounted	64,380
Total	**711640**

Schedule 13: Other Income

Particulars	Amount
Commission, Exchange and brokerage	44,240
	44,240

Schedule 14: Interest Expended

Particulars	Amount
Interest paid	160,520
Total	**160,520**

Schedule 15: Operating Expenses

Particulars	Amount
General Expenses	182,420
Bad debts	128,710
Depreciation on premises	221,790
Total	**532,920**

Balance Sheet as at 31st March 2023.

Particulars	Schedule No.	Amount (₹)
Capital and Liabilities		
Capital	1	200,000
Reserves & Surplus	2	1271780
Deposits	3	27164,550
Borrowings	4	8282,060
Other Liabilities and Provisions	5	84380
Total		37002,770
Assets		
Cash and Balances with Reserve Bank of India	6	2238,640
Balances with Banks and money at call and short notice	7	200,440
Investments	8	10882,640
Advances	9	21684,940
Fixed Assets	10	1996110
Other Assets		

Particulars	Schedule No.	Amount (₹)
Total		37002,770
Contingent Liabilities	11	Nil
Bills for Collection		
Significant Accounting Policies		
Notes to Accounts		

Schedule 1 – Capital.

Particulars	Amount
Share capital	200,000
20,000 shares of ₹100 each	

Schedule 2-Reserves and surplus

Particulars	Amount
Statutory reserves	10,610
Profit and loss a/c	261,170
Reserve Fund	1000,000
Total	**1271,780**

Schedule -3 Deposits

Particulars	Amount
Current Account	20244,220
Deposit Accounts	6920,330
Total	**27164,550**

Schedule 4 Borrowings

Particulars	Amount
Short Loans	8282,060

Schedule -5 other liabilities and Provisions

Particulars	Amount
Reserve for rebate on bills discounted	64,380
Provision for taxation	20,000
Total	**84,380**

Schedule -6 Cash and Balances with RBI

Particulars	Amount
Cash in hand	226,540
Balance with RBI	2012,100
Total	**2238,640**

Schedule -7 Balances with other banks and Money at call and short Notice

Particulars	Amount
Owing by foreign correspondents	200,440
Total	**200,440**

Schedule -8 Investments

Particulars	Amount
Reserve Fund Investments	1000,000
Investments	9882,640
Total	**10882,640**

Schedule -9 Advances

Particulars	Amount
Loans and advances to customers	15456,700
Bills discounted	6228,240
Total	**21684,940**

Schedule -10 Fixed Assets

Particulars	Amount
Premises	2217,900
Less: Depreciation	221790
Total	**1996,110**

Schedule No:11 Contingent Liabilities

Acceptance for customers (Dr.)	1542,820
Endorsement and guarantees (Dr.)	74020
Acceptance for customers (Cr)	1542,820
Endorsement and guarantees (Cr)	74020
Total	**Nil**

Accounts of Electricity Companies

4.2

India is the third-largest producer and second-largest consumer of electricity worldwide, with an installed power capacity of 395.07 GW, as of January 2022. This huge demand of electricity is met by the power generation and distribution companies in India which includes thermal power generating companies, hydro power generating companies and companies producing power from other renewable sources.

4.2.1 Regulatory Framework for Electricity Companies

In India, administration including accounting of electricity companies is guided by the Electricity Act, 2003. The Electricity Act, 2003 replaced the following erstwhile existing legislations, namely:

a. The Indian Electricity Act, 1910;

b. The Electricity (Supply) Act, 1948; and

c. The Electricity Regulatory Commissions Act, 1998.

The provisions of this Act extend to whole of India.

- **Main Features of the Electricity Act, 2003**

  Following are the main features of Electricity Act, 2003.

  a. The activities like generation, transmission and distribution of power have been separately identified.

  b. Power generation has completely been de-licensed (except for hydro power projects, over a certain size).

  c. 10% of the power supplied by suppliers and distributors to the consumers has to be generated using renewable and non-conventional sources of energy.

  d. Setting up State Electricity Regulatory Commission (SERC) has been made mandatory.

  e. Appellate Tribunal to hear appeals against the decision of the CERC and SERCs.

  f. Ombudsman scheme for consumers' grievance redressal has been introduced.

  g. Provision has been incorporated for private licensees in transmission and entry in distribution through an independent network.

  h. Metering of all electricity supplied has been made obligatory.

  i. Provision relating to theft of electricity have been made stricter.

- **Role of Central Electricity Authority**

  The Central Government has the power to constitute a body called Central Electricity 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.

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.

- **Role of Central Electricity Regulatory Commission (CERC)**

  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.

  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.

  The Chairperson and Members of the Central Commission shall be appointed by the Central

  Government on the recommendation of the Selection Committee.

  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.

- **Role of State Electricity Commission (SEC)**

  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.

  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.

4.2.2 Accounting in Electricity Companies

A. Accounting of Some Special Transactions

1. Accounting and Reporting of Security Deposit

As per condition of supply, all State Electricity Boards are empowered to collect security deposit from their consumers. Since, consumers are required to make payment for the electricity consumed on a post-pay basis, security deposit collected from the consumers act as a cushion against the possible loss due to non-payment by the consumer.

- **Legal Provisions**

  The legal provisions relating to security deposit are as follows:

  a. 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.

  b. 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.

  c. The amount of Security Deposit for a consumer shall be determined as follows:

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

Accounting for Security Deposit

The journal entries in the books of a distribution licensee will be as follows:

Date	Particulars	Dr. (₹)	Cr. (₹)
	(i) On Receipt of Security Deposit Bank A/c Dr. To Security Deposit A/c (Being the Security Deposit received)		
	(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)		
	(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)		

Consider the following illustration.

Illustration 21

Consider the following information provided by ABC Power Supply Company Ltd.

Security deposit received from a customer on 01.10.2021 for ₹2,00,000. Interest rate applicable was 8% for 2021-22 and 9% for 2022-23. The accrued interest for the year is adjusted against the bill for the immediate next quarter. Journalize the above transaction for 2021-22 and 2022-23.

Solution:

In the books of ABC Power Supply Company Ltd.

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
01.10.21	Bank A/c Dr. To Security Deposit A/c (Being the Security Deposit received)	2,00,000	2,00,000
31.03.22	Interest Expense A/c Dr. (2,00,000 × 8% × 6/12) To Interest Accrued on Security Deposit A/c (Being the Provision for Interest Accrued on Security Deposit Made)	8,000	8,000
30.06.22	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)	8,000	8,000
31.03.23	Interest Expense A/c Dr. (2,00,000 × 8% × 6/12) To Interest Accrued on Security Deposit A/c (Being the Provision for Interest Accrued on Security Deposit Made)	8,000	8,000

30.06.23	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)	8,000	 8,000

- **Reporting of Security Deposit in the Balance Sheet of Distribution Licensee:**

  a. 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.

  b. 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 satisfy any of the conditions of classifying a liability as current.

2. Accounting for Service Line cum Development (SLD) Charges Received from Consumers

The Service Line cum Development (SLD) Charges can be accounted and reported under any one of the following methods:

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 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.

Under this method, the journal entries in the books of the Distribution Licensee will be as follows:

In the books of Distribution Licensee

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
	(i) On Receipt of SLD Charges Bank A/c Dr. To Capital Service Line Contribution A/c (Being the SLD Charges received)		
	(ii) On Transfer of Proportionate Amount to Income Statement Capital Service Line Contribution A/c Dr. To Statement of Profit and Loss (Being the Transfer of Proportionate amount to the Income Statement)		

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

3. Accounting for Grant Received under APDRP (Currently R-APDRP)

With respect to the accounting for Grant Received under APDRP the following points are noteworthy:

a. 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 Reserve 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.

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

c. The unadjusted balance of Capital Reserve is disclosed under the head, Reserves and Surplus, in the Balance Sheet.

d. In the Cash Flow Statement Grant received under APDRP is reported under Financing Activity.

e. 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.

f. The grant-in-aid assistance received by the utility under APDRP and its utilization 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.

4. Accounting for Depreciation

With respect to accounting for depreciation, the following points are noteworthy:

a. As per Central Electricity Regulatory Commission (Terms and Conditions of Tariff) Regulations, 2009, 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 tariff as well as accounting. In Central Electricity Regulatory Commission (Terms and Conditions of Tariff) Regulations, 2019, the rates have been specified in Appendix – I of the Regulation.

b. 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. The same has been upheld in 2019 regulation also.

c. The CERC prescribes the Straight-Line Method and at rates specified in Appendix – I for the assets of the generating station and transmission system, provided that the remaining depreciable value as on 31st March of the year closing after a period of 12 years from the effective date of commercial operation of the station shall be spread over the balance useful life of the assets. In case of the existing projects, the balance depreciable value as on 1.4.2019 shall be worked out by deducting the cumulative depreciation as admitted by the Commission up to 31.3.2019 from the gross depreciable value of the assets.

- **Calculation of Depreciation for the Purpose of Tariff as per 2019 Regulation**

  The calculation of depreciation shall be done considering the following points:

a. The value base for the purpose of depreciation shall be the capital cost of the asset.

b. 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.

c. Depreciation shall be calculated annually, based on Straight Line Method over the useful life of the asset and at the rates prescribed in Appendix I to the Regulation.

d. The Residual Life of the asset shall be considered as 10 years.

e. The Salvage Value of the Asset shall be considered as 10%.

f. Depreciation shall be allowed up to maximum of 90% of the capital cost of the asset, provided that the salvage value for IT equipment and software shall be considered as NIL and 100% value.

g. of the assets shall be considered depreciable;

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

i. 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 – I of Central Electricity Regulatory Commission (Terms and Conditions of Tariff) Regulations, 2019

Sr. No.	Asset Particulars	Depreciation Rate (Salvage Value = 10%) SLM
A	Land under full ownership	0.00%
B	Land under lease	3.34%
C	Assets purchased new	
a.	Plant and Machinery in generating stations	5.28%
b.	Cooling towers and circulating water systems	5.28%
c.	Hydraulic works forming part of the Hydro-generating stations	5.28%
d.	Building and civil engineering works	
	Temporary erections such as wooden structures	100%
	Others	3.34%
e.	Transformers, Kiosk, sub-station equipment & other fixed apparatus (including plant)	5.28%
f.	Switchgear including cable connections	5.28%
g.	Lightning arrestor	5.28%
h.	Batteries	5.28%
i.	Overhead lines including cable support	5.28%
j.	Meters	5.28%
k.	Self-propelled vehicles	9.50%
l.	Air Conditioning Plants	
	Static	5.28%

	Portable	9.50%
m.	Office furniture and furnishing	
	Street Light fittings	5.28%
	Others	6.33%
n.	Apparatus let on hire	
	Other than motor	9.5%
	Motor	6.33%
o.	Communication equipment	6.33%
p.	I. T Equipment including software	15.00%
q.	Any other assets not covered above	5.28%

Note: Where life of the particular asset is less than useful life of the project, the useful life of such particular asset shall be considered as per the provisions of the Companies Act, 2013 and subsequent amendment thereto.

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 sum total of depreciation calculated on each asset

= Depreciation on Asset1 + Depreciation on Asset2 + ··········

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

Step 4: Calculate Weighted Average Rate of Depreciation.

$$= \frac{\text{Total depreciation on all assets (other than freehold land)}}{\text{Total capital cost of all assets (other than freehold land)}} \times 100$$

The weighted average rate of depreciation is used in tariff calculation.

Illustration 22

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

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 Equipment	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 Equipment	5,00,000
9. Office Furniture, Furnishing, Equipment, 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 c able 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:

Calculation of Total Coat and Total 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
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 Equipment	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 Equipment	6.33%	5,00,000	31,650
9. Office Furniture, Furnishing, Equipment, 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

$$= \frac{\text{Total depreciation on all assets (other than freehold land)}}{\text{Total capital cost of all assets (other than freehold land)}} \times 100$$

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

$$= 6.4731\%$$

5. Components of Tariff (A Thermal Generating Station)

As per Regulation 14 of Central Electricity Regulatory Commission (Terms and Conditions of Tariff) Regulations, 2019, the tariff for supply of electricity from a thermal generating station shall comprise two parts, namely, capacity charge (for recovery of annual fixed cost consisting of the components as specified in Regulation 15 of these regulations) and energy charge (for recovery of primary and secondary fuel cost and cost of limestone and any other reagent, where applicable as specified in Regulation 16 of these regulations).

a. Capacity Charges: The capacity charges shall be derived on the basis of annual fixed cost. The Annual Fixed Cost (AFC) of a generating station or a transmission system including communication system shall consist of the following components:

(i) Return on equity;

(ii) Interest on loan capital;

(iii) Depreciation; Interest on working capital; and

(iv) Operation and maintenance expenses.

Provided that Special Allowance in lieu of R&M, where opted in accordance with Regulation 28 of these regulations, shall be recovered separately and shall not be considered for computation of working capital.

b. Energy Charges: Energy charges shall be derived on the basis of the landed fuel cost (LFC) of a generating station (excluding hydro) and shall consist of the following cost:

(i) Landed Fuel Cost of primary fuel;

(ii) Cost of secondary fuel oil consumption; and

(iii) Cost of limestone or any other reagent, as applicable.

Provided that any refund of taxes and duties along with any amount received on account of penalties from fuel supplier shall be adjusted in fuel cost:

Provided further that the supplementary energy charges, if any, on account of meeting the revised emission standards in case of a thermal generating station shall be determined separately by the Commission.

I. Debt-Equity Ratio

The Capital cost of the generating station or the transmission system, as the case may be, as determined by the Commission after prudence check in accordance with these regulations shall form the basis for determination of tariff for existing and new projects.

For new projects, the debt-equity ratio of 70:30 as on date of commercial operation shall be considered. If the equity actually deployed is more than 30% of the capital cost, equity in excess of 30% shall be treated as normative loan. Where equity actually deployed is less than 30% of the capital cost, actual equity shall be considered for determination of tariff.

II. Return on Equity

Return on equity shall be computed in rupee terms, on the equity base determined in accordance with Regulation 18 of these regulations. The normative equity base for this purpose will be 30% of the capital cost.

Return on equity shall be computed at the base rate of 15.50% for thermal generating station, transmission system including communication system and run-of-river hydro generating station, and at the base rate of 16.50% for the storage type hydro generating stations including pumped storage hydro generating stations and run-of-river generating station with pondage.

Provided that return on equity in respect of additional capitalization after cut-off date beyond the original scope excluding additional capitalization due to Change in Law, shall be computed at the weighted average rate of interest on actual loan portfolio of the generating station or the transmission system.

Calculation of ROE at normal rate is done as follows:

Statement showing Return on Equity at Normal Rate

Sr. No.	Particulars	Year 1	Year 2	Year 3
1	2	3	4	5
	Return on Equity			
1	Gross Opening Equity (Normal)			
2	Less: Adjustment in Opening Equity			
3	Adjustment during the year			
4	Net Opening Equity (Normal)			
5	Add: Increase in equity due to addition during the year / period			
6	Less: Decrease due to De-capitalisation during the year / period			
7	Less: Decrease due to reversal during the year / period			
8	Add: Increase due to discharges during the year / period			
9	Net closing Equity (Normal)			
10	Average Equity (Normal)			
11	Rate of ROE			
12	Total ROE			

Consider the following illustration.

Illustration 23

Consider the following information provided by XYZ Power Supply Company Ltd. (₹ in lakhs):

Gross opening equity ₹3,000 as on 01.04.2023.

Adjustment in opening equity – Nil

Adjustment during the year – Nil

Increase in equity due to addition during the year (over 5 years): ₹500

Decrease due to reversal and de-capitalization (over 5 years): Nil

Increase due to discharges during the year: Nil

Rate of ROE: 18%

Calculate total ROE for the next five years.

Solution:

Statement showing Return on Equity at Normal Rate **(₹ in lakhs)**

S. N	Particulars	Year 1	Year 2	Year 3	Year 4	Year 5
1	2	3	4	5	6	7
	Return on Equity					
1	Gross Opening Equity (Normal)	3,000	3,500	4,000	4,500	5,000
2	Less: Adjustment in Opening Equity	Nil	Nil	Nil	Nil	Nil
3	Adjustment during the year	Nil	Nil	Nil	Nil	Nil
4	Net Opening Equity (Normal)	3,000	3,500	4,000	4,500	5,000
5	Add: Increase in equity due to addition during the year / period	500	500	500	500	500
6	Less: Decrease due to De-capitalisation during the year / period	Nil	Nil	Nil	Nil	Nil
7	Less: Decrease due to reversal during the year / period	Nil	Nil	Nil	Nil	Nil
8	Add: Increase due to discharges during the year / period	Nil	Nil	Nil	Nil	Nil
9	Net closing Equity (Normal)	3500	4,000	4,500	5,000	5,500
10	Average Equity (Normal)	3250	3,750	4,250	4,750	5,250
11	Rate of ROE	18%	18%	18%	18%	18%
12	Total ROE	585	675	765	855	945

Illustration 24

From the following information Calculate Return on Equity:

1. Date of Commercial Operation of COD = 1st April 20239
2. Approved Opening Capital Cost as on 1st April 2023 = ₹15,00,000
3. Details of allowed Additional Capital Expenditure:

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

Rate of ROE: 15.5%

Solution:

Statement showing Return on Equity at Normal Rate

S.N	Particulars	Year 1	Year 2	Year 3	Year 4
1	2	3	4	5	6
	Return on Equity				
1	Gross Opening Equity (Normal) 30% of Opening Capital Cost	4,50,000	4,80,000	4,89,000	4,95,000
2	Less: Adjustment in Opening Equity	Nil	Nil	Nil	Nil
3	Adjustment during the year	Nil	Nil	Nil	Nil
4	Net Opening Equity (Normal)	4,50,000	4,80,000	4,89,000	4,95,000
5	Add: Increase in equity due to addition during the year / period (30%)	30,000	9,000	6,000	3,000
6	Less: Decrease due to De-capitalisation during the year / period	Nil	Nil	Nil	Nil
7	Less: Decrease due to reversal during the year / period	Nil	Nil	Nil	Nil
8	Add: Increase due to discharges during the year / period	Nil	Nil	Nil	Nil
9	Net closing Equity (Normal)	4,80,000	4,89,000	4,95,000	4,98,000
10	Average Equity (Normal)	4,65,000	4,84,500	4,92,000	4,96,500
11	Rate of ROE	15.5%	15.5%	15.5%	15.5%
12	Total ROE	72,075	75,098	76,260	76,958

III. Interest on Loan Capital

a. The loans arrived at in the manner indicated in Regulation 18 of these regulations shall be considered as gross normative loan for calculation of interest on loan. Gross normative loan is 70% of the capital cost.

b. The normative loan outstanding as on 1.4.2023 shall be worked out by deducting the cumulative repayment as admitted by the Commission up to 31.3.2023 from the gross normative loan.

c. The repayment for each of the year of the tariff period 2023-28 shall be deemed to be equal to the depreciation allowed for the corresponding year/period. In case of de-capitalization of assets, the repayment shall be adjusted by taking into account cumulative repayment on a pro rata basis and the adjustment should not exceed cumulative depreciation recovered up to the date of de-capitalisation of such asset.

d. Notwithstanding any moratorium period availed by the generating company or the transmission licensee, as the case may be, the repayment of loan shall be considered from the first year of commercial operation of the project and shall be equal to the depreciation allowed for the year or part of the year.

e. The rate of interest shall be the weighted average rate of interest calculated on the basis of the actual loan portfolio after providing appropriate accounting adjustment for interest capitalized.

f. The interest on loan shall be calculated on the normative average loan of the year by applying the weighted average rate of interest.

IV. Interest on Working Capital

The working capital shall cover cost of fuel stock, advance payment towards such cost, cost towards secondary fuel oil stock, maintenance spares, receivables and operation and maintenance expenses including water charges and security expenses, for one month.

Rate of interest on working capital shall be on normative basis and shall be considered as the bank rate as on 1.4.2023 or as on 1st April of the year during the tariff period 2023-28 in which the generating station or a unit thereof or the transmission system including communication system or element thereof, as the case may be, is declared under commercial operation, whichever is later, provided that in case of truing-up, the rate of interest on working capital shall be considered at bank rate as on 1st April of each of the financial year during the tariff period 2023-28.

Calculation of interest on working capital is done in the following format:

Statement of Interest on Working Capital

Sr. No.	Particulars	Year 1	Year 2	Year 3
1	2	3	4	5
1	Cost of Coal/Lignite			
2	Cost of Main Secondary Fuel Oil			
3	Fuel Cost			
4	Liquid Fuel Stock			
5	O & M Expenses			
6	Maintenance Spares			
7	Receivables			
8	Total Working Capital			
9	Rate of Interest			
10	Interest on Working Capital			

Consider the following illustration:

Illustration 25

Consider the following estimated information provided by XYZ Power Supply Company Ltd. (₹ in lakhs) for the next 5 years:

Cost of coal: ₹2,000 per year

Cost of secondary fuel oil: ₹200 per year for first 2 years and ₹300 per year for 3-5 years

O and M expenses: ₹250 per year for first 2 years and ₹350 per year for 3-5 years

Maintenance spares: ₹100 per years

Receivables: ₹1,800 per year

Rate of interest: 12%

Calculate the interest on working capital.

Solution:

Statement of Interest on Working Capital (₹ in lakhs)

Sr. No.	Particulars	Year 1	Year 2	Year 3	Year 4	Year 5
1	2	3	4	5	6	7
1	Cost of Coal/Lignite	2,000	2,000	2,000	2,000	2,000
2	Cost of Main Secondary Fuel Oil	200	200	300	300	300
3	Fuel Cost	Nil	Nil	Nil	Nil	Nil
4	Liquid Fuel Stock	Nil	Nil	Nil	Nil	Nil
5	O & M Expenses	250	250	350	350	350
6	Maintenance Spares	100	100	100	100	100
7	Receivables	1,800	1,800	1,800	1,800	1,800
8	Total Working Capital	4,350	4,350	4,550	4,550	4,550
9	Rate of Interest	12%	12%	12%	12%	12%
10	Interest on Working Capital	522	522	546	546	546

E. Operation and Maintenance Expenses

It will include normative operation and maintenance expenses. In addition, the Water Charges, Security Expenses and Capital Spares for thermal generating stations shall be allowed separately.

Consider the following illustration.

Illustration 26

Consider the following estimated information provided by XYZ Power Supply Company Ltd. (₹ in lakhs) for the next 5 years:

Normative O & M expenses: ₹2500 for Year 1 and this will increase @10% per year.

Water Charges: ₹500 for year 1 and 2 and it will increase @20% per year thereafter.

Security expenses: ₹750 per year up to year 4 and ₹800 for 5th year.

Calculate total O & M expenses for five years.

Solution:

Statement showing O & M Expenses **(₹ in lakhs)**

Sr. No.	Particulars	Year 1	Year 2	Year 3	Year 4	Year 5
1	2	3	4	5	6	7
1	Normative O & M expenses	2,500	2,750	3,025	3,327.5	3,660.25
2	Water Charges	500	500	600	720	864
3	Security expenses	750	750	750	750	800
4	Total O & M expenses	3,750	4,000	4,375	4,797.5	5324.25

B. Preparation of Financial Statements of an Electricity Company

The financial statements of an insurance company are prepared as per Schedule III of the Companies Act, 2013 (Please refer to Module 2).

Illustration 27

The trial balance of MM Electric Supply Ltd. For the year ended 31st March, 2023 is as below:

Particulars	Dr. Balances Amount (₹ in '000)	Cr. Balances 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 (additions 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	
Electric al Instruments	1,530	
Office Furniture	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		17,100
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 Creditors		6,524

During 2022-23, 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%.

Adjustments:

a. Transfer to Contingency Reserve ₹ 1,70,000 & to General Reserve ₹ 2,00,000

b. Loss on Contingency Reserve Investment ₹ 10,000

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

You are required to prepare the balance sheet as on 31st March, 2023 as per the schedule III.

Solution:

MM Electric Supply Ltd.

Balance Sheet as at 31st March, 2023

Particulars	Note No.	(₹ in '000)
I. EQUITYANDLIABILITIES		
(1) Shareholders' Funds		
(a) Share Capital	1	65,000
(b) Reserves and Surplus	2	33,476
(2) Non-Current Liabilities		
(a) Long-term Borrowings	3	40,000
(3) Current Liabilities		
(a) Trade Payables		6,524
(b) Short-Term Provisions		
Total		
II. ASSETS		1,45,000
(1) Non-Current Assets		
(a) Fixed Assets		
(i) Tangible Assets	4	1,09,960
(ii) Intangible Assets		2,504
(b) Non-Current Investments	5	12,000
(2) Current Assets		
(a) Inventories		12,050
(b) Trade Receivables	6	5,232
(c) Cash and Cash Equivalents		3,254
Total		1,45,000

Notes to Accounts: (figures in ₹)

1. Share Capital

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

Particulars	₹
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

Particulars	₹	₹
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	17,100	
Less: Transfer to General Reserve	(200)	
Less: Transfer to Contingency Reserve	(170)	
Less: Provision for Doubtful Debts	(1,014)	16,066
Total		33,476

3. Long-term Borrowings

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

4. Tangible Assets

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

5. Non-Current Investments

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

6. Trade Receivables

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

Accounts of Insurance Companies

4.3

According to recent studies, the overall insurance penetration in India has reached to 3.69% in 2017 from 2.71% in 2011. The statistics, however, are way below the global average and this eventually holds the huge potential for the industry in coming years. The insurance industry of India has 57 insurance companies - 24 are in the life insurance business, while 34 are non-life insurers. Among the life insurers, Life Insurance Corporation (LIC) is the sole public sector company. There are six public sector insurers in the non-life insurance segment. In addition to these, there is a sole national re-insurer, namely General Insurance Corporation of India (GIC Re).

Concept of Insurance

Insurance is a technique of risk management. It is a contract in which an individual or entity receives financial protection or reimbursement against losses from an insurance company. In insurance, 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.

Insurance Policy

A policy is a contract entered into between the insurance companies called the 'insurer' and the person who insures 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.

Type of Policies

Depending on the type of risk, there are several types of insurance policies as follows:

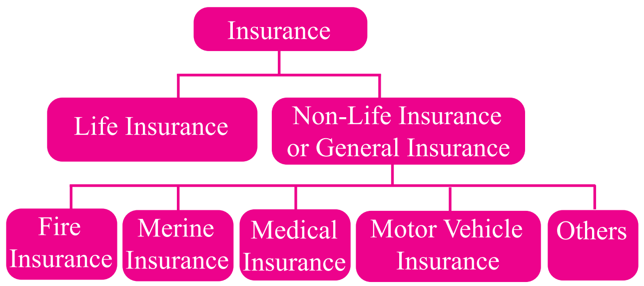

Figure 4.3: Types of Insurance Policies

A life insurance plan is a contract between an insurance policyholder and an insurance company, where the insurer promises to pay a sum of money in exchange for a premium after a set period or upon the death of an insured person. Life insurance offers you and your family financial protection. 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 term policies the family of the insured (the nominee mentioned in the policy) receives a specified sum on the death of insured.

A non-life policy, also known as general insurance policy, is an insurance contract that does not come under the ambit of life insurance. The different forms of general insurance are fire, marine, motor, accident and other miscellaneous non-life insurance.

⊙ **Distinction between Life and Non-life Insurance**

There are certain basic differences between life insurance policies and non-life insurance policies. These are listed below:

a. 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 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.

b. 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.

c. Life insurance is known also by another term ‘assurance’ since the insured gets an assured sum. Other policies are known as insurance.

d. The profit is determined by different methods in life and non-life insurance business. In the case of life insurance 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).

⊙ **Principles of Insurance**

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

a. Principle of indemnity: Insurance is a contract of indemnity. 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.

b. Insurable interest: All and sundry cannot enter into contracts of insurance. One can undertake insurance only if he/she has an insurable interest. For every type of policy insurable interest is insisted upon. In the absence of such interest the contract will amount to a wagering contract.

c. Principle of uberrimae fidei: In a contract of insurance, 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.

d. Principle of Proximate Cause: This is also called the principle of ‘Causa Proxima’ or the nearest cause. This principle applies when the loss is the result of two or more causes. The insurance company will find the nearest cause of loss to the property and if the property is found to be insured against such cause, the insured will get the compensation.

e. **Principle of Subrogation:** Subrogation means one party stands in for another. As per this principle, after the insured, i.e., the individual has been compensated for the incurred loss to him on the subject matter that was insured, the rights of the ownership of that property goes to the insurer, i.e., the company.

f. **Principle of Contribution:** Contribution principle applies when the insured takes more than one insurance policy for the same subject matter. It states that the insured cannot make a profit by claiming the loss of one subject matter from different policies or companies.

g. **Principle of Loss Minimization:** This principle says that as an owner, it is obligatory on the part of the insurer to take necessary steps to minimize the loss to the insured property.

Important Provisions of The Insurance Act, 1938

In India, insurance companies are regulated by 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. These have been separately listed.

a. **Forms for final accounts [Section 11]:** 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. Every insurer shall keep separate accounts relating to funds of shareholders and policyholders.

b. **Audit:** The Act provides that the company carrying on insurance business be audited as per the requirements of the Companies Act, 2013.

c. **Register of policies [Section 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 given effect and a record of any transfer, assignment or nomination of which the insurer has notice.

d. **Register of claims [Section 14(1)(b)]:** 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.

e. **Approved investments (Section 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.

f. **Payment of commission to authorized agents (Section 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.

g. **Limitation of expenses of management in general, health insurance and re-insurance business [Section 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.

h. **Sufficiency of assets [Section 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'.

I. 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 given effect; and

(c) A record of any assignment of the policy.

II. 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.

III. 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

4.3.1 Accounts of Life Insurance Business

Application of Indian Accounting Standards With respect to the Insurance Companies (Relevant Status is reproduced below).

On 1st April 2020 — Mandatory Basis.

(a) Insurers/insurance companies.

(b) Holding, subsidiary, joint venture or associate companies of the above, other than those companies already covered under the corporate roadmap announced by MCA

As Amended by Companies (Indian Accounting Standards) Second Amendment Rules 2019.

Present Status: IRDAI has appointed an expert committee to study about the implementation of Ind AS in insurance sector.

As per IRDA regulations, following are the financial statements of an insurance Company.

1. Revenue A/c
2. Profit and Loss A/C
3. Balance sheet.

Their financial statements are based on the following:

1. Insurance Regulatory and Development Authority (IRDA) Act 1999.
2. Relevant ASs.

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

I. **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 authorizes him to carry on life insurance business in India.

II. **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.

III. **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.

IV. **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.

V. **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

VI. **Section 24:** The Corporation has its own fund and all the receipts are credited to such fund and all payments are made there from.

VII. **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.

VIII. **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.

IX. **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.

X. **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.

XI. **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.

XII. **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.

A Few Important Concepts in Life Insurance Business

a. Premium

It is 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 that the premium amount has to be paid "front end" i.e., before the commencement of the insurance cover/ policy.

b. Claims

A claim occurs when any policy falls 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.

c. 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.

d. 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.

e. 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 claim.

f. Bonus

It is nothing but the share of profit which is payable by the insurance company to the policyholders. There are five basic types of bonuses in insurance. These are as follows:

(i) Simple Reversionary Bonus - It is a bonus that is accrued to almost every traditional life insurance plan. A percentage of the sum assured gets added to the policy every year until maturity or the death claim.

(ii) Compound Reversionary Bonus - It is a bonus calculated as a percentage of the sum assured and the bonus accrued last year. It is again paid as a part of the maturity benefit or death benefit.

(iii) Interim Bonus - Bonus is accrued in a life insurance policy every year. However, there is a chance that the death claim occurs before the next declaration. Hence, insurers declare an interim bonus to set the policyholder's family at an advantage and benefit from the bonus amount.

(iv) **Cash Bonus -** In a cash bonus, the insurance company will declare the bonus and make it available for the policyholder to receive it as cash in hand. It is not accrued till maturity like the other types and is provided at the end of every year.

(v) **Terminal Bonus -** Terminal Bonus is a one-time bonus in insurance paid when the policyholder runs through the entire policy term or a period specified by the insurer. Thus, it is not applicable if the policy is surrendered before the term ends.

Note: 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.

g. 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.

h. 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, it is called Double Insurance.

i. Ceding Company

It is 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.

j. 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.

Consider the following illustration.

Illustration 28

The Revenue Account of a life insurance company shows the life assurance fund on 31st March, 2023 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	(₹)	(₹)	(₹)
Balance of Fund as on 31st March, 2023			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

k. 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 Deficit (Net loss)	

Illustration 29

The life insurance fund of Prakash Life Insurance Co. Ltd. was ₹ 34,00,000 on 31st March, 2023. Its actuarial valuation on 31st March, 2023 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, 2023

Liabilities	(₹)	Assets	(₹)
Net liability	2,880,000	Life Assurance Fund	3,400,000
Net Profit	520,000		
	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 30

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 2023. Also pass necessary journal entries to record the above transactions with narrations:

Particulars	₹ (in lakhs)
Balance of Life Assurance Fund as on 1.4.2022	167.15
Interim bonus paid in the valuation period	25.00
Balance of Revenue Account for the year ended 31.3.2023	240.00
Net Liability as per valuer's Certificates as on 31.3.2023	165.00

The company declares a reversionary 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. 3/5th 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 2023

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

Distribution Statement, i.e., Distribution of Surplus

Particulars	₹ (in lakhs)
Surplus/ Net Profit	75,00,000
Add: Interim Bonus Paid	25,00,000
	1,00,00,000
Policyholders' shares @ 95% of ₹1,00,00,000	95,00,000
Less: Interim Bonus paid	25,00,000
	70,00,000
Shareholders' Share @ 5% of ₹1,00,00,000	5,00,000

Journal

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

Workings:

1. Bonus payable in Cash (@ ₹105 per ₹1000) = 6,00,00,000 × 3/5 × 105/1000 = ₹37,80,000
2. Reversionary Bonus payable (@ ₹185 per ₹1000) = 600,00,000 × 2/5 × 185/1000 = ₹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.

a. 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.

b. 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.

c. 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.

d. 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.

e. 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.

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

g. **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'.

h. **Premium Deficiency**: It is the sum of expected claim costs, related expenses and maintenance costs exceeding the related unearned premium.

i. **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.

j. **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.

k. Valuation of investments must be made in the manner prescribed by the Authority.

l. Loans must be measured on historic al cost subject to impairment provisions.

   The relevant portion of 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.

Schedule A (See Regulation 3)

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 Institute of Chartered Accountants of India.

   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)			
Commission	2		
Operating Expenses related to Insurance Business	3		
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)			
Benefits Paid (Net)	4		
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	8		
Shareholders'	8A		
Policyholders'			
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 disclosed.

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 31

The following balances appeared in the books of Happy Mutual Life Assurance Society Ltd. as on 31 March 2023:

(₹ 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 At the beginning of the year:	
Annuities	12		
Furniture and Office Equipment at cost	500	By death	1,800
(including ₹80 lakh bought during the		By maturity	1,200
year)	154	Credit balances pending adjustments	120
Printing and Stationery	2,700	Consideration for annuities granted	
Cash with Bank in current account	60	Interest, dividends and rents	4
Cash and stamp in hand	80	Registration and other Fees	3,600
Surrenders less Reassurances	500	Sundry Deposits	4
Commission	6,200	Taxation Provision	200
Expenses of Management	2	Premium Deposits	600
Sundry Deposits with Electricity		Sundry Creditors	2,300
Companies	100	Contingency Reserve	700
Advance Payment of Tax	100	Furniture and Office Equipment	300
Sundry Debtors	200	Depreciation Account	80
Agents Balances	900	Building Depreciation Account	600
Income Tax	1,000		
Income Tax on Interest, Dividend and Rents			

Loans and Mortgages	300		
Loans on Policies	6,500		
Investments	1,04,000		
(₹500 lakh deposited with Reserve Bank of India)			
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 2023 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 ₹4,056 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 2023

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 2023

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	500
Add: Commission on Re-Insurance Accepted	130
	630

Schedule 3: Operating Expenses	₹	₹
Expenses of management	6,200	
Add: Outstanding	120	
	6,320	
Less: Prepaid	30	6,290

Printing & Stationary		154
Depreciation on:		
Building	90	
Furniture	30	120
		6,564

Schedule 4: Benefits (Paid)	₹	₹
Insurance Claims:		
By Death-		
Paid	4,400	
Add: Outstanding at the ends	1,200	
	5,600	
Less: Outstanding at the beginning	1,800	3,800
By Maturity-		
Paid	3,000	
Add: Outstanding at the end	800	
	3,800	
Less: Outstanding at beginning	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	300
Add: Other Life Assurance Fund	1,23,218
	1,23,518

Schedule 7: Borrowings	₹
Premium Deposit	2,300
Add: Sundry Deposits	200
	2,500

Schedule 8: Investments	₹	₹
Investment in House Property	10,630	
Additions	170	
	10,800	
Less: Depreciation	690	10,110
Other Investments		1,03,500
		1,13,610

Schedule 9: Loans	₹
Mortgage	300
Policies	6,500
	6,800

Schedule 10: Fixed Assets	₹
Furniture (420-30)	390
	390

Schedule 11: Cash and Book Balance	₹
Cash + Stamps	60
Bank at Current A/c	2,700
	2,760

Schedule 12: Advance and Other Assets	₹	₹
Advances:		
Prepaid Expenses	30	
Adv. Payment of Tax	100	130
Other Assets:		
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	700
Outstanding Expenses	120
Com. Due but not paid	130
Claims outstanding	2,000
Credit balance Pending adjustments	120
	3,070

Schedule 14: Provisions	₹
Provisions for Tax	220
	220

Schedule 15: Miscellaneous	₹
Misc. Expenses	Nil
	Nil

4.3.2 Accounts of General Insurance Business

General Insurance consists of (i) Fire; (ii) Marine (iii) Accidental Insurance etc. 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 dependents 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 addition to the above, there may be travel insurance, health insurance, home insurance etc.

In our country, there are four public sector companies (The New India Assurance Company Limited, United India Insurance Company Limited, The Oriental Insurance Company Limited, National Insurance Company Limited). Moreover, private insurance companies have also come to play. Some of them are: Bajaj Allianz General Insurance Co. Ltd., Bharti AXA General Insurance Co. Ltd., Tata AIG General Insurance Co. Ltd. etc.

⊙ A Few Important Concepts in General 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 concepts first.

a. 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.

Consider the following illustration.

Illustration 32

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, 2021:

Claims:

Intimated in	Admitted in	Paid in	₹
2020	2020	2021	15,000
2021	2021	2022	10,000
2019	2020	2020	5,000
2019	2020	2021	12,000
2021	2022	2022	8,000
2021	2021	2021	1,02,000

Claim on account of re-insurance was ₹25,000

Particulars	₹
Total claim paid in 2021: ₹ (1,02,000 + 12,000 + 15,000)	1,29,000
Less: Outstanding in the beginning i. e., intimated in 2020 or earlier whether accepted in 2020 & accepted in 2021 (₹15,000 + ₹12,000)	27,000
	1,02,000
Add: Outstanding at the end i.e., intimated in 2021 whether accepted in 2021 or in 2022 ₹(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 2019, admitted in 2020, paid in 2020 ₹5,000 is useless as the amount paid in 2020 is not included in the amount paid in 2021.

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].

b. 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 ₹1,26,000

Bonus in reduction of premium is ₹14,000

The revenue account on the credit side will show ₹1,40,000 (₹1,26,000 + ₹14,000) as income and on the debit side ₹14,000 as an expense.

The journal entry is:

Bonus in reduction of premium A/c Dr.

To Premium Account

c. 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.

d. 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 reinsurance business.

e. 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.

f. 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.

g. 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.

⦿ IRDA Regulations Regarding Preparation of Financial Statements

Please See the salient features of the Regulation in Section 'A: Accounts of Life Insurance Business'.

Schedule B

Part V: Preparation of Financial Statements

(1) An insurer shall prepare the Revenue Account, Profit and Loss Account [Shareholders' Account] and the Balance Sheet in Form B-RA, Form B-PL, and Form B-BS, or as near thereto as the circumstances permit.

Provided that an insurer shall prepare Revenue Account separately for fire, marine, and miscellaneous insurance business.

(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 Institute of Chartered Accountants of India.

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)	1		
Others (to be specified)			
Change in provision for unexpired risk			
Interest, Dividend and Rent -Gross			
Total (A)			
Claims Incurred (Net)	2		
Commission	3		
Operating Expenses related to Insurance Business	4		
Others – To be specified			
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 (₹v '000)	Previous Year (₹ '000)
Appropriations			
(a) **Interim Dividends paid during the year**			
(b) **Proposed Final Dividend**			
(c) **Dividend Distribution Tax**			
(d) **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	5		
Reserves and Surplus	6		
Borrowings	7		
Fair Value Change account			
Total			
Application of Funds:			
Investments	8		
Loans	9		
Fixed assets	10		
Current Assets:			
Cash and bank balance	11		
Advances and other assets	12		
Sub-total (A)			
Current Liabilities	13		
Provision	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			
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)
Claims 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 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 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 33

Khush Raho Insurance Co. Ltd. furnishes you the following information:

(i) On 31.3.2022 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, 2023 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, 2023.

Solution:

Journals

Dr. **Cr.**

Date	Particulars	₹ Crore	₹ Crore
31.3.23	Marine Revenue A/c Dr.	8.25	
	To Unexpired Risks Reserve A/c		8.25
	(Excess of closing provision for unexpired risks of ₹45.75 crore over opening provision of ₹37.50 crore charged to Marine Revenue A/c)		
31.3.23	Fire Revenue A/c Dr.	4.63	
	To Unexpired Risks Reserve A/c		4.63
	(Excess of closing provision for unexpired risks of ₹54.63 crore over opening provision of ₹50.00 crore charged to Fire Revenue A/c)		

31.3.23	Unexpired Risks Revenue A/c Dr.	1.25	
	To Miscellaneous Revenue A/c		1.25
	(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)		

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.
2023	To, Revenue A/c	—	—	1.25	2023	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 34

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, 2023:

Particulars		Direct Business	Re-Insurance
		₹	₹
Claim paid during the year		46,70,000	7,00,000
Claim Payable —	1st April, 2022	7,63,000	87,000
	31st March, 2023	8,12,000	53,000
Claims received		–	2,30,000
Claims Receivable —	1st April, 2022	–	66,000
	31st March, 2023	–	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, 2022		
	Direct business	8,12	
	Reinsurance	53	8,65
	Less : Claims receivable from re-insurers		1,13
			7,52
3.	Claims outstanding on 1st April, 2022		
	Direct business	763	
	Reinsurance	87	8,50
	Less : Claims receivable from re-insurers		66
			7,84

Illustration 35

Prepare the Fire Insurance Revenue A/c as per IRDA regulations for the year ended 31st March, 2023 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, 2022	5,50,000
Claims unpaid on 1st April, 2022	50,000
Claims unpaid on 31st March, 2023	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, 2023

	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 31st March, 2023 = 50% of net premium	
i.e. 50% of ₹12,00,000 (See Schedule 1)	6,00,000
Less : Unexpired risk reserve as on 1st April 2022	5,50,000
Change in the provision for unexpired risk	50,000

Illustration 36

1. The Aviva and Axis life Insurance Co. ltd. prepared its Revenue A/c for the year ended 31march 2023 and ascertained its Life Assurance Fund to be ₹ 6670,000. It was found later on that the following had been omitted from the accounts:

   i. Interest accrued on investment ₹ 78,000; income tax liability to be deducted estimated to be ₹ 21,000.

   ii. Outstanding premium ₹ 65,600.

   iii. Bonus utilized in reduction of premiums ₹ 13,500

   iv. Claims intimated but not yet admitted ₹ 34,800

   v. Claims covered under reinsurance ₹ 13,000

What is the correct Life Assurance Fund?

Solution:

Life Assurance Fund	66, 70 ,000
Add:	
Outstanding Premium	65,600
Bonus utilized in reduction of premium	13,500
Interest accrued on Investment	57,000
Claims covered under reinsurance	13,000
	6819,100
Less:	
Claims intimated but not admitted	34,800
Bonus utilized in reduction of premium	13,500
Correct Life Assurance Fund	**6770,800**

Illustration 37

The Revenue a/c of a Life Insurance Company shows the fund for the year ended 31 March 2023 at ₹ 26,20,000 before taking into account the following items;

i. Bonus utilized in reduction of premiums ₹ 2,300

ii. Outstanding premium ₹ 4,500

iii. Claims intimated but not yet admitted ₹ 14,100

iv. Interest accrued on securities ₹ 5,500

v. Claims covered under reinsurance ₹ 6,200

Pass necessary journal entries to give effect to the omission, and show the fund account at the end, after making the above adjustments.

Solution:

Life Assurance Fund	26, 20,000
Add:	
Outstanding Premium	4500

Bonus utilized in reduction of premium	2300
Interest accrued on Investment	5500
Claims covered under reinsurance	6200
	26,38,500
Less:	
Claims intimated but not admitted	14,100
Bonus utilized in reduction of premium	2,300
Correct Life Assurance Fund	**26,22,100**

Illustration 38

The Revenue a/c of a Life Insurance Company shows the Life insurance fund on 31March 2023 at ₹ 58,78,000 before taking into account the following items;

i. Claims intimated but not yet admitted ₹ 65,500
ii. Interest accrued on securities ₹ 19,500
iii. Bonus utilized in reduction of premiums ₹ 6,500
iv. Outstanding premium ₹ 18,000
v. Claims covered under reinsurance ₹ 47,000

Pass the entries giving effect to the above adjustments and show the life fund at the end of the year 2020 after making above adjustments.

Solution:

Life Assurance Fund	58,78,000
Add:	
Outstanding Premium	18,000
Bonus utilized in reduction of premium	6,500
Interest accrued on Investment	19,500
Claims recovered under reinsurance	47,000
	59,69, 000
Less:	
Claims intimated but not admitted	65,500
Bonus utilized in reduction of premium	6,500
Correct Life Assurance Fund	**58,97,000**

Illustration 39

From the following balances as at 31st march 2023, in the books of the X Assurance Co. Ltd. prepare the revenue account and the balance sheet.

Particulars	Amount (₹)	Particulars	Amount (₹)
Life assurance fund as on 1st April 2022	30,00,000	Due from reinsurer	39,000

Particulars	Amount (₹)	Particulars	Amount (₹)
Annuities paid	20,000	Due to reinsurer	49,000
Surrenders	69,000	Agent's balance	20,000
Reserve fund	6,65,000	Interest outstanding	15,000
Deposit with RBI	3,00,000	Sundry creditors	4,000
Govt. securities; Indian govt. securities	32,50,000	Premium less reinsurance	701,000
Foreign govt. securities	1,87,000	Bonus to policy holders	30,000
Loans on Co.'s policies	6,70,000	Commission to agents	60,000
Securities on which interest is guaranteed by the govt.	13,50,000	Claim less reinsurance- On death 4,00,000 On maturity 5,00,000	9,00,000
Share capital	50,00,000		
Mortgages in India	16,36,000	Leasehold ground rent	58,000
Cash with bankers on C/A	30,000	Consideration for annuities granted	40,000
Cash with bankers on Deposit a/c	16,000	Salaries	50,000
Cash in hand	10,500	Director's fees	6,000
State govt. securities	8,88,000	Auditor's fees	8,000
Furniture and fixtures	40,000	Law charges	2,000
Outstanding premium	68,000	Rent paid	5000
		Expenses for management	1,500
		Interest & rent (accountable for the year less taxes 60,000)	3,60,000
		Interest accrued but not due	30,000

Solution:

Revenue A/C of the New X Assurance Co. Ltd for the year ended 31 March 2023.

Particulars	Schedule	Amount (₹)
Premiums earned - net		
(a) Premium	1	701,000
(b) Reinsurance ceded		
(c) Reinsurance accepted		
Sub-Total		701,000

Particulars	Schedule	Amount (₹)
Income from Investments		
(a) Interest, Dividends & Rent - Gross		4,20,000
(b) Profit on sale/redemption of investments		
(c) (Loss on sale/redemption of investments)		
(d) Transfer/Gain on revaluation/change in fair value*		
(e) Other Income		40,000
Total (A)		11,61,000
Commission	2	60,000
Operating Expenses related to Insurance Business	3	1,30,500
Provisions for Doubtful debt		
Provisions for taxation		60,000
Provisions (other than taxation		
(a) For diminution in the value of investments (Net)		
(b) Provision for Required Solvency Margin		
Total (B)		2,50,500
Benefits paid (Net)	4	10,19,000
Interim Bonuses Paid		
Change in valuation of liability in respect of life policies		
(a) Gross		
(b) Amount ceded in Reinsurance		
(c) Amount accepted in Reinsurance		
Total (C)		10,19,000
Surplus/(Deficit) (D) = (A)-(B)-(C)		(1,08,500)
Appropriations		
Transfer to Shareholders' Account		
Transfer to Other Reserves		
Balance being Funds for Future Appropriations		(1,08,500)
Total (D)		(1,08,500)

Schedule -1.Premium

Particulars	**Amount**
Premium less reinsurance	701,000
	701,000

Schedule -2 Commission Expenses

Particulars	**Amount**
Commission to agents	60,000
	60,000

Schedule -3 Operating expenses related with insurance business

Salaries	50,000
Directors fees	6000
Auditors fees	8000
Law charges	2000
Rent paid	5000
Expenses of Management	1500
Leasehold ground rent	58,000
Total	**130,500**

Schedule -4 Benefits Paid

Particulars	**Amount**
Annuities paid	20,000
Surrenders	69,000
Bonus to policy holders	30,000
Claims	9,00,000
Total	**10,19,000**

Balance sheet as on 31 March 2023

Particulars	Schedule	Amount (₹)
Sources of Funds		
Shareholders' Funds		
Share capital	5	50,00,000
Reserves and Surplus	6	35,56,500

Particulars	Schedule	Amount (₹)
Credit/(Debit) Fair value change account		
Sub-Total		85,56,500
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		**85,56,500**
Application of Funds Investments		
Shareholders'	8	
Policyholders'	8A	59,75,000
Assets held to cover linked liabilities	8B	
Loans	9	23,06,000
Fixed assets	10	40,000
Current Assets :		
Cash and Bank Balances	11	56,500
Advances and Other Assets	12	2,32,000
Sub-Total (A)		**2,88,500**
Current Liabilities	13	53,000
Provisions	14	53,000
Sub-Total (B)		**2,35,500**
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		**85,56,500**
Contingent Liabilities		
Significant Accounting Policies & Notes to Accounts 15A		

Schedule 6-Reserves and Surplus

Particulars	**Amount**
Life Assurance fund	3000,000
Add: Surplus	(108500)
Reserve Fund	665,000
	35,56,500

Schedule 8A .Investments-Policy holders

Particulars		**Amount**
Deposits with RBI		300,000
Govt. Securities		
Indian Govt. Securities	3250,000	
Foreign Govt. Securities	187,000	3437000
Securities on which interest is		
Guaranteed by the Govt.		1350,000
State Govt. securities		888,000
Total		**5975,000**

Schedule -9 Loans

Particulars	**Amount**
Mortgages	1636,000
Loan on company's policies	670,000
Total	**2306,000**

Schedule -10.Fixed Assets

Particulars	**Amount**
Furniture	40,000

Schedule -11 Cash and Bank Balances

Particulars	**Amount**
Cash in hand	10,500
Cash with Bank	46,000
Total	**56,500**

Schedule -12 .Advances and other Assets

Particulars	Amount
Outstanding Premium	68,000
Due from re-insurer	39,000
Interest accrued but not due	30,000
Agents' balances	20,000
Interest outstanding	15,000
TDS	60,000
Total	**232,000**

Schedule 13-Current liabilities

Particulars	Amount
Due to reinsurer	49,000
Sundry Creditors	4000
Total	**53,000**

Illustration 40

From the following Trail balance as at 31 March 2023 of the Y Life Insurance Co. Ltd. Prepare Revenue a/c and Balance sheet as at 31March 2023.

Particulars	Dr. (₹)	Cr. (₹)
Share capital 1,00,000 shares of ₹ 10 each		10,00,000
Claims paid	3,36,900	
Premium		6,79,500
Mortgages on property	3,16,000	
Life assurance fund 1-4-2022		43,19,000
Consideration for annuities granted		29,000
Surrenders	13,700	
Loans against policies	2,93,000	
Annuities	14,400	
Commission	20,100	
Outstanding premium	21,800	
Prepaid premium		600

Particulars	Dr. (₹)	Cr. (₹)
Management expenses	32,400	
Investment in Govt. securities	30,40,000	
Debentures in companies	7,18,000	
Cash on deposit & current a/c	8,12,000	
Freehold property	4,00,000	
Claims outstanding on 1-4-2022		9,200
Re-insurance premium	19,000	
Total	60,37,300	60,37,300

The following adjustments are to be made:

(a) Claims outstanding on 31-03-2023 are ₹ 12,400

(b) Claims recoverable under re-insurance are ₹ 7,000

(c) Stationary on 31-03-2023 is valued as ₹ 2,100

Solution:

Revenue A/C of the Y Ltd for the year ended 31 March 2023.

Particulars	Schedule	Amount (₹)
Premiums earned - net	1	6,60,500
(a) Premium		
(b) Reinsurance ceded		
(c) Reinsurance accepted		
Sub-Total		**6,60,500**
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*		
(e) Other Income		29,000
Total (A)		**689,500**
Commission	2	20,100
Operating Expenses related to Insurance Business	3	30,300
Provisions for Doubtful debt		

Particulars	Schedule	Amount (₹)
Provisions for taxation		
Provisions (other than taxation)		
(a) For diminution in the value of investments (Net)		
(b) Provision for Required Solvency Margin		
Total (B)		**50,400**
Benefits paid (Net)	4	3,61,200
Interim Bonuses Paid		
Change in valuation of liability in respect of life policies		
(a) Gross		
(b) Amount ceded in Reinsurance		
(c) Amount accepted in Reinsurance		
Total (C)		**3,61,200**
Surplus/(Deficit) (D) = (A)-(B)-(C)		**2,77,900**
Appropriations		
Transfer to Shareholders' Account		
Transfer to Other Reserves		
Balance being Funds for Future Appropriations		2,77,900
Total (D)		**2,77,900**

Schedule -1 Premium

Particulars	**Amount**
Premium	679,500
Less: Re-Insurance Premium	19,000
	660,500

Schedule -2 Commission Expenses

Particulars	**Amount**
Commission	20,100

Schedule -3 Operating expenses related with insurance business

Expenses of Management	32,400
Stationery	(2,100)
Total	**30,300**

Schedule -4 Benefits Paid

Particulars		**Amount**
Annuities paid		14,400
Surrenders		13,700
Claims Paid		3,36,900
Add: Claims outstanding on 31-03-2023		12,400
Less: Claims outstanding on 01-04-2022		9,200
Less: Claims recoverable under re-insurance	7000	3,33,100
Total		**3,61,200**

Balance sheet as on 31 March 2023

Particulars	Schedule	Amount (₹)
Sources of Funds		
Shareholders' Funds		
Share capital	5	10,00,000
Reserves and Surplus	6	45,96,900
Credit/(Debit) Fair value change account		
Sub-Total		**55,96,900**
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		**55,96,900**
Application of Funds		
Investments		
Shareholders'	8	37,58,000
Policyholders'	8A	
Assets held to cover linked liabilities	8B	

Particulars	Schedule	Amount (₹)
Loans	9	6,09,000
Fixed assets	10	4,00,000
Current Assets :		
Cash and Bank Balances	11	8,12,000
Advances and Other Assets	12	30,900
Sub-Total (A)		8,42,900
Current Liabilities	13	13,000
Sub-Total (B)		**829,900**
Net Current Assets (C) = (A - B)		
Miscellaneous Expenditure (to the extent not written off or adjusted)	14	
Debit Balance in Profit & Loss account (Shareholders' Account)		
Total		**55,96,900**
Contingent Liabilities		
Significant Accounting Policies & Notes to Accounts 15A		

Schedule 6-Reserves and Surplus

Particulars	Amount
Life Assurance fund	4319,000
Add: Surplus	277,900
	4596,900

Schedule 8A Investments-Policy holders

Particulars	Amount
Investments in Govt. Securities	3040,000
Debentures in Companies	718,000
Total	**3758,000**

Schedule -9 Loans

Particulars	Amount
Mortgages on property	316,000
Loans against policies	293,000
Total	**609,000**

Schedule -10.Fixed Assets

Particulars	Amount
Freehold property	400,000

Schedule -11 Cash and Bank Balances

Particulars	Amount
Cash on deposit &current A/C	812,000

Schedule -12 .Advances and other Assets

Particulars	Amount
Outstanding Premium	21,800
Claims recoverable under	
Re-insurance	7,000
Stationery	2,100
Total	**30,900**

Schedule 13-Current liabilities

Particulars	Amount
Prepaid premium	600
Claims outstanding on 31-12-2023	12,400
Total	**13,000**

Illustration 41

The following were the balances extracted from the Trail balance of the Lotus Life Insurance Society at 31st march, 2023:

Particulars	Amount (₹)	Particulars	Amount (₹)
Balance of a/c at the beginning of the year	20,00,000	Premium (other than single)	2,08,000
Govt. securities	10,00,000	Claims admitted but not paid	6,000
Profit on realization of assets	2,000	Surrenders	28,000
Investment fluctuation A/c	10,000	Single premiums	80,000
Claims under policies by death	60,000	Consideration for annuities granted	50,000
Claims under policies by maturity	1,00,000	Interest, dividends & rent received	70,000
Loans on mortgage	5,60,000	Depreciation of furniture	3,000

Particulars	Amount (₹)	Particulars	Amount (₹)
Loans on policies	3,00,000	Administrative expenses	36,000
Freehold property & furniture	83,000	Salaries	3,000
Foreclosed properties	20,000	Auditor's fees	1,500
Agent's balances owing	3,600	Director's fees	300
Sundry creditors	2,000	Legal expenses	1,000
Outstanding premiums	24,000	Advertising	1,400
Commission paid	24,000	Printing, stationary & others	10,800
Interest accrued not due	3,000	Cash at bank	1,68,400
		Provision for depreciation	3,000

Prepare a Revenue account and Balance sheet

Solution

Revenue A/C of the Lotus Life Insurance Society for the year ended 31 March 2023.

Particulars	Schedule	Amount (₹)
Premiums earned - net		
(a) Premium	1	288,000
(b) Reinsurance ceded		
(c) Reinsurance accepted		
Sub-Total		
Income from Investments		
(a) Interest, Dividends & Rent - Gross		70,000
(b) Profit on sale/redemption of investments		
(c) (Loss on sale/redemption of investments)		
(d) Transfer/Gain on revaluation/change in fair value*		
(e) Other Income (2000+50,000)		52,000
Total (A)		4,10,000
Commission	2	24,000
Operating Expenses related to Insurance Business	3	57,000
Provisions for Doubtful debt		
Provisions for taxation		
Provisions (other than taxation		

Particulars	Schedule	Amount (₹)
(a) For diminution in the value of investments (Net)		
(b) Provision for Required Solvency Margin		
Total (B)		**81,000**
Benefits paid (Net)	4	1,88,000
Interim Bonuses Paid		
Change in valuation of liability in respect of life policies		
(a) Gross		
(b) Amount ceded in Reinsurance		
(c) Amount accepted in Reinsurance		
Total (C)		**1,88,000**
Surplus/(Deficit) (D) = (A)-(B)-(C)		**1,41,000**
Appropriations		
Transfer to Shareholders' Account		
Transfer to Other Reserves		
Balance being Funds for Future Appropriations		1,41,000
Total (D)		**1,41,000**

Schedule -1.Premium

Particulars	Amount
Premium (other than single)	208,000
Single premiums	80,000
Total	**288,000**

Schedule -2 Commission Expenses

Particulars	Amount
Commission paid	24,000

Schedule -3 Operating expenses related with insurance business

Administrative expenses	36,000
Salaries	3,000
Auditor's fees	1500
Director's fees	300

Legal expenses	1,000
Advertising	1,400
Printing, stationery &others	10,800
Depreciation of furniture	3000
Total	**57,000**

Schedule -4.Benefits Paid

Particulars	Amount
Claims under policies by death	60,000
Claims under policies by Maturity	100,000
Surrenders	28,000
Total	**188,000**

Balance sheet as on 31 March 2023

Particulars	Schedule	Amount (₹)
Sources of Funds		
Shareholders' Funds		
Share capital	5	
Reserves and Surplus	6	21,51,000
Credit/(Debit) Fair value change account		
Sub-Total		**21,51,000**
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		**21,51,000**
Application of Funds Investment		
Shareholders'	8	10,00,000

Particulars	Schedule	Amount (₹)
Policyholders’	8A	
Assets held to cover linked liabilities	8B	
Loans	9	8,60,000
Fixed assets	10	80,000
Current Assets :		
Cash and Bank Balances	11	1,68,000
Advances and Other Assets	12	50,600
Sub-Total (A)		2,19,000
Current Liabilities	13	8,000
Provisions	14	
Sub-Total (B)		**2,11,000**
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		**21,51,000**
Contingent Liabilities		
Significant Accounting Policies & Notes to Accounts 15A		

Schedule 6- Reserves and Surplus

Particulars	**Amount**
Balance of A/C at the beginning of the year	20,00,000
Investment Fluctuation A/C	10,000
Surplus	141,000
Total	**2151,000**

Schedule 8A .Investments-Policy holders

Particulars	**Amount**
Govt. Securities	1000,000

Schedule -9 Loans

Particulars	**Amount**
Loans on Mortgage	560,000

Loans on policies	300,000
Total	**860,000**

Schedule -10.Fixed Assets

Particulars	**Amount**
Freehold property &Furniture	83,000
Less: Depreciation of furniture	3,000
Total	80,000

Schedule -11 Cash and Bank Balances

Particulars	**Amount**
Cash at Bank	168,400
Total	**168,400**

Schedule -12 .Advances and other Assets

Particulars	**Amount**
Interest Accrued not date	3000
Outstanding Premium	24,000
Agent's Balances owing	3600
Foreclosed properties	20,000
Total	**50,600**

Schedule 13-Current liabilities

Particulars	**Amount**
Claims admitted but not paid	6000
Sundry Creditors	2000
Total	**8,000**

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. Rate of provisioning for advances doubtful for more than 1 year but less than 3 years is
   A. 25%
   B. 40%
   C. 60%
   D. 100%
2. Balance of Interest Accrued on Security Deposit A/C of an electricity company should be shown
   A. Under Current Liability
   B. Under Non-current Liability
   C. Under Current Asset
   D. Under Non-current Asset
3. A Banking Company needs to transfer a minimum of _______ of its profit to reserve fund.
   A. 10%
   B. 15%
   C. 20%
   D. 25%
4. In case of an electricity company, depreciation on assets is calculated based on the rates notified by
   A. Companies Act 2013
   B. State Electricity Commission
   C. Central Electricity Regulatory Commission
   D. Income Tax Act 1961
5. A banking company is required to maintain _________ provision on unsecured portion of doubtful advances.
   A. 25%
   B. 40%
   C. 50%
   D. 100%
6. Which of the following is a principle of insurance?
   A. Principle of indemnity
   B. Insurable interest.
   C. Principle of uberrimae fidei.
   D. All of the above

7. In case of an Electricity Company, balance of Security Deposit A/c at the end of the accounting period should be disclosed as

   A. A current liability in the Balance Sheet

   B. A non-current liability in the Balance Sheet

   C. A current asset in the Balance Sheet

   D. A non-current asset in the Balance Sheet

8. Which of the following is not a mandatory financial statement of a General Insurance Company as per IRDA regulations?

   A. Revenue Account

   B. Profit and Loss Account

   C. Balance Sheet

   D. Cash Flow Statement

9. Which of the following is/are a part of General Ledger of a Banking Company?

   A. Control Accounts of all personal ledgers.

   B. Profit and Loss Account.

   C. Assets' Accounts.

   D. All of the above.

10. Rate of provision on advances doubtful for more than 3 years is ________.

   A. 40%

   B. 25%

   C. 100%

   D. Nil

[Answer: 1-B; 2-B; 3-D; 4-C; 5-D; 6-D; 7-B; 8-D; 9-D; 10-C]

State True or False

1. Every banking company incorporated in India is required to transfer at least 15% of its profit to the reserve fund.

2. 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.

3. 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.

4. Non-performing assets bear a little amount of risk like normal risk and they do not create any trouble regarding their realization.

5. The Electricity Act, 2003 replaced four existing legislations.

6. The Central Electricity Regulatory Commission shall consist of a chairperson and 3 Members

7. 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.

8. 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.

9. 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.

10. Income from non-performing assets of a bank is recognized on cash basis.

[Answer: False; True; False; False; False; True; True; True; False; True]

Fill in the Blanks

1. Sometimes the insurer considers a particular risk too much for his capacity and may ______________ a part of the risk with some other insurer.

2. Bonus paid at the end along with the policy amount to the policy holders is called __________ ____________.

3. In the case of a _________insurance business claim will arise either on death or maturity of policy.

4. In relation to an Electricity Company the amount of Security Deposit = Load × Load Factor of the category in which the consumer falls × ______________× Current tariff.

5. _______________ advance means where a bank grants advance to its customers against any tangible security.

6. Losses of theft are covered by _________ insurance.

7. The __________ ___________ Fund is available to meet the aggregate liability on all policies outstanding.

8. Revenue Account of life Insurance Business is relevant with Form - ________________.

9. In case of Insurance Company the date of discharge of claim is mentioned in the register of_____________.

10. Rebate on Bills Discounted = Amount of Bill × Rate of Discount × __________________.

[Answer: Re-insurance; Reversionary Bonus; Life; (Billing cycle + 45 days); Secured; Burglary; Life Assurance; A – RA; Claims; Unexpired Period/12]

Short Essay Type Questions

1. Discuss about the regulatory restrictions on banking companies in respect of payment of dividend.

2. Discuss about the regulatory restrictions on banking companies in respect of loans and advances.

3. What are the books of accounts to be maintained by a bank?

4. How will you account for Service Line cum Development (SLD) Charges Received from Consumers Accounting Practices?
5. How will account for the grant received by an Electricity Company under R-APDRP?
6. What is the purpose of Valuation Balance Sheet?
7. Write a short note on Life Assurance Fund.
8. What do you mean by Bonus in Reduction of Premium?

- **Essay Type Questions**

1. What is rebate on bills discounted? How will you adjust the same in the books of a banking company?
2. Discuss about the provisioning requirement in case of banking company on performing and non-performing assets.
3. What do you mean by Security Deposit in case of an Electricity Company? How will you treat the same in the books?
4. Discuss various principles of Insurance.
5. Differentiate between life and non-life insurance policy.
6. What do you mean by Valuation Balance Sheet? Discuss its purpose.

B. Numerical Questions

- **Multiple Choice Questions**

1. Given,

Date of bill	15.01.2023
Period	5 months
Rate of discount	8%

Calculate rebate on bill discounted, if accounting year ends on 31.03.22.

A. ₹ 852.46

B. ₹ 818.85

C. ₹ 873.22

D. ₹ 825.45

2. If a loan is identified to be a sub-standard advance with secured exposure of ₹ 200 lakh and unsecured portion of ₹ 300 lakh, calculate the provision at applicable rate in case of a banking company.

A. ₹ 80 lakh

B. ₹ 85 lakh

C. ₹ 90 lakh

D. ₹ 95 lakh

[Answer: 1-A; 2-C]

Comprehensive Numerical Problem

1. From the following information, calculate the amount of discount to be transferred to the Statement of Profit and Loss.

   (i) Rebate on Bills Discounted (as on 01.04.2022) ₹ 28,000. Discount Received ₹ 1,02,000.

   (ii) The following bills have been discounted during the year.

Amount of Bill (₹)	Rate of Discount	Due Date (including grace days)
65,000	13% p.a.	June 14, 2023
1,50,000	15% p.a.	July 19, 2023
4,30,000	12% p.a.	August 10, 2023

   Also pass the necessary journal entry for the unexpired discount as on 31.03.2022.

[Answer: Total rebate is ₹ 21,178]

2. Given below are details of interest on advance of a Commercial Bank as on 31.03.2022:

Particulars	Interest Earned (₹ in Crore)	Interest Received (₹ in Crore)
Performing Assets		
Term Loan	120	80
Cash Credit and Overdraft	750	620
Bills Purchased and Discounted	150	150
Non-Performing Assets		
Term Loan	75	5
Cash Credit and Overdraft	150	12
Bills Purchased and Discounted	100	20

   Find out the income to be recognized for the year ended 31st March 2022.

[Answer: ₹1,057 crore]

3. From the following information calculate Return on Equity as per Regulation 21 of the Central Electricity Regulatory Commission (Terms and Conditions of Tariff) Regulation 2019:

   (i) Date of commercial operation of COD = 01.04. 2023

   (ii) Approved opening capital cost as on 01.04. 2023 = ₹30,00,000

   (iii) Details of allowed additional capital expenditure:

Year	1	2	3	4
Additional Capital Expenditure (₹)	2,00,000	60,000	40,000	20,000

[Answer: ₹ 1,30,200, ₹ 1,35,660, ₹1,37,760, ₹ 1,39,020]

4. While closing the books of a bank on 31.12.2022, it was found that in the loan ledger there was an unsecured balance of ₹4,00,000 in the account of a merchant whose financial condition is reported as bad and doubtful. Interest on the same account amounted to ₹40,000 during the year. How would you deal with this item of interest in 2022 account?

   During the year 2023, the bank accepts 75 paise in the rupee on account of the total debt due up to 31.12.2022. Show the necessary accounts showing the ultimate effect of the transactions in 2023 books of accounts under Interest Suspense Method.

[Answer: Bad Debt ₹1,00,000]

5. Calculate rebate on bills discounted as on 31st March 2022 and pass journal entry.

Date of bill	Amount (₹)	Period	Rate of discount
15.1.2022	50,000	5 months	8%
10.2.2022	30,000	4 months	7%
25.2.2022	40,000	4 months	7%
20.3.2022	60,000	3 months	9%

[Answer: Total rebate is ₹3,217

6. The following information of advances has been provided by PQR Bank Ltd. as on 31.03.2023.

Asset classification	₹ in lakhs
Standard	3,000
Sub-standard	2,200
Doubtful:	
For one year	900
For two years	600
For three years	400
For more than three years	300
Loss assets	800

Calculate the amount of provision to be made in for the year ended 31.3.2023.

[Answer: ₹2,067 Lakhs]

7. Prepare the Fire Insurance Revenue A/C as per IRDA regulations for the year ended 31st March, 2023 from the following details:

Particulars	₹
Claims paid	9,80,000
Legal expenses regarding claims	20,000
Premiums received	26,00,000
Re-insurance premium paid	2,00,000
Commission	6,00,000

Particulars	₹
Expenses of management	4,00,000
Provision against unexpired risk on 1st April, 2020	11,00,000
Claims unpaid on 1st April, 2022	1,00,000
Claims unpaid on 31st March, 2023	1,60,000

Create Reserve for Unexpired Risk @ 50%.

[Answer: Operating Profit ₹2,40,000]

8. Consider the following estimated information provided by XYZ Power Supply Company Ltd. (₹ in lakhs) for the next 5 years:

   Cost of coal: ₹4,000 per year

   Cost of secondary fuel oil: ₹400 per year for first 2 years and ₹600 per year for 3-5 years

   O and M expenses: ₹500 per year for first 2 years and ₹700 per year for 3-5 years

   Maintenance spares: ₹200 per years

   Receivables: ₹3,600 per year

   Rate of interest: 12%

   Calculate the interest on working capital.

[Answer: ₹1,044 lakhs for first 2 years and ₹1,092 lakhs for next 3 years]

⊙ References:

1. Corporate Accounting by Hanif and Mukherjee; McGraw Hill Publications
2. Banking Regulations Act, 1949
3. Electricity Act, 2003
4. Central Electricity Regulatory Commission (Terms and Conditions of Tariff) Regulations, 2019
5. Insurance Act, 1938

Accounting Standards 5

This Module includes:

Accounting Standards 5

SLOB Mapped against the Module

To develop detail understanding on preparation of mandatory financial statements by companies (including Banking, Insurance and Electricity companies) in an Ind AS environment. (CMLO 4 c)

Module Learning Objectives:

After studying this module, the students will be able to –

- Appraise the role of Conceptual Framework
- Understand the principles, structure and minimum contents of General-Purpose Financial Reporting as prescribed in Ind AS 1
- Understand the methodology in valuing inventories as per Ind AS 2
- Comprehend the treatment of events after the reporting period under Ind AS 10
- Understand the treatment of employee benefits in accounting under Ind AS 19
- Comprehend the methodology to calculate basic and diluted EPS under Ind AS 33
- Understand the treatment of provisions and contingencies as per Ind AS 37
- Know the major differences of the above Ind ASs from their corresponding ASs.

Conceptual Framework

5.1

5.1.1 Meaning of Conceptual Framework

The Conceptual Framework is a basic document that sets objectives and the concepts for general purpose financial reporting. It basically acts as a guideline for the setters of accounting standards and often guides the accountants where there is no accounting standard available.

- **Background of Conceptual Framework for Financial Reporting under Ind AS**

In India, the current version of conceptual framework issued by The Institute of Chartered Accountants of India for Ind AS based financial reporting is known as 'Conceptual Framework for Financial Reporting under Ind AS'. It is applicable for preparers for accounting periods beginning on or after April 1, 2021. This version of the conceptual framework is in line with the Conceptual Framework for the Financial Reporting published by the IASB in 2018 which overrides the previous version issued in 2010.

- **Components of Conceptual Framework for Financial Reporting under Ind AS**

The Conceptual Framework for Financial Reporting under Ind AS issued by The Institute of Chartered Accountants of India comprises of eight chapters as follows:

1. Objective of general purpose financial reporting (GPFR).
2. Qualitative characteristics of useful financial information.
3. Financial statements and the reporting entity.
4. The elements of financial statements(FS).
5. Recognition and derecognition.
6. Measurement.
7. Presentation and Disclosures.
8. Concepts of capital and capital maintenance.

These has been discussed, in brief, in the following segments.

- **Status and Purpose of Conceptual Framework**

Conceptual framework serves three purposes as follows:

a. assist the Institute in formulation of Ind ASs that are based on consistent concepts;

b. assist preparers to develop consistent accounting policies when no Ind AS applies to a particular transaction or other event, or when an Ind AS allows a choice of accounting policy; and

c. assist all parties to understand and interpret the Ind ASs.

Chapter 1: Objectives of General Purpose Financial Reporting

Objectives of General Purpose Financial Reporting

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity.

Limitations of General Purpose Financial Reporting

General purpose financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need. Those users need to consider pertinent information from other sources. For example, general economic conditions and expectations, political events and political climate, and industry and company outlooks.

General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders and other creditors to estimate the value of the reporting entity.

Moreover, other parties, such as regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful.

Information Provided by General Purpose Financial Reporting

The information provided by General Purpose Financial Reporting are as follows:

1. Economic resources i.e., assets;
2. Claims against the entity i.e., liabilities;
3. Changes in economic resources and claims;
4. Financial performance reflected by accrual accounting;
5. Financial performance reflected by past cash flows;
6. Changes in economic resources and claims not resulting from financial performance;
7. Information about use of entity's economic resources.

Chapter 2: Qualitative Characteristics of Useful Financial Information

In order to make financial information, published in the financial statements, useful for the users, the information must possess certain qualitative characteristics. The Conceptual Framework prescribes the following types of qualitative characteristics to be embedded in the financial information to make them useful for decision making.

A. Fundamental Qualitative Characteristics

Fundamental qualitative characteristics include –

a. Relevance – financial information will be relevant if it is capable of making a difference in decisions. For this it must have predictive value, confirmatory value or both. Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. It has confirmatory value if it provides feedback about (confirms or changes) previous evaluations. While assessing relevance, materiality shall be considered.

Example:

Salary for the current year, which can be used as a basisi for predicting the salary in the future years, can also be compared with salary predictions for the current years that were made in the past years.

b. Faithful Representation - To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral and free from error.

B. Enhancing Qualitative Characteristics

Enhancing qualitative characteristics include the following:

a. Comparability – it enables users to identify and understand similarities in, and differences among, items.

b. Verifiability – it helps assure users that information faithfully represents the economic phenomena it purports to represent.

c. Timeliness - it means having information available to decision-makers in time to be capable of influencing their decisions.

d. Understandability - classifying, characterising and presenting information clearly and concisely makes it understandable.

- **Chapter 3 – Financial Statements and the Reporting Entity**

Financial statements provide information about economic resources of the reporting entity, claims against the entity, and changes in those resources and claims.

The objective of financial statements is to provide financial information about the reporting entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the reporting entity and in assessing management's stewardship of the entity's economic resources.

Financial information is provided in Balance Sheet, Statement of Profit and Loss and in other statements and notes.

Financial statements are prepared for a specified period of time, known as reporting period.

Financial statements provide information about transactions and other events viewed from the perspective of the reporting entity as a whole, not from the perspective of any particular group of the entity's existing or potential investors, lenders or other creditors.

A reporting entity is an entity that is required or chooses to prepare financial statements. A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity. A reporting entity is not necessarily a legal entity.

Financial statements are normally prepared on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future.

Reporting entities prepare consolidated financial statements and unconsolidated financial statements, as required. Consolidated financial statements are not designed to provide separate information about the assets, liabilities, equity, income and expenses of any particular subsidiary. Unconsolidated financial statements are designed to provide information about the parent's assets, liabilities, equity, income and expenses, and not about those of its subsidiaries.

- **Chapter 4: Elements of Financial Statements**

The elements of financial statements defined in the Conceptual Framework are:

a. assets, liabilities and equity, which relate to a reporting entity's financial position; and

b. income and expenses, which relate to a reporting entity's financial performance.

Chapter 5: Recognition and Derecognition

Recognition is the process of capturing for inclusion in the balance sheet or the statement of profit and loss an item that meets the definition of one of the elements of financial statements - an asset, a liability, equity, income or expenses. The amount at which an asset, a liability or equity is recognised in the balance sheet is referred to as its 'carrying amount'.

Recognition links the elements, the balance sheet and the statement of profit and loss as follows:

a. in the balance sheet at the beginning and end of the reporting period, total assets minus total liabilities equal total equity; and

b. recognised changes in equity during the reporting period comprise:

   (i) income minus expenses recognised in the statement of profit and loss; plus

   (ii) contributions from holders of equity claims, minus distributions to holders of equity claims.

   Only items that meet the definition of an asset, a liability or equity are recognised in the balance sheet. Similarly, only items that meet the definition of income or expenses are recognised in the statement of profit and loss. However, not all items that meet the definition of one of those elements are recognised.

   Recognition of a particular asset or liability and any resulting income, expenses or changes in equity may not always provide relevant information. That may be the case if, for example:

   a. it is uncertain whether an asset or liability exists; or

   b. an asset or liability exists, but the probability of an inflow or outflow of economic benefits is low.

   Derecognition is the removal of all or part of a recognised asset or liability from an entity's balance sheet. Derecognition normally occurs when that item no longer meets the definition of an asset or of a liability. Such assets and liabilities are called transferred components.

   The accounting involves –

   a. derecognising any assets or liabilities that have expired or have been consumed, collected, fulfilled or transferred, and recognising any resulting income and expenses. Such assets and liabilities are called transferred components.

   b. continuing to recognise the assets or liabilities retained, referred to as the 'retained component', if any.

   c. applying one or more of the following procedures, if that is necessary to achieve one or both of the aims:

      (i) presenting any retained component separately in the balance sheet;

      (ii) presenting separately in the statement of profit and loss any income and expenses recognised as a result of the derecognition of the transferred component; or

      (iii) providing explanatory information

Chapter 6: Measurement

Elements recognised in financial statements are quantified in monetary terms. This requires the selection of a measurement basis.

Conceptual Framework provides the following measurement bases:

A. Historical Cost

Historical cost measures provide monetary information about assets, liabilities and related income and expenses, using information derived, at least in part, from the price of the transaction or other event that gave rise to them. The historical cost of an asset when it is acquired or created is the value of the costs incurred in acquiring or creating the asset, comprising the consideration paid to acquire or create the asset plus transaction costs.

The historical cost of an asset is updated over time to depict consumption of part or all of economic resources, payments received that extinguish part or all of the asset, the effect of events that cause part or all of the historical cost of the asset to be no longer recoverable (impairment) and accrual of interest to reflect any financing component of the asset.

The historical cost of a liability is updated over time to depict fulfilment of part or all of the liability, the effect of events that increase the value of the obligation to transfer the economic resources needed to fulfil the liability to such an extent that the liability becomes onerous and accrual of interest to reflect any financing component of the liability.

B. Current Value

Current value measures provide monetary information about assets, liabilities and related income and expenses, using information updated to reflect conditions at the measurement date. Current value measurement bases include:

a. Fair value – 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.

b. Value in use and fulfilment value - Value in use is the present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal. Fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability.

c. Current cost - The current cost of an asset is the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid at the measurement date plus the transaction costs that would be incurred at that date.

Conceptual Framework provides a summary of information provided by particular measurement bases with respect to assets, liabilities and various items of the Statement of Profit and Loss on account of various events.

- **Chapter 7: Presentation and Disclosure**

A reporting entity communicates information about its assets, liabilities, equity, income and expenses by presenting and disclosing information in its financial statements.

When developing presentation and disclosure requirements in Ind ASs a balance is needed between:

a. giving entities the flexibility to provide relevant information that faithfully represents the entity's assets, liabilities, equity, income and expenses; and

b. requiring information that is comparable, both from period to period for a reporting entity and in a single reporting period across entities.

Effective communication in financial statements is also supported by considering the following principles:

a. entity-specific information is more useful than standardised descriptions, sometimes referred to as 'boilerplate'; and

b. duplication of information in different parts of the financial statements is usually unnecessary and can make financial statements less understandable.

Classification plays an important role in this regard. Classification is the sorting of assets, liabilities, equity, income or expenses on the basis of shared characteristics for presentation and disclosure purposes.

Classification is applied to the unit of account selected for an asset or liability. However, it may sometimes be appropriate to separate an asset or liability into components that have different characteristics and to classify those components separately.

Sometimes, the entity may apply offsetting. Offsetting occurs when an entity recognises and measures both an asset and liability as separate units of account, but groups them into a single net amount in the balance sheet.

To provide useful information, it may be necessary to classify equity claims separately if those equity claims have different characteristics.

Classification also applies to income and expenses resulting from the unit of account selected for an asset or liability; or components of such income and expenses.

Income and expenses are classified and included either in the profit or loss section of statement of profit and loss or outside the profit or loss section of statement of profit and loss, in other comprehensive income.

Sometime a reporting entity uses aggregation for better presentation and disclosure. Aggregation is the adding together of assets, liabilities, equity, income or expenses that have shared characteristics and are included in the same classification. Aggregation makes information more useful by summarising a large volume of detail. However, aggregation conceals some of that detail. Hence, a balance needs to be found so that relevant information is not obscured either by a large amount of insignificant detail or by excessive aggregation.

- **Chapter 8: Concepts of Capital and Capital Maintenance**

Conceptual Framework provides two concepts of capital – Financial Capital and Physical Capital. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the entity. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the entity based on, for example, units of output per day.

The selection of the appropriate concept of capital by an entity should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the entity, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

The concepts of capital, as above, give rise to the following concepts of capital maintenance:

a. Financial capital maintenance: Under this concept, a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

b. Physical capital maintenance: Under this concept, a profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the entity. In general terms, an entity has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

Under the concept of financial capital maintenance, where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

Under the concept of physical capital maintenance, where capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the entity are viewed as changes in the measurement of the physical productive capacity of the entity; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

The revaluation or restatement of assets and liabilities gives rise to increase or decrease in equity. While these increase or decrease meet the definition of income and expenses, they are not included in the income statement under certain concepts of capital maintenance. Instead, these items are included in equity as capital maintenance adjustments or revaluation reserves.

- **Conclusion**

The Conceptual Framework contributes to the mission of The Institute of Chartered Accountants of India to formulate Ind ASs in order to bring transparency, accountability and efficiency to financial markets. The Institute of Chartered Accountants of India's accounting standards formulation related work serves the public interest by fostering trust, growth and long-term financial stability in the global economy. The Conceptual Framework provides the foundation for Ind ASs that:

a. contribute to transparency by enhancing the international comparability and quality of financial information, enabling investors and other market participants to make informed economic decisions.

b. strengthen accountability by reducing the information gap between the providers of capital and the people to whom they have entrusted their money. Ind ASs based on the Conceptual Framework provide information needed to hold management to account. As a source of globally comparable information, those Ind ASs are also of vital importance to regulators.

c. contribute to economic efficiency by helping investors to identify opportunities and risks across the world, thus improving capital allocation. For businesses, the use of a single, trusted accounting language derived from Ind ASs based on the Conceptual Framework lowers the cost of capital and reduces international reporting costs.

Indian Accounting Standards have been modified as per the following rules. (From 2015 to 2023).

- Companies (Indian Accounting Standards) Amendment Rules, 2023.
- Companies (Indian Accounting Standards) Amendment Rules, 2022.
- Companies (Indian Accounting Standards) Amendment Rules, 2021.
- Companies (Indian Accounting Standards) Amendment Rules, 2020.

- Companies (Indian Accounting Standards) Second Amendment Rules, 2019
- Companies (Indian Accounting Standards) Amendment Rules, 2019.
- Companies (Indian Accounting Standards) Second Amendment Rules, 2018.
- Companies (Indian Accounting Standards) Amendment Rules, 2018.
- Companies (Indian Accounting Standards) Amendment Rules, 2017.
- Companies (Indian Accounting Standards) Amendment Rules, 2016.
- Companies (Indian Accounting Standards) Amendment Rules, 2015.

List of Current Ind AS.

- Ind AS 101 First Time Adoption of Indian Accounting Standards
- Ind AS 102 Share- based Payment
- Ind AS 103 Business Combinations
- Ind AS 104 Insurance Contracts
- Ind AS 105 Non-Current Assets Held for sale and Discontinued Operations
- Ind AS 106 Exploration for and Evaluation of Mineral Resources
- Ind AS 107 Financial instruments Disclosures
- Ind AS 108 Operating Segments
- Ind AS 109 Financial Instruments
- Ind AS 110 Consolidated Financial statements
- Ind AS 111 Joint Arrangements
- Ind AS 112 Disclosure of Interests in other Entities
- Ind AS 113 Fair value Measurement
- Ind AS 114 Regulatory Deferral Accounts
- Ind AS 115 Revenue from contracts with customers
- Ind AS 116 Leases
- Ind AS 117 Insurance Contracts.
- Ind AS1Presentation of Financial Statements
- Ind AS 2.Inventories
- Ind AS 7.Statement of Cash Flows
- Ind AS 8. Accounting Policies, Changes in Accounting Estimates and Errors.
- Ind AS10.Events after the Reporting Period.
- Ind AS 12.Income Taxes
- Ind AS 16.Property, Plant and Equipment.
- Ind AS-19.Employee Benefits.
- Ind AS -20.Accounting for Government Grants and Disclosure of Government Assistance
- Ind AS-21.The Effects of changes in Foreign Exchange Rates

- Ind AS-23 .Borrowing Costs
- Ind AS-24.Related Party Disclosures
- Ind AS-27. Separate Financial Statements
- Ind AS -28.Investments in Associates
- IndAS 29-Ind AS 29, Financial Reporting in Hyperinflationary Economies
- Ind AS-32.Financial Instruments: Presentation
- Ind AS-33 Earnings per Share
- Ind AS-34.Interim Financial Reporting
- Ind AS-36.Impairment of Assets
- Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets
- IndAS 38 Intangible Assets
- Ind AS 40 Investment Property
- Ind AS 41 Agriculture

Specified Ind AS with Comparative Provisions under AS

5.2

5.2.1 Presentation of Financial Statements (Ind AS 1)

- **Introduction**

Financial statements are the end products of accounting. Thus, they must reflect a true and fair view of the financial performance and financial position of the organisation in order to facilitate appropriate decisions by the users of accounting information. Accordingly, the financial statements must possess certain characteristics and be prepared based on certain well-defined principles. Ind AS 1, Presentation of Financial Statements, prescribes the principles for preparation of General Purpose Financial Statements, their structures and minimum content requirements as well as guidelines for specific disclosure in India.

- **Applicability**

This Standard applies to all profit-oriented business undertakings including public sector business entities. Non-profit entities may also apply the provisions of this Standard with suitable modification in terminology used. It is also equally applicable to all entities which prepares Consolidated Financial Statements and Separate Financial Statements as defined in Ind AS 27, Consolidated and Separate Financial Statements. However, the standard does not apply to condensed/summarized financial statements covered by Ind AS-34, Interim Financial Reporting.

- **Meaning of General Purpose Financial Statements**

General purpose financial statements (referred to as 'financial statements') are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs. Hence, their use is 'General' and not specific.

- **Objectives of Financial Statements**

Financial statements are a structured representation of the financial position and financial performance of an entity. The objective of financial statements is to provide information about the financial position (assets, liabilities and equity), financial performance (income/expenses, gains and losses) and cash flows (movement of cash and cash equivalent) of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it.

The information available from financial statements, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

- **Complete Set of Financial Statements**

A complete set of financial statements comprises:

(a) a balance sheet as at the end of the period;

(b) a statement of profit and loss for the period in a single statement of profit and loss, with profit or loss and other comprehensive income presented in two sections. The sections shall be presented together, with the profit or loss section presented first followed directly by the other comprehensive income section.;

(c) Statement of changes in equity for the period;

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

(e) notes, comprising a summary of significant accounting policies and other explanatory information; and comparative information in respect of the preceding period.

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

Note: An entity shall present with equal prominence all of the financial statements in a complete set of financial statements.

Entities may provide additional information on a voluntary basis such as Environmental Reports, Value Added Statement and Human Resource Statement.

⊙ General Features of Financial Statements

The above financial statements must possess the following features or characteristics in order to be relevant and reliable:

a. True and fair presentation and compliance with Ind ASs.

b. Adherence to Going Concern assumption

c. Accrual basis of accounting

d. Materiality and aggregation

e. Offsetting

f. Frequency of reporting (financial statements are to be prepared at least annually)

g. Comparative information (information for the previous period should be disclosed unless exempted by Ind AS)

h. Consistency of presentation (similar accounting policies should be continued; changes if any for appropriate presentation or as required by Ind AS will be allowed).

These features are discussed below.

a. True and fair presentation and compliance with Ind ASs.

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

An entity whose financial statements comply with Ind ASs shall make an explicit and unreserved statement of such compliance in the notes.

However, an entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material. Any departure from any Ind AS requirement must be disclosed along with the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement.

b. Going Concern

Financial statement should be prepared assuming that the entity will continue its business in foreseeable future unless management intends to liquidate the entity or cease trading or has no realistic option but to close. Material uncertainties regarding the continuance of the business, if any, should be disclosed. In case the financial statement have not been prepared on going concern basis that fact should be disclosed together with the basis on which they have been prepared.

c. Accrual basis of accounting

An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting. Thus, asset and liabilities will be recognized when they are receivable and payable rather than when actually received or paid.

d. Materiality and aggregation

Each material class of similar items shall be presented separately in the financial statement, Items which are not material need not to be disclosed except if it is required by law.

e. Offsetting

An entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an Ind AS.

f. Frequency of reporting

An entity shall present a complete set of financial statements (including comparative information) at least annually. When an entity changes the end of its reporting period and presents financial statements for a period longer or shorter than one year, an entity shall disclose the following, in addition to the period covered by the financial statements:

(a) the reason for using a longer or shorter period, and

(b) the fact that amounts presented in the financial statements are not entirely comparable.

g. Comparative information

(i) Minimum comparative information

Except when Ind ASs permit or require otherwise, an entity shall present comparative information in respect of the preceding period for all amounts reported in the current period's financial statements. An entity shall present, as a minimum, two balance sheets, two statements of profit and loss, two statements of cash flows and two statements of changes in equity, and related notes.

(ii) Additional comparative information

An entity may present comparative information in addition to the minimum comparative financial statements required by Ind ASs, as long as that information is prepared in accordance with Ind ASs.

Note: When there is change in accounting policy and such change is retrospectively applied or there is retrospective restatement of item in the financial statement then the entity shall present a minimum of three balance sheet, two profit or loss statement and two cash flow.

When it is impracticable to re-classify comparative amounts, an entity must disclose the reason thereof.

h. Consistency of presentation

Entities should retain their presentation and classification of items from one period to the next. Change may be allowed only when

(i) the change result in a more appropriate presentation

(ii) it is required by an Ind AS.

- **Structure and Content**

Students are advised to follow Module 2 of this Study Material for detail discussion on structure and content of financial statement.

- **Disclosure Under Ind AS 1**

a. Significant Accounting Policies

An entity shall disclose in the summary of significant accounting policies:

(i) the measurement basis (or bases) used in preparing the financial statements, and

(ii) the other accounting policies used that are relevant to an understanding of the financial statements.

An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

b. Sources of estimated uncertainty

An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation of uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

In respect of those assets and liabilities, the notes shall include details of:

(a) their nature, and

(b) their carrying amount as at the end of the reporting period.

c. Capital Management Policies

An entity shall disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital. Accordingly, the entity shall disclose information relating to the qualitative aspects of capital, quantitative aspects of capital, management of both the aspects, externally imposed restrictions on capital and any violation of these restrictions during the year.

d. Information regarding puttable financial instruments

e. Other disclosures

An entity shall disclose in the notes:

(i) the amount of dividends proposed or declared before the financial statements were approved for issue but not recognised as a distribution to owners during the period, and the related amount per share; and

(ii) the amount of any cumulative preference dividends not recognised.

An entity shall disclose the following, if not disclosed elsewhere in information published with the financial statements:

(i) the domicile and legal form of the entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office);

(ii) a description of the nature of the entity's operations and its principal activities;

(iii) the name of the parent and the ultimate parent of the group; and

(iv) if it is a limited life entity, information regarding the length of its life.

Model of Statement of Profit and Loss (Prepared based on Ind AS 1 and Annual Reports of Listed Companies).

Statement of Profit and Loss for the year ended 31st March.

Particulars	Note No	Amount (₹)
Revenue from Operations		
Other Income		
Total Income		
Expenses		
Cost of Material Consumed		
Purchase of Stock-in-Trade		
Changes in Inventories of Finished Goods, Work-in-Progress and Stock-in-Trade		
Excise Duty		
Employee Benefits Expense		
Finance Costs		
Depreciation/Amortization and Depletion Expense		
Other Expenses		
Total Expenses		
Profit Before Exceptional Item and Tax		
Exceptional Item (Net of Tax)		
Profit Before Tax		
Tax Expenses		
Current Tax		
Deferred Tax		
Profit From Continuing Operations		
Profit From Discontinued Operations (Net of Tax)		
Profit for the Year		
Other Comprehensive Income		
A.i. Items that will not be reclassified to Profit or Loss		
ii. Income tax relating to items that will not be reclassified to Profit or Loss		

Particulars	Note No	Amount (₹)
B.iii. Items that will be reclassified to Profit or Loss		
iv. Income tax relating to items that will be reclassified to Profit or Loss		
Total Other Comprehensive Income/(Loss) for the Year (Net of Tax)		
Total Comprehensive Income for the Year		
Earnings Per Equity Share of Face Value of --- each		
Basic		
Diluted		
Significant Accounting Policies		
See accompanying Notes to the Financial Statements		

If discontinued operations exist details should be given in the statement of profit and loss

Model of STATEMENT OF CHANGES IN EQUITY (Prepared based on Ind AS 1 and Annual Reports of Listed Companies).

STATEMENT OF CHANGES IN EQUITY For the year ended 31st March.

A. Equity Share Capital

1. Current reporting period

Balance at the beginning of the current reporting period	Changes in Equity Share Capital due to prior period errors	Restated balance at the beginning of the current reporting period	Changes in equity share capital during the current year	Balance at the end of the current reporting period

2. Previous reporting period

   Data should be given

B. Other Equity.

(1) Current reporting period

	Balance as at 1st April-	Total Comprehensive Income for the year	Dividend	Transfer (to)/from Retained Earnings	Transfer (to)/from General Reserve	On Rights Issue#	On Employee Stock Options	Others	Balance as at 31st March, 2023
As at 31st March, 2023 Reserves and Surplus									

	Balance as at 1st April-	Total Comprehensive Income for the year	Dividend	Transfer (to)/from Retained Earnings	Transfer (to)/from General Reserve	On Rights Issue#	On Employee Stock Options	Others	Balance as at 31st March, 2023
Capital Reserve									
Securities Premium									
Debenture Redemp-tion Re-serve									
Share Based Payments Reserve									
General Reserve									
Other Com-prehensive Income									
Retained Earnings									
Total									

(2) Previous reporting period

Data should be given

Model of BALANCESHEET (Prepared based on Ind AS 1 and Annual Reports of Listed Companies).

BALANCESHEET As at 31st March, 2023

Particulars	Note No	Amount (₹)
Assets		
Non-Current Assets		
Property, Plant and Equipment		
Capital Work-in-Progress		
Goodwill		
Other Intangible Assets		
Intangible Assets Under Development		

Particulars	Note No	Amount (₹)
Financial Assets.		
Investments		
Loans		
Deferred Tax Assets (Net)		
Other Non-Current Assets		
Total Non-Current Assets		
Current Assets		
Inventories		
Financial Assets		
Investments		
Trade Receivables		
Cash and Cash Equivalents		
Loans		
Other Financial Assets		
Total Current Assets		
Assets Held for Sale		
Total Assets		
Equity and Liabilities		
Equity		
Equity Share Capital		
Other Equity		
Liabilities		
Non-Current Liabilities		
a. Financial Liabilities		
i. Borrowings (ia) Lease liabilities] (ii) Trade Payables:- (A) total outstanding dues of micro enterprises and small enterprises; and (B) total outstanding dues of creditors other than micro enterprises and small enterprises		
iii. Other Financial Liabilities		

Particulars	Note No	Amount (₹)
Deferred Payment Liabilities		
b. Provisions		
c. Deferred Tax Liabilities (Net)		
Provisions		
Deferred Tax Liabilities (Net)		
d. Other Non-Current Liabilities		
Total Non-Current Liabilities		
Current Liabilities a. Financial Liabilities (i) Borrowings. (ia) Lease liabilities (ii) Trade Payables:- (A) total outstanding dues of micro enterprises and small enterprises; and (B) Total outstanding dues of creditors other than micro enterprises and small enterprises.		
Other Financial Liabilities		
Other Current Liabilities		
Provisions		
Total Current Liabilities		
Liabilities directly associated with Assets Held for Sale		
Total Liabilities		
Total Equity and Liabilities		
Significant Accounting Policies See accompanying Notes to the Financial Statements		

5.2.2 Inventories (Ind AS 2)

- **Objective**

  The objective of this Standard is to prescribe the accounting treatment for inventories. This Standard deals with the determination of cost and its subsequent recognition as an expense, including any write-down to net realisable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

- **Scope**

  This Standard is applicable to all inventories, except:

  a. financial instruments (to be accounted under Ind AS 32, Financial Instruments: Presentation and Ind AS 109, Financial Instruments)

b. biological assets (i.e., living animals or plants) related to agricultural activity and agricultural produce at the point of harvest (to be accounted under Ind AS 41, Agriculture)

This Standard does not apply to the measurement of inventories held by:

a. producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries.

b. commodity broker-traders who measure their inventories at fair value less costs to sell.

⊙ Important Definitions

■ Definition of Inventories

Inventories are assets:

a. held for sale in the ordinary course of business; (Finished Goods)

b. in the process of production for such sale; or (Work in progress)

c. in the form of materials or supplies to be consumed in the production process or in the rendering of services. (Raw material)

■ Net Realisable Value

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

■ Fair Value

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.

⊙ Measurement of Inventories

Inventories shall be measured at the lower of cost and net realisable value.

■ Cost of inventories

The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

a. Costs of purchase

The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

b. Cost of conversion

It consists of:

(i) Direct production cost (i.e., Direct Labour, Direct Material and Direct Expenses)

(ii) Production overheads based on normal capacity Le., expected on average under normal circumstances,

(iii) Joint product costs (deduct net realizable value of by-products).

Note: Production overheads

This can be of two types – fixed and variable.

- Fixed Production Overhead refers to indirect cost of production that remains relatively constant regardless of volume of production (e.g., Depreciation and Maintenance of factory building, cost of factory management).

  Fixed production overhead should be allocated based on normal capacity. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. The amount of fixed overheads allocated to each unit of production is not increased as a consequence of low production or idle plant.

- Variable Production Overhead refers to indirect cost of production that varies directly or nearly directly with the volume of production (e.g., indirect material, indirect labour). production overhead should be allocated based on actual production.

  Note: Joint/By-Product Cost

  A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product.

  When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production.

  Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

c) Other Costs

Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories. Ind AS 23, Borrowing Costs, identifies limited circumstances where borrowing costs are included in the cost of inventories.

Note: An entity may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing.

- **Exclusions from the Cost of Inventories**

Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:

(a) abnormal amounts of wasted materials, labour or other production costs;

(b) storage costs, unless those costs are necessary in the production process before a further production stage;

(c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and

(d) selling costs.

- **Cost of inventories of a service provider**

  To the extent that service providers have inventories, they measure them at the costs of their production. These costs consist primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. Labour and other costs relating to sale and administrative personnel are not included but are recognized as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include profit margins or non-attributable overheads that are often factored into prices charged by service providers.

- **Cost of Agricultural Produce Harvested from Biological Assets**

  In accordance with Ind AS 41, Agriculture, inventories comprising agricultural produce that an entity has harvested from its biological assets are measured on initial recognition at their fair value less costs to sell at the point of harvest. This is the cost of the inventories at that date for application of this Standard.

- **Techniques for the measurement of cost**

  Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate cost. Standard costs take into account normal levels of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.

  The retail method is often used in the retail industry for measuring inventories of large numbers of rapidly changing items with similar margins for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing the sales value of the inventory by the appropriate percentage of gross margin. The percentage used takes into consideration inventory that has been marked down to below its original selling price. An average percentage for each retail department is often used for measurement.

- **Cost Formula**

  a. Specific identification method for determining cost of inventories

  Specific identification method means directly linking the cost with specific item of inventories. This method has application in the following conditions:

  (i) In case of purchase of item specifically segregated for specific project and is not ordinarily inter-changeable.

  (ii) In case of goods or services produced and segregated for specific project

  b. When specific identification method is not applicable

  Where specific identification method is not applicable, the cost of inventories is valued by the following methods:

  (i) FIFO (First In First Out)

  (ii) Weighted Average cost.

  An entity must use the same cost formula for all inventories having a similar nature and use within the entity. Different cost formulae may be used for inventories that have different characteristics.

- **Net realizable Value**

  The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale have increased. The practice of writing inventories down below cost to net realisable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use. Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Inventories are usually written down to net realisable value item by item. In some circumstances, however, it may be appropriate to group similar or related items.

Note: Estimation of Net Realizable Value

The net realizable value of the materials and other supplies held for use in production of finished goods is estimated as under:

a. If finished product in which raw material and supplies used is sold at cost or above cost, then the estimated realizable value of raw material and supplies is considered more than its cost.

b. If finished product in which raw material and supplies used is sold below cost. Then the estimated realizable value of raw material or supplies is equal to replacement price of raw material or supplies.

Note: The comparison between cost and net realizable value should be made item by item or by group of items.

- **Recognition as an Expense**

When inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised. The amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from an increase in net realisable value, shall be recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs. Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognised as an expense during the useful life of that asset.

- **Disclosures**

The financial statements shall disclose:

(a) the accounting policies adopted in measuring inventories, including the cost formula used;

(b) the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;

(c) the carrying amount of inventories carried at fair value less costs to sell;

(d) the amount of inventories recognised as an expense during the period;

(e) the amount of any write-down of inventories recognised as an expense in the period;

(f) the amount of any reversal of any write-down that is recognised as a reduction in the amount of inventories recognised as expense in the period;

(g) the circumstances or events that led to the reversal of a write-down of inventories; and

(h) the carrying amount of inventories pledged as security for liabilities.

Illustration 1

How do you deal with the following?

On 31.3.2023, the closing stock of Gourav Ltd. includes 10,000 units costing @ ₹ 10 i.e., ₹1,00,000. But the current market price as on that date was @ ₹ 9 i.e., ₹ 90,000.

Solution:

According to Ind AS 2, valuation of Inventories will be at lower of Cost and Net Realisable Value. In the present case the cost is ₹(10×10,000) i.e., ₹1,00,000 and the Net Realisable Value is ₹90,000. Therefore, the inventories will be valued at ₹90,000 i.e., at Net Realisable Value.

Illustration 2

From the following information presented by P Ltd. ascertain the value of stock to be included in Balance Sheet: Cost Price of certain stock amounted to ₹60,000; being obsolete, it can be used for production purposes after incurring ₹10,000 for modification. The same could be used as a raw material for an existing product, the purchase price for the same amounts to ₹40,000.

Solution:

Cost price of the product (given) ₹60,000.

Net Realisable Value of the product = ₹40,000 – ₹10,000 = ₹30,000. Inventories are valued at lower of Cost and Net Realisable value. Hence, ₹30,000 should be treated as the Value of Stock to be included in Balance Sheet.

Illustration 3

How will you deal with the following situation?

"A company deals in purchase and sale of timber and has included notional interest charges calculated (on the paid-up share capital and free reserves) in the value of stock of timber as at the Balance Sheet date as part of cost of holding the timber".

Solution:

According to Ind AS 2, Inventories, interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories. Hence, the valuation of closing stock of timber cannot be considered as it is not in conformity with Ind AS 2.

Illustration 4

The company deals in three products A, B and C which are neither similar nor interchangeable. At the time of closing of its account for the year 2022-23, the historical cost and net realisable value of the items of closing stock are determined as:

Items	Historical Cost (₹ in lakhs)	Net Realizable Value (₹ in lakhs)
A	40	28
B	32	32
C	16	24

What will be the value of closing inventories?

Solution:

According to Ind AS 2, inventories should be valued as per the cost or net realisable value, whichever is lower. Thus, inventories should be valued item wise as:

Items	Historical cost (₹ In lakhs)	Net Realizable Value (₹ In lakhs)	Valuation of Closing Stock (₹ In lakhs)
A	40	28	28

Items	Historical cost (₹ In lakhs)	Net Realizable Value (₹ In lakhs)	Valuation of Closing Stock (₹ In lakhs)
B	32	32	32
C	16	24	16
Total	88	84	76

So, Closing Inventory should be valued at ₹76 lakhs

Illustration 5

Z Co. Ltd. purchased goods at the cost of ₹ 40 lakhs in October 2022. Till March 2021, 75% of the stocks were sold. The company wants to disclose closing stock at ₹10 lakhs. The expected sales value is ₹11 lakhs and a commission at 10% on sale is payable to the agent. What is the correct closing stock to be disclosed as at 31.3.2023?

Solution:

The stand of the company to disclose the closing stock at ₹10 lakhs is not in line with Ind AS 2. As per Ind AS 2, inventory should be valued as per cost price or net realisable value, whichever is lower. In the given problem, cost price is ₹10 lakhs, but the net realisable value is ₹11,00,000 x 90% = ₹9,90,000. So, the value of closing inventory should be taken as ₹9,90,000 being the lower.

Illustration 6

How would you deal with the following in the annual accounts of a company for the year ended 31.3.2023?

"The company has to pay delayed cotton clearing charges over and above the negotiated price for asking delayed delivery of cotton from the supplier's godown. Up to 2021-22, the company has regularly included such charges in the valuation of closing stock. This being in the nature of interest the company has decided to exclude it from closing stock valuation for the year 2021-22. This would result into decrease in profit by ₹7.60 lakhs."

Solution:

As per Ind AS 2, Inventories, interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories. Thus, it becomes quite clear that delayed cotton clearing charges which were treated in the nature of interest must not be included while valuing closing stock as per the provision of Ind AS 2 and it is not in compliance with Ind AS 2 which was done up to 2020-21.

But from year 2021-22, the company decided to change the earlier view i.e. they decided to exclude the same from the valuation of closing stock which is, no doubt, in compliance with Ind AS 2.

As a result of change in accounting policy regarding valuation of stock, the profit was reduced by is. ₹7.60 lakhs which must be disclosed in the financial statement.

Illustration 7

Sonar Bhandar deals in old colour TVs. It has 4 TVs the particulars of which are given below:

You are asked to compute the value of inventory to be included, in Balance Sheet for the year ended 31st March 2023.

TVs	Onida (₹)	Philips (₹)	EC (₹)	Sony (₹)	Total (₹)
Cost Price	10,000	20,000	35,000	50,000	1,15,000

TVs	Onida (₹)	Philips (₹)	EC (₹)	Sony (₹)	Total (₹)
Expenses incurred to bring into salable conditions	3,000	2,000	5,000	-	10,000
Net Realizable Value	18,000	30,000	36,000	55,000	1,39,000

Solution:

As per Ind AS 2, Inventories, inventories should be valued at the lower of cost or net realisable value on an item-by-item basis, which are:

TVs	Onida (₹)	Philips (₹)	EC (₹)	Sony (₹)	Total (₹)
Cost Price (including expenses)	13,000	22,000	40,000	50,000	1,25,000
Net Realizable Value	18,000	30,000	36,000	55,000	1,39,000
Value of Stock	13,000	22,000	36,000	50,000	1,21,000

Value of inventory to be included in Balance Sheet will be ₹1,21,000.

Illustration 8

The following particulars are presented by M Ltd. (deals in clothing) as on 31.3.2023:

Compute the value of stock as per Ind AS 2.

Stock held by M Ltd.:

Cost Price ₹10,550

Net Realisable Value ₹11,500

The details of such stocks were:

Particulars	Cost Price (₹)	Net Realizable Value (₹)
Cotton	5,600	4,960
Woolen	3,450	4,540
Synthetic	1,500	2,000
Total	10,550	11,500

Solution:

Valuation of Inventory as per Ind AS 2

As per Ind AS 2, inventories are usually valued at lower of cost and net realisable value on an item-by-item basis.

	Cost Price (₹)	Net Realizable Value (₹)	Value of Closing Stock (₹)
Cotton	5,600	4,960	4,960
Woolen	3,450	4,540	3,450
Synthetic	1,500	2,000	1,500
	10,550	11,500	9,910

Hence, value of stock will be considered for ₹ 9,910 as per Ind AS 2.

Illustration 9

The total stock of A Ltd. as on 31.3.2023 was ₹5,00,000 of which stock amounting to ₹31,000 were not ascertained as per Ind AS 2.

Compute the value of the said stocks as per Ind AS 2 for inclusion in financial statements as on that date.

Type of Product	Cost of Materials (₹)	Production Expenses incurred (₹)	Selling and Distribution expense to be incurred (₹)	Estimated Selling Price (₹)
P	10,000	2,000	1,000	15,000
S	5,000	---	500	4,500
T	12,000	3,000	2,000	18,000
	27,000	5,000	3,500	37,500

Solution:

As per Ind AS 2, inventories are usually written-down to net realisable value on item-by-item basis. Thus, value of stock will be computed as:

Type of Product	Cost Price (including Production Exp.)(₹)	Net Realizable Value (excluding Selling & Distribution Expenses from Selling Price) (₹)	Value of Stock to be taken (lower of Cost Price & Net Realizable Value) (₹)
P	12,000 (₹ 10,000 + ₹ 2,000)	14,000 (₹15,000 – ₹ 1,000)	12,000
S	5,000	4,000 (₹ 4,500 – ₹500)	4,000
T	15,000 (₹ 12,000 + ₹ 3,000)	16,000 (₹18,000 – ₹ 2,000)	15,000
			31,000

So, Value of Stock will be ₹31,000 for inclusion in financial statements as per Ind AS 2.

Illustration 10

X Ltd. presented the following particulars as on 31.3.2023 on the total cost of product:

Particulars	Cost per unit (₹)
Cost of materials (₹12 each)	50
Manufacturing inputs	30
Total Cost	80
Profit	20
Selling Price	100

On 31.3.2023, selling price has gone down suddenly from ₹ 100 to ₹70. Price of raw material has also gone down to ₹8 each. X Ltd. had in its stock 6,000, units of materials which was bought as per the above rate on the same date. Compute the value of stock as on 31.03.2023.

Solution:

As per Ind AS 2, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written-down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value. In this case, the total cost of ₹80 exceeds the net realisable value, i.e., selling price, of ₹70 (as the price of raw materials had gone down from ₹12 to ₹8). So, inventories should be valued @ ₹70 each and, as such, the total value of stock would be ₹4,20,000 (i.e., 6,000 units x ₹70).

Illustration 11

State with reference to accounting standards how will you value the inventories in the following cases:

(i) Raw materials were purchased at ₹100 per kg. Prices of raw materials are on the decline. The finished goods in which the raw materials is incorporated is expected to be sold at below cost. 10,000 Kgs. of raw materials is on stock at the year end. Replacement cost is ₹80 per kg.

(ii) In a production process, normal waste is 5% of input. 5,000 MT of input were put in process resulting in a wastage of 300 MT. Cost per MT of input is ₹1,000. The entire quantity of waste is on stock at the year-end.

(iii) Per kg of finished goods consisted of:

	₹
Material Cost	100
Direct Labour	20
Direct Variable Production Overhead	10

Fixed production charges for the year on normal capacity of one lakh kg is ₹10 lakhs. 2,000 kg of finished goods are on stock at the year end.

Solution:

(i) As per Ind AS 2, materials and other supplies held for use in the production of inventories are not written-down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value.

In this case, cost of raw material was ₹100 per kg. But the finished goods (which are produced from the said raw materials) are expected to realise at below the Cost Price. So, the value of 10,000 kg of raw materials will be @ ₹80 per kg (i.e., on the basis of replacement cost) ₹8,00,000.

(ii) As per Ind AS 2, in determining the cost of inventories it is appropriate to exclude abnormal amount of wasted materials, labour or other production expenses in the period in which they are incurred.

Input 5,000 MT; Normal loss 5% of 5,000 MT = 250 MT.

Wastage 300 MT; Abnormal loss = 300 MT – 250 MT = 50 MT

Cost of one MT of input = ₹1,000. So, cost of 250 MT should be included in the cost of finished goods. But the cost of entire abnormal wastage (i.e., 1,000 x ₹50) ₹50,000 should be charged against Profit and Loss of the company.

(iii) As per Ind AS 2, the allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities.

Thus, the cost of finished goods per kg will be:

Cost per kg = Direct Material + Direct Labour + Variable Production overhead + Fixed production overhead = ₹100 + ₹20 + ₹10 + ₹10 = ₹140.

Note: Fixed Production overhead per kg = 10,00,000/1,00,000 = ₹10 per kg.

Therefore, value of closing stock of finished goods will be ₹2,80,000 (i.e., 2,000 kg x ₹140)

Ind AS 2 vs. AS 2 – A Comparative View

Following are the major differences between Ind AS 2, Inventories and AS 2, Valuation of Inventories

S. No.	Ind AS 2	AS 2
1.	Ind AS 2 deals with subsequent recognition of cost/ carrying amount of inventories as an expense	AS 2 does not provide the same.
2.	Ind AS 2 provides separate explanation for inventories of service providers	AS 2 does not contain such an explanation.
3.	Ind AS 2 does not contain specific explanation for spares which is covered under Ind AS 16.	AS 2 says that inventories do not include spare parts, servicing equipment and standby equipment which meet the definition of property, plant and equipment as per AS 10.
4.	Ind AS 2 provides detailed guidance in case of subsequent assessment of net realisable value. It also deals with the reversal of the write-down of inventories to net realisable value to the extent of the amount of original write-down, and the recognition and disclosure thereof in the financial statements.	AS 2 does not deal with reversal.
5.	Ind AS 2 excludes from its scope only the measurement of inventories held by producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products. However, the Standard provides guidance on measurement of such inventories.	AS 2 excludes from its scope such types of inventories.
6.	Ind AS 2 requires the use of consistent cost formulas for all inventories having a similar nature and use to the entity.	AS 2 specifically provides that the formula used in determining the cost of an item of inventory should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition
7.	Ind AS 2 does not apply to measurement of inventories held by commodity broker-traders.	This aspect is not covered in the AS 2
8.	Ind AS 2 defines fair value and distinguishes between 'net realizable value' and 'fair value'	AS 2 does not contain the such definition and explanation.

Illustration 12

Calculate the cost of purchase of inventories that should be included in purchase cost

Purchase price	248,000
Penalty charges for overdue payments	7700

Discount on purchase price	3% on purchase price
Travel expense of purchase department	8000
GST	2% on purchase price
Import duties	10,000
Forwarding charges for external transport	2000
Transport insurance	2000
Internal storage cost of receiving materials	6000
Cost of letter of reference	1000
Internal transport between stock location	3000
Commission and brokerage paid	8000

Solution

Cost of Inventory as per Ind AS 2

Purchase Price	248,000
Less:	
Discount on purchase price- 248,000 × 0.03	7440
Add:	
GST -2% 248,000 × 0.02	4960
Import duties	10,000
Forwarding charges for external transport	2000
Transport insurance	2000
Cost of letter of reference	1000
Commission and brokerage paid	5000
Cost of Inventory	274,500

5.2.3 Events after the Reporting Period (Ind AS 10)

Though financial statements are to be prepared for a financial year, generally, it is not possible for an entity to prepare and finalize the financial statements on the reporting date itself. A firm takes some time to prepare and finalize the financial statements and further more time to get it approved by the board. Only after the financial statements are approved, they may be used by the users. The raises a question as to how to deal with the events occurring after the balance sheet date but before the date financial statements are approved for issue.

Suppose, the reporting date is 31.03.2022 and the Board of directors has approved the accounts on 30th May, 2022. In between these two dates, there may occur some significant event (these events are called as event occurring after the balance sheet date or reporting period). Suppose there was a fire in company plant on 27th May, 2022, which destroyed assets worth ₹15 lakh.

These events after the reporting period are accounted as per the guidelines given in Ind AS 10, i.e., Events after the Reporting Period.

Illustration 13

X Ltd. finalized its accounts on 31.03.2023. However, the financial statements were approved by the Board on 20.05.2023. An accident occurred in the premises of X Ltd. on 30.05.2023 and properties worth ₹50 lakh has been lost. Will it be considered as an event after the reporting period as per the scope of Ind AS 10?

Solution:

As per Ind AS 10, events occurring after the end of the reporting period but before the financial statements are approved by the BOD are not regarded as 'events after the reporting period'. Since the accident took place after the financial statements have been approved, the event should not be treated as events after the reporting period.

- **Objective**

  The objective of this Standard is to prescribe:

  (a) when an entity should adjust its financial statements for events after the reporting period; and

  (b) the disclosures that an entity should give about the date when the financial statements were approved for issue and about events after the reporting period.

- **Scope**

  This Standard shall be applied in the accounting for, and disclosure of, all events after the reporting period.

- **Definition of Events after the Reporting Date**

  Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are approved by the Board of Directors in case of a company, and, by the corresponding approving authority in case of any other entity for issue.

  Note: Events after the reporting period include all events up to the date when the financial statements are approved for issue, even if those events occur after the public announcement of profit or of other selected financial information.

Illustration 14

A Ltd. closed its accounting year on 31/03/2023 and the accounts for that period were considered and approved by the board of directors on 20th May, 2023. The company was engaged in boring tunnels for metro railway. While doing the boring work on 01/06/2023 it hit an aquifer and as a result 18 building were damaged. It was estimated that there would be extra cost to the tune of ₹15 crores. You are required to state with reasons, how it would be dealt with in the financial statements for the year ended 31.03.2023.

Solution:

Ind AS 10 defines 'events after the reporting date' are those 'significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which financial statements are approved by the Board of Directors'. In this case the incidence, which was expected to push cost, became evident after the date of approval of the accounts. So that was not an 'event after the reporting date' as per Ind AS 10. However, this maybe mentioned in the Director's Report.

- **Types of Events after the Reporting Date**

  Two types of events can be identified:

(a) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and

(b) those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period).

Recognition and Measurement

Adjusting Events after the Reporting Date

An entity shall adjust the amounts recognised in its financial statements to reflect adjusting events after the reporting period. The following are examples of adjusting events after the reporting period that require an entity to adjust the amounts recognised in its financial statements, or to recognise items that were not previously recognised:

(a) the settlement after the reporting period of a court case that confirms that the entity had a present obligation at the end of the reporting period. The entity adjusts any previously recognised provision related to this court case in accordance with Ind AS 37 Provisions, Contingent Liabilities and Contingent Assets or recognises a new provision. The entity does not merely disclose a contingent liability because the settlement provides additional evidence that would be considered in accordance with paragraph 16 of Ind AS 37.

(b) the receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period, or that the amount of a previously recognised impairment loss for that asset needs to be adjusted. For example:

(i) the bankruptcy of a customer that occurs after the reporting period usually confirms that a loss existed at the end of the reporting period on a trade receivable and that the entity needs to adjust the carrying amount of the trade receivable; and

(ii) the sale of inventories after the reporting period may give evidence about their net realisable value at the end of the reporting period.

(c) the determination after the reporting period of the cost of assets purchased, or the proceeds from assets sold, before the end of the reporting period.

(d) the determination after the reporting period of the amount of profit-sharing or bonus payments, if the entity had a present legal or constructive obligation at the end of the reporting period to make such payments as a result of events before that date.

(e) the discovery of fraud or errors that show that the financial statements are incorrect.

Illustration 15

While preparing its final accounts for the year ended 31st March, 2023, a company made a provision for doubtful debts @ 5% of its total debtors. In the last week of February 2023, a debtor for ₹20 lakh suffered heavy loss and subsequently became insolvent in April, 2023. Can the company provide the full loss out of the insolvency of the debtor in the final accounts for the year ended on 31.03.2023?

Solution:

As per Ind AS 10, for ‘events after the reporting date’, if circumstances were existing on the balance sheet date, adjustments should be made in accounts. In the given case, circumstances were pre-existing and the event in April, 2021 only confirms the same. Hence, it is adjustable event. Hence, the company can provide the full loss out of the insolvency of the debtor in the final accounts for the year ended on 31.03.2023.

Illustration 16

B Ltd. supplies parts to a car manufacturer in respect of a particular model of car. On the reporting date, B Ltd. has a high level of inventory of parts due to low order levels. After the reporting date but before the date of approval of the financial statements, the car manufacturer announces that the specific model will no longer be produced. There is no alternative market for the inventory. Should B Ltd. write-down of inventory to net realizable value and adjust the inventory reported on the reporting date?

Solution:

Estimates of net realizable value are based on the most reliable evidence available at the time the estimates are made. These estimates consider fluctuations of price or cost directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period. This inventory should be written down to net realizable value, the high inventory levels indicated slow demand from the manufacturer. The post balance sheet announcement confirmed the over-supply at year end.

Illustration 17

Prior to the approval of the financial statements but subsequent to the balance sheet date, C Ltd. in trading difficulties obtained a valuation of its properties for the purpose of providing additional security to its bankers. C Ltd. is also considering selling certain properties to generate additional cash. The amount estimated by the valuer is materially lower than the carrying amount attributed to the properties at the balance sheet date based on the last impairment review carried out three years ago. How should this be reflected in the financial statements?

Solution:

In the given scenario, the valuation provides sufficient evidence of impairment in value that had occurred prior to the balance sheet date. Thus, an impairment review should be carried out in accordance with IAS 36 and a provision to write down the properties would be regarded as an 'adjusting event' with the values attributed to the properties in the balance sheet being adjusted accordingly.

■ **Non-adjusting Events after the Reporting Date**

An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period.

An example of a non-adjusting event after the reporting period is a decline in market value of investments between the end of the reporting period and the date when the financial statements are approved for issue. The decline in market value does not normally relate to the condition of the investments at the end of the reporting period, but reflects circumstances that have arisen subsequently. Therefore, an entity does not adjust the amounts recognised in its financial statements for the investments.

Following are a few other examples:

(i) A major business combination or disposal of a major subsidiary after the balance sheet date.

(ii) Announcing or commencing the implementation of, a major restructuring.

(iii) Changes in tax rates or tax laws enacted or announced after the balance sheet date that have a significant effect on current and deferred tax assets and liabilities (Ind AS 12, Income taxes)

(iv) Entering into significant commitments or contingent liabilities, for example by issuing significant guarantees;

(v) Commencing major litigation arising solely out of events that occurred after the reporting period.

Illustration 18

The exchange differences arising on the translation of the bank overdraft since the balance sheet date exceed the profit for the period under review due to an adverse movement on the foreign exchange rate after year end. How should this be reflected in the financial statements?

Solution:

Exchange rate changes are included in the list of non-adjusting post balance sheet events set out in Ind AS 10. Although the bank overdraft existed at the balance sheet date, the conditions that gave rise to the loss did not exist on that date. The exchange rate fluctuation occurred subsequent to the balance sheet date. Accordingly, in normal circumstances, the effect should not be adjusted in the financial statements. However, if the same is material, it should be disclosed by way of a note to the financial statements.

- **Going Concern**

  An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

Illustration 19

AIR Aviation Co. Ltd. announced a restructuring programme in 2020 which was implemented in full in 2021. The workforce was adequately downsized and a number of non-profitable routes were suspended. However, in view of the still -difficult market environment, the high cost of aviation fuel and continuing declines in yields, the Board of Directors approved a further package of measures on January 31, 2022 under which the regional aircraft fleet will be reduced by at least 15 aircraft. This action is intended to reduce net annual cost by recurring ₹200 lakh. The actions will be taken over the next 15 months. The company is expecting a break-even in 2023. Should the company prepare its financial statements on a going concern basis?

Solution:

As per Ind AS 10, an entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.

In the given situation, the company has no plan to discontinue its operation and rather expects to break-even in the near future after implementing the additional restructuring package to be executed in 15 months' time. Consequently, the company should prepare its financial statements were prepared on a going concern basis.

- **Treatment of Dividends**

  If an entity declares dividends to holders of equity instruments (as defined in Ind AS 32 Financial Instruments: Presentation) after the reporting period, the entity shall not recognise those dividends as a liability at the end of the reporting period.

- **Distribution of Non-cash Assets to Owners**

  Sometimes an entity distributes assets other than cash (non-cash assets) as dividends to its owners acting in their capacity as owners. In those situations, an entity may also give its owners a choice of receiving either non-cash assets or a cash alternative. Indian Accounting Standards (Ind ASs) do not provide guidance on how an entity should measure distributions to its owners (commonly referred to as dividends). Ind AS 1 requires an entity to present details of dividends recognised as distributions to owners either in the statement of changes in equity presented as a part of the balance sheet or in the notes to the financial statements.

  In this context Ind AS 10 provides the following guidelines (in Appendix of Ind AS 10) in respect of distribution of non-cash assets to the owners. However, the guidelines are applicable to the following types of non-reciprocal distributions of assets by an entity to its owners acting in their capacity as owners:

(a) distributions of non-cash assets (e.g., items of property, plant and equipment, businesses as defined in Ind AS 103, ownership interests in another entity or disposal groups as defined in Ind AS 105; and

(b) distributions that give owners a choice of receiving either non-cash assets or a cash alternative. The guidelines apply only to distributions in which all owners of the same class of equity instruments are treated equally.

Moreover, the guidelines do not apply to a distribution of a non-cash asset that is ultimately controlled by the same party or parties before and after the distribution. This exclusion applies to the separate, individual and consolidated financial statements of an entity that makes the distribution.

For a distribution to be outside the scope of this guidelines on the basis that the same parties control the asset both before and after the distribution, a group of individual shareholders receiving the distribution must have, as a result of contractual arrangements, such ultimate collective power over the entity making the distribution.

Example 1

Assume Company A is owned by public shareholders. No single shareholder controls Company A and no group of shareholders is bound by a contractual agreement to act together to control Company A jointly. Company A distributes certain assets (e.g., available-for-sale securities) pro rata to the shareholders. This transaction is within the scope of the guidelines.

However, if one of the shareholders (or a group bound by a contractual agreement to act together) controls Company A both before and after the transaction, the entire transaction (including the distributions to the non-controlling shareholders) is not within the scope of the Appendix. This is because in a pro rata distribution to all owners of the same class of equity instruments, the controlling shareholder (or group of shareholders) will continue to control the non-cash assets after the distribution.

Finally, the guidelines do not apply when an entity distributes some of its ownership interests in a subsidiary but retains control of the subsidiary.

Example 2

Assume Company A is owned by public shareholders. No single shareholder controls Company A and no group of shareholders is bound by a contractual agreement to act together to control Company A jointly. Company A owns all of the shares of Subsidiary B. Company A distributes all of the shares of Subsidiary B pro rata to its shareholders, thereby losing control of Subsidiary B. This transaction is within the scope of the guidelines.

However, if Company A distributes to its shareholders shares of Subsidiary B representing only a non-controlling interest in Subsidiary B and retains control of Subsidiary B, the transaction is not within the scope of the guidelines. Company A accounts for the distribution in accordance with Ind AS 27 Consolidated and Separate Financial Statements. Company A controls Company B both before and after the transaction.

The important issues in the context of distribution of non-cash assets to owners can be addressed as follows:

(a) When to recognise a dividend payable?

The liability to pay a dividend shall be recognised when the dividend is appropriately authorised and is no longer at the discretion of the entity, which is the date:

(i) when declaration of the dividend, e.g., by management or the board of directors, is approved by the relevant authority, e.g., the shareholders, if the jurisdiction requires such approval, or

(ii) when the dividend is declared, e.g., by management or the board of directors, if the jurisdiction does not require further approval.

(b) Measurement of a dividend payable

(i) An entity shall measure a liability to distribute non-cash assets as a dividend to its owners at the fair value of the assets to be distributed.

(ii) If an entity gives its owners a choice of receiving either a non-cash asset or a cash alternative, the entity shall estimate the dividend payable by considering both the fair value of each alternative and the associated probability of owners selecting each alternative. (iii) At the end of each reporting period and at the date of settlement, the entity shall review and adjust the carrying amount of the dividend payable, with any changes in the carrying amount of the dividend payable recognised in equity as adjustments to the amount of the distribution.

(c) Accounting for any difference between the carrying amount of the assets distributed and the carrying amount of the dividend payable when an entity settles the dividend payable

When an entity settles the dividend payable, it shall recognise the difference, if any, between the carrying amount of the assets distributed and the carrying amount of the dividend payable in profit or loss.

(d) Presentation and Disclosure

- An entity shall present the difference mentioned above as a separate line item in profit or loss.
- An entity shall disclose the following information, if applicable:
  (i) the carrying amount of the dividend payable at the beginning and end of the period; and
  (ii) the increase or decrease in the carrying amount recognised in the period as result of a change in the fair value of the assets to be distributed.
- If, after the end of a reporting period but before the financial statements are approved for issue, an entity declares a dividend to distribute a non-cash asset, it shall disclose:
  (i) the nature of the asset to be distributed;
  (ii) the carrying amount of the asset to be distributed as of the end of the reporting period; and
  (iii) the estimated fair value of the asset to be distributed as of the end of the reporting period, if it is different from its carrying amount, and the information about the method used to determine that fair value required by Ind AS 107.

Disclosures under Ind AS 10

Following are the major differences between Ind AS 10, Events after the Reporting Period and AS 4, Contingencies and Events Occuring after the Balance Sheet Date.

Ind AS 10 requires the following disclosures:

a) An entity shall disclose the date when the financial statements were approved for issue and who gave that approval. If the entity's owners or others have the power to amend the financial statements after issue, the entity shall disclose that fact.

b) Updating disclosure about conditions at the end of the reporting period:

(i) If an entity receives information after the reporting period about conditions that existed at the end of the reporting period, it shall update disclosures that relate to those conditions, in the light of the new information.

(ii) In some cases, an entity needs to update the disclosures in its financial statements to reflect information received after the reporting period, even when the information does not affect the amounts that it recognises in its financial statements. For example, contingent liability that existed at the end of the reporting period.

c) Non-adjusting events after the reporting period:

If non-adjusting events after the reporting period are material, non-disclosure could influence the economic decisions that users make on the basis of the financial statements. Accordingly, an entity shall disclose the following for each material category of non-adjusting event after the reporting period:

(i) the nature of the event; and

(ii) an estimate of its financial effect, or a statement that such an estimate cannot be made.

- **Following are the major differences between Ind AS 10, Events after Reporting Period and AS 4, Contingencies and Events Occuring after Balance Sheet Date**

S. No	Ind AS 10	AS 4
1.	Ind AS 10 does not cover contingencies but only covers events after the reporting period	AS 4 covers contingencies as well.
2.	The standard requires material non- adjusting events to be disclosed in the financial statements.	AS 4 requires the same to be disclosed in the report of approving authority.
3.	If after the reporting date it is determined that the fundamental accounting assumption of going concern is no longer appropriate, Ind AS 10 requires a fundamental change in the basis of accounting.	AS 4 requires assets and liabilities to be adjusted for events occurring after the balance sheet date that indicate that the fundamental accounting assumption of going concern is not appropriate.
4.	In the context of going concern assumption not being valid anymore, Ind AS 10 refers to Ind AS 1, which requires an entity to make the disclosures that the financial statements are not prepared on a going concern basis together with the basis on which the financial statements are prepared and the reason thereof.	AS 4 does not require any such disclosure. However, AS 1 requires the disclosure of the fact in case going concern assumption is not followed.
5.	Consequent to carve-out made in Ind AS 1, it has been provided in the definition of 'Events after the reporting period' that in case of breach of a material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date, if the lender, before the approval of the financial statements for issue, agrees to waive the breach, it shall be considered as an adjusting event.	No such guidance is given in AS 4.
6.	Ind AS 10 includes an Appendix Distribution of Non-cash Assets to Owners which deals, inter alia, with when to recognize dividends payable to its owners.	No such guidance is given in AS 4

Illustration 20

K Ltd has finalized their financial statements for the year ending 31 March, 2023 and approved by their approving authority on 25 th June 2023.

A. A major fire broke out in the night of 31 May, 2023 destroying factory premises. Loss of Property estimated to be 125 lakhs.

B. Consultations with another company started in April, 2023 for acquisition of two manufacturing units which may involve additional investments of 150 lakhs.

C. Foreign exchange loss during the period 1st April, 2023 and 1st June, 2023 has resulted in assets being reduced by 130 lakhs.

You are requested to state how to deal with the above information's in the annual accounts.

Solution:

All the three situations are non-adjusting events.

Definition of Non-Adjusting Event

Those that are indicative of conditions that arose after the reporting period **(non-adjusting events after the reporting period)**.

Because all those are non-adjusting events, no adjustments will be made to the amounts recognized in the financial statements of the entity for the year ending 31 st March 2023.

If non-adjusting events after the reporting period are material, non-disclosure could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity. Accordingly, an entity shall disclose the following for each material category of non-adjusting event after the reporting period- (a).the nature of the event; and (b) an estimate of its financial effect, or a statement that such an estimate cannot be made. Therefore, Disclosure should be made about those non-adjusting events.

Illustration 21

Mr. Kumar is being sued for using copyright of Mr.Balu. This is denied by Mr Kumar. Kumar showed only a contingent liability in his financial statements as on 31/03/2023.On 25/4/2023, Court award damages of ₹ 18, 750, 00 against Mr. Kumar. The financial statements were approved on 29/06/2023.State whether this is an adjusting event and why?

Solution:

The event is an adjusting event as per Adjusting event definition of Ind AS 10.The definition is given below:-

......those that provide evidence of conditions that existed at the end of the reporting period….

(Adjusting events after the reporting period);

Kumar was sued in the court before 31/03/2023.The court awarded 18,750, 00 as damages against Kumar .Therefore Kumar should adjust the effect of adjusting event in his financial statements. He must create a provision of 18,750, 00 in the financial statements to replace contingent liability as shown earlier.

Illustration 22

While auditing the financial statements of K Co for the year 2022-2023 on 11/05/2023.The auditors found that there were a fictitious salary of 795,000.State whether this is an adjusting event and why?

Solution:

This is an adjusting event as per the relevant paragraph of Ind AS 10 and IAS 10.The relevant paragraph is given below:-

......those that provide evidence of conditions that existed at the end of the reporting period……

(Adjusting events after the reporting period); ....

The auditors found that there were a fictitious salary of 795,000. Therefore K Co should adjust ₹ 795,000 in the financial statements for the year ending 31/03/2023.

Illustration 23

Raju LTD with a financial year end of 31 st March has an amount of 60,00,000 that is due from a debtor named Sajeev as of 31 st march 2023.The company provided for impairment on 31 st march 2023 of 800,000 against the gross value of 60,00,000 due from Rajeev. On 30 th June 2023, before the financial statements were authorized for issue , Sajeev goes bankrupt and files for protection from its creditors .Is Sajeev 's bankruptcy and filing for protection from its creditors an adjusting or non-adjusting event ?

Solution:

It is an adjusting event as per relevant paragraph of Ind AS 10.Therefore,the company should increase provision for bad debts from 800,000 to 60,00,000 as on 31 st March 2023.

Illustration 24

An entity gives warranties at the time of sale to purchasers of its products .On 31 st March 2023 an entity assessed its warranty obligation as 700,000.Immediately before 28 May 2023,annual financial statements were approved for issue ,the entity discovered a latent defect in one of its line of product (i.e the defect that was not discoverable or customary inspection).As a result of discovery ,the entity reassessed its estimate of its warranty obligation at 31 st March 2023 at 750,000.Comment on the above issue in the light of Ind AS 10

Solution:

It is an adjusting event as per the relevant paragraph of Ind AS 10.Therefore the accounting treatment is correct.

Illustration 25

A major fire has damaged the assets in factory of a limited company on 2 nd April two days after the year-end closure of account. The loss is estimated at 140 crores out of which 132 crores will be recoverable from the insurers .Explain briefly how the loss should be treated in the final account for the previous year.

Solution:

This is non-adjusting event. It should be disclosed by way of note.

If non-adjusting events after the reporting period are material, non-disclosure could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity. Accordingly, an entity shall disclose the following for each material category of non-adjusting event after the reporting period- (a) the nature of the event; and (b) an estimate of its financial effect, or a statement that such an estimate cannot be made.

Illustration 26

Z Ltd Company entered into an agreement to sell its immovable property included in the Balance sheet at 81 lakhs to another company for 130 lakhs .The agreement to sell was concluded on 31/01/2022 and the sale deed was registered on 31/04/2023.How this will be treated in Balances heet as on 31/03/2013

Solution:

This is clearly an event after the balance sheet Date. Agreement to sell was concluded on 31/01/2022 and the sale deed was registered on 30/4/2023.Registration of the sale deed simply Provides additional information relating to the conditions existing at the balance sheet date. So adjustments to assets are necessary and Asset will be de-recognized in the Balance sheet as on 31/03/2023.

Illustration 27

On 1 st June, 2023 an entity's financial statements for the year ended 31 st March, 2023 were authorized for issue. On 28 th May ,2023 the entity declared a final dividend of 900,000 in respect of profits earned in the year ended 31 st March 2023.Explain the accounting treatment of this particular event in the books of accounts.

Solution:

It is an Non adjusting event as per relevant paragraph of Ind AS10.Therefore, the entity should disclose about the dividends as note as per relevant paragraph of Ind AS 10.No need to adjust it .

Illustration 28

Board of Directors approved the financial account of year 2022-23 on 31 st July 2023.The following events occurred before the approval of financial accounts by Board of directors. State how you would deal with these situations.

The Board of directors at their meeting on June 23, 2023 has recommended a dividend of 15% to be paid to the shareholders after it is approved at the annual general meeting

Solution:

This is non-adjusting event .It should be disclosed by way of note

Illustration 29

On 15 June, 2023 an entity's financial statements for the year ended 31 March, 2023 were authorized for issue. On 29 May, 2023 the entity declared a final dividend of 800,000 in respect of profits earned in the year ended 31 March 2023.Explain the accounting treatment of this particular event in the books of accounts.

Solution:

It is a Non adjusting event as per relevant paragraph of Ind AS 10.Therefore, the entity should disclose about the dividends as note as per relevant paragraph of Ind AS 10.No need to adjust it.

Illustration 30

X Ltd carries its inventory at the lower of cost and net realizable value. At 31 st December ,2022 the cost of inventory determined under FIFO method ,as reported in its financial statements for the year then ended ,was 40,000.Due to recession in the market ,the inventory could not be sold during the entire month of January 2023.The company entered into an agreement to sell the entire inventory for 27,000.The financial statements were approved for issue on 15 th feb 2023.

State whether this is an adjusting event or non –adjusting event?

Solution:

It is an adjusting event as per the relevant paragraphs of Ind AS 10 .

The relevant paragraph is given below:-

……those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); …….

Due to recession in the market, the inventory could not be sold during the entire month of January 2023. Thecompany entered into an agreement to sell the entire inventory for 27,000. Therefore the entity should adjust in its financial statements. X Ltd should write down of 13,000 in financial statements for the year ended Dec 31, 2022.

5.2.4 Employee Benefits (Ind AS 19)

- **Meaning of Employee Benefits**

  Employee benefits are all forms of considerations given by an employer directly to the employee or their spouses, children or other dependents, or to others such as trusts, insurance companies in exchange of the service rendered by the employee.

  Accounting for employee benefits is governed by Ind AS 19, 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**

  1. 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.
  2. This Standard does not deal with reporting by employee benefit plans.
  3. 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.

- **Meaning of an Employee**

  For the purpose of this Standard, employee includes whole time directors and management personnel as well. Further, the Standard applies to all types of employer-employee relationships and there may not necessarily be a formal relationship.

- **Type of Employee Benefits**

  According to the Standard, there are four types of employee benefits as follows:

  (a) 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;

(b) 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;

(c) 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

(d) Termination benefits including voluntary retirement benefits (VRS).

Note: 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.

Note: 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.

⊙ **Accounting for Short Term Employee Benefits**

Accounting for short-term employee benefits as classified above is simple as there is no actuarial gain or loss to be recognized, as these are accounted for on undiscounted basis. Basic principles for accounting short-employee benefits are that the undiscounted amount of short-term employee benefits should be recognized when the employee rendered service:

- It is recognized as an expense unless another Standard such as Ind AS-16 "Property, Plant and Equipment" requires it to be included in the cost of assets.
- It is recognized as a liability if the amount of short-term benefits exceeds amount actually paid or spent
- It is recognized as asset (pre-paid expenses) when amount actually paid exceeds the amount of short-term benefits.

(a) Treatment of Short Term Paid Absences

An entity may pay employees for absence for various reasons including holidays, sickness and short-term disability, maternity or paternity, jury service and military service. Entitlement to paid absences falls into two categories - (a) accumulating; and (b) non-accumulating.

Accumulating paid absences are those that are carried forward and can be used in future periods if the current period's entitlement is not used in full. Accumulating paid absences may be either vesting (in other words, employees are entitled to a cash payment for unused entitlement on leaving the entity) or non-vesting (when employees are not entitled to a cash payment for unused entitlement on leaving).

An entity shall recognise the expected cost of short-term employee benefits in the form of paid absences as follows:

(i) in the case of accumulating paid absences, when the employees render service that increases their entitlement to future paid absences.

(ii) in the case of non-accumulating paid absences, when the absences occur.

Cost of non-accumulating type of compensated absences is automatically computed if the employees are on the regular pay-roll. In case employees are not in the regular pay-roll, then cost should be computed during their absences in the period in which the absences occur.

An entity shall measure the expected cost of accumulating paid absences as the additional amount that the entity expects to pay as a result of the unused entitlement that has accumulated at the end of the reporting period.

Illustration 31

A Ltd. has 100 employees. Each employee is entitled to 10 days sick leave each year. Unused sick leave is carried forward for one year. An employee avails the carried forward leave only if the current year's entitlement falls short of the leave he or she requires.

On December 31, 2022, the average unused sick leave is 2 days per employee. The management, based on experience, estimates that in the year 2023, only 10% of the employees will use one day from their carried forward leave and the rest of the employees will not require more than 10 days of leave. Average payment per employee per day is ₹100. How will you treat this?

Solution:

In 2023, the firm will pay, in total, an additional ($100 \times 0.10 \times 1$) or 10 days of pay as a result of unused entitlement accumulated as at December 31, 2022.

If the average payment per employee per day is ₹100, the firm should provide for a liability of ₹1,000. Therefore, expense on salaries and wages to be recognized in the profit and loss account for the current year is the total of the amount paid or payable for the current year (2022) and ₹1,000. The ₹1,000 is the provision for the additional amount to be paid in 2023 as a result of unused entitlement accumulated as at December 31, 2022.

Illustration 32

Mr. X is an employee of ABC Ltd. His annual salary is ₹15 lakh. The company follows a 300 working days policy. As per the policy of the company, Mr. X is entitled to a leave of 10 days for 2022-23. He, however, utilises 8 days leave. The unutilised leaves are not allowed to be carried forward but are settled by way of payment to the employee. Compute the total employee benefit expenses of ABC Ltd. in respect of Mr. X.

Solution:

Salary payable per day = ₹15,00,000 ÷ 300 = ₹5,000

Unutilised leaves = 10-8 = 2 days

Payment for unutilised leaves = ₹ 5,000 x 2 = ₹10,000

Total expense to be recognised = ₹15,00,000 + ₹10,000 = ₹15,10,000.

(b) Treatment of Profit Sharing and Bonus Plan

Under some profit-sharing plans, employees receive a share of the profit only if they remain with the entity for a specified period. Such plans create an obligation as employees render service that increases the amount to be paid if they remain in service until the end of the specified period. The measurement of such obligations reflects the possibility that some employees may leave without receiving profit-sharing payments. Similarly, an entity may not have any legal obligation to pay bonus, but it may have the practice of bonus payment. As such the entity has no realistic alternative but to make the payment.

An entity should recognize the expected cost of profit-sharing and bonus payments when and only when;

- The entity has a present obligation to make such payments as a result of past events and;
- A reliable estimate of the obligation can be made.

Illustration 33

A profit-sharing plan requires an entity to pay a specified proportion of its net profit for the year to employees who serve throughout the year. If no employee leaves during the year, the total profit-sharing payments for the year will be 5% of net profit. The entity estimates that some of the staff may leave during the year and therefore not entitled for profit sharing this will reduce the payment of profit-sharing plan from 5% to 4% of net profit. Advise the company.

Solution:

The entity recognizes a liability and expense of 4% of net profit.

Note: An obligation under profit-sharing and bonus plans results from employee service and not from a transaction with the entity's owners. Therefore, an entity recognizes the cost of profit-sharing and bonus plans not as a distribution of net profit but as an expense. If profit-sharing and bonus payments are not due wholly within 12 months after the end of the period in which the employees render the related service, those payments are other long term employee benefits.

Illustration 34

Consider the following information:

No. of employees (same as the previous year) = 150

Employees' turnover rate = 6%

Bonus paid to each employee last year = ₹1,00,000

Increase in bonus rate due to inflation = 7% (as per company's regular practice)

Determine the liability and expense to be recognised.

Solution:

Bonus payable for current year = ₹1,00,000 + 7% of ₹1,00,000 = ₹1,07,000

No. of employees in payroll = 150 – 6% of 150 = 141

Provision for bonus = ₹1,07,000 x 141 = ₹1,50,87,000

Accounting treatment:

Employee Benefits Expenses A/c……Dr. 1,50,87,000

To Provision for Bonus A/c 1,50,87,000

Note: Here, the company has a constructive obligation and not a legal obligation to increase the bonus.

⊙ Accounting for Post-Employment Benefits

Post-employment benefits are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment. They include (i) retirement benefits (e.g., pensions and lump sum payments on retirement); and (ii) other post-employment benefits, such as post-employment life insurance a post-employment medical care.

Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans, depending on the economic substance of the plan as derived from its principal terms and conditions.

(a) Defined Contribution Plan

Under defined contribution plans, the entity's obligation is limited to the amount that it agrees to contribute to the fund. Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an employer (and also by the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions; and employer is no longer liable to pay the post-employment benefits to the employee. In consequence, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall, in substance, on the employee.

Defined contribution plans may be of following three types:

(i) Multi-employer Plans;

(ii) State Plans;

(iii) Insured Benefits.

(i) Multi-employer Plans: Multi-employer plans are defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:

- pool the assets contributed by various entities that are not under common control; and
- 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.

  An entity shall classify a multi-employer plan as a defined contribution plan or a defined benefit plan under the terms of the plan (including any constructive obligation that goes beyond the formal terms).

  If an entity participates in a multi-employer defined benefit plan, it shall:

- account for its proportionate share of the defined benefit obligation, plan assets and cost associated with the plan in the same way as for any other defined benefit plan; and
- disclose the information required.

When sufficient information is not available to use defined benefit accounting for a multiemployer defined benefit plan, an entity shall:

(a) account for the plan as if it were a defined contribution plan; and

(b) disclose the information required.

(ii) **State Plan:** State plans are established by legislation to cover all entities or entities of a specific industry and are operated by national or local Government, example of such plan in India are Provident Fund administrated by the Govt. of India.

State plan may be categorized as defined contribution plan or defined benefit plan based on obligation under the plan. However, in most of the cases such plans are defined contribution plans as entities/ employer has only obligation to pay the contribution and has no obligation to pay those future benefits.

Accounting in case of State plans: As State plans are normally defined contribution plans the contribution paid by the employer is debited to expense and if payable is credited to liability account.

(iii) **Insured Benefits:**

Where an employer takes insurance policy from an insurance company for meeting its obligation under post-employment benefits and the employer has no obligation to pay benefits to the employee and the insurer has sole responsibility for paying the post-employment benefits. The payments of fixed premium under such contract are, in substance, the settlement of the employee benefit obligation. Therefore, entities treat such payment as contribution to defined contribution plan.

However, if employer has the obligation to pay employee benefits when they fall due or to pay further amount if insurer does not pay, such plan shall be treated as defined benefit plan and not defined contribution plan and accounting shall be done accordingly.

Note: Accounting for defined contribution plans is straightforward because the reporting entity's obligation for each period is determined by the amounts to be contributed for that period. Consequently, no actuarial assumptions are required to measure the obligation or the expense and there is no possibility of any actuarial gain or loss. Moreover, the obligations are measured on an undiscounted basis, except where they are not expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service. When an employee has rendered service to an entity during a period, the entity shall recognise the contribution payable to a defined contribution plan in exchange for that service:

(a) as a liability (accrued expense), after deducting any contribution already paid. If the contribution already paid exceeds the contribution due for service before the end of the reporting period, an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund.

(b) as an expense, unless another Ind AS requires or permits the inclusion of the contribution in the cost of an asset. When contributions to a defined contribution plan are not expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service, they shall be discounted.

Note: An entity shall disclose the amount recognised as an expense for defined contribution plans.

(b) Defined Benefits Plan

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

Under defined benefit plans:

(a) the entity's obligation is to provide the agreed benefits to current and former employees; and

(b) actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the entity. If actuarial or investment experience are worse than expected, the entity's obligation may be increased.

Accounting for defined benefit plans is complex because actuarial assumptions are required to measure the obligation and the expense and there is a possibility of actuarial gains and losses. Moreover, the obligations are measured on a discounted basis because they may be settled many years after the employees render the related service.

Accounting by an entity for defined benefit plans involves the following steps:

(a) determining the deficit or surplus. This involves:

(i) using an actuarial technique, the projected unit credit method, to make a reliable estimate of the ultimate cost to the entity of the benefit that employees have earned in return for their service in the current and prior periods.

(ii) discounting that benefit in order to determine the present value of the defined benefit obligation and the current service cost.

(iii) deducting the fair value of any plan assets from the present value of the defined benefit obligation.

(b) determining the amount of the net defined benefit liability (asset) as the amount of the deficit or surplus determined in (a), adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

(c) determining amounts to be recognised in profit or loss:

(i) current service cost.

(ii) any past service cost and gain or loss on settlement.

(iii) net interest on the net defined benefit liability (asset).

(d) determining the remeasurements of the net defined benefit liability (asset), to be recognised in other comprehensive income, comprising:

(i) actuarial gains and losses;

(ii) return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and

(iii) any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

Where an entity has more than one defined benefit plan, the entity applies these procedures for each material plan separately.

An entity shall determine the net defined benefit liability (asset) with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period.

(c) Accounting for Other Long-Term Employee Benefits

Other long-term employee benefits include items such as the following, if not expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service:

(a) long-term paid absences such as long-service or sabbatical leave;

(b) jubilee or other long-service benefits;

(c) long-term disability benefits;

(d) profit-sharing and bonuses; and

(e) deferred remuneration.

The accounting for long-term employee benefits is similar to post-employment defined benefit plans except that all past service cost is recognised immediately.

The measurement of other long-term employee benefits is not usually subject to the same degree of uncertainty as the measurement of post-employment benefits. For this reason, this Standard requires a simplified method of accounting for other long-term employee benefits. Unlike the accounting required for post-employment benefits, this method does not recognise remeasurements in other comprehensive income.

Although this Standard does not require specific disclosures about other long-term employee benefits, other Ind ASs may require disclosures. For example, Ind AS 24 requires disclosures about employee benefits for key management personnel. Ind AS 1 requires disclosure of employee benefits expense.

(d) Accounting for Termination Benefits

Termination benefits result from either an entity's decision to terminate the employment or an employee's decision to accept an entity's offer of benefits in exchange for termination of employment. Termination benefits do not include employee benefits resulting from termination of employment at the request of the employee without an entity's offer, or as a result of mandatory retirement requirements, because those benefits are post-employment benefits.

An entity shall measure termination benefits on initial recognition, and shall measure and recognise subsequent changes, in accordance with the nature of the employee benefit, provided that if the termination benefits are an enhancement to post-employment benefits, the entity shall apply the requirements for post-employment benefits. Otherwise:

(a) if the termination benefits are expected to be settled wholly before twelve months after the end of the annual reporting period in which the termination benefit is recognised, the entity shall apply the requirements for short-term employee benefits.

(b) if the termination benefits are not expected to be settled wholly before twelve months after the end of the annual reporting period, the entity shall apply the requirements for other long-term employee benefits.

Although this Standard does not require specific disclosures about termination benefits, other Ind ASs may require disclosures. For example, Ind AS 24 requires disclosures about employee benefits for key management personnel. Ind AS 1 requires disclosure of employee benefits expense.

⦿ Additional Illustrations

Illustration 35

The following information applies to a company's defined benefit pension plan for the year:

FMV of plan assets (beginning of the year)	₹2,00,000
FMV of plan assets (end of the year)	₹2,85,000
Employer's contribution	₹ 70,000
Benefit paid	₹ 50,000

Calculate the actual return on plan assets.

Solution:

Calculation of actual return on plan assets

Particulars	₹	₹
Change in plan assets (2,85,000 – 2,00,000)		85,000
Adjustments:		
Employer's contribution	70,000	
Less: Benefit paid	50,000	20,000
Actual return on plan assets		65,000

Illustration 36

Consider the following information provided by Y Ltd:

PV of defined contribution obligations ₹15 lakh.

Fair value of plan assets ₹14.12 lakh

How will you treat the above for presentation in the Balance Sheet?

Solution:

Since, PV of defined contribution obligations is greater than Fair value of plan assets, there is a deficit.

Deficit = ₹ (15 – 14.12) = ₹0.88 lakh.

The above deficit should be treated as Net Defined Benefit Liability under Non-current Liabilities as Provisions in the Balance Sheet.

Illustration 37

Consider the following information provided by Z Ltd:

PV of defined contribution obligations ₹15 lakh.

Fair value of plan assets ₹15.22 lakh

Asset ceiling ₹0.19 lakh

How will you treat the above for presentation in the Balance Sheet?

Solution:

Since, PV of defined contribution obligations is lower than Fair value of plan assets, there is a surplus.

Surplus = ₹ (15.22 – 15.00) = ₹0.22 lakh.

Asset Ceiling ₹0.19 lakh

Lower of the above (i.e., ₹0.19 lakh) is surplus to be treated as Net Defined Benefit Assets under Non-current Assets in the Balance Sheet.

Ind AS 19 vs. AS 15 – A Comparative View

Following are the major differences between Ind AS 19, Accounting for Employee Benefits and AS 15, Employee Benefits:

S. No.	Ind AS 19	AS 15
1.	In Ind AS 19, employee benefits arising from constructive obligations are also covered.	AS 15 does not deal with the same.
2.	Ind AS 19 the term 'employee' includes directors.	As per AS 15, the term 'employee' includes whole-time directors.
3.	Ind AS 19 deals with 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 (or the deficit funded).	AS 15 does not deal with it.
4.	As per Ind AS 19, participation in a defined benefit plan sharing risks between various entities under common control is a related party transaction for each group entity and some disclosures are required in the separate or individual financial statements of an entity.	AS 15 does not contain similar provisions.
5.	Ind AS 19 encourages, but does not mandate, entities to involve a qualified actuary in the measurement of all material post-employment benefit obligations.	No such guidelines are present in AS 15. AS 15 does recognise that enterprises would normally use the services of a qualified actuary.
6.	Detailed actuarial valuation to determine the present value of net defined benefit liability (asset) is performed with sufficient regularity so that the amounts recognized in the financial statements do not differ materially from the amounts that would have been determined at the end of the reporting period. Ind AS 19 does not specify sufficient regularity.	Detailed actuarial valuation to determine the present value of defined benefit obligation is carried out at least once every 3 years and fair value of plan assets are determined at each balance sheet date.
7.	Ind AS 19 requires that the same shall be recognised in other comprehensive income and should not be recognised in profit or loss.	AS 15 requires recognition of actuarial gains and losses immediately in the profit and loss.
8.	Ind AS 19 makes it clear that financial assumptions shall be based on market expectations, at the end of the reporting period, the period over which the obligations are to be settled.	AS 15 does not clarify the same.
9.	As per Ind AS 19, subsidiaries, associates, joint ventures and branches domiciled outside India shall discount post-employment benefit obligations arising on account of post-employment benefit plans using the rate determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In case, such subsidiaries, associates, joint ventures and branches are domiciled in countries where there is no deep market in such bonds, the market yields (at the end of the reporting period) on government bonds of that country shall be used.	As per AS 15, the rate used to discount post- employment benefit obligations should always be determined by reference to market yields at the balance sheet date on government bond.

S. No.	Ind AS 19	AS 15
10.	Under Ind AS 19, more guidance has been given for timing of recognition of termination benefits.	Recognition criteria for termination benefits differ from the criteria given in Ind AS 19.
11.	It provides guidance on accounting for contributions from employees or third parties to defined benefit plans, which are linked to service - both dependent and independent of the number of years of service.	No specific guidance.

5.2.5 Earnings Per Share (Ind AS 33)

Earnings Per Share (EPS) is an important performance measure for a company which provides the information regarding the earnings available per equity share (also known as ordinary share in Ind AS 33). A higher EPS vis-à-vis the previous year indicates growth in earnings achieved by the company which is normally associated with a higher valuation in the secondary market.

Computation and reporting of EPS is guided by Ind AS 33, Earnings per Share.

- **Objective**

  The objective of this Standard is to prescribe principles for the determination and presentation of earnings per share, so as to improve performance comparisons between different entities in the same reporting period and between different reporting periods for the same entity.

- **Scope**

  a. This Indian Accounting Standard shall apply to companies that have issued ordinary shares to which Indian Accounting Standards (Ind ASs) notified under the Companies Act apply.

  b. An entity that discloses earnings per share shall calculate and disclose earnings per share in accordance with this Standard.

  c. When an entity presents both consolidated financial statements and separate financial statements prepared in accordance with Ind AS 110, Consolidated Financial Statements, and Ind AS 27, Separate Financial Statements, respectively, the disclosures required by this Standard shall be presented both in the consolidated financial statements and separate financial statements.

- **Important Definitions**

  Anti-dilution is an increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

  A contingent share agreement is an agreement to issue shares that is dependent on the satisfaction of specified conditions.

  Contingently issuable ordinary shares are ordinary shares issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement.

  Dilution is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

  Options, warrants and their equivalents are financial instruments that give the holder the right to purchase ordinary shares.

An ordinary share is an equity instrument that is subordinate to all other classes of equity instruments.

A potential ordinary share is a financial instrument or other contract that may entitle its holder to ordinary shares.

Put options on ordinary shares are contracts that give the holder the right to sell ordinary shares at a specified price for a given period.

- **Types of EPS**

There are two types of EPS that are reported by an entity on the face of the Statement of Profit and Loss. These are:

a. Basic EPS; and

b. Diluted EPS

- **Measurement**

a. Basic earnings per share

An entity shall calculate basic earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders. The objective of basic earnings per share information is to provide a measure of the interests of each ordinary share of a parent entity in the performance of the entity over the reporting period.

Basic earnings per share shall be calculated by the following formula -

$$\text{Basic EPS} = \frac{\text{Profit or loss attributable to ordinary equity holders of the parent entity}}{\text{Weighted average number of ordinary shares outstanding during the period}}$$

(i) Calculation of Profit or loss attributable to ordinary equity holders of the parent entity

- Consider the amounts attributable to ordinary equity holders of the parent entity in respect of Profit or loss (after tax) from continuing operations attributable to the parent entity;
- Add profit or loss attributable to the parent entity (after adjusting for non-controlling interests);
- Deduct the amount of preference dividend and any attributable tax on preference dividend from the figure calculated above. Dividend on non-cumulative preference share is deducted if dividend is provided, however in case of cumulative preference share, dividend of current year is deducted even if not provided in accounts. Dividend paid during the current year in respect of previous periods is to be excluded.
- Where any item of income or expense which is otherwise required to be recognized in profit or loss in accordance with Ind AS is debited or credited to securities premium account/other reserves, the amount is respect thereof shall be deducted from profit or loss from continuing operations for the purpose of calculating basic earnings per share.

Illustration 38

The following information has been provided by A Ltd.

Paid up capital: 100000 ordinary shares of ₹ 1.00 = ₹ 1,00,000

20000, 10% Preference shares of ₹ 1.00 = ₹20,000

Gross Profit for the year ended on 31.03.2023 = ₹3,50,000

Other operating expenses = ₹1,00,000

Tax rate 30%

Determine profit or loss attributable to ordinary equity holders.

Solution:

Calculation for profit or loss attributable to ordinary equity holders

Particulars	₹
Gross Profit for the year ended on 31.03.2023	3,50,000
Less: Other operating expenses	1,00,000
PBT	2,50,000
Less: Tax @ 30%	75,000
PAT	1,75,000
Less: Preference dividend (20000 × 10%)	2,000
Profit or loss attributable to ordinary equity holders	1,73,000

(ii) Calculation of weighted average number of outstanding ordinary shares during the period

For the purpose of calculating basic earnings per share, the number of ordinary shares shall be the weighted average number of ordinary shares outstanding during the period.

The weighted average number of ordinary shares outstanding during the period is the number of ordinary shares outstanding at the beginning of the period, adjusted by the number of ordinary shares bought back or issued during the period multiplied by a time-weighting factor. The time-weighting factor is the number of days that the shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

For different type of circumstances, the time to be considered for inclusion in the weighted average number of outstanding shares are summarized below:

Circumstances	Date to be considered for weights
Ordinary shares issued in exchange of cash	Date of cash receivable
Ordinary shares against conversion of debt instrument	Date when interest ceases to accrue
Ordinary shares issued upon the conversion of mandatorily convertible instruments	Date the contract is entered into
Ordinary shares against interest or principal of any financial instrument	Date when interest ceases to accrue
Ordinary shares issued in exchange for the settlement of a liability of the entity	Date on which settlement becomes effective
Ordinary shares issued in consideration of acquisition of assets other than cash	Date on which acquisition is recognized
Ordinary shares issued against services rendered	When service is rendered
Partly paid-up ordinary share	Ordinary shares in the ratio of amount paid up to the total face value of the share
Right issue	Adjusted with Right factor
Equity shares issued as consideration in Business Combination:	

Circumstances	Date to be considered for weights
- Common Control business combination	Shares included in the calculation of weighted average from the beginning of the reporting period
- Acquisition	Included in the weighted average from the date of acquisition
Bonus shares	Shares included in weighted average from the beginning of the reporting period
Share split	Shares included in weighted average from the beginning of the reporting period
Reverse share split (consolidation of shares):	
- Consolidation without reduction in the re¬sources	Shares included in weighted average from the beginning of the reporting period
- Consolidation with reduction in resources combined with special dividend	Date with special dividend is recognized
Contingently issuable shares	Date when all necessary conditions are satisfied (i.e., event has occurred)
Contingently refundable shares	Will be included in the weighted average number of ordinary shares only from the time they are no longer subject to recall
Purchase of treasury shares for cash (reduction in outstanding shares)	From the date of purchase

Note: The weighted average number of ordinary shares outstanding during the period and for all periods presented shall be adjusted for events, other than the conversion of potential ordinary shares, that have changed the number of ordinary shares outstanding without a corresponding change in resources.

Illustration 39

01.04.2022 B Ltd. has 3600 ordinary shares outstanding. On 31.08.2023 it issued 1200 ordinary shares for cash. On 31.01.23 it bought back 600 ordinary shares. Calculate weighted average number of shares as on 31.03.23.

Solution:

Computation of weighted average as per Ind AS-33

Weighted average number of ordinary shares = (3600 × 5/12) + (4800 × 5/12) + (4200 × 2/12) = 4200 shares

The weighted average number of shares can alternatively be computed as follows:

= (3600 × 12/12) + (1200 × 7/12) - (600 × 2/12) = 4200 shares

Illustration 40

Refer to Illustration 2. If profit or loss attributable to ordinary equity holders of B Ltd. for the year ended on 31.03.23 was ₹21,00,000, calculate Basic EPS.

Solution:

$$\text{Basic EPS} = \frac{\text{Profit or loss attributable to ordinary equity holders of the parent entity}}{\text{Weighted average number of ordinary shares outstanding during the period}}$$

$= 21,00,000/4200$

$=$ ₹500

b. Diluted earnings per share

Diluted earnings per share are calculated when there are potential ordinary shares in capital structure of the entity. A potential ordinary share is a financial instrument or other contract that may entitle its holder to ordinary shares.

An entity shall calculate diluted earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.

Diluted EPS is calculated using the following formula –

$$\text{Diluted EPS} = \frac{\text{Profit or loss attributable to ordinary shareholders after adjustment for diluted earnings}}{\text{Weighted average number of ordinary shares outstanding during the period assuming conversion}}$$

Note: For the purpose of calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity holders of the parent entity by the after-tax effect of:

(a) any dividends or other items related to dilutive potential ordinary shares deducted in arriving at profit or loss attributable to ordinary equity holders of the parent entity;

(b) any interest recognised in the period related to dilutive potential ordinary shares; and

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

Note: For the purpose of calculating diluted earnings per share, the number of ordinary shares shall be the weighted average number of ordinary shares calculated as per the process stated earlier, plus the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares. Dilutive potential ordinary shares shall be deemed to have been converted into ordinary shares at the beginning of the period or, if later, the date of the issue of the potential ordinary shares. A subsidiary, joint venture or associate may issue to parties other than the parent or investors with joint control of, or significant influence over, the investee potential ordinary shares that are convertible into either ordinary share of the subsidiary, joint venture or associate, or ordinary shares of the parent or investors with joint control of, or significant influence (the reporting entity) over, the investee. If these potential ordinary shares of the subsidiary, joint venture or associate have a dilutive effect on the basic earnings per share of the reporting entity, they are included in the calculation of diluted earnings per share.

Note: Potential ordinary shares are dilutive, if their conversions to ordinary shares decrease the earning per share or increase loss per share from continuing operation, if their conversion does not decrease the EPS, rather it increases the EPS, then the potential ordinary shares are not to be considered dilutive.

Potential ordinary shares are antidilutive when their conversion to ordinary shares would increase earnings per share or decrease loss per share from continuing operations. The calculation of diluted earnings per share does not assume conversion, exercise, or other issue of potential ordinary shares that would have an antidilutive effect on earnings per share. In determining whether potential ordinary shares are dilutive or antidilutive, each issue or series of potential ordinary shares is considered separately rather than in aggregate. The sequence in which potential ordinary shares are considered may affect whether they are dilutive. Therefore, to maximise the dilution of basic earnings per share, each issue or series of potential ordinary shares is considered in sequence from the most dilutive to the least dilutive, i.e., dilutive potential ordinary shares with the lowest 'earnings per incremental share' are included in the diluted earnings per share calculation before those with a higher earnings per incremental share. Options and warrants are generally included first because they do not affect the numerator of the calculation.

Illustration 41

D Ltd. had outstanding ordinary shares of 10,00,000on 01.04.2022. Profit for the year is ₹20,00,000. D Ltd. had 12% 20,000 convertible debentures outstanding of ₹100 each to be converted into 10 ordinary shares. Tax rate is 30%. Calculate (i) Basic EPS (ii) Diluted EPS

Solution:

Basic earnings per share = (20,00,000/10,00,000) = ₹2.00

Number of 12% convertible debentures of ₹ 100 each = 20,

Each debenture is convertible into 10 ordinary shares

Interest expenses for the current year = 20,00,000 × 12% = ₹2,40,000

Tax relating to interest expense (30%) = 240000 × 30% = ₹72,000

Adjusted net profit for the current year ₹ (20,00,000 + 2,40,000 - 72,000) = ₹21,68,000

Number of ordinary shares on conversion = 20000 × 10 = 2,00,000

Number of equity shares used to compute diluted earnings per share = 10,00,000 + 2,00,000 = 12,00,000

Diluted earnings per share as per Ind AS-33 = 21,68,000/12,00,000 = ₹1.81

Illustration 42

Consider the following information given by F Ltd.

Net Profit for the year ended on 31.03.2023 = ₹ 86,50,000

Paid-up capital: 25,00,000 ordinary shares of ₹10 each

100000, 10% Debentures of ₹100 each were issued on 31.09.2022.

Tax rate 30%

Conversion rate: 10 ordinary shares for each debenture.

Calculate Diluted EPS.

Solution:

Adjusted net profit for the current year:

Net Profit for the current year	₹86,50,000
Add: Interest expense for the current year	₹5,00,000
Less: Tax relating to interest expense (30% of ₹ 5,00,000)	₹(1,50,000)
Adjusted net profit for the current year	₹90,00,000

Note: Conversion of convertible debentures into Equity Share is a dilutive potential equity share. Hence, to compute the adjusted profit, the interest paid on such debentures will be added back as the same would not be payable, in case these are converted into equity shares.

Weighted average number of equity shares

Number of equity shares resulting from conversion of debentures

= (100000 × 100)/10 = 10,00,000

Weighted average number of equity shares used to compute diluted earnings per share

= [(25,00,000 × 12) + (10,00,000 × 6)]/12 = 30,00,000 Shares

Diluted earnings per share = ₹ 90,00,000/30,00,000 = ₹ 3.00 per share

- **Options, Warrants and Their Equivalents**

For the purpose of calculating diluted earnings per share, an entity shall assume the exercise of dilutive options and warrants of the entity. The assumed proceeds from these instruments shall be regarded as having been received from the issue of ordinary shares at the average market price of ordinary shares during the period. The difference between the number of ordinary shares issued and the number of ordinary shares that would have been issued at the average market price of ordinary shares during the period shall be treated as an issue of ordinary shares for no consideration. Options and warrants are dilutive when they would result in the issue of ordinary shares for less than the average market price of ordinary shares during the period.

Illustration 43

E Ltd. had 10,00,000 ordinary shares outstanding on 01.04.2022. Profit for 2022-23 was ₹24,00,000. Average fair value per share during 2022-23 was ₹ 20. E Ltd. has given share option to its employees of 2,00,000 shares at option price of ₹15. Calculate basic EPS and diluted EPS.

Solution:

Profit for the year = ₹24,00,000

Weighted average number of shares = 10,00,000

Basic EPS = 24,00,000/10,00,000 = ₹2.40

No. of shares under option = 2,00,000

No. of shares that would have been issued at fair value = 2,00,000 x 15/20 = 1,50,000

Weighted average number of shares = 10,00,000 + (2,00,000 – 1,50,000) = 10,50,000

Adjusted earnings = ₹24,00,000

Diluted EPS = 24,00,000/10,50,000 = ₹2.29

- **Contingently Issuable Shares**

Contingently issuable ordinary shares are treated as outstanding and included in the calculation of diluted earnings per share if the conditions are satisfied (i.e., the events have occurred). Contingently issuable shares are included from the beginning of the period (or from the date of the contingent share agreement, if later).

If the conditions are not satisfied, the number of contingently issuable shares included in the diluted earnings per share calculation is based on the number of shares that would be issuable if the end of the period were the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period expires.

- **Contracts that may be settled in ordinary shares or cash**

When an entity has issued a contract that may be settled in ordinary shares or cash at the entity's option, the entity shall presume that the contract will be settled in ordinary shares, and the resulting potential ordinary shares shall be included in diluted earnings per share if the effect is dilutive.

- **Purchased options**

  Contracts such as purchased put options and purchased call options (i.e., options held by the entity on its own ordinary shares) are not included in the calculation of diluted earnings per share because including them would be antidilutive.

- **Written put options**

  Contracts that require the entity to repurchase its own shares, such as written put options and forward purchase contracts, are reflected in the calculation of diluted earnings per share if the effect is dilutive. If these contracts are 'in the money' during the period (ie the exercise or settlement price is above the average market price for that period), the potential dilutive effect on earnings per share shall be calculated as follows:

  (a) it shall be assumed that at the beginning of the period sufficient ordinary shares will be issued (at the average market price during the period) to raise proceeds to satisfy the contract;

  (b) it shall be assumed that the proceeds from the issue are used to satisfy the contract (ie to buy back ordinary shares); and

  (c) the incremental ordinary shares (the difference between the number of ordinary shares assumed issued and the number of ordinary shares received from satisfying the contract) shall be included in the calculation of diluted earnings per share.

Illustration 44

X Ltd. has 320 written put options outstanding on 320 of its ordinary shares, with an exercise price of ₹ 10 per option. The put obligation is therefore ₹3,200. The average market price of the entity's ordinary shares is ₹8 for the period. The company expects to issue 400 ordinary shares at ₹ 8 per share to raise the proceeds necessary to satisfy the put option. How will you treat the above?

Solution:

The difference between the 400 ordinary shares assumed to be issued and the 320 ordinary shares that would have been received on exercise of the option (that is, 80 shares) is added to the denominator (number of shares) in calculating the diluted EPS. No adjustments are made to the numerator (profit attributable to ordinary) in calculating diluted EPS, the entity assumes that it issues

- **Rights Issue**

  Right issues are generally made at a price lower than fair value of share. Therefore, a right issue usually includes a bonus element. Hence, the number of ordinary shares to be used in calculating basic EPS for all periods prior to right issue is the number of ordinary shares outstanding prior to the issue multiplied by right factor which is calculated as under:

$$\text{Right Factor} = \frac{\text{Fairvalue per share immediately prior to right issue}}{\text{Theoritical ex-right fair value per share}}$$

$$\text{Theoretical Ex-right fair value} = \frac{\text{Aggregate Market value of Share immediately prior to the exercise of the rights + Proceeds from exercise of the rights}}{\text{Number of shares outstanding immediately after the right issue}}$$

Illustration 45

Y Ltd. supplied the following information:

Net Profit for 2021-22 = ₹10,00,000

Net Profit for 2022-23 = ₹15,00,000

No. of shares prior to right issue = 5,00,000

Terms of right issue: 1 new share for every 4 shares held; right issue price = ₹20

Fair value of 1 ordinary share immediately prior to exercise of right = ₹25

Calculate basic EPS.

Solution:

Basic EPS for 2021-22 = 10,00,000/5,00,000 = ₹2.00

$$\text{Theoretical Ex-right fair value} = \frac{\text{Aggregate Market value of share immediately prior to the exercise of the rights + Proceeds from exercise of the rights}}{\text{Number of shares outstanding immediately after the right issue}}$$

= (5,00,000 × 25 + 1,25,000 × 20)/(500000+125000) = ₹24

$$\text{Right factor} = \frac{\text{Fairvalue per share immediately prior to right issue}}{\text{Theoritical ex-right fair value per share}} = 25/24 = 1.04$$

Basic EPS for 2022-23 = 15,00,000/(500000 × 1.04 × 3/12 + 625000 × 9/12) = ₹2.50

Restated EPS for 2021-22 = 10,00,000/(500000 × 1.04) = ₹1.92

- **Retrospective adjustments**

If the number of ordinary or potential ordinary shares outstanding increases as a result of a capitalisation, bonus issue or share split, or decreases as a result of a reverse share split, the calculation of basic and diluted earnings per share for all periods presented shall be adjusted retrospectively. If these changes occur after the reporting period but before the financial statements are approved for issue, the per share calculations for those and any prior period financial statements presented shall be based on the new number of shares. The fact that per share calculations reflect such changes in the number of shares shall be disclosed. In addition, basic and diluted earnings per share of all periods presented shall be adjusted for the effects of errors and adjustments resulting from changes in accounting policies accounted for retrospectively.

Illustration 46

C Ltd. had 10,00,000 ordinary shares outstanding as on 01.04.2022. On 01.01.2023 it issued 2 ordinary shores bonus for each shore outstanding on 31.12.2022, Profit for the year 2021-22 was ₹9,00,000. Profit for 2022-23 was ₹30,00,000. Calculate Basic EPS the year 2022-23 and adjusted EPS for the year 2021-22.

Solution:

Earnings per share for the year 2022-23 as per Ind AS-33 = 30,00,000/(10,00,000 + 20,00,000) = ₹ 1.00

Adjusted/Restated earnings per share for the year 2021-22 = 9,00,000/(10,00,000 + 20,00,000) = ₹ 0.30

Since the bonus issue is an issue without consideration the issue is treated as if it had occurred in the beginning of the year 2022-23, the earliest period reported.

- **Presentation**

An entity shall present in the statement of profit and loss basic and diluted earnings per share for profit or loss

- from continuing operations attributable to the ordinary equity holders of the parent entity and
- for profit or loss attributable to the ordinary equity holders of the parent entity for the period for each class of ordinary shares that has a different right to share in profit for the period.

- An entity shall present basic and diluted earnings per share with equal prominence for all periods presented.
- If basic and diluted earnings per share are equal, dual presentation can be accomplished in one line in the statement of profit and loss.
- An entity that reports a discontinued operation shall disclose the basic and diluted amounts per share for the discontinued operation either in the statement of profit and loss or in the notes.
- An entity shall present basic and diluted earnings per share, even if the amounts are negative (i.e., a loss per share).

⦿ Disclosure

An entity shall disclose the following:

(a) the amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to profit or loss attributable to the parent entity for the period. The reconciliation shall include the individual effect of each class of instruments that affects earnings per share.

(b) the weighted average number of ordinary shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other. The reconciliation shall include the individual effect of each class of instruments that affects earnings per share.

(c) instruments (including contingently issuable shares) that could potentially dilute basic earnings per share in the future, but were not included in the calculation of diluted earnings per share because they are antidilutive for the period(s) presented.

(d) a description of ordinary share transactions or potential ordinary share transactions, other than those accounted for, that occur after the reporting period and that would have changed significantly the number of ordinary shares or potential ordinary shares outstanding at the end of the period if those transactions had occurred before the end of the reporting period.

If an entity discloses, in addition to basic and diluted earnings per share, amounts per share using a reported component of the statement of profit and loss other than one required by this Standard:

- Such amounts shall be calculated using the weighted average number of ordinary shares determined in accordance with this Standard.
- Basic and diluted amounts per share relating to such a component shall be disclosed with equal prominence and presented in the notes.
- An entity shall indicate the basis on which the numerator(s) is (are) determined, including whether amounts per share are before tax or after tax.
- If a component of the statement of profit and loss is used that is not reported as a line item in the statement of profit and loss, a reconciliation shall be provided between the component used and a line item that is reported in the statement of profit and loss.

⦿ Ind AS 33 vs. AS 20 – A Comparative View

Following are the major differences between Ind AS 33, Earning Per Share and AS 20, Earning Per Share:

S.No.	Ind AS 33	AS 20
1.	Ordinary shares to be issued upon conversion of a mandatorily convertible instrument are included in the calculation of basic EPS from the date the contract is entered into.	No specific requirement is specified in Ind AS.

S.No.	Ind AS 33	AS 20
2.	Disclosure is required for instruments (including contingently issuable shares) that could potentially dilute basic earnings per share in the future but were not included in the calculation of diluted earnings per share because they are anti-dilutive for the periods presented.	No such additional disclosures are required.
3.	Ordinary shares that are issuable solely after a passage of time are not treated as contingently issuable shares because passage of time is a certainty.	No specific guidelines included.
4.	Outstanding ordinary shares that are contingently returnable are not treated as outstanding and are ignored in the calculation of basic EPS until the shares are no longer subject to recall.	No guidance available on contingently returnable shares.

Illustration 47

PKL Limited had an after tax profit of 40,00,000 for the year.80,000 of this was earned from the once off sale of machinery. In the period it paid dividends to the ordinary shareholders ₹ 100,000 and 600,000 to preference shareholders. It had 100,000 ordinary shares in issue for the entire period. Calculate the basic earnings per share for PKL Ltd in the period.

Solution:

Basic earnings per share = profit or loss attributable to ordinary equity holders of the parent entity / The weighted average number of ordinary shares outstanding during the period.

Earnings is calculated as follows.

Profit before tax (from continuing operations)

Less:

(1) Tax

(2) Preference Dividend

(3) Tax on Preference Dividend

(4) Minority interest

Basic EPS = (4000,000-600,000)/(100,000 × 12/12) = ₹ 34.

Illustration 48

PKL Ltd reported net earnings of 7000,000 for the financial year ending 2022-2023.The company had 350,000 shares of ₹ 10 par value common stock and 100,000 shares of ₹ 80 par value convertible preference shares outstanding in the year. The dividend rate on the preference shares was ₹ 5 per share. Each share of the convertible preference shares can be converted into two shares of Akash Ltd class A Common shares. In the year no convertible preference shares were converted .What were Akash LTD's Basic EPS?

Solution:

Basic earnings per share = profit or loss attributable to ordinary equity holders of the parent entity / The weighted average number of ordinary shares outstanding during the period.

Earnings is calculated as follows:

Profit before tax (from continuing operations)

Less:

(1) Tax

(2) Preference Dividend

(3) Tax on Preference Dividend

(4) Minority interest

Basic EPS = 70,00,000 - (100,000 × 5)/350,000 × 12/12 = ₹ 18.57

Illustration 49

On 01/01/2018 BHN Corp. has 3800 ordinary shares outstanding. On 31/05/2019 it issued 600 ordinary shares for cash (without Bonus claim). On 01/11/2019 it bought back 300 ordinary shares .Calculate weighted average number of shares as on 31/12/2019.

Solution:

Computation of weighted average as per IndAS -33

= 3800 × 5/12 + 4400 × 5/12 + 4100 × 2/12 = 1583 + 1833 + 683 = 4099.

Illustration 50

H L td has 2000 million ₹ 20 shares in issue .It also has 3 million ₹ 200 convertible bonds. The bonds have an interest rate of 8%.The tax rate is 25%.Each bond will be convertible into 10 shares. Earnings for the period were ₹ 7000 million .Calculate (a) basic EPS, and (b) diluted EPS

Solution:

Basic EPS = 7000M/2000M = ₹ 3.5 per share

Calculation of Diluted EPS

Diluted EPS = 7000M + (3M × 200 × 0.06) / (2000M × 12/12 + 3M × 10 × 12/12) = 7000 M + 36M / (2000M + 30M) = 7036 M/2030M = 3.47.

5.2.6 Provisions, Contingent Liabilities and Contingent Assets (Ind AS 37)

- **Objective**

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

- **Scope**

  This Standard shall be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, except (a) those resulting from executory contracts, except where the contract is onerous; and those covered by another Standard (e.g., Ind AS 12, 17, 19, 103, 104, 115).

- **Important Definitions**

  A provision is a liability of uncertain timing or amount.

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

  An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

A legal obligation is an obligation that derives from:

(a) a contract (through its explicit or implicit terms);

(b) legislation; or

(c) other operation of law.

A constructive obligation is an obligation that derives from an entity's actions where:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

A Contingent Liability is:

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

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

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

  (ii) the amount of the obligation cannot be measured with sufficient reliability.

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

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

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

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

- **Provisions and Other Liabilities**

Provisions can be distinguished from other liabilities such as trade payables and accruals because there is uncertainty about the timing or amount of the future expenditure required in settlement. Accruals are often reported as part of trade and other payables, whereas provisions are reported separately.

- **Provisions vs. Contingent Liabilities**

As per this Standard, provisions are recognised as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations. On the other hand, contingent liabilities are not recognised as liabilities because they are either - possible obligation or present obligations that do not meet the recognition criteria in this Standard.

- **Recognition**

a. Recognition of Provision

A provision shall be recognised when:

(i) an entity has a present obligation (legal or constructive) as a result of a past event;

(ii) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(iii) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision shall be recognised.

b. Contingent liabilities

An entity shall not recognise a contingent liability. A contingent liability is disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.

Where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The entity recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.

Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs.

c. Contingent Assets

An entity shall not recognise a contingent asset. Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity. An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.

Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

A contingent asset is disclosed where an inflow of economic benefits is probable.

- **Measurement**

The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. While making estimate of amount of the provision, the following points should be considered:

a. Entity should take account of the uncertainty surrounding the transaction, this may involve an expected value calculation (suitable in situation where there is a large population e.g. determining the size of warranty provisions).

b. Provision should be measured before tax.

c. The time value of money (the amount provided should be the present value of the expected cash flows using a pre-tax discount rate).

d. Profit on expected disposal of assets, even if closely linked with the provision should not be deducted from the amount of provision. For example, a restructuring provision cannot be reduced by an expected gain on disposal of a factory that is being sold as part of the restruc¬turing. Instead, the gain will be recognized when the factory is sold.

e. Additional evidence provided by events after balance sheet date should be considered.

f. Future events may affect the provision. For example, entity may believe that the cost of clean¬ing up a site at the end of its life will be reduced by future improved/changes in technology (not new technology) provision or cleaning up cost can be made on the basis of changes in technology (not on the basis of new technology expected). However, it should be supported by sufficient objective evidence. Provision for reimbursement cost should include only the direct expenditure arising from restructuring and should not include retraining or relocating cost of continuing staff marketing or investment in new system and distribution network.

Illustration 51

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of ₹ 1 lakh would result. If major defects were detected in all products sold, repair costs of ₹ 4 lakh would result. The

entity's past experience and future expectations indicate that, for the coming year, 75 per cent of the goods sold will have no defects, 20 per cent of the goods sold will have minor defects and 5 per cent of the goods sold will have major defects.

Calculate the amount to be provided.

Solution:

The expected value of the provision for repairs is:

(75% × 0) + (20% × 100000) + (5% of 400000) = ₹ 40,000

Illustration 52

An entity has an obligation to restore an asset for the damage it has in the past. It has ₹20 lakh cash to pay on 31.03.2022 relating to this liability. The entity considers that 15% is an appropriate discount rate. the time value of money is considered material. Calculate the amount to be provided.

Solution:

PV of the provisions = ₹ 20 lakh/$(1 + 0.15)^2$ = ₹15.12 lakh

- **Changes in provisions**

Provisions shall be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision shall be reversed.

Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.

Illustration 53

X Ltd. has become subject to an obligating event on 01.04.2021 for which the company is committed to expenditure of ₹5,00,000 at the end of 10 years. An appropriate discount rate is 10%. Show how the same is to be treated by X Ltd. (Show treatment up to 31.03.2023)

Solution:

PV as on 01.04.2021 = ₹5,00,000/$(1.10)^{10}$ = ₹1,92,772

PV as on 01.04.2022 = ₹5,00,000/$(1.10)^{9}$ = ₹2,12,049; increase = ₹19,277

PV as on 01.04.2023 = ₹5,00,000/$(1.10)^{8}$ = ₹2,33,254; increase = ₹21,205

<u>On 01.04.2021</u>

Expense A/c ………………Dr.	1,92,772	
To Provision A/c		1,92,772

<u>On 31.03.2022</u>

Interest (Expense) A/c ………………Dr.	19,277	
To Provision A/c		19,277

<u>On 31.03.2023</u>

Interest (Expense) A/c ………………Dr.	21,205	
To Provision A/c		21,205

Note: Thus, every year interest @10% will be provided and interest will be written off to Profit and Loss A/c. At the end of the 10th year, the provision will become ₹5,00,000.

- **Use of Provision**

  A provision shall be used only for expenditures for which the provision was originally recognised.

- **Accounting for Provision**

  The amount of provision should be shown as an expense in profit and loss statement. Expenses relating to provision should be shown in profit and loss statement net of reimbursement. The amount of provision outstanding at the year end should be shown as a liability without netting off reimbursements, if any. The reimbursement expected should be shown as an asset.

- **Application of the recognition and measurement rules**

  a. Future operating losses

     Provisions shall not be recognised for future operating losses.

  b. Onerous contracts

     If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.

  c. Restructuring

  The following are examples of events that may fall under the definition of restructuring:

  (a) sale or termination of a line of business;

  (b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;

  (c) changes in management structure, for example, eliminating a layer of management; and

  (d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

A provision for restructuring costs is recognised only when the general recognition criteria for provisions set out are met.

A constructive obligation to restructure arises only when an entity:

(a) has a detailed formal plan for the restructuring identifying at least:

- (i) the business or part of a business concerned;
- (ii) the principal locations affected;
- (iii) the location, function, and approximate number of employees who will be compensated for terminating their services;
- (iv) the expenditures that will be undertaken; and
- (v) when the plan will be implemented; and

(b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

No obligation arises for the sale of an operation until the entity is committed to the sale, i.e., there is a binding sale agreement.

A restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both:

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the entity.

- **Reimbursements**

Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement shall be treated as a separate asset. The amount recognised for the reimbursement shall not exceed the amount of the provision.

- **Disclosures**

A. Provisions

- For each class of provision, an entity shall disclose:
  - (a) the carrying amount at the beginning and end of the period;
  - (b) additional provisions made in the period, including increases to existing provisions;
  - (c) amounts used (i.e., incurred and charged against the provision) during the period;
  - (d) unused amounts reversed during the period; and
  - (e) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

  Comparative information is not required.
- An entity shall disclose the following for each class of provision:
  - (a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
  - (b) an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events, as addressed in paragraph; and
  - (c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

B. Contingent Liability

Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of its financial effect;

(b) an indication of the uncertainties relating to the amount or timing of any outflow; and

(c) the possibility of any reimbursement.

C. Contingent Assets

Where an inflow of economic benefits is probable, an entity shall disclose a brief description of the nature of the contingent assets at the end of the reporting period, and, where practicable, an estimate of their financial effect measured using the principles set out.

D. Prejudicial Information

In extremely rare cases, disclosure of some or all of the information required can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

⊙ Ind AS 37 vs. AS 29 – A Comparative View

Following are the major differences between Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets and AS 29, Provision, Contingent Liabilities and Contingent Assets.

S. No.	Ind AS 37	AS 29
1.	The definition of provision and obligating event have been revised in Ind AS 37.	
2.	Ind AS 37 also defined the terms legal and constructive obligation.	
3.	Rules relating to restructuring provisions has been revised in Ind AS 37.	
4.	When the effect of time value of money is material, Ind AS 37 requires discounting.	Discounting is not permitted except for decommissioning, restoration and similar liabilities associated with property, plant and equipment
5.	Contingent assets are not recognized but disclosed in the financial statements when an inflow of economic benefits is probable.	Contingent assets are neither recognized nor disclosed in the financial statements and are usually disclosed in the report of the approving authority.
6.	Ind AS 37 makes it clear that before a separate provision for an onerous contract is established, an entity should recognize any impairment loss that has occurred on assets dedicated to that contract in accordance with Ind AS 36.	There is no such provision in As 29.
7.	Ind AS 37 gives an exception to this principle.	AS 29 states that identifiable future operating losses up to the date of restructuring are not included in a provision.

Illustration 54

KSG Ltd will have a liability for environmental damage, from a Bihar High court case that is still in progress at the balance sheet date. Nobody knows how much it will have to pay. Z Insurance Company offers to settle its case for 30 million. Calculate the amount of provision.

Solution:

Environmental Damage is 30 m.

If yes is the answer to all the following questions, then you have to make provisions

a. Whether a confirmed present legal or constructive obligation as a result of past obligating event?

b. Whether it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation?

c. Whether reliable estimate can be made of the obligation?.

Nobody knows how much it will have to pay. Oriental Insurance Company offers to settle its case for 30 million. No other better estimate is available. Therefore following amount of provision is required in that case.

Amount of Provision: 30 M

Illustration 55

There is a GST demand of ₹ 4.50 crores against the company relating to prior years against which the company has gone on appeal to the appellate authority in the department .The ground of appeal deals with points covering ₹ 4 crores of the demand. State how the matter will have to be dealt with in the financial account for the year.

Solution:

If yes is the answer to all the following questions, then you have to make provisions

a. Whether a confirmed present legal or constructive obligation as a result of past obligating event?

b. Whether it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation?

c. Whether reliable estimate can be made of the obligation?

Contingent liability.

A contingent Liability is

a. A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

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

   i. It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

   ii. The amount of the obligation cannot be measured with sufficient reliability.

Here Provision for ₹ 0.50 crores and contingent liability of ₹ 4 crores is to be recognized by the entity

Illustration 56

Board of directors approved the financial account of year 2021-2022 on 31 st July, 2022. The following events occurred before the approval of financial accounts by Board of Directors. State how you would deal with the situation.

The wages of the employees are revised retrospectively from Jan 1, 2022.The agreement is signed on July 1, 2022. The negotiations have been going on since Feb1, 2022.Due to this revision extra wages payable from Jan 1, 2022 to March 31, 2022was 777,000.

Solution:

Here answer to the following questions is yes .Therefore a provision of ₹ 777,000 is needed.

a. Whether a confirmed present legal or constructive obligation as a result of past obligating event?
b. Whether it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation?
c. Whether reliable estimate can be made of the obligation?

Illustration 57

Waste from an XYZ Ltd Co's production process contaminated the groundwater at the Co's plant. In a lawsuit brought against the company, members of the local company seek compensation for damages to their health as a result of the contamination. The Company acknowledges its wrong doing and the court is deciding on the extent of the compensation to be awarded to the members of the local community. It is uncertain when the ruling will take place but the company's lawyers expect it will take place in about two years and they estimate that the compensation awarded by the court will be in the range of ₹ 15.25 crores to 30.356 crores. How will you treat the above case? And why?

Solution:

Here answer to the following questions is yes .Therefore a maximum provision of ₹ 30.356 crores is needed.

a. Whether a confirmed present legal or constructive obligation as a result of past obligating event?
b. Whether it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation?
c. Whether reliable estimate can be made of the obligation?.

Illustration 58

K industries Ltd has filed the damages case of ₹ 2.896 crores against YJN Ltd for not supplying the quantity and quality of raw-material as per order, chances of winning of the case by the K industries Ltd is possible. State whether there is a contingent asset

Solution:

Contingent Asset

No need to recognize it. Whereas, the entity should disclose in the financial statements Contingent Asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of entity. Here the amount of Contingent Asset is ₹ 2.896 crores.

Illustration 59

KSD Ltd entered into a contract to supply 3000 Radio sets for 2.3687 Million. An increase in the cost of inputs has resulted into an increase in the cost of sales to 3 Million .The penalty for non-performance of the contract is expected to be ₹ 0.56 Million. Is the contract onerous and how much provision in this regard is required?

Solution:

Onerous Contracts. It's a contract entered into with another party under which the unavoidable costs of fulfilling the terms of contract exceed any revenues to be received from goods or services supplied or purchased directly or indirectly under the contract and the entity would have to compensate the other party if it did not fulfil the terms of contract. Provision is needed. Cost of fulfilling the contract is 3 Million-2.3687 Million=0.6313 Million T.he penalty for non-performance of the contract is expected to be ₹ 0.56 Million. Provision should be recognized at the best estimate of the unavoidable cost, which is lower of the following:

a. Cost of fulfilling the contract is 3 Million-2.3687 Million = 0.6313 Million.

b. The penalty for non-performance of the contract is expected to be ₹ 0.56 Million.

Provision needed is 0.56 Million.

Illustration 60

Raju Electronics Ltd manufactures and sells the TV Sets under the terms of the contract of sale. The manufacturer undertakes to make good by repairs or replacement, manufacturing defect that become apparent within three years from the date of the sale. By experience it is probable that there will be some claims under the warranties .State whether provision for warranties is required or not.

Solution:

Recognition of Provisions. If yis the answer to all the following questions, then you have to make provisions

a. Whether a confirmed present legal or constructive obligation as a result of past obligating event?

b. Whether Settlement of liability should result in an outflow from entity of resources?

c. Whether reliable estimate can be made of the obligation?

1. Past event –Sale of the TV set Present Legal obligation-Yes
2. Answer to the second Question-Yes
3. Reliable estimate of warranties has to be made-Yes. Yes .Therefore, Provision should be made

Illustration 61

XYZ Industries Ltd has filed the damages case of ₹ 8 crores against Y Ltd for not supplying the quantity and quality of goods as per order, chances of winning of the case by the XYZ Industries Ltd is probable. Whether there is a contingent asset.

Solution:

There is a possible asset. Existence of future event will be confirmed in this case. Occurrence of future event is not within the control of the entity. Therefore XYZ Industries Ltd should recognize Contingent Asset of ₹ 8 crores.

Illustration 62

A company has a lease on a property at a rental of ₹ 80,00,000 per year. There are 10 years remaining on the lease. The market rent is 7,00,000 per year. The company no longer occupies the property and it is not used in the business. A Sub lease on the property has been arranged at a rent of ₹ 700000 per year for the remaining 10 years on the lease .Determine the provision that is required to be provided.

Solution:

Gross Provision = 80,00,000 × 10 = 8 crores

Less: Expected value of Income from Sublease = 7,00,000 × 10 = 70,00,000

Net Provision = 7,30,00,000.

Illustration 63

A super market has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known. What are your views on the recognition of provision?

Solution:

Provision is required because of the following reasons

1. The past event is the sale in the retail store. This gives rises to present constructive obligation.
2. An outflow of resources embodying economic benefits in settlement is probable; a proportion of goods returned for refund.
3. Here best estimate of the cost of refunds is possible

Illustration 64

There is a GST demand of ₹ 19.50 crores against the company relating to prior years against which the company has gone on appeal to the appellate authority in the department. The ground of appeal deals with points covering ₹ 19 crores of the demand. State how the matter will have to be dealt with in the financial account for the year.

Solution:

Provision for 0.50 crores and contingent liability of 19 crores

Illustration 65

Board of Directors approved the financial account of year 2022-23 on 31 st July, 2023. The following events occurred before the approval of financial accounts by Board of Directors .State how you would deal with this situation : The wages of the employees are revised retrospectively from Jan,1, 2023. The agreement is signed on July 1, 2020. The negotiations have been going on since Feb 1, 2023. Due to this revision extra wages payable from Jan1, 2023 to March 31, 2023 was 900,000.

Solution:

Recognition of Provisions. If Yes is the answer to the following questions, then you may make provisions

a. Whether a confirmed present legal or constructive obligation as a result of past obligating event?
b. Whether Settlement of liability should result in an outflow from entity of resources?
c. Whether reliable estimate can be made of the obligation?

Here, the answer is yes to all the above questions

Besides you should consider Ind AS -10-Events after reporting Period in this case.

Here Provision is to made for ₹ 900000

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. The objective of Ind AS 1 Presentation of Financial Statements is to:
   - A. provide basis for presentation of general-purpose financial statements
   - B. sets out overall requirements for the presentation of financial statements,
   - C. sets out guidelines for financial statements structure
   - D. All of the above
2. An entity shall apply Ind AS 1 in:
   - A. preparing and presenting general purpose financial statements in accordance with Indian Accounting Standards (Ind ASs).
   - B. preparing and presenting financial statements in accordance with Indian Accounting Standards (Ind ASs).
   - C. preparing and presenting financial statements in accordance with Accounting Standards.
   - D. preparing and presenting general purpose financial statements in accordance with Accounting Standards.
3. Ind AS 1 "Presentation of financial statements" applies to
   - A. Consolidated financial statements in accordance with Ind AS 110, Consolidated Financial Statements,
   - B. Separate financial statements in accordance with Ind AS 27, Separate Financial Statements.
   - C. Both of the above
   - D. Only a
4. Ind AS 2, Inventories, does not apply to
   - A. Financial Instruments
   - B. Biological Assets
   - C. Both the above
   - D. (A) but not (B)
5. Cost of inventories does not include
   - A. costs of purchase,
   - B. costs of conversion
   - C. other costs incurred in bringing the inventories to their present location and condition
   - D. Finance cost
6. Which of the following costs are not excluded from cost of inventory?
   - A. Selling cost
   - B. Administrative cost
   - C. Abnormal loss
   - D. Carriage and freight inward

7. Which of the following is an employee benefit?
   - A. Short term employee benefits
   - B. Long term employee benefits
   - C. Termination benefits
   - D. All of the above
8. Which of the following is not a part of other long-term benefits?
   - A. long-term disability benefits
   - B. retirement benefits
   - C. profit-sharing and bonuses
   - D. deferred remuneration
9. Short term employee benefits include –
   - A. Wages
   - B. Salaries
   - C. Employer's contribution to P.F
   - D. All of the above
10. Which of the following is a defined contribution plan?
    - A. Multi-employer plan
    - B. State plan
    - C. Insured benefits
    - D. All of the above
11. Find out Cost of Purchase from the following data:

a.	Purchases	₹ 257,000
b.	Customs duty	44,000
c.	Air Freight	17,250
d.	Penalty charges for overdue payment	7000

   - A. 147,000
   - B. 325,250
   - C. 318,250
   - D. 450,000
12. Find out Cost of Conversion from the following data:

a.	Wages paid	87,000
b.	Repairs and Maintenance	7000
c.	Abnormal cost	7000

   - A. 94,000

B. 101,000

C. 225,000

D. 87,000

[Answer: 1-D; 2-A; 3-C; 4-C; 5-D; 6-D; 7-D; 8-B; 9-D; 10-D; 11-C; 12-A]

State True or False

1. Abnormal amounts of wasted materials, labour or other production costs are not part of the cost of inventories.
2. Financial statement should normally be prepared assuming going concern.
3. Provisions shall be recognised for future operating losses.
4. Purchased options are dilutive.
5. Under defined contribution plans, the entity's obligation is limited to the amount that it agrees to contribute to the fund.

[Answer: True; True; False; False; True]

Fill in the Blanks

1. In case of a company, events after the reporting period are event that occur between the end of the reporting period and ________________.
2. Voluntary retirement scheme is a type of ________ benefits.
3. ________ earnings per share are calculated when there are potential ordinary shares in capital structure of the entity.
4. An entity shall _______ the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period.
5. Contingent liabilities do not have any ________ obligation.

[Answer: date of approval of the financial statements; termination; Diluted; not adjust; present]

Short Essay Type Questions

1. What does a complete set of financial statements include?
2. What do you mean by inventory? What is net realizable value?
3. State the disclosure requirements of Ind AS 2.
4. Discuss different types defined contribution plans.
5. How will you calculate basic EPS?
6. When is diluted EPS calculated?

Essay Type Questions

1. Discuss the general features of financial statements.
2. How will you account for termination benefits?
3. How will you account for distribution of non-cash assets to the owners?
4. State the disclosure requirements for provisions as per Ind AS 37.
5. How will you treat written put options in calculating diluted EPS?

B. Numerical Questions

⦿ Multiple Choice Questions

1. The expected sales value of stock is ₹20 lakhs and a commission at 10% on sale is payable to the agent. Calculate NRV.

   A. ₹12 lakh

   B. ₹14 lakh

   C. ₹16 lakh

   D. ₹18 lakh

2. 01.04.2022 B Ltd. has 1200 ordinary shares outstanding. On 31.08.2023 it issued 400 ordinary shares for cash. On 31.01.23 it bought back 200 ordinary shares. Calculate weighted average number of shares as on 31.03.23.

   A. 1300

   B. 1400

   C. 1500

   D. 1600

3. Fair value before right issue ₹20. Theoretical ex-right fair value ₹18. Calculate right factor.

   A. 1.2

   B. 1.15

   C. 1.11

   D. 1.10

4. Salary payable per day ₹1000; Working days 300; leave unutilized during the year 3 days; unutilized leaves are not allowed to carried forward but are settled through payment. What is the expense to be recognised as per Ind AS 19?

   A. ₹3,00,000

   B. ₹3,30,000

   C. ₹3,03,000

   D. ₹3,000

5. Ordinary shares are 1,00,000 of ₹ 1.00;10% Preference shares are 200000 of ₹ 1.00; PAT ₹10,00,000. Calculate basic EPS.

   A. ₹9.80

   B. ₹9.60

   C. ₹9.40

   D. ₹9.20

[Answer: 1-D; 2-B; 3-C; 4-C; 5-A]

⦿ Comprehensive Numerical Problems

1. ABC Ltd. produced 20,00,000 units of product A during the year 2022-23 per unit cost is as follows:

Raw Material	₹100
Direct wages	₹ 50
Direct Expenses	₹2

Production overhead is ₹ 40,00,000 of which 40% is fixed. The company sold 16,00,000 units and 4,00,000 units were in stock as on 31/3/2023. Normal capacity is 10,00,000 units. Calculate the value of closing stock.

[Answer: ₹ 6.192 crores]

2. Cost of Production of product M is given below:

Material per unit	₹ 120
Wages per unit	₹ 80
Overhead per unit	₹ 50

As on the balance sheet date, the replacement cost of raw material is ₹ 105 per unit. There were 2000 units of raw material on 31.03.2023.

Calculate the value of closing stock of raw material in following conditions:

(a) If finished product is sold at the rate of ₹270 per unit, what will be value of closing stock of raw material?

(b) If finished product is sold at the rate of ₹ 235 per unit, what will be value of closing stock of raw material?

[Answer: (a) ₹ 2,40,000. (b) ₹ 2,10,000]

3. On the basis of the following information, calculate the actual return on pension plan assets.

Benefits paid	₹2,50,000
Contribution	₹3,25,000
FMV of plan assets at the end	₹15,00,000
FMV of plan assets at the beginning	₹10,00,000

[Answer: ₹4,25,000]

4. ABC Ltd. is a pharmaceutical company. It has received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹10,00,000. the company wants to spread the same over the next 5 years by reducing the contribution from ₹5,00,000 to ₹3,00,000. The average remaining life of the employee is 10 years. You are required to advise the company.

[Answer: Actuarial gain to be immediately recognised in other comprehensive income]

5. PQR Ltd. is in a legal suit with the municipal authorities regarding property tax. The company gets a court order in its favour on 10th April, 2023, which resulted into reducing the tax liability as on 31st March, 2023. The financial statements for 2022-23 were approved by the BODs on 11th May, 2023. The management is not in favour of adjusting the event as it thinks that favourable events after the reporting period would hamper the realisation concept of accounting. Comment on the company's views in the light of Ind AS 10.

[Answer: Favourable events should also be considered]

6. The financial statements of XYZ Ltd. for the financial year 2022-23 were approved by the BOD on 10.05.2023. A fraud relating to the accounts of 2021-22 was identified on 15.04.2023. Is it an adjusting event? Give your opinion in the light of Ind AS 10.

[Answer: It is an adjusting event.]

7.

Ordinary shares outstanding on 01.01.23	1000,000
Profit for the year ended on 31.12.23	₹1,00,000
Average fair value during the year	₹8

The company has in issue 200,000 options to purchase equal ordinary shares at exercise price of ₹6 per share.

Calculate the diluted EPS.

[Answer: ₹0.95]

8. P Ltd. had outstanding ordinary shares of 1,00,000 on 01.01.2023. Profit for the year is 2022 is ₹2,20,000 and for 2023 is ₹3,00,000. On 01.03.23 it issued 1 new share for every 5 shares outstanding at ₹15. Fair value of 1 ordinary share before right issue was ₹21. Calculate (i) Basic EPS for 2023 and (ii) Restated EPS for 2022.

[Answer: (i) ₹2.55; (ii) 2.10]

[Note: Each of the Illustrations and Comprehensive Numerical Problems may be considered as small cases]

References

1. Conceptual Framework for Financial Reporting under Ind ASs, issued by ASB of The Institute of Chartered Accountants of India.
2. Companies (Accounting Standards) Rules 2021
3. Companies (Indian Accounting Standards) Rules 2015
4. Relevant Ind ASs and Accounting Standards

SECTION - B

AUDITING

Basic Concepts of Auditing 6

This Module includes:

Basic Condept of Auditing

SLOB Mapped against the Module

To equip oneself with the fundamental concepts of auditing. (CMLO 4 a)

Module Learning Objectives:

After studying this module, the students will be able to –

- Understand nature, scope, objectives and importance of auditing.
- Have an overview of Auditing Standards governing the audit practices in India.
- Understand the role of internal control in managing the audit risk.
- Develop and understanding of audit techniques and analytical procedure.
- Have an understanding of auditing in a technology enabled environment.

Introduction

6

Financial statements are the end products of formal accounting system. They are often used by various interested parties in making useful decisions. Accordingly, authenticity, truthfulness and fairness are considered to be the integral characteristics of these statements so as to make them really worthy to support a decision-making process. However, mere recording of transactions in the books of accounts may not be adequately ensure the above qualities. Considering the possibility of unintentional mistakes as well as organised frauds, an independent appraisal of the recorded facts is essential. Auditing, in its fundamental form, ensures the above appraisal of financial accounting data and management assertions in order to support the decision-making process.

Moreover, the emerging dimensions of audit extend the above appraisal exercise beyond the traditional financial accounting data and address issues more focused. In today's business world, auditing plays a multifaceted dynamic role in almost all the important functional areas of an organisation.

Nature, Scope, Objectives and Significance of Auditing

6.1

6.1.1 Evolution of Auditing

In the early days of commerce and business the concept of auditing did not exist. 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 to 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 conduct 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 organisations 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 the 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.

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, the Joint Stock Companies Act, 1857, introduced the provisions of annual audit but was made optional. Later, the Companies Act, 1913, made it compulsory. This Act was replaced in 1956 by the 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 requisite qualifications should be appointed as statutory auditors of companies. In 1965, an amendment in the Act took place and concept of Cost Audit was introduced. The amendment in the Income Tax Act, 1961, which took place in 1984, introduced the concept of Tax Audit. Sales Tax (VAT), Trust Act, Co-operative Societies Act etc. which 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, 1956 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 its development and caused considerable changes and improvements in the techniques, principles, standards, reporting, professional ethics and responsibilities of auditor.

6.1.2 Concept and Definitions of Auditing

The concept of audit has undergone continuous change over the period. Hence it is required that the meaning of the term 'audit' is analysed both in the (traditional) narrow and (modern) broad sense of the term.

A. Narrow Perspective

The term "audit" has been derived from the Latin word "audire" which means 'to hear'. In early days, the person appointed to check the accounts, used to hear the explanations required from responsible officers and that's why, he was called as an "auditor".

Some of the definitions given by a few well-known experts in the field indeed highlight the above narrow perspective.

According to 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.

In the words of 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 thereto 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".

According to Prof. Montgomery- "Auditing is a systematic examination of the books and records of business or other organisation, in order to ascertain or verify and to report upon the facts regarding its financial operations and the result thereof.

In the words of 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.

According to 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".

Thus, in its narrow sense, the scope of an audit is limited to only authenticating the accounting records and thereby to assure the accuracy and reliability of the financial statements and reports.

B. Broader Perspective

Over time, with the changes in socio-economic environment, the concept of audit has also changed. Today auditing is not confined to mere authentication of financial accounting records. It is now considered to be an independent appraisal activity that extends itself towards evaluation of non-financial aspects as well.

As per the General Guidelines on Internal Auditing issued by The Institute of Chartered Accountants of India, "auditing is 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".

According to SA 200, 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".

Thus, in the broader perspective, auditing is a holistic appraisal of all the relevant aspects (be it financial or otherwise) of an enquiry sought after a stated purpose.

- **Essential Features of Auditing**

  The essential features of auditing are enumerated below;

  (i) It involves evaluation & verification of the relevance, reliability and adequacy of evidence in support of verifiable information such as vouchers, documents, explanations.

  (ii) It is analytical, critical and investigative review of systems of Accounting & Internal Controls.

  (iii) The information audited may be financial or non-financial.

  (iv) There should be standards or criteria for evaluation of the information in a systematic & scientific manner.

  (v) The auditor should be competent and independent, qualified & possessing prescribed qualification & certificate of practice.

  (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 of state of affairs of Business and of profit or loss made during financial period disclosed therein.

6.1.3 Nature of Auditing

Auditing has generally been associated with only accounting and financial records. Thus, International Auditing and Assurance Standard Board (IAASB) opined that "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."

In the above definitions, 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 organisation. 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.

However, 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. The Institute of Chartered Accountants of India 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."

⊙ Relationship between Accounting and Auditing

The basic objective of accounting is to record all the economic events that change the financial position of the entity and to prepare a statement of performance and a statement of affairs for each accounting period. On the other hand, auditing and more specifically financial auditing is undertaken to appraise the authenticity and reliability of the of the accounting records and other relevant documents in order to arrive at a conclusive opinion as to whether the financial statements exhibit a true and fair view of the financial performance and state of affairs of the organisation. Thus auditing, in its conduct, aims to detect all material misstatements and frauds and thereby put a check on the accountants and management. In other words, auditing is the critical aspect of accounting.

In this context, the following differences between accounting and auditing can be mentioned.

Sr. No.	Accounting	Auditing
1.	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.
2.	It is the recording of transactions at the time of occurrence.	It is the post mortem examination of recorded transactions.
3.	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.
4.	Its primary responsibility is of the management towards the shareholders or 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.
5.	An accountant is not expected to review or 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.
6.	An accountant works for the management.	The auditor is an independent person accountable to the owners or shareholders and not to the management.
7.	No such liability is there in accounting.	In certain circumstances, the auditor could be held liable to third parties also.

8.	Maintenance of accounts may not be mandatory for small individuals or partnership firms, e. g. under section 44AA of the Income Tax Act, but could be mandatory under other laws, e.g., for companies under the Companies Act.	Audit could be exempt for various individuals or small partnerships, e. g. under section 44AB of the Income tax Act, and even in case where maintaining books of accounts is a statutory requirement under section 44AA, but may be mandatory under other laws e. g. for Companies under the companies Act.
9.	Accounting is done as per the principles set by Indian Accounting standards (Ind AS)	Auditing is done as per the principal set in standards on auditing.

- **Audit and Investigation**

It is to be noted that both Auditing and Investigation have a fact-finding character. Both involve a systematic and critic al examination of the available evidence, yet these are quite distinct from each other as follows:

	BASIS	AUDIT	INVESTIGATION
1.	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.
2.	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.
3.	Objective	ln 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)
4.	Audit Procedure	The audit is conducted in accordance with the generally accepted auditing principle.	Investigations involve an extended auditing procedure.
5.	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.
6.	Approach	Auditor is skeptical and not suspicious.	Whereas an investigator starts with suspicion and collects evidence to either confirm or dispel that suspicion.
7.	Periodicity	Auditing is a routine exercise (normally conducted annually).	Investigation may spread over a period longer than one year.

6.1.4 Scope of Auditing

In ancient period, the scope of audit was really limited. But over the time the same has extended considerably.

The scope of an audit of financial statements is determined by the auditor having regard to the terms of the engagement, the requirements of relevant legislation and the pronouncements of The Institute of Chartered Accountants of India. Moreover, the auditor must also ensure that no relevant aspect of the organisation is left unchecked even if it is not specifically mentioned in the terms, regulations or pronouncements. Again, the terms of engagement cannot, limit the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of The Institute of Chartered Accountants of India.

According to SA-200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, the scope of audit should cover the following aspects:

(a) The auditor shall assess the reliability and sufficiency of the information contained in the underlying accounting records and shall undertake appropriate audit procedures for this purpose. Appropriate audit procedure may include either Compliance Procedures (i.e., study of accounting system and internal control) or Substantive Procedures (i.e., testing the authenticity, accuracy and completeness of information in accounting records).

(b) The auditor has to determine whether the relevant information is properly disclosed in the financial statements in conformity with the applicable generally accepted accounting principles and statutory requirements (i.e., requirements as per Accounting Standards and Companies Act).

(c) The auditor's work shall involve an exercise of judgement. He shall be principally concerned with items that either individually or as a group are material in relation to the affairs of an organisation.

Thus, the duty of the auditor shall not be limited to mere verification of accounting entries based on the available vouchers and other documents, but he shall evaluate the authenticity of the transaction, appropriate recoding of the same in the books of accounts as well as compliance of the accounting and reporting process with prevalent statutes in this respect.

- **Basic Principles Governing an Audit**

SA 200 issued by The Institute of Chartered Accountants of India 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.

6.1.5 Objectives of Auditing

According to SA 200, Overall Objective of the Independent Auditor and the Conduct of an Audit as per Standard of Auditing, in conducting an audit of financial statements, the overall objectives of the auditor are:

(i) 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

(ii) 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:

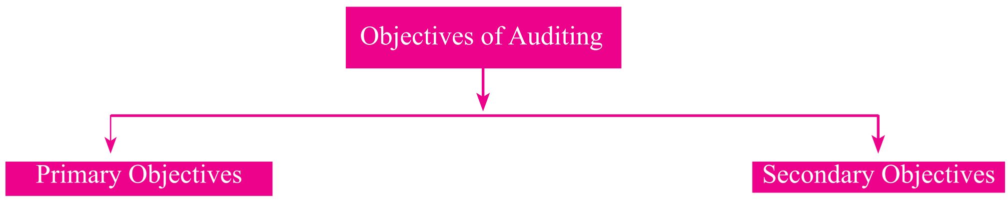

Figure 6.1: Objectives of Auditing

(i) Primary Objective: The main objective of an audit is to determine whether the financial statements present 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 non-existence. He is also to report on the existence of such misstatement and their magnitude through his audit report.

In the process of adhering to the above objectives, an audit also attains certain social objectives as follows:

(i) To protect the shareholders' interest of shareholders.

(ii) To stop evasion of taxes

(iii) To safeguard against capital erosion

(iv) To ensure fair return on investors

(v) To ensure reasonable price to customers

(vi) To ensure fair compensation to workers

(vii)Complying with polices regarding corporate social responsibilities

6.1.6 Significance of Auditing

While discharging their stewardship role, the management furnishes various reports including financial statements to the owners or shareholders stating the utilisation of resources, financial performance and financial state of affairs. However, the problem that always exists is the credibility of the report. The report may — (a) contain errors, (b) may not disclose frauds, (c) may be inadvertently misleading, (d) may be deliberately misleading, (e) may fail to disclose relevant information, and (f) may fail to conform to regulations. The solution to this problem of credibility lies in appointing an independent person called an auditor to investigate the report and submit his findings.

Moreover, 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 organisations as well as to owners and outsiders.

Many financial statements must conform to statutory and other requirements. All company accounts have to conform to the requirements of the Companies Act 2013. In addition, all accounts should conform to the requirements of Accounting Standards or Indian Accounting Standards (Ind AS). 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 up to 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 technic al points although it is not the duty of the auditor to give advice.

  (iv) **Uniformity in Accounts —** If the accounts have been prepared on a 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 200, 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 The Institute of Chartered Accountants of India (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 The Institute of Chartered Accountants of India (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 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 The Institute of Chartered Accountants of India (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 scepticism — Professional scepticism 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 reliability of management's representations. The auditor is entitled to accept the records and documents as genuine unless there is some evidence to the contrary.

(iii) Materiality is one of basic fundamental concepts in process of Auditing as well as Accounting. Auditor has to constantly & continuously judge whether transaction is material or not. It is used by him in his Audit Planning. Materiality means important cost wise, profit wise, effect wise, value wise; which influences economic decision of user. What is material in one circumstance, may not be material in another circumstances. Therefore, changes need to be done accordingly.

⦿ Classification of Auditing

In today's world, organisations differ in their characteristics. As a result, auditing to be carried out in these organisations must also be different to capture the basic organisational character. In addition, auditing also differs based on the stated purpose to be achieved as well as the procedure and frequency of conducting the verification. Therefore, different basis may be followed in classifying audits. There are (i) organisational structure-wise classification of audit, (ii) objective-wise classification of audit, (iii) periodicity-wise classification of audit, and (iv) scope-wise classification of audit, and (v) Subject matter -wise classification of audit.

I. Organisational Structure-wise Classification

A. Statutory Audit

Statutory audit is the checking of accounts as 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 organisation.

(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 valid Certificate of Practice (COP) 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 organisation 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) By the shareholders, 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 organisations, 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.

B. Non-Statutory Audit

When audit is conducted without any legal requirement, it is called non-statutory audit or private audit. This kind of audit is arranged purely voluntarily or sometimes as per internal rules of the organisations. Here the auditor is appointed as per an agreement which determines the nature and scope of audit to be conducted, the rights and duties of the auditor, requirement of reporting etc. Sole-proprietors, partnership firms, non-profit seeking organisations such as clubs, associations of persons, hospitals, etc, get their accounts audited to make them reliable and acceptable to their stakeholders. Some of these benefits are stated below:

- **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 and 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.

  (iv) It enables firm to get loans from banks, financial institutions as they rely on audited accounts of firm.

  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 benefits.

- **Statutory Audit vs. Non-Statutory Audit**

S. No.	Points of Distinction	Statutory Audit	Non-statutory Audit
1.	Legal compulsion	It is compulsory.	It is voluntary.
2.	Scope	The relevant statute or law determines the scope of work.	The employer or partners determine the scope of work.
3.	Qualification of auditor	The academic or professional qualification is prescribed for the auditor.	The auditor need not possess any academic or professional qualifications.
4.	Powers, rights and duties of an auditor	The statute dictates the powers, rights and duties of an auditor.	The agreement between an auditor and firm decides these matters.
5.	Independence	The auditor has independence in status and in mental attitude.	The auditor does not enjoy such independence.
6.	Auditor's liability	The auditor is liable for negligence under the Common Law and for misfeasance under the relevant statute governing the audit.	The auditor is liable for negligence only under the Common Law.
7.	Publication of audit report	The audit report is published for the public.	The audit report is made known to the employers or partners.

II. Objective-wise Classification of Audit

A. Internal Audit

The Institute of Chartered Accountants of India describes Internal Audit as "an independent management function, which involves a continuous and critic al 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 organisation's operations. It not only includes matters related to finance but also critical appraisal of the policies and procedures of the company. Internal Audit is based on principle of "early detection & prevention of further damage". It points out irregularities, non-compliances timely and not after year end as in case of Statutory Audit.

B. 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 organisation 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.

III. Periodicity-wise Classification of Audit

A. Periodical or Final Audit

Final Audit is conducted at the end of the accounting year, after the books of accounts have been closed. 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.

- **Advantages and Limitations**

  Final audit is cost effective and ensures continued focus, planned approach to work and non-interference with client's accounting work being continued.

  However, 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.

B. Interim Audit

Interim audit is the 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.

It is useful for:

a. Ascertainment of interim profit and loss and declaration of interim dividend.

b. Change in the structure of a partnership firm.

c. Determining goodwill and net worth of any business for acquisition purpose.

d. Investigation of any suspected fraud.

e. Obtaining loans from financial institutions.

C. Continuous Audit

According to the Institute of Internal Auditors, USA, continuous auditing is "a method used to perform control and risk assessments automatic ally 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.

- **Basic Features of Continuous Audit**

  a. It is a process conducted throughout the year.

  b. It is conducted at regular or irregular intervals.

  c. It focuses on testing 100% of transactions.

  d. Technology is important to enable it.

  e. It provides advance notice about errors and irregularities detected.

  f. Surprise visits by the auditor are involved.

- **Necessary of Continuous Audit**

  Continuous audit is necessary where:

  a. Internal controls are inadequate.

  b. The transactions run in large numbers.

  c. The management is interested in getting statements of accounts audited periodic ally for enabling better management of resources.

- **The Advantages of Continuous Audit**

  a. 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.

  b. Quick rectification: rectification of errors at an early stage is possible.

  c. Guidance: Continuous guidance to client.

  d. Finalizations of accounts completion in time: Just at the end of the accounting period.

  e. Moral check: Make employees of the client alert and more efficient in conducting their work.

  f. Improves statutory auditor's focus: It relieves statutory auditors of routine testing and allows them to focus efforts on more valuable activities.

- **Demerits of Continuous Audit**

  a. 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.

  b. Frequent visits made by the auditor may cause inconvenience at times inconvenient at work.

  c. The client may suffer due to the clash of duties between his staff and that of the auditor clash of work.

  d. It is more expensive because the auditor has to devote more time to this audit.

  e. The work of audit becomes too mechanical and repetitive work.

Continuous Audit vs. Periodical Audit

S. No.	Points of Distinction	Continuous Audit	Periodical Audit
1.	Timing	It is conducted throughout the year.	It is conducted after preparation of final accounts.
2.	Cost	It is more expensive.	It is less expensive.
3.	Detection of errors and frauds	Errors and frauds are detected early.	Errors and frauds are detected late.
4.	Scope	Detailed checking is possible.	Detailed checking is not possible.
5.	Interim dividend	It helps in finalization of interim accounts and thus facilitates in declaration of interim dividend.	It does not facilitate in declaration of interim dividend.
6.	Monotony of the audit staff	It leads to monotony of the audit staff as they are engaged in the same work throughout the year.	It does not lead to monotony of the audit staff as they are engaged in different organisations.
7.	Efficiency of the client's staff	It improves the efficiency of the client's accounting staff.	Here the accounting staff may become lazy and inefficient and keep works pending.
8.	Collusion	There is a possibility of collusion between audit staff and employees of the organisation.	There is hardly any possibility of collusion between audit staff and employees of the organisation.
9.	Moral Pressure	As the audit staff are continuously engaged in the organisation, it maintains a moral pressure on the client's staff.	There will be less moral pressure on the client's staff as the auditor visits only after the finalization of accounts.
10.	Applicability	It is applicable for large organisations.	It is applicable for small organisations.
11.	Report	It facilitates timely submission of audit report.	It takes time to prepare and submit the audit report under periodical audit.

D. Limited Review

As per Clause 33 of SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015, a company shall submit its quarterly, year-to-date and annual financial results to the stock exchange in the manner prescribed in this clause. Accordingly, a company has an option to submit audited or unaudited quarterly and year to date financial results to the stock exchange within forty-five days from the end of each quarter (other than the last quarter). Under most of these circumstances the auditor finds little time to conduct thorough examination of books and other supporting documents. Moreover, it may also not be possible for the client to balance books and provide all documentary evidences. So instead of conducting a full-fledged audit, the auditor has to make restricted study of books and other documents. This system of review is called Limited Review.

It is to be noted that in case of Limited Review, generally accepted auditing standards are not followed. So, the scope of Limited Review is substantially narrower as compared to an audit.

IV. Scopewise Classification of Audit

A. Complete 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.

B. Partial Audit: 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 c ash sales, or he may be appointed to conduct an audit for the month of Diwali only.

C. Detailed Audit: 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.

V. Subject Matter -wise Classification of Audit.

A. Cost Audit

Cost Audit involves an examination of cost books, cost accounts, cost statements and subsidiary and prime documents with a view to satisfying the auditor that these represent true and fair view of the cost of production. This includes the examination of the appropriateness of Cost Accounting system.

The Institute of Cost Accountants of India on the other hand, defines cost audit as "a system of audit introduced by the Government of India for the review, examination and appraisal of the cost accounting records and attendant information, required to be maintained by specified industries."

Cost Audit renders invaluable services to various parties connected with the business directly or indirectly. It acts as a tool of control in the hands of management enabling it to identify the areas of inefficiency and wastage.

B. Management Audit

Management audit is a comprehensive and critical review of each and every aspect of the management process. It is basically a tool of management control. It covers all areas of management like planning, organising, co-ordination and control. It assists managers at all levels in the effective discharge of managerial functions.

Management audit is a forward-looking, independent and systematic evaluation of the activities of the management for the improvement of the organisational profitability and attainment of other predefined objectives of the organisation through well directed management function. It acts as a guide, which helps in improving the efficiency of the management.

C. Operational Audit

Operational Audit involves examination of all the operations and activities of the entity under audit. The objective of operational audit includes 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 also 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 predefined overall goals of the entity.

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.

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 organisations 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.

D. Tax Audit

Tax audit can be defined as ‘an examination of financial records to assess correctness of calcu¬lation of taxable profit, to ensure compliance with provisions of the Income Tax Act and also ensure fulfilment of conditions for claiming deductions under Income Tax Act.’ Tax audit is required in addition to the financial audit since taxable income largely differs from accounting profit because of various allowances, disallowances, deductions and exemptions suggested under tax laws.

In India, the Income Tax Act, 1961 contains a number of provisions requiring tax audit of an entity. Section 44AB gives the provisions relating to the class of taxpayers who are required to get their accounts audited from a chartered accountant. The audit under Section 44AB aims to ascertain the compliance of various provisions of the Income-tax Law and the fulfilment of other requirements of the Income-tax Law. The prime objective of tax audit is to stop tax evasion.

E. Social Audit

Business is a social institution and evolves out of social environment. In course of earning profit business takes resources from society, so in return they should discharge certain duties to society also for long term sustainability. In order to measure and examine how far the business concerns have been able to discharge their social responsibility, that is, how much contribution has been made by the concern towards social welfare, the concept of ‘social audit’ was introduced in business arena.

Social audit is defined as the system of independent evaluation of operations of an organisation, examination of records relating to social responsibility accounting and critical appraisal of the impact of organisations on the society.

Social audit is not mandatory in most of the countries including India. This exercise is often undertaken by business houses voluntarily.

F. Propriety Audit

Propriety audit is the independent and systematic evaluation of the appropriateness of management decisions on the basis of public interest, financial discipline and behavioural standards. In other words, it is an evaluation as to whether decisions have been undertaken in tune with the accepted rules, standards, policy and delegated power. The objective of propriety audit is to ensure safeguard of assets, check misappropriation of funds, misutilisation of delegated authority and increase the productivity of management etc.

In India, propriety audit is not separately practiced. However, the Companies Act, CARO and other legislations contain sufficient provisions that require performance of propriety audit in the context of conventional statutory audit.

G. Forensic Audit

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.

Major accounting scandals involving Enron, World Tel, 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.

H. Performance Audit

A performance audit is an independent assessment of an entity's operations to determine if specific programs or functions are working as intended to achieve stated goals. Performance audits are typically associated with government agencies at all levels as most government bodies receive federal funding.

Performance audits serve a fundamental purpose of government accountability. Through performance audits government entities are held to objective standards of executing the responsibilities that they are legally authorized and charged to carry out.

I. Secretarial Audit

Secretarial audit is also a relatively new concept and is coming to be recognized with growing complexities the corporate laws. Compliance with the provisions of various corporate laws is as important to be in the Any failure to comply with corporate laws may invite heavy penalty and/or even imprisonment.

It is therefore imperative for corporate entities to ensure compliance with the applicable legal requirements which are numerous. A secretarial audit assures the corporate body that the legal requirements have been duly complied with and in time. If non-compliances are noticed by the auditor, management will have to rectify the situation with mush lesser problems and costs.

J. Human Resource Audit

Human Resource Audit is a comprehensive method of objective and systematic verification of current practices, documentation, policies and procedures prevalent in the HR system of the organisation. An effective HR audit helps in identifying the need for improvement and enhancement of the HR function. It also guides the organisation in maintaining compliance with ever-changing rules and regulations. HR audit, thus, helps in analysing the gap between 'what is the current HR function' and 'what should be/could be the best possible HR function' in the organisation.

Though HR auditing is not mandatory like financial auditing, yet, organisations these days are opting for regular HR audits in order to examine the existing HR system in line with the organisations policies, strategies and objectives, and legal requirements. HR auditor can be internal or external to the organisation.

K. Information Systems Audit

According to Ron Weber, "Information systems auditing is an organisational function that evaluates asset safeguarding, data integrity, system effectiveness, and system efficiency in computer-based information systems". The effectiveness of an information system's controls is evaluated through an information systems audit. An audit aims to establish whether information systems are safeguarding corporate assets, maintaining the integrity of stored and communicated data, supporting corporate objectives effectively, and operating efficiently. It is a part of a more general financial audit that verifies an organisation's accounting records and financial statements.

The factors that led to the development of Information System Audit are:

(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.

L. Environmental Audit

Environmental audit is an excellent management tool for relating productivity to pollution. Environmental audit is the examination of the correctness of environmental accounts. In broader sense, environmental auditing is the examination of accounts of revenues and costs of environmental and natural resources, their estimate, depreciation and values recorded in the books of accounts.

In India, recognising the importance of environmental audit, its procedure was first notified under the Environment (Protection) Act, 1986 by the Ministry of Environment of Forests. Under this Act, every person carrying operations of an industry, operation or process requiring consent under Section 25 of the Water (Prevention & Control of Pollution) Act, 1974 or under Section 21 of the Air (Prevention & Control of Pollution) Act, 1981 or both or authorisation under the Hazardous Wastes (Management and Handling) Rule of 1989 issued under the Hazardous (Protection) Act, 1986 is required to submit an environmental audit report.

Brief Introduction to Auditing Standards 6.2

6.2.1 Concept

Standards on auditing are a set of well-defined guidelines which are followed by auditors in conducting audit of the client's accounts. These are formulated by professional bodies of accountants based on the collective deliberations and suggestions received from various interested groups or potential stakeholders including industry, academia and regulators. The Standards provide principles and techniques expected to be followed by an auditor in order to improve the quality of his audit work.

6.2.2 Purpose of Standards of Auditing

Standards of auditing serves a number of purposes as follows:

a. Standards act as a ready reference of the procedures to be followed by an auditor under a given situation.

b. Adherence to Standards reduces audit risk considerably.

c. An auditor conducting the audit work based on the relevant standards can always defend himself against possible allegations of negligence.

d. Standards improve the quality of audit work and thereby restore the public trust on the profession.

6.2.3 International Auditing and Assurance Standards Board (IAASB)

In 1977, the International Federation of Accountants (IFAC) was established with a view to bring harmony in the profession of accountancy on an international scale. In pursuing this objective, the IFAC Board established the International Auditing and Assurance Standards Board (IAASB). The IAASB functions as an independent standard setting body under the auspices of IFAC. The objective of the IAASB is to serve public interest by developing and issuing high quality auditing standards and by facilitating the convergence of international and national standards, thereby enhancing the uniformity and quality of audit practice throughout the world and strengthening public confidence on the audit profession globally.

6.2.4 Auditing and Assurance Standards Board (AASB)

The Institute of Chartered Accountants of India is one of the founder members of the International Federation of Accountants (IFAC). Hence, it is one of the membership obligations of The Institute of Chartered Accountants of India to actively propagate the pronouncements of International Auditing and Assurance Standards Board (IAASB) of the IFAC to contribute towards the global harmonisation and acceptance of the Standards issued by IAASB. Accordingly, The Institute of Chartered Accountants of India constituted the Auditing Practices Committee (APC) in 1982 to develop Statements on Standard Auditing Practices (SAPs). In July 2002, the APC was converted into the Auditing and Assurance Standards Board (AASB). The composition of the AASB is fairly broad-based and attempts to ensure participation of all interest groups in the standard setting process. Apart from the elected members of the Council of The Institute of Chartered Accountants of India, the Board includes members from profession, members from SEBI, RBI, IRDA, IIMs, industry associations etc.

The following are the objectives and functions of the Auditing and Assurance Standards Board:

a) To review the existing and emerging auditing practices worldwide and identify areas in which Standards on Quality Control, Engagement Standards and Statements on Auditing need to be developed.

b) To formulate Engagement Standards, Standards on Quality Control and Statements on Auditing so that these may be issued under the authority of the Council of the Institute.

c) To review the existing Standards and Statements on Auditing to assess their relevance in the changed conditions and to undertake their revision, if necessary.

d) To develop Guidance Notes on issues arising out of any Standard, auditing issues pertaining to any specific industry or on generic issues, so that those may be issued under the authority of the Council of the Institute.

e) To review the existing Guidance Notes to assess their relevance in the changed circumstances and to undertake their revision, if necessary.

f) To formulate General Clarifications, where necessary, on issues arising from Standards.

g) To formulate and issue Technical Guides, Practice Manuals, Studies and other papers under its own authority for guidance of professional accountants in the cases felt appropriate by the Board.

6.2.5 Structure of Pronouncements Issued by AASB

In order to facilitate understanding of the scope and authority of the pronouncements of the AASB issued under the authority of the Council of The Institute of Chartered Accountants of India, a revised preface titled Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services has been issued which has come into effect from April 1, 2008. Accordingly, the pronouncements by AASB are covered by the following two broad categories of Standards:

A. **Engagement Standards:** The following Standards issued by the Auditing and Assurance Standards Board under the authority of the Council are collectively known as the Engagement Standards:

   a) Standards on Auditing (SAs), to be applied in the audit of historical financial information.

   b) Standards on Review Engagements (SREs), to be applied in the review of historical financial information.

   c) Standards on Assurance Engagements (SAEs), to be applied in assurance engagements, other than audits and reviews of historical financial information.

   d) Standards on Related Services (SRSs), to be applied to engagements involving application of agreed- upon procedures to information, compilation engagements, and other related services engagements, as may be specified by The Institute of Chartered Accountants of India.

B. **Standards on Quality Control (SQCs):** These are issued by the AASB under the authority of the Council and are to be applied for all services covered by the Engagement Standards as described above.

   In addition to above, AASB issues the following:

   a) Statements on Auditing: These are issued with a view to securing compliance by professional accountants on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. Statements are, therefore, mandatory.

   b) General Clarifications: These are issued by the Board under the authority of the Council of the Institute with a view to clarify any issues arising from the Standards. General Clarifications are mandatory in nature.

   c) Guidance Notes: these are issued to assist professional accountants in implementing the Engagement Standards and the Standards on Quality Control issued by the AASB under the authority of the Council.

Guidance Notes are also issued to provide guidance on other generic or industry specific audit issues, not necessarily arising out of a Standard.

The Structure of Standards issued by AASB under the authority of the Council of The Institute of Chartered Accountants of India is given in the following diagram (Source: The Institute of Chartered Accountants of India).

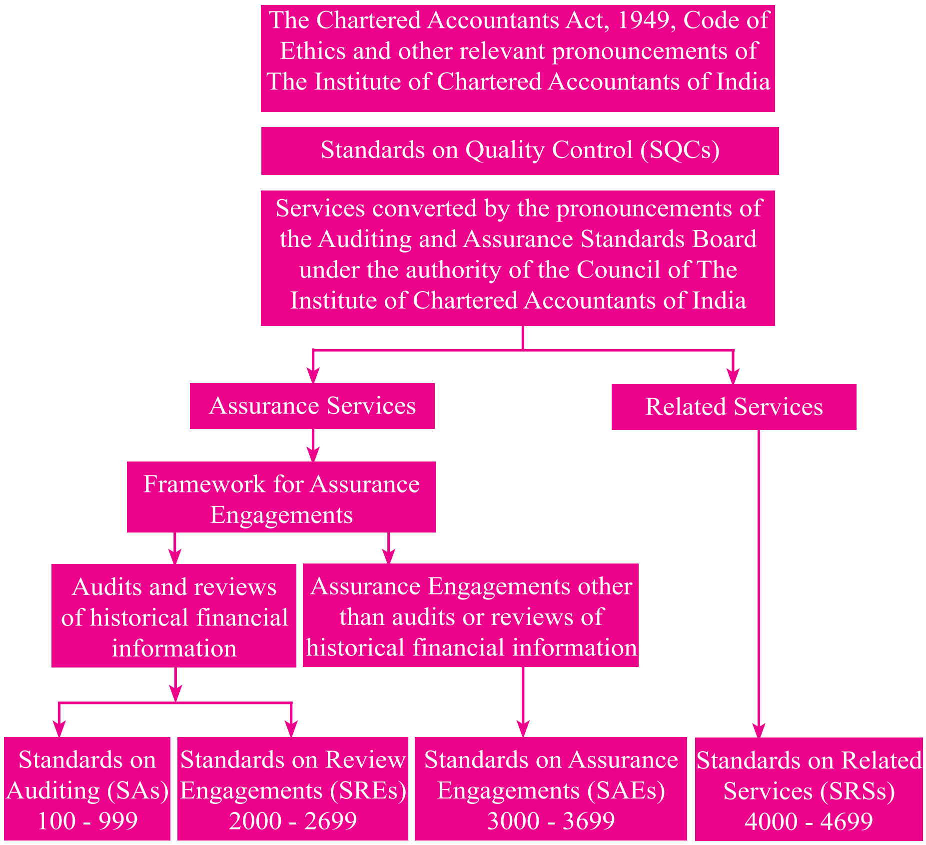

Figure 6.2 Structure of Standrads Issued by AASB

6.2.6 Procedures for Issuing Standards on Auditing

Auditing and Assurance Standards Board (AASB) of the Institute formulates the auditing standards. Broadly, the following procedure is adopted for the formulation of Standards on Auditing (SAs):

a) The Auditing and Assurance Standards Board identifies the areas where auditing standards need to be formulated and the priority in regard to their selection.

b) In the preparation of Auditing Standards, AASB is assisted by study groups/task force constitute to consider specific project. Study group comprising of a cross section of members of the Institute. The study group/task force will consider the specific subject and prepare the primarily draft of Standards.

c) Based on the work of the study groups, an exposure draft of the proposed Standards is prepared by the Committee and issued for comments by members of The Institute of Chartered Accountants of India

d) After taking the comments into consideration, AASB finalize the draft and submit to the Council of the Institute.

e) The Council on its review of the draft, makes suitable modifications in consultations with the AASB and then Standards/Statements is issued under the authority of the Council. While formulating the auditing standards, the Board also takes into consideration International Standards on Auditing (ISA) issued by the International Auditing Practices Committee (IAPC), applicable laws, customs, usages and business environment in the India.

6.2.7 List of Different Standards Issued by AASB in India

Standards on Quality Control (SQCs)

- SQC 1, Quality Control for Firms that Perform Audit and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements

Audits and Reviews of Historical Financial Information

New/Revised Standards (Auditing, Review and Others) under the Clarity Project

- 100-199 Introductory Matters
- 200-299 General Principles and Responsibilities
  - SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
  - SA 210, Agreeing the Terms of Audit Engagements
  - SA 220, Quality Control for an Audit of Financial Statements
  - SA 230, Audit Documentation
  - SA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
  - SA 250, Consideration of Laws and Regulations in an Audit of Financial Statements
  - SA 260, Communication with Those Charged with Governance (Revised)
  - SA 265, Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
  - SA 299, Joint Audit of Financial Statements (Revised)
- 300-499 Risk Assessment and Response to Assessed Risks
  - SA 300, Planning an Audit of Financial Statements
  - SA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment
  - SA 320, Materiality in Planning and Performing an Audit
  - SA 330, The Auditor's Responses to Assessed Risks
  - SA 402, Audit Considerations Relating to an Entity Using a Service Organisation
  - SA 450, Evaluation of Misstatements Identified During the Audit
- 500-599 Audit Evidence
  - SA 500, Audit Evidence
  - SA 501, Audit Evidence-Specific Considerations for Selected Items

- SA 505, External Confirmations
- SA 510, Initial Audit Engagements – Opening Balances
- SA 520, Analytical Procedures
- SA 530, Audit Sampling
- SA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
- SA 550, Related Parties
- SA 560, Subsequent Events
- SA 570, Going Concern (Revised)
- SA 580, Written Representations

⊙ 600-699 Using Work of Others

- SA 600, Using the Work of Another Auditor
- SA 610, Using the Work of Internal Auditors (Revised)
- SA 620, Using the Work of an Auditor's Expert

⊙ 700-799 Audit Conclusions and Reporting

- SA 700, Forming an Opinion and Reporting on Financial Statements (Revised)
- SA 701, Communicating Key Audit Matters in the Independent Auditor's Report
- SA 705, Modifications to the Opinion in the Independent Auditor's Report (Revised)
- SA 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report (Revised)
- SA 710, Comparative Information—Corresponding Figures and Comparative Financial Statements
- SA 720, The Auditor's Responsibilities Relating to Other Information (Revised)

⊙ 800-899 Specialized Areas

- SA 800, Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks
- SA 805, Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
- SA 810, Engagements to Report on Summary Financial Statements

⊙ 2000-2699 Standards on Review Engagements (SREs)

- SRE 2400, Engagements to Review Historical Financial Statements (Revised)
- SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity

Assurance Engagements Other Than Audits or Reviews of Historical Financial Information

⊙ 3000-3699 Standards on Assurance Engagements (SAEs)

⊙ 3000-3399 Applicable to All Assurance Engagements

- 3400-3699 Subject Specific Standards
  - SAE 3400 The Examination of Prospective Financial Information
  - SAE 3402, Assurance Reports on Controls at a Service Organisation
  - SAE 3420, Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

Related Services

- 4000-4699 Standards on Related Services (SRSs)
  - SRS 4400 "Engagements to Perform Agreed-upon Procedures Regarding Financial Information"
  - SRS 4410 (Revised), Compilation Engagements

Audit Engagement, Program, Documentations, Evidence, Note Book

6.3

6.3.1 Audit Engagement

In case of statutory audit, the appointment of the auditor and his duties and responsibilities are governed by the respective statutes. In all other organisations, however, these are decided by the agreement between the auditor and the client. Such an agreement plays a significant role in the conduct of audit of the client because if the auditor is held responsible for anything beyond the nature and scope of the current engagement, he can be relieved without any doubt. In addition, existence of an agreement can easily avoid any misunderstanding or ambiguity in future. Thus, it is desirable that before commencement of audit, the auditor and the client must agree on the terms of engagement and the auditor should send an audit engagement letter in the interest of both of them.

As per SA-210, Agreeing the Terms of Audit Engagements, an auditor and the client should agree to the terms of audit engagement prior to commencement of the audit. The agreed terms

should then be recorded by the auditor in an audit engagement letter or any other suitable form of written agreement. However, if the law or regulation prescribes in sufficient detail the terms of audit engagement, the auditor need not record them in written agreement.

- **Contents of Audit Engagement Letter**

  As per SA-210, Agreeing the Terms of Audit Engagements, every engagement letter as per should contain the following:

  a. Objective & scope of engagement

  b. Management responsibility

  c. Existence of inherent limitations

  d. Need for use of Internal Auditor

  e. Management confirmation letter

  f. Restrictions & limitations of Auditor liabilities

  g. Basis of computation of Audit fees

  h. Billing arrangement

  i. Form of report & Other communications of engagement

  j. Validity of report

  k. Limits on submission of report to other authorities

6.3.2 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, Planning an Audit of Financial Statements, 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 audits - 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.

⊙ **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.

(ix) He can prove that there has no negligence on his part and he exercised reasonable care and skill while performing the task.

⊙ **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.

6.3.3 Audit Documentation (Audit Working Papers)

In course of audit of an organisation, an auditor adopts various methods and procedures to accumulate and thereafter analyse audit evidences and other important documents to reach at some meaningful conclusion regarding his engagement. Audit working papers include all such records kept by an auditor in relation to the evidences accumulated, methods and procedures adopted and conclusions reached during the course of the audit.

As per SA-230, 'Audit Documentation', (also called audit working papers) refer to the record of audit procedures performed, relevant audit evidences obtained and conclusions the auditor reached.

Such records can be kept either in physical form or in an electronic form.

- **Purpose of Audit Working Papers**

  According to SA-230, 'Audit Documentation', audit working papers or audit documentation serves a number of purposes as follows:

  a. Providing evidence of auditor's basis for a conclusion about the achievement of the overall objectives of the auditor.

  b. Providing evidence that audit was planned and performed in accordance with Standards of Audit (SAs) and applicable legal and regulatory requirements.

  c. Assisting the engagement team to plan and perform the audit.

  d. Assisting members of the engagement team responsible for the supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA220, 'Quality Control for an Audit of Financial Statements'.

  e. Enabling the engagement team to be accountable for its work.

  f. Retaining a record of matters of continuing significance to future audits.

  g. Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.

  h. Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

- **Contents of Audit Working Papers**

  As per SA-230, 'Audit Documentation', an auditor should follow the guidelines mentioned below to decide on the form, content and extent of audit documentation (or working papers).

  (i) The auditor shall prepare audit working papers on a timely basis. They should be prepared while performing the task itself rather than after the audit work is performed.

  (ii) The auditor shall prepare audit working papers that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

    (a) the nature, timing and extent of audit procedures performed to comply with the SAs and applicable legal and regulatory requirements;

    (b) the results of the audit procedures performed and the audit evidence obtained; and

    (c) significant matters arising during the audit, the conclusion reached thereon and significant professional judgments made in reaching those conclusions.

  (iii) In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:

    (a) the identifying characteristics of the specific items or matters tested;

(b) who performed the audit work and the date such work was performed; and

(c) who reviewed the audit work performed and the date and extent of such review.

(iv) The auditor shall document discussions of significant matters with management, those charged with governance and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

(v) If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency.

(vi) If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement in a SA, the auditor shall document how the alternative audit procedures performed achieved the aim of that requirement, and the reasons for the departure.

⊙ **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 organisational 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 of 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 signific ant accounting policies.	(f) Audit programme.
(g) Significant audit observations of the earlier years.	(g) Conclusions reached on significant aspects of audit.

⊙ **Ownership and Custody of Audit Working Papers**

Working papers are the property of the auditor, the portions or extracts of which can be had at his discretion. These working papers should be 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.

The Institute of Chartered Accountants of India 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.

6.3.4 Audit Evidence

While auditing, the auditor comes 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.

As per SA-500, 'Audit Evidence', the term 'audit evidence' includes information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

In short, substantive evidence collected by an auditor from various sources to base his opinion on the financial statements of the organisation is called audit evidence.

⊙ Need for Audit Evidence

Audit evidence is an important element of audit process. In order to form his unbiased opinion on the reliability and fairness of the financial performance and financial state of affairs, an auditor needs to objectively examine the financial statements based on sufficient and appropriate evidence. Opinion based on casual and subjective evaluation may leave material misstatements or frauds undetected and as a result the auditor may be held guilty of professional negligence.

The auditor, therefore, should always try to obtain sufficient and appropriate audit evidence and analyse them thoroughly before arriving at any opinion. Only by doing so, the auditor can keep the audit risk to a substantially low level.

In SA-200, it is recognised that reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Here, sufficiency refers to the quantity and appropriateness refers to the quality of audit evidence.

⊙ Auditor's Judgement while Obtaining Audit Evidence

The auditor should evaluate whether he has obtained sufficient appropriate audit evidence so that reasonable conclusions can be drawn therefrom. It is to be noted that sufficiency and 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.

⊙ Types of Audit Evidence

Depending upon the source, audit evidences may be of two types—internal evidences and external evidences. These are discussed below:

a. Internal Evidences

These are evidences collected from within the organisation. For example, sales invoices, counterfoils of cash memos, goods received notes, credit notes and debit notes, etc.

b. External Evidences

These are evidences collected from outside sources. For example, quotations, confirmation from debtors and creditors, etc.

⊙ Relevance and Reliability of Audit Evidence

In order to arrive at an appropriate conclusion regarding the truthfulness and fairness of financial statements, the audit evidences under examination must be relevant and reliable.

As per SA-500, relevance of audit evidence deals with the logical connection with the purpose of audit procedure and is therefore affected by the direction of testing. On the other hand, 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 arithmetic al accuracy of source documents and accounting records or performing independent calculations.

e. Analytical Review - It consists of studying signific ant ratios and trends and investigating unusual fluctuations and items.

⊙ Audit Procedure to Obtain Audit Evidence

As per SA-315 and SA-330, audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(i) Risk assessment procedures; and

(ii) Further audit procedures, which comprise:

  (a) Test of control or Compliance Procedure, and

(b) Test of details and analytical procedures known as Substantive Procedure.

Risk assessment procedures are the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion level (assertions are management representations, explicit or otherwise, that are embodied in the financial statements).

Compliance procedures or Tests of controls 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 (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

a. physically examine inventory on balance date as evidence that inventory shown in the accounting records actually exists (validity assertion);

b. 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

c. make inquires of management about the collectability 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 (See Section 6.5.3 of this chapter), whereas tests of detail are only applied in the substantive testing stage.

6.3.5 Audit Note Book

In the course of conducting audit of an organisation, the audit staff may come across various misstatements, frauds or any other issues which need further clarification from the management or investigation and in-depth observation later on. In order to avoid any chance of such issues being unanswered, the audit staff generally records the same in a separate note book and raises the issue in future. Such a record is known as Audit Note Book.

Generally separate note books are prepared for each client.

- **Contents of Audit Note Book**

  a. Name of the business enterprise.

  b. Organisation structure.

  c. Important provisions of Memorandum of Association (MOA) and Articles of Association (AOA).

  d. Communication with the previous auditor, if any.

  e. Management representations and instructions.

  f. List of books of accounts maintained by the enterprise.

  g. Accounting methods, internal control systems followed by the enterprise, applicable laws etc.

  h. Key managerial personnel.

  i. Errors and fraud discovered.

  j. Matters requiring explanations or clarifications.

  k. Special points that need attention in the audit report.

Audit Risk, Assessment of Audit risk, Internal Control, Internal Check, Internal Audit - Industry Specific, Interplay between Internal Audit and Statutory Audit, Risk based Internal Audit, Internal Financial Control and Internal Control over Financial Reporting

6.4

6.4.1 Audit Risk and Its Assessment

- **Concept of Audit Risk**

A statutory auditor is required to express an opinion as to whether the financial statements prepared by the entity exhibit a true and fair view of the financial performance and financial position of the entity. However, in spite of his sincere efforts, it may not be possible for an auditor to guarantee that the audited accounts are free from all sorts of material misstatements; rather, there is every possibility that an auditor expresses an incorrect opinion in his report.

Audit risk refers to the risk that an auditor gives an inappropriate opinion when the financial statements are materially misstated. In other words, it is the risk that an auditor fails to express an appropriate opinion on the financial statements of the entity. Consider the following example.

A Ltd. spent ₹50 lakh to repair a machinery. The repair was likely to improve the capacity of the existing machine by 30%. Accordingly, the cost of repair should be capitalised and not to be treated as a revenue expenditure. Unfortunately, the accountant debited the amount in the Repairs and Maintenance A/C and changed the same as a revenue expenditure in the Statement of Profit and Loss instead of debiting the Machinery A/c. The auditor, while auditing the accounts of the company overlook the same and did not report anything regarding the error. In this situation, the auditor's opinion is inappropriate resulting into audit risk.

- **What is Not Audit Risk?**

The following two, however, does not come under the purview of audit risk.

(a) Audit risk does not include the risk that the auditor may express an opinion that the financial statements are materially misstated when actually they are not so.

(b) Audit risk also doesn't include the business risk of the auditor such as loss due to litigation, negative publicity, etc. It is something very technical and related to the audit of the financial statement of the client.

- **Types of Audit Risk**

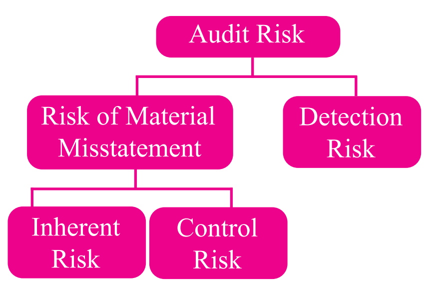

Figure 6.3: Types of Audit Risk

Audit risk can broadly be classified into – Risk of Material Restatement and Detection Risk.

A. Risk of Material Misstatement

It may be defined as the risk that the financial statements are materially misstated prior to the audit exercise either due to any unintentional error or any organised fraud. This risk may exist at two levels:

(i) At Overall Financial Statement Level: It refers to the possibility that material misstatement relates pervasively to the financial statements as a whole and may potentially affect multiple assertions.

(ii) At Assertion[1] **Level:** It refers to the possibility that material misstatement may exist while classifying the transactions, calculating the balances or disclosing some material information.

The risk of material misstatement at the assertion level has two components as follows:

(a) Inherent Risk: This refers to the possibility of material misstatement due to complex transactions or even due to organised fraud. Accordingly, this risk may be higher for some classes of transactions, account balances and disclosures. For example, transactions such as fire damage or acquiring another company are non-recurring and hence the auditor runs the risk of focusing too much or too little on the unique event.

(b) Control Risk: This refers to the possibility of material misstatement due to ineffective design, implementation and maintenance of internal control system. Thus, a sound internal control system significantly reduces this risk. However, internal control can reduce but cannot eliminate the risk completely because of its inherent limitations. For example, due to inefficient internal control system in the organisations, there may be a risk that bank reconciliations have not been prepared for any month or not appropriately reviewed, resulting in misstatement of bank balance.

B. Detection Risk

This refers to the possibility that the audit procedures applied by the auditor to reduce the audit risk to an acceptably low level will not be able to detect a misstatement which, either individually or in aggregate, may be material. For example, if the auditor applies a testing method that checks the accuracy of the invoice rather than the occurrence of the particular sale, he may run into a detection risk.

As audit risk comprises risk of material misstatement and detection risk, it may be said that,

Audit risk = Risk of material misstatement × Detection risk.

Again, Risk of material misstatement (at the assertion level) = Inherent Risk × Control Risk.

Therefore, Audit risk = Inherent Risk (I) × Control Risk (C) × Detection Risk (D).

⊙ **Solved Case 1**

J Mart Ltd. is a multi-brand retailer and operates though in multiple locations across the nation. It sells products of thousands of categories from food to consumer durables. Each individual product item has a price tag with barcode. In addition, there is another security tag which is removed only after the billing is done. Inventory records are physically verified on a fortnightly basis by the auditor of J Mart. Identify the risk associated with the audit of inventory in J Mart.

Solution:

The auditor may perceive the following risks:

[1] The dictionary meaning of the term ‘assertion’ is a confident and forceful statement of fact or belief. However, when used in the context of auditing, it refers to some implicit or explicit claims.

(a) Inherent Risk: It is possible that the employees might have misappropriated the inventory by manipulating the inventory records. So, inventory records may not be accurate. This leads to a risk of material misstatement.

(b) Control Risk: Here each item of inventory carries a price tag with bar code as well as a security code (which is removed only after the billing). Additionally, physical verification of inventory is done on a fortnightly basis. Thus, the internal control appears to be quite satisfactory. However, collusion among employees at multiple layers can evade the control implemented at any time. Hence, an element of control risk is present.

(c) Detection Risk: It is expected that the auditor will apply appropriate procedures to judge the efficiency of the control system before deciding on the extent of test checking. However, there may still be possibilities of material misstatements and the same may not be detected due to adoption of test checking. Hence, an element of detection risk can also exist.

⊙ Assessment of Audit Risk

As per SA 315, Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment, the auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

The risk assessment procedures shall include the following:

(a) Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.

(b) Analytical procedures.

(c) Observation and inspection.

These are discussed below.

(a) Inquiries of Management and Others Within the Entity: Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example,

- inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared;
- inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

(b) Analytical Procedure[2]: This means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

[2] See SA 520, "Analytical Procedures"

Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

However, when such analytical procedures use data aggregated at a high level, the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist.

(c) Observation and Inspection: Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:

- The entity's operations.
- Documents (such as business plans and strategies), records, and internal control manuals.
- Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
- The entity's premises and plant facilities.

Some other relevant factors are as follows:

a. Information Obtained in Prior Periods: The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as past misstatements and whether they were corrected on a timely basis, the nature of the entity and its environment, and the entity's internal control, significant changes that the entity or its operations. This information may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

b. Discussion among the Engagement Team: The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement provides an opportunity for experienced team members to share their insights based on their knowledge of the entity, allows the team members to exchange information about the business risks, assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

c. The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control: An understanding of the entity and its environment helps the auditor a lot in assessing the risk of material misstatements. Factors such as industry, and regulations have significant bearing on an entity. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. Similarly, relevant regulatory issues such as applicable financial reporting framework, taxation, government policies, regulatory framework for a regulated industry can well be the potential source of the risk of material misstatements. In addition, the nature and structure of the entity (complex or simple), ownership and relations between the owner and stakeholders may also give rise to audit risk.

An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing, and extent of further audit procedures. However, internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control. Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit.

Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures[3] or as tests of controls.

During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements.

6.4.2 Internal control

- **Concept of Internal Control**

Internal control is the process, effected by an entity's Board, management, and other personnel, designed to provide reasonable assurance regarding achievement of the objectives in the following categories:

(i) Reliability of financial reporting,

(ii) Effectiveness and efficiency of operations, and

(iii) Compliance with applicable laws and regulations.

SA 265 defines the system of internal control as "all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information".

Therefore, internal control system is the total system of control established by the management of an organisation so as to ensure achievement of organisational objective effectively and efficiently.

- **Scope of Internal Control**

Internal control comprises both administrative control and accounting control.

[3] As per SA 330, substantive procedure is an audit procedure designed to detect material misstatements at the assertion level. It includes test of details and substantive analytical procedure.

A. **Administrative Control:** It ensures adherence to management's plans and procedures. Therefore, administrative control relates to the production process, quality control, pricing strategies etc.

B. **Accounting Control:** It refers to the control system which ensures recording of transactions in the books of accounts adhering to the established accounting policies and principles. Accounting control relates to maintaining proper books of accounts, recording transactions timely, checking arithmetical accuracy of books of accounts, rotation of duties of staffs, etc. Accounting control is again divided into two sub-sections namely (a) Internal Check and (b) Internal Audit.

⊙ Basic Elements of Internal Control

An effective system of internal control should have the following basic elements:

(i) Financial and Other Organisation 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.

(ii) 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 operated efficiently and effectively.

(iii) Division of Work: In any internal control system, each and every work of the organisation should be divided in different stages and should be allocated to the employees in accordance with quality and skill.

(iv) Separation of Operational Responsibility from Record Keeping: In order to ensure reliable records and information, record-keeping function must be separated from the operational responsibility of the concerned department.

(v) Separation of the Custody of Assets from Accounting: To protect assets from misuse and misappropriation, it is required that the custody of assets and their accounting should be done by separate persons.

(vi) Authorization: In an internal control system, all the activities must be authorized by a proper authority.

(vii) Managerial Supervision and Review: The internal control system should be implemented and maintained in conformity with the environmental and elemental changes of the concern. There must be regular supervision and review of the effectiveness of the internal control system of the organisation.

⊙ Objectives of Internal Control

Each organisation must have a system of internal control in place for achieving the predetermined goals. In addition to accomplishing the desired goals and objectives of the organisation, this system plays a very important role in any organisation in several other ways. The main objectives of internal control are:

a. To ensure that the business transactions take place as per the general and specific authorisation of the management.

b. To make sure that there is a sequential and systematic recording of every transaction, with the accurate amount in their respective account and in the accounting period in which they take place.

c. To ensures that all recorded transactions fairly represent the economic events that actually occurred, are lawful in nature, and have been executed in accordance with management's general authorisation.

d. To ensure that all valid transactions are accurately recorded as per the accounting policies and standards.

e. To provide security to the company's assets from unauthorised use.

f. To review the working of the business, locate weak points in operations and to take corrective measures for proper working.

g. To ensure there is the optimum utilization of the firm's resources.

In this respect, SA-315, Risk Assessment and Internal Control, advocates the following objectives of internal control:

(i) To ensure that transactions are executed as per management's authorisation

(ii) To ensure that transactions are recorded in proper way to facilitate preparation of financial information for maintaining record of assets.

(iii) To ensure that assets are protected from unauthorised use, sale, etc.

(iv) To ensure that assets are verified at frequent intervals.

Advantages of Internal Controls

(i) 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 organisation's funds and other resources.

(ii) Prevention of errors and irregularities: It prevents errors and irregularities by detecting them in a timely manner, thereby promoting reliable and accurate accounting records.

(iii) Safeguard from irregularities or misappropriations: A good internal control system ensures the protection of organisation resources from misappropriation.

(iv) Employees' satisfaction and productivity: It enhances employee satisfaction and productivity by segregation of duties and delegation of responsibilities.

Types of Internal Control

The type of internal control system to be employed in an organisation 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.

a. Preventive Control: Preventive Controls are designed to discourage errors or irregularities from occurring. They are proactive controls that help to ensure achievement of departmental. Examples of preventive controls are:

   (i) 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.

   (ii) 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.

   (iii) 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.

b. Detective Control: Detective Controls are designed to find errors or irregularities after they have occurred. Examples of detective controls are:

(i) 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.

(ii) Reconciliations: An employee relates different sets of data to one another, identifies and investigates differences, and takes corrective action, when necessary.

(iii) Physical Verification of Inventories: The auditor may conduct physical verification of inventory to detect any misappropriation.

Techniques for Evaluation of Internal Control System

The following methods are generally suggested for evaluation of internal control system:

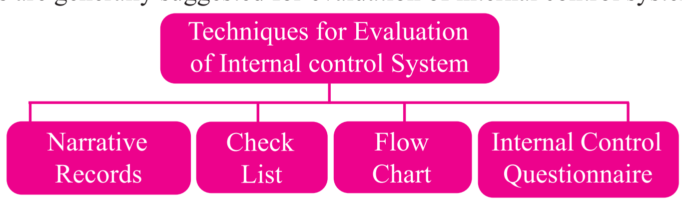

Figure 6.4: Techniques for Evaluation of Internal Control System

a. **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.

b. **Check List:** The Internal Control Checklist is a tool to help evaluate and strengthen internal controls, promote effective and efficient business practices, and improve compliance in a department or functional unit. The checklist is not meant to be absolute but informative when reviewing controls in a given area. In fact, checklist is a series of instructions and/or questions which the auditor or the audit staff must follow and answer. When he completes the instructions, he initials the space against the instruction. Answers to the checklist instructions are usually 'Yes', 'No' or 'Not Applicable'.

c. **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 organisation'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.

d. **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 organisation. 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', whereby the answer 'Yes' is satisfactory, whereas the answers 'No' appear to indicate a weakness. However, not always the questionnaire is designed to receive responses in 'Yes-No' format as the same may not provide adequate information. Hence, questionnaire may receive descriptive responses also.

⊙ Checklist vs. Internal Control Questionnaire

Sl. No	Basis	Check List	Internal Control Questionnaire
i.	Point of Time	It is issued at the commencement of audit and reported back after completion of audit.	It can be issued at any point of time and reported back immediately.
ii.	Issued To	It is issued to the audit staff to be followed by them during audit and reported back at completion.	It is issued to various people at different levels in the organisation.
iii.	Contents	It contains instructions to be followed by audit assistants.	It contains questions to be answered by the employees of the organisation.
iv.	Objective	It works as a guideline for audit staff so that no major issues remain unchecked.	This is used to collect the information to know about the internal control system and to evaluate the weaknesses therein.

⊙ Inherent Limitations of Internal Control

Internal controls can provide only a reasonable assurance that objectives have been achieved. This is because, some limitations are inherent in all internal control systems. These are as follows:

(i) Breakdowns: Even well-designed internal controls can break down. Employees may misunderstand instructions or commit mistakes. Errors may also result from application of new technology.

(ii) Judgment: The effectiveness of internal controls is highly impaired when decisions are made with human judgment under pressure.

(iii) Management Override: High level personnel may be able to override prescribed policies and procedures for personal gain or advantage.

(iv) Collusion: Internal control systems may become ineffective due to collusion among employees. Several individuals may act collectively to alter financial data or other management information in a manner that cannot be identified by control systems.

(v) Control Over Common Business Activities Internal control system is suitable for common and reparative business activities only.

(vi) Costly System: Operating an internal control system often turns up to be very costly. If the losses incurred on account of errors and frauds exceed the benefits of internal control system, then the system becomes completely redundant for the entity.

6.4.3 Internal Check

⊙ Concept of Internal Check

Internal Check is an integral part of the internal control system. It is a process in which the duties of various staff of a business are arranged in such way that work performed by one is automatically checked by the next staff while performing his duties. As a consequence, any error or fraud committed by the previous staff is automatically detected and corrected by the next one and thus misstatements are easily prevented. For example, suppose a customer presents a cheque of ₹1000 to the bank for payment. As per the bank policy, the work of the encashment of cheques is divided among three employees. One shall investigate the cheque, and make entries in the books of accounts. The second employee shall check this entry and send it to the third employee making cheque payments who will make the final payment. Thus, any mistake by any previous employee will be automatically detected by the next one and thereby errors and frauds can be prevented.

According to The Institute of Chartered Accountant of England and Wales, London, "Internal Check System is a system of instituting checks on the day-to-day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors and frauds".

Thus, internal check or internal check system may be defined as a system of allocation of duties among the staff of the entity in such a manner that the chances of any duplicity of work are eliminated and at the same time work done by the previous employee is automatically checked by the next one.

⊙ Objectives of Internal Check

The objectives of internal check are as follows:

a. Lessen the possibility of fraud and error.

b. Identify fraud and error at an early stage due to independent checking.

c. Improve the efficiency of the workforce, by implementing division of labor.

d. Allocate the duties and responsibilities of each worker in a way that they can be easily identified and held responsible for the actions performed.

e. Receive confirmation of facts and entries both physical as well as financial by way of presentation and necessary maintenance of records.

f. Exercise moral pressure on the workforce with the implementation of a continuous receive process.

g. Reduce the workload of independent auditors by adopting an internal check system.

⊙ Essential Characteristics of Internal Check System

Following are the essential characteristics or principles of a good internal check system.

a. Division of work: The entire task should be divided among the staff in such a way that no single person is allowed to complete the work solely by himself from the beginning to the end.

b. Provision of check: There must be clear instruction that the work performed by any staff must be checked by the next staff.

c. Responsibility: Responsibility of each individual must be properly defined and fixed.

d. Use of technology: As far as possible, various technology enabled devices should be used to minimise human error.

e. Rotation of employees: A system of transfer or rotation of employees from one responsibility to another must be followed by the business.

f. Control over employees: Generally, chances of frauds are high in case there is direct contact between staff and the customers. So, a manager can keep eyes in those areas to make internal check system more effective.

g. Supervision: A strict supervision should be exercised to ensure that the prescribed internal checks and procedures are fully operative.

h. Periodical review: The system of internal check is reviewed from time to time to introduce improvements.

⊙ Advantages of Internal Check System

A good system of internal check offers many benefits as follows:

To the Auditor	To the Client
■ It saves time and cost of checking all records. Auditor may apply test checking approach. ■ Auditor devotes more time to appraise critical areas. This improves quality of audit work.	■ It reduces chances of errors and frauds. ■ As work is distributed among the employees based on their skill the entire work process gets completed smoothly. ■ A moral pressure can be built on the employees. So, they remain reasonably honest. ■ Final accounts are prepared promptly.

⊙ **Auditor's Liability for Relying on the Internal Check System**

Reliance on an effective internal check system and thereby streamlining the audit process enables the auditor to devote more time in examining the critical areas of accounting including valuation of closing stock, valuation of assets and liabilities, determining the reasonableness of provisions etc. However, such reliance simultaneously increases the risk of the auditor. This is because, even a sound internal check system cannot guarantee the elimination of all errors and frauds in the accounts. Hence, if the auditor relies on the internal check system and performs test checking rather than a detail checking, he cannot escape his responsibility of any such error or fraud remaining undetected. This was also held in the famous case law of Mc. Bride Ltd vs. Rooke and Thomas, Canada (1941). Thus, the auditor should always keep in mind that resorting to test checking by relying on internal check system of the organisation no way reduces the liability of the statutory auditor.

6.4.4 Internal Audit

Internal audit is a part of the internal control system of an organisation. Traditionally internal audit was seen as a continuous evaluation appraisal of financial operations within a given organisational framework. However, today it is recognised as an independent appraisal of various operating activities of the entity. Thus, an internal auditor is not only to see that a purchase transaction has been appropriately recorded in the books of accounts but also to see that there was a valid purchase requisition, the order was placed to the vendor who was in the approved list of the entity, the terms were reasonable and the goods was duly received and included in the stock.

As per the Committee of Internal Audit, formed by The Institute of Chartered Accountants of India, internal audit is, "An independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggesting improvements thereto and add value to and strengthen overall governance mechanism of the entity, including the entity's risk management and internal control system."

As per SA 610, Using the Work of Internal Auditor, internal audit is a function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control process.

Thus, internal audit is a continuous appraisal of the different operational activities of the entity, including verification of the books of accounts, by a competent employee of the organisation, with an objective to report on the effectiveness of operations so that governance, risk management and internal control process can be improved further.

⊙ **Scope and Objectives of the Internal Audit Function**

The objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The activities of the internal audit function may include one or more of the following:

a. Monitoring of internal control: The internal audit function may be assigned specific responsibility for reviewing controls, monitoring their operation and recommending improvements thereto.

b. Examination of financial and operating information: The internal audit function may be assigned to review the means used to identify, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

c. Review of operating activities: The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non- financial activities of an entity.

d. Review of compliance with laws and regulations: The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

e. Risk management: The internal audit function may assist the organisation by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.

f. Governance: The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organisation and effectiveness of communication among those charged with governance, external and internal auditors, and management.

Advantages of Internal Audit

Internal audit offers a number of advantages as follows:

a. Assistance to Management: Internal audit helps management in executing various plans and policies effectively and efficiently.

b. Detection Errors and Frauds: Through internal audit, frauds and errors can be detected easily.

c. Prevention of Errors and Frauds: By ensuring continuous evaluation, it contributes a lot in preventing the errors and frauds.

d. Reduction in Wastage: Internal audit identifies the weaknesses and deficiencies of the organisation and thereby helps in reducing wastages.

e. Safeguarding Assets: Internal audit ensures that proper measures are in place to safeguard the assets.

f. Increased Efficiency: It helps in improving the effectiveness of the internal control system and thereby improves the overall efficiency of the entity.

Internal Audit in India

Section 138 of the Companies Act, 2013 read with Rule 13 of Companies (Accounts) Rules, 2014, specifies certain classes of companies which are required to appoint Internal Auditors who shall either be a Chartered Accountant, Cost Accountant or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company. The following class of companies shall be required to appoint an internal auditor or a firm of internal auditors, namely:

(a) every listed company;

(b) every unlisted public company having-

  (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

  (ii) turnover of two hundred crore rupees or more during the preceding financial year; or

  (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

  (iv) outstanding deposits of twenty-five crore rupees or more at any point of time during the preceding financial year; and

(c) every private company having-

  (i) turnover of two hundred crore rupees or more during the preceding financial year; or

  (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

The internal auditor may be an employee of the company. The scope, functioning, periodicity and methodology for conducting the internal audit shall be finalised by the Audit Committee of the company or the Board in consultation with the Internal Auditor.

Solved Case Study 2

During the financial year 2022-23, ABC Private Ltd. had a paid-up share capital of ₹52 Crore and a turnover of ₹198 Crore. The company didn't have outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during 2022-23 financial year. Explain whether the company would be required to appoint an internal audit, keeping in view of the provisions of Companies Act, 2013. Will your answer change if the company is an unlisted public company?

Solution:

As per section 138 of Companies Act, 2013, every private company having-

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

- is required to appoint an internal auditor.

In the given scenario, ABC Private Ltd. didn't have outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during 2022-23 financial year and its turnover during the year also did not exceed the threshold ₹200 Crore limit. Hence, it would not be required to appoint an internal auditor.

In case of an unlisted public company, a paid-up share capital of at least ₹50 Crore will require the company to appoint an internal auditor, though the turnover is still below ₹200 Crore. Hence, in that case the company will need to appoint an internal auditor.

Interplay between Internal Audit and Statutory Audit – Statutory Auditor's Reliance on the Work of Internal Auditor

As per SA 610, Using the Work of Internal Auditor, the external auditor can use the work of an internal auditor after conducting an evaluation of internal audit functions.

Accordingly, the external auditor shall consider the following factors to determine the extent to which he can rely on the work of an internal auditor:

(i) whether internal audit is undertaken by an outside agency or by a separate audit department within the entity.

(ii) the scope of internal audit, management action and the internal audit report.

(iii) experience and qualification of internal auditor.

(iv) the technical compliance by internal auditor.

(v) authority vested on internal auditor and level of management to whom he is accountable.

(vi) whether professional care has been taken by the internal auditor in conducting audit work.

After the evaluation, if the external auditor is satisfied with all the above criteria and if the law doesn't prohibit, he can decide to rely upon the work of an internal auditor.

The external auditor, in such a case, shall discuss his plans to use direct assistance of the internal audit function with the internal auditor. He shall carefully undergo the reports of internal audit function and obtain an understanding of the nature and extent of the audit procedures that has been applied and the related findings. In addition, the external auditor shall also perform sufficient and appropriate audit procedure on the body of work of the internal audit function as a whole to determine its adequacy for purposes of the statutory audit. He shall also inform the management about his decision to rely on the internal audit function. Additionally, the external auditor shall obtain a written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions without their intervention. A written agreement from the internal auditors shall also be obtained that they will keep confidential specific matters as instructed by the external auditor. Moreover, the external auditor also needs to document adequately the basis of his decision to use the work of internal auditor in an appropriate manner.

Whatever is the nature and extent of use of direct assistance from an internal auditor, an external auditor cannot escape his liability for his opinion in the audit report. His reliance on the work of the internal auditor can, in no way, reduce his responsibility and he will be held responsible for all damages arising out of any material misstatement in the accounts remaining undetected because of his reliance on the work of the internal auditor. An external auditor cannot be relieved by the law under the plea that he relied upon the work of an internal auditor.

Internal Control vs. Internal Check vs. Internal Audit

The differences between internal audit, internal control and internal check are as follows:

S. No.	Point of Distinction	Internal Audit	Internal Control	Internal Check
1.	Mode 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 a greater 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.

6.4.5 Risk Based Internal Audit

⊙ **Concept of Risk Based Internal Audit**

Risks are inherent in every organisation. Thus, the success of an organisation largely depends on how well it can manage its risks. In recent times, many corporate failures may be attributed to poor risk management approaches followed by the management. Effective internal controls, however, contribute to a great extent in minimising the adverse impact of inherent business risks.

Institute of Internal Auditors (IIA) defines risk based internal auditing (RBIA) as a methodology that links internal auditing to an organisation's overall risk management framework. RBIA allows internal audit to provide assurance to the board that risk management processes are managing risks effectively, in relation to the risk appetite. Thus, while traditional internal audit only provides control assurance based on routine audit, RBIA provides Assurance on the effectiveness of risk management in addition to control assurance. To put it differently, RBIAs give auditors a larger role in your risk reduction program. Beyond simply diagnosing the problems, they are also a part of the creation of effective controls and maintaining risk management efforts over time.

By following RBIA internal audit should be able to conclude that:

a. Management has identified, assessed and responded to risks above and below the risk appetite.

b. The responses to risks are effective but not excessive in managing inherent risks within the risk appetite.

c. Where residual risks are not in line with the risk appetite, action is being taken to remedy the same.

d. Risk management processes, including the effectiveness of responses and the completion of actions, are being monitored by management to ensure they continue to operate effectively.

e. Risks, responses and actions are being properly classified and reported.

This enables internal audit to provide the board with assurance that it needs on three areas:

a. Risk management processes, both their design and how well they are working.

b. Management of those risks classified as 'key', including the effectiveness of the controls and other responses to them.

c. Complete, accurate and appropriate reporting and classification of risks.

⊙ **Traditional Internal Audit vs. Risk Based Internal Audit**

The differences between the two approaches are as follows:

Sr. No.	Traditional IA Approach	Risk Based IA Approach
1.	Audit plan is based on the audit cycle	Audit plan is based on the results of the business risk evaluation. Risky areas are covered first and more frequently.
2.	Important risks might not be covered during the audit plan	Provides assurance that important risks are being managed properly

3.	Focuses on deficiencies in controls and cases of non-compliance with policies and procedures	Focuses on risks that are not properly controlled and overly-controlled
4.	IA resources are spread over all business activities	More efficient use of IA resources by concentrating on risk areas
5.	Business risks are not being mapped	The importance of risks is established during the risk assessment phase and in agreement between IA
6.	Disagreement with the business management over the action plans leading to delays in implementation	Facilitates consensus with line management on the needed action plans thus improving timely the implementation of corrective measures

Advantages of Risk Based Internal Audit

Risk-based internal auditing has a number of benefits over a more traditional audit approach.

a. **Consistency:** Developing a consistent and comprehensive approach to risk management makes it easier for an organisation to adapt to changing conditions. Adjusting audit schedule to risk management framework will also help switch tactics quickly when business objectives need to change.

b. **Transparency:** A risk-based approach to audit enables the internal auditors to identify risks correctly and allows management to put the right internal controls in place for the best performance. This provides a better understanding of the risks and enables organisation to better manage them.

c. **Specificity:** Ranking and mapping risks with RBIA will allow allocate activity and funds to the areas that need the most attention, creating a unique risk management program rather than relying on external frameworks and recommendations. While compliance frameworks are necessary for many industries, they don't account for every potential risk the entity could face; relying on those requirements alone could result in risks going unnoticed and unattended.

Risk Based Internal Audit Process Plan

The steps involved in a RBIA process plan are depicted below:

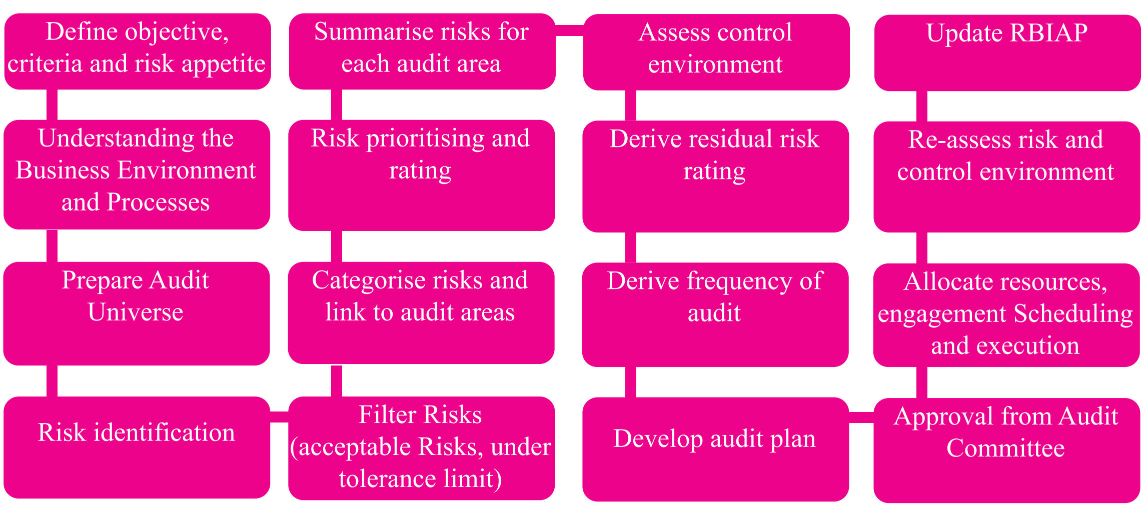

Figure 6.4: RBIA Process Plan

Internal Audit and Assurance Standards of the Institute of Cost Accountants of India.

Following are the important Internal Audit and Assurance Standards of the Institute of Cost Accountants of India.

Category-I: Standards on General Principles of Internal Audit

IAAS-1: Objectives, Authority and Charter

Internal audit charter is the most basic document as far as an internal audit is concerned. An internal auditor should read it carefully as it contains the objectives and authority of the internal auditor .Besides, it contains the responsibilities of the internal auditor. Internal audit plan and other processes should be based on internal audit charter. The Internal audit charter is an extensive document so that it can contain various aspects of the internal audit.

IAAS-2: Internal Audit Engagement

Internal audit engagement letter is very important and significant as it defines the scope of internal audit .The letter may vary from entity to entity. Besides , it should be in consistent with the internal audit charter approved by audit committee/board of the entity.

IAAS-3: Independence, Integrity and Objectivity

An internal auditor should be independent in all aspects .Objective examination of the transactions is expected from the auditor .He/she should be free from all types of bias. Chief internal auditor should be very much careful in performing his/her role as a captain of the team.

IAAS-4: Proficiency and Due Professional Care

Internal audit is a value added/value created function to the entity. Therefore, one person as an internal auditor should obtain proficiency through ordinary education and professional education and the application of maximum professional care is expected from the internal auditor.

IAAS-5: Using the work of an Expert

The chief internal auditor may seek the help the expert outside his/her team .The expert opinion may be in specialized areas and the chief internal auditor should do all those activities with utmost confidential manner and reliability of the information provided should be subject to the verification by chief internal auditor.

IAAS-6: Quality Assurance and Continuous Improvement

The chief internal auditor should supervise the activities of the internal auditor .Both internal and assessment of the quality of internal audit is essential and significant .Besides ,Continuous professional development and improvement is must for an internal auditor to perform his/her internal audit engagements satisfactorily.

IAAS-7: Communication and Confidentiality

Chief internal auditor should communicate with audit committee/director board in regular intervals to discuss about various aspects of the internal audit. Communication to the parties outside the entity should be made only after getting sanction from the proper authorities of the entity.

IAAS-8: Risk Based Internal Audit

Internal auditor has to review the entity's risk management & internal control system to understand the effectiveness of the system.

IAAS-9: Technology Driven Internal Audit

The internal auditor should understand the IT Environment of the entity to understand about the potential risks which may creep in the entity .Besides, the chief internal auditor can use Information Technology to analyze data related with the internal audit processes.

IAAS-10: Enhancing Governance through Internal Audit

Internal audit activities should evaluate governance procedures of the entity .Besides ,proper recommendations to improve governance of the entity is expected from the internal audit team .Actually ,Internal audit is value added process with respect to the governance procedure of the entity.

IAAS-11: Internal Audit of Cost Records

Internal audit should include the internal audit of cost records and cost accounting system. Besides, Chief internal auditor should report the effectiveness of the cost accounting system to the audit committee/director board of the entity where the internal audit is performed on the basis of internal audit charter and the internal audit engagement letter.

Category-II: Standards on Principles related to Internal Audit Process

IAAS-21: Internal Audit Planning

Chief Internal auditor cannot prepare an internal audit plan in isolation. As per the Companies Act and significant rules associated with the companies act 2013, internal audit plan should be by-product of the consultations of the different stake holders relating to the internal audit .The audit committee has a significant role in it.

IAAS-22: Internal Audit Sampling

Auditing is a process which is based on sampling .Internal audit is not an exception to that popular principle. Therefore, this standard deals with the selection of audit sample from an audit population.

IAAS-23: Analysis and Evaluation

An Internal auditor should use significant and sufficient analytical procedures to derive information from the audit and thereby reach a conclusion based on the internal audit

IAAS-24: Internal Audit Evidence

Audit evidence is very relevant as far as an internal audit is concerned. Therefore, the chief internal auditor should design audit procedures which helps the entire team to get the audit evidence.

IAAS-25: Internal Audit Documentation

This standard deals with responsibility of the chief internal auditor with respect to the audit document preparation

IAAS-26: Disclosure and Reporting

Every standard deals with different aspects of the preparation of the internal audit report and disclosure requirements in it .The internal report should be addressed to the chairman of the audit committee/board of directors.

IAAS-27: Monitoring Progress.

The responsibility of the chief internal auditor should not end with the completion of the internal audit .He should monitor the action taken by the entity based on the recommendations and observations contained in the internal audit report.

Besides the above mentioned standards, the standard document includes the following:

i. Glossary to the Internal Audit & Assurance Standards

Appendices

ii. Appendix-I: Model Internal Audit Charter

iii. Appendix-II: Model Internal Audit Engagement Letter

iv. Appendix-III: Illustrative Internal Audit Plan

v. Appendix-IV: Internal Audit Report Template.

6.4.6 Internal Financial Control and Internal Control over Financial Reporting

6.4.6.1 Internal Financial Control (IFC)

- **Background**

  The Satyam Scam of 2009 and the failure of statutory audit process to detect the financial fraud of such a huge scale committed by the management brought to notice various loopholes in the regulatory and legal framework dealing with board of directors and auditors of the company. The scam compelled the Indian regulators to search for best practises across the world like Sarbanes Oxley regulations in United States (US), Turnbull Guidance in United Kingdom (UK) and JSOX in Japan to raise the standard of corporate governance in India. Consequently, this motivated the regulators to introduce the Internal Financial Control regulations within the ambit of the Companies Act, 2013.

- **Concept of IFC**

  As per Section 134(5)(e) of Companies Act, 2013, the term 'internal financial controls' means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

- **Statutory Provisions Regarding IFC**

  The following are the statutory provisions associated with IFC.

  For listed entities only:

  a. As per Section 134(5)(e) of Companies Act, 2013, the Directors' Responsibility Statement shall state that directors have laid down IFC to be followed by the company and that such controls are adequate and operating effectively.

  For all entities, listed or unlisted

  b. Section 143(3)(i) of Companies Act, 2013, the auditor's report should state whether the company has adequate IFC system in place and the operating effectiveness of such controls.

  c. Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 states that the director's report should contain details in respect of adequacy of internal financial controls with reference to the financial reporting.

  For all companies having independent directors

  d. Section 149 (7) and Schedule IV of the Companies Act, 2013, requires that the independent directors should satisfy themselves on the integrity of financial information and ensure that financial controls and systems of risk management are robust and defensible.

  For all entities having Audit Committee

  e. Section 177 of the Companies Act, 2013 states that the Audit Committee may call for comments of auditors about internal control systems before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.

- **Benefits of Internal Financial Control**

With adequate and effective internal financial controls, some of the benefits that the companies would experience include:

a. Senior Management Accountability.

b. Improved controls over financial reporting process.

c. Improved investor confidence in entity's operations and financial reporting process.

d. Promotes culture of openness and transparency within the entity.

e. Trickling down of accountability to operational management.

f. Improvements in Board, Audit Committee and senior management engagement in financial reporting and financial controls.

g. More accurate, reliable financial statements.

h. Making audits more comprehensive.

Internal financial controls also become important as they help derive values in the form of:

a. Fresh independent look at key business processes.

b. Identification of potential operating process opportunities.

c. Updated formal, centralized, and managed internal financial controls documentation for the company.

d. Enhanced support to CEO/CFO certifications.

e. Enhanced control environment, thereby mitigating risk.

f. Better understanding of inherent and residual control risks in internal controls.

g. Rationalizing the number of controls across organisation - moving to smart and automated controls.

h. Standardizing policies and procedures for multi-location/ multi-business companies.

i. Fostering a control conscious work culture for people behind controls

j. Providing assurance to the CEO/ CFO as well as improves business performance.

6.4.6.2 Internal Financial Control over Financial Reporting (IFC-FR)

- **Background**

The definition of Internal Financial Control essentially suggests that the intent of the regulators is to have control framework beyond financial controls. However, an auditor cannot be expected to comment on the operational conduct of the business as a whole. Hence, it can be logically inferred that reporting of Internal Financial Control by auditors as required in Section 143(3)(i) is on financial reporting aspect only. This led to the introduction of the term Internal Financial Control over Financial Reporting (IFC-FR or ICFR).

- **Meaning of IFC-FR**

As per the Guidance Note, Audit of Internal Financial Controls Over Financial Reporting, issued by Institute of Chartered Accountants of India, IFC-FR shall mean, "A process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles".

A company's internal financial control over financial reporting includes those policies and procedures:

a. Pertain to the maintenance of the records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company:

b. Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statement in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and director of the company.

c. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect of the financial statement.

Thus IFC-FR = Maintenance of Financial records + Authorisation of transactions in accordance with GAAP + Safeguarding of assets of the company

- **IFC vs. IFC-FR**

Internal Financial Control over Financial Reporting (IFC-FR) covers those controls which are elements of Financial Reporting i.e., of balance sheet, profit and loss accounts. IFC-FR processes like order to cash, procurement to pay, Human Resource, Inventory Management cover risks only to the extend having direct or indirect impact on financial reporting. Therefore, IFC-FR majorly ensures controls which provide reasonable assurance that financial statements are free from material misstatements.

Internal Financial Control (IFC), in addition to ICFR, covers controls which ensure efficient and effective functions of business, controls which safeguard assets and ensure compliance of policies.

To put it differently, IFC as a concept is much wider in scope when compared to IFC-FR.

In fact, IFC = IFC-FR + Operational Controls + Anti-fraud Controls

Thus, it can be said that IFC-FR is a concept which is more intended towards users/readers of financial statement whereas IFC is more intended towards functions and management of the business.

[Note: For further discussion on IFC-FR, please refer to sub-module 7.6 of this study material.]

Audit Sampling, Audit Techniques and Analytical Procedure (including Scrutiny of Trial Balance and Grouping Schedules)

6.5

6.5.1 Audit Sampling

Concept of Audit Sampling

In case of a large organisation with umpteen number of transactions, it is not feasible for the auditor to verify each and every transaction to form his opinion on the financial performance and the state of affairs. The auditor, in such a large organisation with adequate internal control in place, should certainly apply partial checking to form his opinion. However, the success of part checking largely depends on appropriateness of the sample selected.

According to SA-530, Audit Sampling, issued by The Institute of Chartered Accountants of India (CA), sampling in the context of auditing is the application of audit procedures to less than 100% of the items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis to draw a conclusion about the entire population.

Benefits of Audit Sampling

Audit sampling offers a number of benefits as follows:

a. It reduces the workload of the auditor.

b. It saves time and cost.

c. As it substantially reduces the time for audit work, the auditor may devote more time for critical issues.

d. In order to decide on the extent of sampling, the auditor evaluates the effectiveness of internal control system. In this process, any weakness of the internal control system, if identified, can immediately be brought to the notice of the management for necessary corrective actions.

e. It gives dependable result as it is based on statistical sampling methods.

Factors to be Considered for Audit Sampling

The factors to be considered for audit sampling are as follows:

a. Objectives of audit: Audit sampling has to be done keeping in mind the objective of the audit procedure.

b. Nature of population: Audit sampling technique must be selected based on the degree of heterogeneity in the population.

c. Internal Control System: Adequate internal control helps the auditor to reduce his sample size.

d. Materiality of Items: For material items the auditor must increase the sample size to reduce the risk.

e. Sampling Risk: Audit sample must be so designed as to keep the sampling risk within the acceptable limit.

f. Non-sampling Risk: This is the risk factor emanating from human error. The auditor must take due care to avoid non-sampling risk.

g. Tolerable Error: It is the limit of error which does not significantly impact auditor's opinion. For material items, the limit should be kept low.

Approaches to Sampling

The approaches or methods can be classified as follows:

A. Non-Statistical Sampling or Judgemental Sampling

Under this technique, the sample size and its composition are determined based on auditor's own experience and knowledge and no statistical tool is applied to select the sample. The method is easy but subject to personal judgement.

B. Statistical Sampling

This approach is more scientific and does not depend on auditor's personal judgement. The approach includes the following methods:

a. Random Sampling: In this method of sampling each item of the population or within a given group (popularly known as stratum) has a known chance of selection. Random sampling can again be of two types:

(i) Simple Random Sampling: Under this method of sampling, each unit of the population has an equal chance of being selected in the sample. Here selection is normally done either by choosing a random number manually from a random number table or allowing the computer programme to select a random number and then identifying the population unit that corresponds to the random number by using any predefined rule. However, this method essentially requires the population units to be reasonably homogeneous or similar in nature.

(ii) Stratified Sampling: This method requires a given heterogeneous population to be first divided into a number of sub-populations (known as stratum) with homogeneous items and then selecting equal or unequal proportion of items from each group to form a representative sample of reasonable size. For example, trade receivable balances may be divided in five groups with specified ranges and then selection of trade receivables of a certain percentage can be done from each group.

b. Systematic/ Interval Sampling: This method requires selecting items using a constant interval between selections with the first selection being random. The interval can be based on a number (like every 30th item in the list) or a monetary value (like 30000 of cumulative value of sales after the last selection).

c. Monetary Unit Sampling: This method uses the monetary value of the transaction rather than the items as the basis for sample size determination and item selection. It is also known as value-based sampling or value-weighted sampling.

d. Multi-Stage Sampling: This method is suitable when data are stored in more than one level. For example, an organisation may have stock stored at a number of shops. Here, the first step would be to randomly select a few shops and then to randomly select a few stock items from the shops already selected. If applied cautiously, this method proves to be very effective.

Risk Associated with Sampling

According to SA-500, an auditor may use audit sampling in selecting items required to conduct an effective test to provide appropriate audit evidence. However, it cannot be denied that such a method will always involve some amount of risk. This risk associated with sampling can broadly be divided into two categories:

a. **Sampling Risk:** Since sample is only a selected part of the population, it can never reflect all the characteristics of the population. Thus, there will always be some amount of risk unavoidable in this process. This sampling risk can again be of two types as follows:

(i) **Sampling Risk associated with Compliance Procedure (i.e., Test of Control):** Here, the auditor, based on sampling procedure, may come to the conclusion that that the controls are more effective (or less effective) while they are not.

(ii) **Sampling Risk associated with Substantive Procedure (i.e., Test of Details):** Here, the auditor, based on sampling procedure, may come to the conclusion that that the financial statements are free from any material misstatements while they are not.

b. **Non-Sampling Risk:** While conducting sampling, error may also arise due to improper processing of data, lack of expertise to analysis, etc. These are called non-sampling error or bias. Accordingly, risk of any wrong opinion on the part of the auditor due to such errors is called non-sampling risk.

Non-sampling risk is avoidable. If the sampling is done by experienced audit clerks and they remain alert while analysing the selected transaction, non-sampling risk can be reduced to minimum or even zero. On the other hand, sampling risk is unavoidable. The auditor can only reduce it to the possible extent by adhering to a proper method of sampling and by increasing the sample size reasonably.

⊙ **Stages in Audit Sampling**

Audit sampling requires the following steps:

a. **Sample Design:** Here, the auditor selects the appropriate method based on the consideration of objectives of audit and nature of population.

b. **Sample Size Determination:** Auditor decides the sample size to minimise the sampling risk. He generally applies statistical techniques to avoid subjectivity.

c. **Sample Selection:** At this stage, using the selected methods, sample units are drawn from the population.

d. **Performance of Audit Procedure:** Audit procedure is then performed on the selected sample units. If the procedure cannot be applied on the selected unit, the same is replaced. Based on the results of the audit procedure, the auditor forms his opinion.

6.5.2 Audit Techniques

While conducting the audit of an organisation, an auditor resorts to various techniques. Some of these are invariably applied in all cases whereas some others are used only, if situation so demands. These are popularly known as Audit Techniques.

Some of the common techniques which have wide application are discussed below:

a. **Routine Checking**

Routine checking may be defined as the procedure to check whether the transactions are properly entered in the books of accounts and whether the posting and carry forwards are done accurately. In other words, routine checking is done to ensure that mathematical accuracy is maintained while recording transactions in the books of accounts. This is quite helpful to detect errors and frauds of very simple nature.

Routine checking is normally performed by audit clerks. They examine the correctness of casting and balancing of the books of primary entry, correctness of posting to ledgers, correctness of casting, balancing and carry forwards of ledger accounts, correctness of trial balance and correctness of the final accounts i.e., Statement of Profit and Loss and Balance Sheet.

Routine checking ensures arithmetical accuracy and, in the process, detect the material misstatements, if any. It provides the base for the subsequent audit work to find out serious and organised frauds.

b. Test Checking

In large organisations with huge number of transactions recorded in the books of accounts, conducting a detail examination of all accounts becomes a mounting task for the auditor. Additionally, due to the prevalent periodic audit system, the auditor is required to submit his report within a definite time period. Thus, in organisations, where there exists a sound internal control, the auditor selects a few transactions out of a number of similar transactions and conduct in-depth examination of those. If no irregularities are found, then it is assumed that all the transactions have been recorded properly. This procedure is known as test checking.

The rationale behind test checking lies in the 'Sampling Theory' of Statistics. According to this theory, a well representative sample will always reflect most of the characteristics of the aggregate, i.e., population. Moreover, as the sample size increases, the deviations between the results based on sample and that of aggregate or population will get reduced. Thus, under test checking, the auditor applies an appropriate sampling technique to draw a representative sample from the population items (transactions or disclosure issues) and apply audit procedures only to those selected items and thereby form his overall opinion on the class.

Test checking, based on appropriate sampling technique, helps the auditor to form his opinion based on a limited examination of transactions. It also saves time and cost of audit work.

However, it also involves sufficient amount of risk. Use of faulty sampling technique, sampling risk (which is unavoidable) and non-sampling risk may result in non-detection of material errors and frauds. The auditor, in such cases, cannot deny his responsibility due to application of test checking instead of routine checking or other appropriate audit procedures.

Thus, test checking is never recommended for seasonal industries, for transactions of non-recurring in nature, for transactions of legal importance, for accounting estimates, for rectification and adjustments and for presentation and disclosures.

c. Auditing in Depth

Auditing in depth refers to the procedure where a few selected transactions are meticulously examined from their beginning to their conclusion. In other words, it is a system which reviews each and every single aspect of a transaction during its execution as well as recording. It is particularly helpful in case of large organisations where detailed examination of all records at every stage of a transaction is almost impossible. Hence, through this system, the auditor selects a few representative transactions of material importance from a particular category and then conducts a detailed stage by stage examination. If no irregularity is found, the auditor may come to a conclusion that the entire category of transactions is likely to be free from any material irregularity.

Audit in depth is a three-step process where (a) the auditor first reviews the effectiveness of the internal control system, (b) then selects a few transactions of material importance from each category and (c) finally conducts examination of each and every stage of the execution and recording of the selected transactions based on sufficient documentary evidence.

d. Cut-off Examination

For some entities, there may be a number of items especially at the end of an accounting period that may have their impact carried to the next accounting period. Work in progress, goods in transit, goods sent on approval basis lying with the customers, outstanding and prepaid items are only a few. Even purchase and sale transactions during the end of the accounting period may have their impact on the next year. Improper treatment of these items and inclusion of items relating to one year in the next or previous year (like purchase and sales) may seriously distort the financial results and mislead the decision makers. Hence, an auditor, during the course of his audit work, should apply definite procedure to separate transactions at the end of one accounting period from those at the commencement of the next accounting period. Such a procedure is known as Cut-off Examination or Cut-off Procedure. Here, the auditor first decides a cut-off date (in case of annual audit, generally balance sheet date is considered to be the cut-off date) and then examines all the transactions that occurred within a definite time period prior and post such cut-off (known as cut-off period) date to discriminate transactions of current year from that of the next year. This is essential to eliminate any scope of manipulation in accounts.

e. Surprise Checking

Under traditional audit practices, an auditor generally informs the client about his routine checking plan and timing of next visit well in advance. This is considered essential so that the client's staff can keep the books of accounts complete in all respects and readily available for verification. Unfortunately, this also provides them ample scope for concealing any wrongdoings whatsoever. Thus, it is generally recommended that an auditor must also conduct surprise tests of some material items without any prior communication with the client's office. These surprise checks, as a part of the normal audit procedure, are likely to increase the efficiency of the audit work. Hence, surprise checking may be defined as an audit procedure where verification of some material items is conducted on a non-routine and surprise basis.

f. Walk Through Tests

Walk through test may be defined as tracing one or more transactions through the accounting system and observing how it is actually passed through the internal control system. For example, the auditor may decide to trace a purchase transaction from its initiation to its completion and recording. This will require him to see how are requisitions generated, orders placed with the suppliers, goods received and taken to the stores, bills processed and finally the accounting treatment done. If the auditor is satisfied about the appropriateness of all the relevant stages of the transaction, he may conclude that the internal control is functioning well. Accordingly, the auditor may decide to put reliance on the system to a certain extent and plan his audit work to verify some selective transactions only. Alternatively, if walk through test reveals serious weakness of the internal control system, the auditor may opt for verifying

6.5.3 Analytical Procedure

- **Concept of Analytical Procedure**

Traditional audit techniques such as routine checking or test checking help an auditor to identify the existence of material misstatements or misappropriation of relatively simple in nature. However, the books of accounts may contain complex errors or planned frauds that are difficult to identify by these traditional methods. Existence of such errors or frauds may be quite fatal as that will eventually make the audit report unreliable. Hence, the auditor should apply some innovative procedures to deal with a situation of that kind. Analytical procedure has become very effective in this respect.

According to SA 520, Analytical Procedures, analytical procedure means evaluation of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedure also encompasses such investigation, as is necessary, of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

- **Nature of Analytical Procedures**

As per SA520, the nature of analytical procedures includes the following:

(i) Analytical procedures consider comparison of entity's financial information with

(a) Comparable information of prior periods.

(b) Any anticipated results of the organisation like budget or forecast or any estimation by the auditor like estimation of depreciation.

(c) Similar information of any other comparable entity belonging to the same industry or the industry averages.

(ii) Analytical procedures may also include consideration of relationships:

(a) Among different items of financial data that is expected to follow a predictable pattern like the operating profit margin.

(b) Between financial and non-financial information like the number of employees and the total compensation cost.

(iii) Analytical procedures consider application of diverse analytical tools that may range from a simple comparison to complex analysis involving advanced statistical techniques.

(iv) Analytical procedures may be applied either on standalone or on consolidated financial statements. Moreover, they can be applied on any component or individual information of the statements.

Application of Analytical Procedure

According to SA 520, analytical procedures can be applied at different steps of the audit work.

These include:

a. **Audit Planning:** During the planning stage, the auditor may apply analytical procedures to have an understanding of the nature of client's business.

b. **Substantive Test:** In order to reduce the audit risk by relying on substantive procedures, the auditor may apply substantive analytical procedures either alone or in combination with the test of details (i.e., vouching and verification).

c. **Investigation of Unusual Items:** If the analytical procedures performed in the organisation identify any inconsistency in relationships or any significant deviation from the respective expected value of the items, the auditor should investigate such items

d. **Overall Conclusion:** The auditor may also apply the results of analytical procedures to assess how far the conclusions drawn based on individual components or elements of the financial statements are consistent and whether there is any need to revise them.

Tools and Techniques of Analytical Procedures

As per SA-520, analytical procedures include application of the following tools and techniques:

a. **Trend Analysis:** Under this method, analysis is done for to assess fluctuation of the amount of any item over the year or years.

b. **Testing of Reasonableness:** This is done by comparing certain items or account balances with other accounts or balances. Some examples are as follows;

(i) Raw material consumption to production (quantity)

(ii) Percentage of wastage and scrap against production and raw material consumption

(iii) Work-in-progress based on material issued

c. **Ratio Analysis:** This technique calculates different ratios between various items of financial statements in order to study their relationships. Some common ratios include:

(i) Gross Profit Ratio

(ii) Receivable Turnover Ratio

(iii) Inventory Turnover Ratio

d. **Sources of Information:** Analytical procedures also require analysing the following sources of information.

(i) Interim financial information

(ii) Budgets

(iii) Management Accounts

(iv) Non-financial information etc.

6.5.4 Scrutiny of Trial Balance and Grouping Schedule

A. Scrutiny of Trial Balance

- **Concept of Trial Balance**

A Trial Balance is defined as a statement of debit and credit balances of individual general ledger accounts. It is prepared primarily to test first-hand arithmetical accuracy of books of accounts and to facilitate quick preparation of financial statements. It is generally prepared at the end of an accounting period, e. g., a month a quarter or year. It is also known as a list of balances of General Ledger Accounts

In a mechanized accounting system, each Account head of a Chart of Accounts is given a code following a codification logic in order of Balance Sheet, Income Statement and Clearing Accounts to ensure compliance with the entity's declared accounting and reporting policies, disclosure requirements mandated by relevant regulations. Any Trial Balance adheres to the same codification in assembling the account balances and gives a bird's eye view of all accounts based on which the organisation may prepare financial statements. In manual accounting system, it also helps testing arithmetical accuracy of books of accounts and detecting clerical errors. However, it can only detect errors other than errors of principle, compensating errors and errors of complete omission.

In addition to the above, a Trial Balance also facilitates identification of any unusual increase/decrease in number in any account head or unusual nature of balances, e.g., credit balance in Depreciation A/c or debit balance of TDS Payable A/c, etc. by providing a summarized view of account balances. It also helps in budgetary control of incomes, expenses, element-wise working capital, and capital expenditure.

- **Scrutiny of Trial Balance by Auditor**

An auditor can use Trial Balance to reap important benefits. He can reasonably be assured about the arithmetical accuracy of the accounts when the trial balance has tallied. An appraisal of Trial Balance may also help him in identifying the areas where analytical procedures should be undertaken. For example, when the Trial Balance for a given period end shows an unusual change in specific account balances or unusual nature of account balances, the auditor may decide to conduct trend analysis and/or variance analysis with reference to the balance of corresponding previous period to identify reasons for such unusual changes or unusual nature of balances. However, while undertaking the scrutiny of Trial Balance to reap the above benefits, the auditor should ensure that:

a) it has been prepared after a declared cut-off date for considering primary accounting entries for business transactions and other journal entries,

b) the codification logic has been adhered to while preparing the trial balance.

c) it has been prepared strictly based on 'As the Books written' without any adjustments inserted from any sources other than Financial Ledgers on a given date/or period end.

d) before the grouping schedule is prepared ledger accounts are corrected based on adverse observations emerging from Trial Balance scrutiny.

B. Scrutiny of Grouping Schedule

⊙ Concept of Grouping Schedule

Grouping Schedules or clusters of related ledger account heads under specified account groups and sub-groups are prepared before aggregated financial numbers are carried forward to Income Statement, Balance Sheet, and Notes to Accounts. This is an essential step before proceeding forward to draft financial statements in compliance with requirements of all the four 'Frameworks of Accounting.'

⊙ Objectives of Grouping Schedule

The objectives of preparing Grouping Schedule are as follows:

a) Compilation of heads of accounts according to the line items prescribed under relevant regulations for preparation and reporting of financial statements of the organisation.

b) Preparation of Notes to Accounts and clustering ledger account heads to comply with disclosure requirements as mandated by respective provisions of laws and regulations governing the accounting of the organisation.

c) Exercising budgetary control both at granular level and group of accounts level in conformity with the process followed for forecasting, budgeting, and budgetary control, and

d) Automating presentation of financial analyses required for different purposes and by different stakeholders using an automated computing process and or disjointed excel sheets.

Following is an example of Grouping Schedule relating to Balance Sheet.

Table 1: Illustrative Group and Detailed Accounts Hands – Balance Sheet

GL Account Code	Primary Group	Secondary Group	Tertiary Group
Non-Current Assets	Property, Plant & Equipment	Land	
		Building	
		Plant & Machinery	
		Furniture & Fixture	
		Motor Vehicles, etc.	
	Intangible Assets	Intellectual Property Rights	
		ICT Software, etc.	
	Investments		
		Shares of Companies	
		Government Bonds	
		Other Bonds	
		Mutual Funds, etc,	

Current Assets	Receivables	Government Entities	
		MSMEs	
		Others	
	Inventory	Raw Materials	
		Finished Goods	
		Work-in-Progress	
		Stores and Spare Parts	
	Investments		
	Cash and Cash Equivalents	Short term Deposits	
		Cash Balances	

Auditor's Role with respect to Grouping Schedule

Under a mechanized accounting system with a descent and pretested reliable software, accounts are finalized and financial statements are prepared automatically based on organisation's policy for Grouping Schedules. While this automated process minimises infiltration of human bias, chances of unintentional errors and organised frauds cannot be ruled out completely. Management, by inappropriately compiling the heads, may still misguide the users in their process of interpreting the line items. In addition, any attempt of relational analysis may also be jeopardized. As a result, methodology adopted in designing the Grouping Schedule may be a potential cause of concern for the auditor. The auditor, in this respect, should ensure that -

a) the composition of Grouping Schedules for various line items of the financial statements has adhered to the prescription of the relevant regulations.

b) the composition of the Grouping Schedule for various line items has been decided only by the person(s) authorized for this purpose.

c) appropriate customization of the accounting software has been done to meet organisation's accounting and reporting requirements.

d) the composition of the Grouping Schedule has not been altered without appropriate authorization triggered by any legal and/ or regulatory authority.

A scrutiny of the Grouping Schedule helps the auditor confirm that the composition of individual line items in the financial statements are appropriately computed and are in compliance with the organisational policy and provisions of relevant laws and regulations. It further helps him to administer suitable analytical audit procedures, including relational analyses of financial variables and stage-wise operating results and financial state of affairs across several past periods to identify complex errors or planned frauds, if any.

Application of Technology in Auditing and Audit Trail

6.6

6.6.1 Application of Technology in Auditing

Auditing in an Automated Environment

In recent years, there is growing application of computer assisted information systems in business organisations for processing and storage of accounting records and other information. This has truly revolutionized the accounting and administrative controls, information flow and preparation and finalization of annual accounts. In many organisations, the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems which makes the environment automated.

Automated environment offers a lot of advantages:

a. It enables accurate data processing. As a result, computation becomes more reliable.

b. It can process high volume of transactions easily.

c. It makes business processes faster.

d. It improves control efficacy and security.

e. It minimizes the human errors.

f. It offers better integration among business processes.

In an automated environment, auditing also undergoes through significant changes as traditional auditing techniques may not be applicable in the same way.

Components of Automated Environment

Following are the general components of an automated environment.

a) Databases - Oracle 19C, MS-SQL Server;

b) Operating systems - Windows, Unix, Linux;

c) Hardware and Storage devices – servers, disks, tapes, network storage;

d) Network devices - switches, routers and firewalls;

e) Networks - local area networks, wide area networks, virtual private networks, etc.;

f) Physical and environmental landscape –IT facilities like Data center, physical access control mechanisms like biometric based access system, CCTVs, adequate HVAC system, fire suppression system etc.

In addition, there are application software such as Package Software (e.g., Tally, QuickBooks), Small ERPs (e.g., Tally ERP, SAP, Business One, Focus ERP) and ERP applications for medium to large enterprises (e.g., SAP ECC, Oracle Enterprise Business Suite).

⊙ Areas of Use of Computer in Auditing

The following are certain areas where the use of computer in auditing may be useful:

a) Preparation of detailed audit programming.

b) Preparation of audit planning, scheduling and assignment of available manpower to different assignments in hand.

c) Checking of validity, consistency and reasonableness of entries.

d) Reviewing the internal control of the system.

e) Retrieving requires key information from the files for making comparison with the set of standard information.

f) Doing arithmetical computations and checking the arithmetical computations.

g) Doing analytical review of the data by way of comparison, ratio analysis, trend analysis, tests of reasonableness and so on.

h) Selecting representatives for vouching, verification-debtors accounts may be planned to be listed if they comply with certain predetermined criteria.

i) Preparation of flow- charts.

j) Preparation of audit reports, documenting working papers and writing other communication, etc.

⊙ Controls in an Automated Environment and Auditor's Role

Authenticity and reliability of information in an automated environment largely depends on the controls in place in such environment. Thus, auditing in an automated environment requires an auditor to evaluate the same before applying the audit procedures. There are following types of controls in an automated environment.

(a) Application controls

Application controls are those controls (manual and computerised) that relate to the transaction and standing data pertaining to a computer-based accounting system. Application controls need to be ascertained, recorded and evaluated by the auditor as part of the process of determining the risk of material misstatement in the audit client's financial statements.

(b) Input controls

Control activities designed to ensure that input is authorised, complete, accurate and timely are referred to as input controls. The auditor needs to apply specific input validation checks to evaluate the same.

(i) Range checks: These ensure that information input is reasonable in line with expectations.

(ii) Compatibility checks: These ensure that data input from two or more fields is compatible. For example, a sales invoice value should be compatible with the amount of sales tax charged on the invoice.

(iii) Validity checks: These ensure that the data input is valid.

(iv) Exception checks: These ensure that an exception report is produced highlighting unusual situations that have arisen following the input of a specific item.

(v) Sequence checks: These facilitate completeness of processing by ensuring that documents processed out of sequence are rejected.

(vi) Control totals: These also facilitate completeness of processing by ensuring that pre-input, manually prepared control totals are compared to control totals input.

(vii)Check digit verification: This process uses algorithms to ensure that data input is accurate.

(c) Processing controls

Processing controls exist to ensure that all data input is processed correctly and that data files are appropriately updated accurately in a timely manner. The processing controls for a specified application program should be designed and then tested prior to 'live' running with real data.

(d) Output controls

Output controls exist to ensure that all data is processed and that output is distributed only to prescribed authorised users. While the degree of output controls will vary from one organisation to another (dependent on the confidentiality of the information and size of the organisation), common controls comprise use of batch control totals, exception reports etc. The auditor must ensure that output is kept confidential and available to authorized users only.

(e) Master file controls

The purpose of master file controls is to ensure the ongoing integrity of the standing data contained in the master files. It is vitally important that stringent 'security' controls should be exercised over all master files. The auditor must ensure that master file controls are effective and adequate.

The above evaluation largely determines the auditor's workload and scope of the audit work.

- **Testing Methods in an Automated Environment**

An auditor applies four types of tests to identify the reliability of controls and associated risks. These are inquiry, observation, inspection and reperformance. Though inquiry is the most efficient, it must always be used with any of the three other methods to produce better results. Again, reperformance, though the most effective method, is time consuming and less efficient. Thus, keeping in mind the risk assessment, internal controls in place, desired level of evidence required, past history of errors and complexity of the business processes, the auditor needs to decide the appropriate method of testing. Some of the common testing in an automated environment include the following:

a. Obtain an understanding of the processing of an automated transaction by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.

b. Observe how a transaction is recorded by a user in different scenarios.

c. Inspect the configuration of an application control.

For example, the auditor may perform a test check (negative testing) and observe the error message displayed by the system or he may inspect the technical manual of systems and applications.

6.6.2 Audit Trail

- **Concept of Audit Trail**

Audit trail may be defined as the documents, records relating to transactions that enables an auditor to trace the transactions from the source documents to the summarised total in accounting reports. It is an orderly, step-by-step record of transactions that serves as a proof of a transaction's history, right from recording to tracking all changes that may take place. For example, a sequentially numbered sales invoice copies would normally be listed in a Register and subsequently filed either in numerical or chronological order. Thus, it would be possible to trace a particular invoice from the daybook to the original file by reference to the number or date of the invoice.

In an automated environment accounting software provides the ideal example of audit trails. For example, when a transaction is entered in the software, the software will maintain a record of it. Any further edits made to the details, such as a change in the name or amount will also be tracked by the software along with the user who made the changes and the time of change. Even if some transactions were to be deleted, the software will track that as well and keep the record of everything since the original entry was made.

- **Statistical Requirement for Audit Trail**

According to Rule 3(1) of Companies (Accounts) Rules, 2014, as amended by Companies (Accounts) Amendment Rules, 2021, for the financial year commencing on or after the 1st day of April, 2022, every company which uses accounting software for maintaining its books of account, shall use only such accounting software which has a feature of recording audit trail of each and every transaction, creating an edit log of each change made in books of account along with the date when such changes were made and ensuring that the audit trail cannot be disabled.

In simple words, the expectation is to maintain the edit log of every transition right from recording to tracking the changes that may take place.

- **How Does an Audit Log Operate?**

An automatic record has automated logs, unlike a manual record that needs one to input the logs. The operations depend on the nature of IT infrastructure of the entity. It varies as per the operating systems, applications, and devices.

Audit trails record every activity that occurs within your system. It takes details of when, how and by whom the activity was done. It also shows the response of your system to the activities that took place.

Edit Log feature of software allows tracking the edits for masters and every transactions, capture the date details and username when changes are made, generation of difference report etc. Thus, through audit trail it is possible to identify unauthorised changes causing material misstatements very easily.

- **Benefits of Audit Trail**

A well-functioning audit trail offers the following benefits:

a. **User Accountability:** In an automated environment, a well-functioning audit trail system records the activities of every user. This promotes appropriate user behaviour because everyone is held accountable for their doings. Thus, introduction of virus to the system or unauthorised alteration of data can be prevented. Additionally, it helps to identify the intruders.

b. **Promotes Organisation's Data Security:** A well-functioning audit trail system ensures data security as it protects data from unauthorized access and fraudulent activities by staff and external parties.

c. **Allows Reconstruction of Events:** An excellent audit log system allows organisations to understand the operations of users, including cyber attackers. Data retrieval is also possible in some cases.

d. **Detection of System Interference and Errors:** A functioning audit trails system indicates upcoming system interference, failures, and errors. Such detections allow an organisation to respond accordingly to allow a smooth continuation of its operations.

- **Auditor's Duty to Report on Audit Trail**

According to Rule 11 of Companies (Audit and Auditors) Rules, 2014, as amended by Companies (Audit and Auditors) Amendment Rules, 2021, an auditor needs to report whether the company, in respect of financial years commencing on or after the 1st April, 2022, has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and the same has been operated throughout the year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention.

Exercise:

- **Multiple Choice Questions**

1. Which of the following is not an audit risk?
   A. Inherent Risk
   B. Detection Risk
   C. Control risk
   D. Omission Risk
2. Permanent Audit File does not contain
   A. A record of study and evaluation of internal control system
   B. Significant audit observations of earlier years
   C. Copies of management letters
   D. Analysis of significant ratios and trends
3. Audit Procedures to obtain audit evidences include
   A. Compliance Procedure
   B. Substantive Procedure
   C. Both of A and B
   D. Neither A nor B
4. SA 530 stands for
   A. Audit Documentation
   B. Audit Sampling
   C. Responsibility of Joint Auditor
   D. Agreeing the terms of Audit Engagements
5. Which of the following is not a part of Temporary Audit file?
   A. Correspondence relating to acceptance of annual reappointment.
   B. Audit programme.
   C. Extracts of minutes of board meetings
   D. Legal and organisation structure of the company.
6. 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
7. Internal Audit is mandatory for every unlisted public company having paid up share capital of
   A. ₹ 100 crores during the preceding financial year
   B. ₹ 50 crores during the preceding financial year

C. ₹ 500 crores during the preceding financial year

D. ₹ 200 crores during the preceding financial year

8. Check list contains the instructions to be followed by the

A. Employer of the organisation

B. Employee of the organisation

C. Banker to the organisation

D. Audit staff engaged by the auditor of the organisation

9. SA 210 stands for

A. Audit Planning

B. Audit Working Papers

C. Agreeing the terms of Audit Engagements

D. Audit Documentation

10. Test checking requires application of _____________.

A. mathematical theory

B. sampling theory

C. geometry theory

D. stakeholder theory

[Answer: 1-D; 2-C; 3-C; 4-B; 5-D; 6-C; 7-B; 8-D;9-C;10-B]

State True or False

1. There is no difference between statutory and external audit.
2. An investigation is done with the generally accepted auditing procedure.
3. The primary objective of the audit is for detecting frauds and error in the books of accounts and financial records of the client's business.
4. The concept of true or fair is a fundamental concept in auditing.
5. An audit engagement is the initial stage of an audit during which the auditor notifies the client that he has accepted the audit work.
6. An audit programme is a detailed plan of the auditing.
7. An Audit note book is a bound book in which a large variety of matters observed during the course of audit are recorded.
8. Internal Auditing is a function distinct from authorisation and recording.
9. Internal auditor of a company cannot be its Cost Auditor.
10. Risk based internal auditing (RBIA) is a methodology that links internal auditing to an organisation's overall risk management framework.
11. Auditing in depth refers to the procedure where a few selected transactions are meticulously examined from their beginning to their conclusion.
12. Analytical procedure includes trend analysis.

[Answer: False; False; False; False; True; True; True; True; False; True; True; True]

Fill in the Blanks

1. Audit is derived from Latin word ________________.
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 working papers are the record of the ___________ and execution of the audit engagement.
6. Internal Audit is an Independent ___________ activity.
7. Cut off procedures are generally applied to _____________ transactions.
8. The Internal Auditor is appointed by the ________________.
9. IFC = IFC-FR + _____________ + Anti-fraud Controls
10. This risk associated with sampling can broadly be divided into two categories – sampling and____________.

[Answer: audire; checklist; internal or external; final; planning; appraisal; trading; directors; operational control; non-sampling risk]

Short Essay Type Questions

1. Define the term Auditing? State the benefits that accrue out of Auditing?
2. Distinguish between the following:
   a. Audit and Investigation
   b. Accounting and Auditing
   c. Statutory and Non-statutory audit
   d. Continuous and Periodical Audit
   e. Traditional and Risk Based Internal Audit
3. What are the various principles governing an Audit?
4. Discuss the objectives of Audit.
5. Write short notes on:
   a. Audit Working Paper
   b. Audit Note Book
   c. Permanent and Temporary Audit Files
   d. Limited Review
   e. Cut-off Procedure
   f. Walk Through Test
   g. Reliability of audit evidence
   h. Components of automated environment
6. Discuss the contents of Audit note book.
7. Discuss different types of audit risks.
8. ‘Checklist and Internal Control Questionnaire are not the same’ – Discuss.
9. Distinguish between Statutory Audit and Internal Audit
10. Does reliance on internal auditor reduce the risk of the statutory audit? Discuss.

11. 'Internal Audit and Internal Check are not synonymous' –Discuss.
12. 'An auditor applies various techniques to evaluate the internal control system of an organisation' – Discuss.
13. Discuss different types of internal control systems.
14. Discuss the procedures for issuing standards on auditing.
15. How will you distinguish IFC and IFC-FR.
16. Discuss the risks associated with audit sampling.
17. What are the benefits of audit trail?

Essay Type Questions

1. Define 'Audit Engagement Letter'. What are the general contents of an audit engagement letter?
2. Define Audit Evidence. Discuss the methods of obtaining Audit Evidence.
3. What do you mean by Audit Programme? Discuss its advantages.
4. Discuss the objectives and functions of the Auditing and Assurance Standards Board:
5. What is Risk Based Internal Audit? Discuss its advantages.
6. What are analytical procedures? Discuss the tools and techniques of analytical procedures.
7. Discuss different types of controls in an automated environment.
8. What is the significance of Audit?
9. Discuss the advantages of Audit.
10. What is audit trail? Discuss the statutory provisions relating to audit trail.
11. Distinguish between Internal Control, Internal Check and Internal Audit.

Unsolved Cases

1. XYZ Ltd., an unlisted public company, is required to appoint an internal auditor as per the provisions of Companies Act, 2013. Accordingly, it has appointed Mr. A as the internal auditor who is a qualified Chartered Accountant. The statutory auditor of XYZ Ltd., M/S PQR and Associates is of the view that as the company has an internal auditor, they can rely on the direct assistance of the internal auditor and it can sufficiently reduce their audit work and liability. Give your opinion citing the guidance from relevant Standard.

   [Hint: SA 610; Reliance on internal auditor does not reduce the liability of the statutory auditor]

2. The cashier of a trading firm has also control of all the financial books. He also opens all incoming mails comprising cash and cheques. Under these circumstances, what malpractices are open to the cashier in respect of both receipts and payments and what checks would you, as an auditor, suggest to the company.

   [Hint: Teeming and lading procedure, recoding bad debt, showing short receipts, non-recording of receipts is possible. Strict internal check ensuring different jobs to different employees may be recommended.]

References

1. Auditing and Assurance (2e) by Sana, Sarkar, Biswas & Das, McGraw Hill Publication
2. Fundamentals of Auditing by S K Basu, Pearson Publication
3. Companies Act, 2013
4. Company (Accounts) rules, 2014
5. Company (Audit and Auditor) Rules, 2014

Provision Relating to Audit under Companies Act, 2013

7

This Module includes

Provision Relating to Audit under Companies Act, 2013

SLOB Mapped against the Module

To develop in depth understanding of various aspects of statutory auditing mechanism under the guidance of Companies Act and Assurance Standards. (CMLO 4 a)

Module Learning Objectives:

After studying this module, the students will be able to –

- Understand various statutory provisions relating to financial audit of a company.
- Know the legal framework guiding cost audit and secretarial audit.
- Understand the process of audit of various items of financial statements.
- Understand the issuing associated with preparation of audit report.

Introduction 7

A company is a special form of organisation created, maintained and even winded up through the application of law. In other words, every single operation in a company is subject to certain legal provisions. Accordingly, auditing in a company is exclusively guided by the provisions of various acts, rules and other judicial pronouncements.

In this context, the following sources of legal provisions may be mentioned:

(i) Companies Act, 2013 (with all relevant amendments);

(ii) Various Company Rules (with all relevant amendments);

(iii) Relevant Sections of The Chartered Accountants Act, 1949;

(iv) Accounting Standards notified by the Ministry of Corporate Affairs;

(v) Various Standards of Auditing issued by the Institute of Chartered Accountants of India.

Since, companies are the most dominant organisations and eventually the largest consumers of societal resources, the above legal framework is imperative to attain the highest possible standard in conducting the mandatory audit of companies.

Statutory Audit, Branch Audit and Joint Audit, Role of Audit Committee

7.1

The term 'statutory' signifies anything regulated by laws of the state. Accordingly, an audit which is conducted under any specific statute or Act may be called 'statutory audit'.

In a company form of organisation, the management is separated from ownership. Though shareholders are the owners of company's properties, they do not actively take part in the management of the company; instead, the company is managed by a group of managers who are entrusted with the proper utilization of the resources procured by the company with the objective of maximization of shareholders' wealth. Therefore, in this context, the management's stewardship must be properly vouched by an independent third party. This is why, audit of the books of accounts by a qualified and independent auditor has been made mandatory in every company.

7.1.1 Company Auditor's Eligibility

A. Qualifications of a Company Auditor

As per Section 141 of Companies Act, 2013, the following persons should be considered as qualified for being a company auditor:

(i) A person shall be eligible for appointment as an auditor of a company, only if he is a Chartered Accountant [Section 141(1)].

(ii) A firm can also be appointed by its firm name to act as the auditor of a company if majority of its partners practicing in India are qualified for appointment as company auditor [Section 141(1)].

(iii) 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 authorized to act and sign on behalf of the firm [Section 141(2)].

Note: In this context, the meaning of the term 'Chartered Accountant' shall be interpreted based on the provisions of The Chartered Accountants Act, 1949 as follows:

(i) "Chartered Accountant" means a person who is a member of the Institute [Section 2].

(ii) A person is a member of the Institute if his name appears in the Register of the Institute [Section 3].

(iii) The following persons shall be entitled to have his name entered in the Register [Section 4]:

(a) any person who is a registered accountant or a holder of a restricted certificate at the commencement of this Act.

(b) any person who has passed such examination and completed such training as may be prescribed for members of the Institute.

(c) any person who has passed the examination for the Government Diploma in Accountancy or an examination recognized as equivalent thereto by the rules for the award of the Government Diploma in Accountancy before the commencement of this Act and fulfils such conditions as specified by the Central Government in this behalf.

(d) any person who, at the commencement of this Act, is engaged in the practice of accountancy in any State and fulfils such conditions as specified by the Central Government in this behalf.

(e) any person who has passed such other examination and completed such other training without India as is recognized by the Central Government or the Council as being equivalent to the examination and training prescribed for members of the Institute.

(f) any person domiciled in India, who at the commencement of this Act is studying for any foreign examination and is at the same time undergoing training, whether within or without India, have passed the examination or completes the training within five years after the commencement of this Act.

In order to become the member of the Institute, the aforesaid persons must reside in India or must be in practice in India. For any person outside India with all other requisite qualifications, the Central Government or the Institute may impose additional conditions. Moreover, any qualified persons will have to formally apply for the membership to the Institute with requisite fees. His name will be included in the Register only if the application is accepted.

B. Disqualification of a Company Auditor

As per Section 141(3), read with Rule 10 of Company (Audit and Auditor) Rule 2014, the following persons shall not be eligible for appointment as an auditor of a company:

(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, of face value not exceeding rupees one lakh;

(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 rupees five lakh;

(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, in excess of rupees one lakh;

(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;

Note: For this purpose, the term 'business relationship' shall be construed as any transaction entered into for a commercial purpose, except –

(a) commercial transaction which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Companies Act, 2013 or the Chartered Accountants Act, 1949 and the rules or regulations made under those Acts;

(b) 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 auditor as customer.

(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) a person who, directly or indirectly, renders any service referred to in Section 144 to the company or its holding company or its subsidiary company.

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 [Section 141(4)].

Note: According to Section 144 of the Companies Act, 2013, 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 may be. However, such services shall not include the following services, whether rendered directly or indirectly to the company or its holding company or subsidiary company.

(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.

7.1.2 Appointment of a Company Auditor

Appointment of a company auditor is governed by Section 139 of Companies Act, 2013.

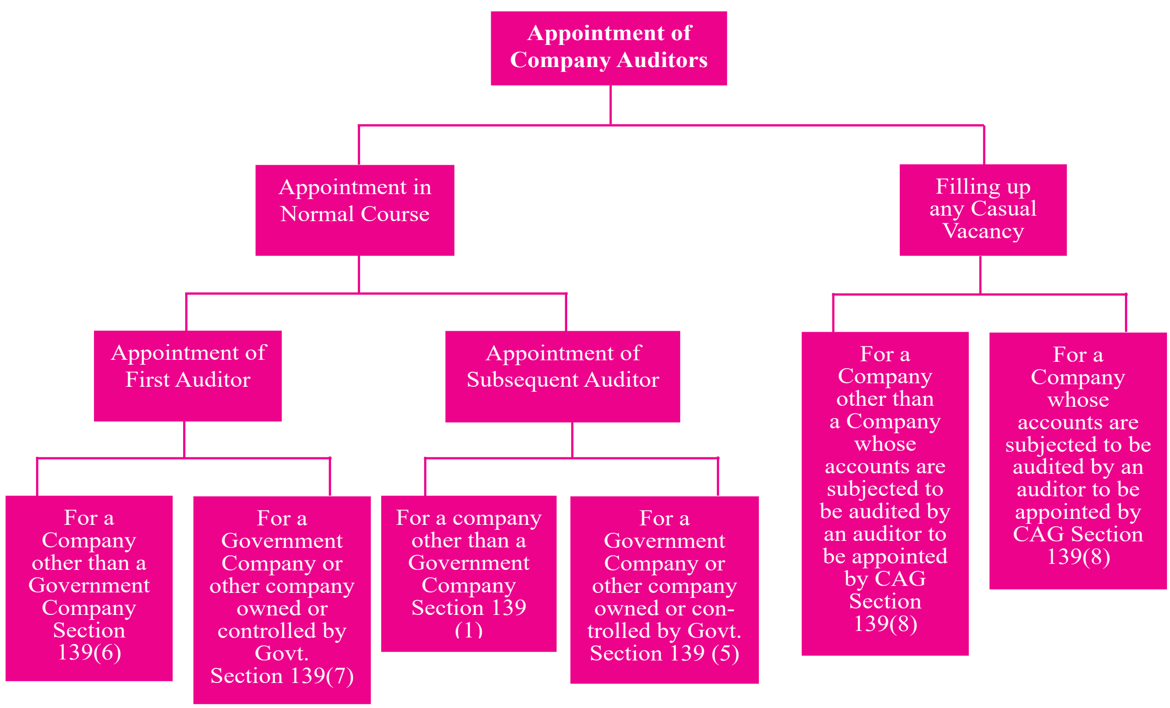

Figure 7.1: Various Instances of Appointment of Company Auditor

A. Appointment in Normal Course

(i) Provisions Relating to Appointment of First Auditor

(a) In case of a company other than a Government Company [Section 139(6)]

- 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.
- In the case of failure of the Board to appoint such auditor, it shall inform the members of the company, who shall appoint such auditor within ninety days at an extraordinary general meeting.
- The auditor, so appointed, shall hold office till the conclusion of the first annual general meeting.

(b) In case of a Government Company [Section 139(7)]

- 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.
- In case the Comptroller and Auditor-General of India does not appoint such auditor within the aforesaid period, the Board of Directors of the company shall appoint such auditor within the next thirty days.
- Further, 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 sixty days at an extraordinary general meeting.
- The auditor, so appointed, shall hold office till the conclusion of the first annual general meeting.

Note: For the aforesaid purpose 'Government Company' shall mean a company in which not less than 51% of the paid-up share capital is held 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, and includes a company which is a subsidiary company of such a Government Company.

(ii) Provisions Relating to Appointment of Subsequent Auditor

(a) In case of a company other than a Government Company [Section 139(1), read with Rule 3 and 4 of Company (Audit and Auditors) Rule 2014]

- 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.
- 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 prescribed, shall be obtained from the auditor.
- The certificate shall also indicate whether the auditor satisfies the criteria provided in Section 141.
- 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 in Form ADT-1 [Rule 4(2)].

(b) In case of a Government Company [Section 139(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 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 180 days from the commencement of the financial year.
- The auditor, so appointed, shall hold office till the conclusion of the annual general meeting.

B. Appointment in Case of Filling a Casual Vacancy [Section 139(8)]

(i) In case of a company other than a company whose accounts are subject to audit by an auditor appointed by the CAG

- Any casual vacancy will be filled by the Board of Directors within thirty days.
- 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.
- The auditor, so appointed, shall hold the office till the conclusion of the next annual general meeting.

(ii) In case of a company whose accounts are subject to audit by an auditor appointed by the CAG

- Any casual vacancy will be filled by the Comptroller and Auditor-General of India within thirty days.
- In case the Comptroller and Auditor-General of India does not fill the vacancy within the aforesaid period, the Board of Directors shall fill the vacancy within next thirty days.

Note: Though not defined clearly, 'casual vacancy' for the aforesaid purpose usually implies cessation of service of an existing auditor due to his death, resignation, disqualification, etc.

7.1.2.1 Re-appointment of a Company Auditor

As per Section 139(9), 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.

7.1.2.2 Automatic Re-appointment of a Company Auditor

According to Section 139(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.

7.1.2.3 Role of Audit Committee's Recommendation in Appointment of Auditors

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.

7.1.2.4 Ceiling on the Number of Audit Assignments

As per Section 141(3)(g), a person or a partner of a firm shall not be eligible for appointment as the auditor of a company if –

(i) Such person is in full time employment elsewhere; or

(ii) Such person or partner is, at the date of such appointment or reappointment, holding appointment as auditor of more than twenty companies, other than one person companies, dormant companies, small companies and private companies having paid up capital less than ₹100 crore.

Accordingly, the following points shall be kept in mind:

- Every qualified chartered accountant who is not in full time employment can be the auditor of a maximum of twenty companies.
- In case of a partnership firm, the limit will be twenty companies for each individual partner. Hence, for a firm with three partners, the overall limit will be (20 × 3) = 60 companies.
- While computing the ceiling in case of a partnership firm, a partner with full time employment elsewhere should not be taken into account.
- If any chartered accountant is a partner in a number of audit firms, then all the firms together will be entitled to audit 20 companies with respect to such common partner.
- Similarly, if a chartered accountant is practicing individually and is also the partner in other firm or firms, the overall ceiling with respect to him as individual and also the partner will be 20 companies.
- While calculating the above ceiling, a joint audit assignment will be taken as one unit. Moreover, if an auditor is appointed to audit even a part of company's accounts, it will be considered as one unit.
- Every auditor, as an individual or as a partner of a firm can accept a maximum of 60 tax audit assignments.

Note: If any chartered accountant in practice, at any time, holds appointment of more than the specified number of audit assignments of companies, he shall be deemed to be guilty of professional misconduct. (Council General Guidelines 2008, Chapter VIII)

7.1.3 Resignation by a Company Auditor

According to Section 140(2) of Companies Act, 2013 read with Rule 8 of Company (Audit and Auditors) Rule 2014, a company auditor resigning from his post must comply with the following steps:

(i) The auditor shall file within a period of thirty days from the date of resignation, a statement in the prescribed Form ADT-3 with the company and the Registrar, indicating the reasons and other facts as may be relevant with regard to his resignation.

(ii) In case of companies referred to in sub-section (5) of Section 139, i.e., Govt. Companies 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 auditor shall file such statement with the Comptroller and Auditor-General of India.

If the auditor does not comply with the above provision, he or it shall be punishable with fine of fifty thousand rupees or the amount equal to the remuneration of the auditor, whichever is less, and in case of continuing failure, with further penalty of five hundred rupees for each day after the first during which such failure continues, subject to a maximum of two lakh rupees. [Section 140(3)]

7.1.4 Rotation of Company Auditor

A. Eligible Companies

The provisions for rotation of auditors shall be applicable to -

(i) Every listed company excluding one person companies and small companies.

(ii) Every unlisted public company having paid up share capital of rupees ten crore or more;

(iii) Every private limited company having paid up share capital of rupees fifty crore or more;

(iv) All other companies having public borrowings from financial institutions, banks or public deposits of rupees fifty crore or more.

B. Maximum Term

(i) No individual shall be appointed or reappointed as auditor for more than one term of five consecutive years.

(ii) No audit firm shall be appointed or reappointed as auditor for more than two terms of five consecutive years.

C. Additional Conditions for Rotation

(i) An individual auditor or an audit firm who/which has completed his/its term shall not be eligible for re-appointment as auditor in the same company for five years from the completion of such term.

(ii) 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:

(iii) Every company, existing on or before the commencement of this Act, which is required to comply with provisions of Section 139(2), shall comply with requirements of this sub-section within a period which not be later than the date of the first AGM of the company held within the period specified in Section 96(1), after 3 years from the date of commencement of Companies Act.

(iv) The above provisions shall not prejudice the right of the company to remove an auditor or the right of the auditor to resign from such office of the company.

D. Rotation of Partners in the Audit Firm

According to Section 139(3), the members of a company may resolve to provide that -

(i) 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

(ii) the audit shall be conducted by more than one auditor.

E. Manner of Rotation of Auditors by the Companies on Expiry of Their Term

As per Section 139(4), the Central Government may, by rules, prescribe the manner in which the companies shall rotate their auditors in pursuance of Section 139(2). Accordingly, the Central Government has prescribed the following provisions under Rule 6 of the Company (Audit and Auditor) Rules 2014.

(i) Where a company is required to constitute an Audit Committee u/s 177 of the Act, 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.

(ii) Where a company is not required to constitute an Audit Committee u/s 177 of the Act, the Board shall consider the matter of rotation of auditors and make its recommendation for appointment of the next auditor by the members in annual general meeting.

Note: For the purpose of the rotation of auditors –

(i) 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.

The term "same network" shall include the firms operating or functioning, hitherto or in future, under the same brand name, trade name or common control.

Note: For the purpose of rotation,

(i) a break in the term for a continuous period of five years shall be considered as fulfilling the requirement of rotation;

(ii) 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.

7.1.5 Remuneration of Company Auditor

Section 142 of Companies Act, 2013 contains the statutory provisions in relation to remuneration of auditors are contained in. These are as follows:

(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. The Board may, however, fix remuneration of the first auditor appointed by it.

(2) The above remuneration shall be in addition to the fee payable to an auditor and shall include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him. However, it must not include any remuneration paid to him for any other service rendered by him at the request of the company.

7.1.6 Removal of the Company Auditor

According to Companies Act, 2013, a company auditor can be removed from his office in two ways as follows:

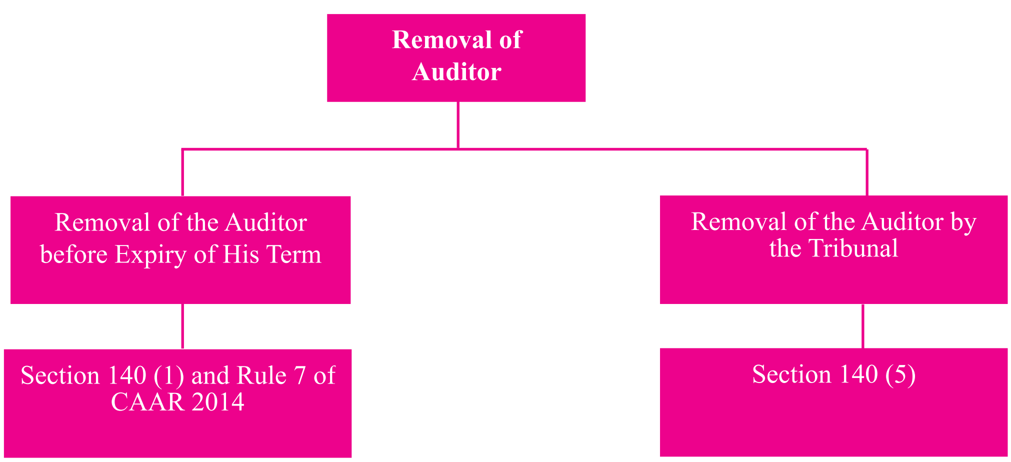

Figure 7.2: Different Ways of Removal of a Company Auditor

A. Removal of the Auditor before Expiry of his Term

The auditor appointed under Section 139 may be removed from his office before the expiry of his term, subject to the fulfilment of the following conditions under Section 140 (1) read with Rule 7 of CAAR 2014:

(i) An application to the Central Government for removal of the auditor shall be made in Form ADT-2. The application shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.

(ii) The application shall be made to the Central Government within thirty days of the resolution passed by the Board.

(iii) The company shall hold the general meeting within sixty days of receipt of approval of the Central Government for passing the special resolution for removal of the said auditor.

(iv) The auditor concerned shall be given a reasonable opportunity of being heard.

B. Removal of the Auditor by the Tribunal

As per Section 140(5), an auditor can be removed from his office by the Tribunal in the following manner:

(i) The Tribunal either suo motu or on an application made to it by the Central Government or by any person concerned, may, by order, direct the company to change its auditor, if it is satisfied that the auditor 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.

(ii) 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 to the removal of the auditor from his office.

(iii) The Central Government may appoint another auditor in his place.

(iv) 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.

Note: For this purpose, the word 'auditor' shall include a firm of auditors. Moreover, in 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 directors or officers.

7.1.7 Rights and Duties of the Company Auditor

7.1.7.1 Rights of the Company Auditor

Effective discharge of duties on the part of the auditor requires certain rights and power which are legally protected. Accordingly, the Companies Act, 2013 provides the following statutory rights to a company auditor:

(i) **Inspect Books of Accounts and Vouchers:** Every auditor of a company shall have the 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. In addition, auditor of a holding company shall also have the right of access to the records of all its subsidiaries and associate companies in so far as it relates to the consolidation of its financial statements with that of its subsidiaries [Section 143(1)].

(ii) **Obtain Information and Explanations:** The auditor 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 the auditor [Section 143(1)].

(iii) **Inspect Branch Offices and Branch Accounts:** The company auditor is also entitled to inspect the accounts of any branch office in case he considers it necessary in order to discharge his duties as the company auditor. He can do so, even if a separate auditor has already been appointed to audit the branch accounts [Section 143(8)].

(iv) **Receive the Report of Branch Audit from the Branch Auditor:** In case a separate auditor has been appointed to audit the branch accounts, the company auditor has the right to receive the branch audit report from the branch auditor so appointed and use it to prepare the overall audit report [Section 143(8)].

(v) **Sign the Audit Report and Other Documents:** The company auditor also has the right to 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 [Section 145].

(vi) **Have Audit Report Read at the AGM:** The company auditor has the right to have the report read before the company in the General Meeting (especially in case the qualifications, observations or comments on financial transactions or matters, mentioned in the auditor's report, have any adverse effect on the functioning of the company) and the same shall be open to inspection by any member of the company [Section 145].

(vii) **Receive Notices and Attend General Meetings:** The company auditor is entitled to receive all notices of, and other communications relating to, any general meeting and to attend such meetings either by himself or through his authorised representative, who shall also be qualified to be an auditor. The auditor shall also have the right to be heard at such meeting on any part of the business which concerns him as the auditor [Section 146].

(viii) **Attend the Meeting of the Audit Committee:** The auditors of a company shall have a right to attend the meetings of the Audit Committee and to be heard in the meetings when the Committee considers the auditor's report, but shall not have the right to vote [Section 177(7)].

(ix) **Right to be Indemnified:** The auditor of a company shall also have the right to be indemnified for any expenses incurred by him in defending himself in case the judgement in any law suit (whether civil or criminal) against the company goes in favour of the auditor.

The above rights of a company auditor are protected by law and no clause of the Articles of Association of a company or resolution adopted in any meeting can supersede them.

7.1.7.2 Duties of the Company Auditor

The Companies Act, 2013 provides a comprehensive list of duties of a company auditor. These are enumerated below:

- **Duty to Inquire:**

As per Section 143(1), it is the duty of the auditor to inquire into the following matters:

(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) In case of a company other than 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.

⊙ **Duty to Report on Financial Statements of the Company**

As per Section 143(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 after taking into account the provisions of this Act, the accounting and auditing standards etc. Additionally, he has also to report whether in his opinion and according 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.

⊙ **Duty Regarding Inclusion of Certain Matters in the Audit Report**

As per Section 143(3), the auditor's report shall also clearly 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 the law have been kept by the company 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 by a person other than the company's auditor has been sent to him 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 subsection (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 with reference to financial statements in place and the operating effectiveness of such controls.

(j) The auditor's report shall also include his views and comments on the following matters, namely:

    (i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(ii) 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;

(iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company;

(iv) (1) whether the management has represented that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries.

(2) whether the management has represented, that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and

(3) based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (1) and (2) contain any material mis-statement.

(v) whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.

(vi) whether the company, in respect of financial years commencing on or after the 1st April, 2022, has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and the same has been operated throughout the year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention.

⊙ Duty to Provide Reasons for any Negative Remarks/Qualification

According to Section 143(4), where any of the above-mentioned matters required to be included in the audit report is answered in the negative or with a qualification, the report shall state the reasons therefor.

⊙ Duty to Comply with the Directions of CAG

As per section 143(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 auditor shall, in his report, include–

(i) The directions, if any, issued by the Comptroller and Auditor-General of India regarding the manner of audit of accounts; and

(ii) The action taken on such directions and its impact on the accounts and financial statement of the company.

⊙ Duty to Comply with Auditing Standards

Section 143(9) provides that it is the duty of every company auditor to comply with the applicable auditing standards in conduct of his audit.

⊙ Duty to Report any Fraud to the Central Government

According to Section 143(12) read with Rule 13 of the Company (Audit and Auditors) Rules 2014 -

(1) If an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of rupees one crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

(2) The auditor shall report the matter to the Central Government as under:

(a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than two days of his knowledge of the fraud, seeking their reply or observations within forty-five days;

(b) 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 from the date of receipt of such reply or observations;

(c) 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 has not received any reply or observations;

(d) 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;

(e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and

(f) The report shall be in the form of a statement as specified in Form ADT-4.

(3) In case of a fraud involving lesser than the amount specified in sub-rule (1), the auditor shall report the matter to Audit Committee constituted under Section 177 or to the Board immediately but not later than two days of his knowledge of the fraud and he shall report the matter specifying the following:

(a) Nature of Fraud with description;

(b) Approximate amount involved; and

(c) Parties involved.

The provisions of this section regarding the duties of an auditor also apply to the cost accountant conducting cost audit under Section 148 and the company secretary in practice conducting secretarial audit under Section 204 [Section 143(14)].

⊙ Duty to Pay Penalty

As per Section 143 (15), if any auditor, cost accountant or company secretary in practice fails to comply with the provisions of sub-section (12) of Section 143, he will be liable –

(a) in case of a listed company, to pay a penalty of five lakh rupees; and

(b) in case of any other company, to pay a penalty of one lakh rupees.

⊙ **Duty to Make Comments Sought by the Audit Committee on Certain Matters**

According to Section 177(5), it is the duty of the company auditor to offer comments on internal control systems, the scope of audit, including the observations of the auditors and review of financial statement, if asked by the Audit Committee.

⊙ **Other Duties under Companies Act, 2013**

In addition to the above, the auditor shall have the following duties under the Companies Act, 2013 –

(i) To report on the accounts of the company which will be included in the prospectus of the company while issuing new shares [Section 26].

(ii) To sign on the audit report [Section 145].

7.1.8 Liabilities of the Company Auditor

The duties of a company auditor have been specified in various provisions of the Act. Accordingly, if a company auditor fails to discharge his specified duties, he will be legally held liable. Moreover, there are a number of occasions where an auditor may be held liable to his appointing authority, the Government or any other persons.

The liabilities of an auditor may be discussed as follows:

A. Statutory Liabilities

I. Under Companies Act, 2013

⊙ **Civil Liabilities:** The civil liabilities as per Companies Act, 2013 are stated below:

(a) **For Misstatement in the Prospectus:** As per Section 35, where a person has subscribed for securities of a company acting on any statement included in the prospectus, or on the inclusion or omission of any matter in the prospectus which is misleading and thereby has sustained any loss or damage and where the auditor as an expert has either made such statement or has given written consent to the issue of the prospectus, he shall be held liable.

(b) **Liability for Misfeasance:** Misfeasance implies breach of trust or negligence in the performance of duties. As per Section 340, a company auditor may be charged with misfeasance only at the time of liquidation of the company, if it is found that he -

(i) has misapplied, or retained, or become liable or accountable for, any money or property of the company; or

(ii) has been guilty of any misfeasance or breach of trust in relation to the company.

⊙ **Criminal Liability:** The criminal liabilities of an auditor under the Companies Act, 2013 are as follows:

(a) **Criminal Liability for Misstatement in the Prospectus:** As per Section 34, where the auditor has authorised the issue of any prospectus which includes any statement which is untrue or misleading or where the prospectus has included or omitted any matter which may mislead, the auditor shall be held liable under Section 447.

Accordingly (i.e., as per Section 447), for any fraud, involving an amount of at least ten lakh rupees or one per cent of the turnover of the company, whichever is lower, the auditor shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud. Moreover, where the fraud in question involves public interest, the term of imprisonment shall not be less than three years.

However, where the fraud involves an amount less than ten lakh rupees or one per cent of the turnover of the company, whichever is lower, and does not involve public interest, any person guilty of such fraud shall be punishable with imprisonment for a term which may extend to five years or with fine which may extend to fifty lakh rupees or with both.

(b) Punishment for Non-compliance with Sections 139, 144 and 145 of the Act: As per Section 147 -

(i) If an auditor contravenes the provisions of Section 139, 144 or 145, he shall be punishable with fine which shall not be less than ₹25,000 but which may extend to ₹5,00,000 or four times the remuneration of the auditor, whichever is less.

(ii) If an auditor has contravened the above 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 1 year and with fine which shall not be less than ₹50,000 but which may extend to ₹25,00,000 or eight times the remuneration of the auditor, whichever is less.

(iii) Convicted auditor shall be liable to refund the remuneration received by him from the company and pay for damages to the company, statutory bodies or authorities or to members or creditors of the company for loss arising out of incorrect or misleading statements of particulars made in his audit report.

(iv) In case where the audit of a company is being conducted by an audit firm, if 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, the company or its directors or officers, the partner or partners concerned of the audit firm as well as the firm itself shall be liable for fine jointly and severally. However, for criminal liability other than fine, only the partner or partners will be liable.

(c) Punishment for Refusal or Failure to Produce Documents: As per Section 217, if any auditor fails without reasonable cause or refuses to produce to an inspector or any person authorised by him in this behalf any book or paper, to furnish any information, to appear before the inspector personally when required, to answer any question which is put to him by the inspector, or to sign the notes of any examination referred to in sub-section (7) of Section 217, he shall be punishable with imprisonment for a term which may extend to six months and with fine ranging from twenty-five thousand rupees to one lakh rupees, and also with a further fine which may extend to two thousand rupees for every day after the first during which the failure or refusal continues.

(d) Fraud in Relation to a Company in Winding-up: As per Section 336, if any auditor is engaged in any fraudulent activities in relation to any company in winding up, he shall be punishable with imprisonment for a term which shall not be less than three years but which may extend to five years and with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees.

(e) Punishment for False Statement: As per Section 448, if any auditor deliberately makes any false statement in any return, report, certificate, financial statement, prospectus, statement or other document required by the act or deliberately omits any material fact, he shall be liable under Section 447 and shall be subject to the punishment as stated earlier in point (a).

(f) Punishment for False Evidence: As per Section 449, if the auditor intentionally gives false evidence upon any examination on oath or solemn affirmation or in any affidavit, deposition or solemn affirmation, in or about the winding up of any company or about any matter under this Act, he shall be punishable with imprisonment for a term which shall not be less than three years but which may extend to seven years and with fine which may extend to ten lakh rupees.

II. Under Other Acts

- **Liabilities under Income Tax Act, 1961:** As per Section 278 of the Act, if any auditor abets or induces in any manner another person to make and deliver an account, statement or declaration relating to any income chargeable to tax which is false and which the auditor either knows or does not believe to be true, the auditor shall be punished.
- **Liabilities under Chartered Accountants Act, 1949:** Schedule I and II of the Act contains a list of instances where a Chartered Accountant shall be held guilty of professional misconduct under Section 22 of the Act.
- **Liabilities under Life Insurance Act, 1956:** As per Section 104 of the Act, if an auditor makes any false statement in any return, report or other such forms to be issued under this Act, he shall be sentenced to imprisonment or fine or both.
- **Liabilities under Banking Regulation Act, 1949:** As per Section 46 of the Act, if an auditor in any return, balance sheet, or other document wilfully makes a statement, which is false in any material particulars, knowing it to be false, or wilfully omits to make a material statement, he shall be held liable.

B. Contractual Liabilities

The scope of any audit work is determined by the written contract entered into between the auditor and the client. Thus, if any of the terms of the said contract is contravened, the auditor may be held liable under the Indian Contract Act, 1872.

In case of absence of any written contract between the auditor and the appointing authority, the auditor is expected to conduct complete audit. Hence, if in such a circumstance, he conducts only partial audit and any error or fraud is discovered later on, he shall be held liable.

Moreover, an auditor shall also be held liable if he discloses any secret information of the client to any third party. In the case Wilde and Others vs. Cape and Dalgeish (1897) also, it was held that if the client suffers any loss due to the auditor not complying with the contract, the auditor will have to compensate the client for such loss.

7.1.9 Branch Audit

Section 128(1) of the Companies Act, 2013 provides that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statements for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting.

The Board of Directors may, however, decide to keep all or any of the aforesaid books of account and other relevant papers at such other place in India. In such circumstances, the company shall, within seven days thereof, file with the Registrar a notice in writing giving the full address of that other place.

Section 128(2) further specifies that, where a company has a branch office in India or outside India, it shall be deemed to have complied with the provisions of Section 128(1), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns periodically are sent by the branch office to the company at its registered office or the other place as decided.

Hence, given the provisions of Section 128(1) and 128(2), there arises the scope of auditing the records of transactions effected at branch office(s) in India or outside India, whether such records are kept at the registered office, branch office or any other place.

Accordingly, Section 143(8) of the Companies Act, 2013, read with Rule 12 of CAAR 2014, states the following provisions relating to the accounts of a branch office of a company:

(i) 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.

(ii) 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.

(iii) 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.

(iv) Similarly, if the branch auditor is appointed separately, the duties and powers of the branch auditor shall be as same as applicable to the company auditor under sub-sections (1) to (4) of Section 143.

(v) The branch auditor shall submit his report to the company's auditor.

(vi) Provisions of sub-section (12) of Section 143 regarding reporting of fraud by the auditor shall also extend to the branch auditor to the extent it relates to the concerned branch.

7.1.10 Joint Audit

7.1.10.1 Concept of Joint Audit

Joint audit refers to the process of conducting the audit of a single organisation by more than one auditor. Large Companies with diversified business operations often resort to this process of auditing where they employ multiple auditors to conduct statutory audit. The basic aim in applying joint audit is to pull the resources of multiple auditors to conduct audit efficiently and within lesser amount of time.

7.1.10.2 Benefits of Joint Audit

The benefits of joint audit are as follows:

a) Joint audit reduces the workload of a single auditor.

b) Since different auditors may be engaged to handle different parts of accounts, timely completion of work is possible even in a large organisation.

c) The auditors may share their expertise and solve critical problems in the process.

d) Joint audit improves the quality of audit work to a great extent.

e) There may be healthy competition among the auditors which improves the quality and speed of the audit work.

f) Under joint audit, it is possible to get the benefit of extensive knowledge of different auditors at the same time.

7.1.10.3 Limitations of Joint Audit

The limitations of joint audit are enumerated below:

a) Established auditors may have a superiority complex over the less experienced one.

b) It is not suitable for a small entity due to substantial cost burden.

c) At times, lack of coordination among the auditors may slow down the speed of work.

d) There may be uncertainty about the liability of any work.

e) Areas of common concern may be neglected.

f) The auditors have to share the fees.

7.1.10.4 Guidelines on Joint Audit

SA 299, Responsibility of Joint Auditor, has prescribed the following guidelines with respect to joint audit:

A. Division of Work:

a) Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible.

b) In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time.

c) Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors.

d) The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

B. Co-ordination

Where, in the course of his work, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgement by, other joint auditors, he should communicate the same to all the other joint auditors in writing. This should be done by the submission of a report or note prior to the finalisation of the audit.

C. Relationship among Joint Auditors and Their Responsibility

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.

If any matters of the nature referred to in (B) above are brought to the attention of the entity or other joint auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible for those matters.

D. Dependence on Other Auditors

Each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner. Each joint

auditor is entitled to rely upon the other joint auditors for bringing to his notice any departure from generally accepted accounting principles or any material error noticed in the course of the audit.

E. Reporting Responsibilities

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.

7.1.11 Role of Audit Committee

7.1.11.1 Concept of Audit Committee

Regulators across the world have suggested strict corporate governance codes to minimize corporate frauds by management. Since, an independent audit report may, to a great extent, reveal the existence of frauds in corporate accounts, ensuring independence of audit can significantly help in enhancing fair conduct or good governance. Thus, governance codes have been designed to incorporate a number of regulations to ensure auditor's independence, elimination of the scope of any conflict of interest on the part of the auditor as consultant, review of auditor's performance etc. by establishing a separate committee known as Audit Committee.

The concept of audit committee is not new in India. Clause 49 of the Listing Agreement as issued by SEBI had specified such a requirement long ago. However, such a requirement was limited to only listed companies and not for all others. The new Companies Act 2013 has broadened the scope further by bringing it in the purview of the Act.

7.1.11.2 Provisions of Companies Act 2013 regarding Audit Committee

A. Formation of Audit Committee: As per Section 177(1) read with Companies (Meetings of Board and its Powers) Rules, 2014, the Board of directors of every listed company and the following classes of companies shall constitute an Audit Committee of the Board-

(i) all public companies with a paid-up capital of ten crore rupees or more;

(ii) all public companies having turnover of one hundred crore rupees or more;

(iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

B. Composition: The Audit Committee shall consist of a minimum of three directors with independent directors forming a majority: Moreover, majority of members of Audit Committee including its Chairperson shall be persons with ability to read and understand, the financial statement. [Section 177(2)]

C. Broad Functions of Audit Committee: As per Section 177(4) of the Act, The Board shall specify, in writing, the terms of reference for the Audit Committee which shall, inter alia, include —

(i) the recommendation for appointment, remuneration and terms of appointment of auditors of the company;

(ii) review and monitor the auditor's independence and performance, and effectiveness of audit process;

(iii) examination of the financial statement and the auditors' report thereon;

(iv) approval or any subsequent modification of transactions of the company with related parties:

(v) scrutiny of inter-corporate loans and investments;

(vi) valuation of undertakings or assets of the company, wherever it is necessary;

(vii) evaluation of internal financial controls and risk management systems;

(viii) monitoring the end use of funds raised through public offers and related matters.

D. Power of Audit Committee

(a) Committee may ask for Auditor's Comment: The Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, the observations of the auditors and review of financial statement before their submission to the Board. The Committee may also discuss any related issues with the internal and statutory auditors and the management of the company. [Section 177(5)]

(b) Investigation: The Audit Committee shall have authority to investigate into any matter in relation to the items specified in Section 177(4) or referred to it by the Board. For this purpose, the Committee shall have power to obtain professional advice from external sources and have full access to information contained in the records of the company. [Section 177(6)]

(c) Board's Report and Audit Committee: The Board's report under sub-section (3) of section 134 shall disclose the composition of an Audit Committee and where the Board had not accepted any recommendation of the Audit Committee, the same shall be disclosed in such report along with the reasons therefor. [Section 177(8)]

(d) Whistle Blowing Policy: Every listed company and company accepting public deposits or borrowing in excess of fifty crore rupees from banks and financial institutions shall establish a vigil mechanism for directors and employees to report genuine concerns in such manner as may be prescribed. [Section 177(9)]

(e) Safeguards against Victimization: The vigil mechanism under sub-section (9) shall provide for adequate safeguards against victimization of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases. The company shall disclose establishment of such mechanism on its website, if any, and in the Board's report. [Section 177(10)]

7.1.12 Solved Cases

Case 1

M/S ABC & Co. is an audit firm having partners A, B and C. All of them are qualified Chartered Accountants. The firm has been offered the appointment as a company auditor of X Ltd. for the financial year 2020-21. Mr. P, a relative of Mr. A, is holding is holding 6,000 shares (face value of ₹10 each) in X Ltd. having market value of ₹1,75,000. As a legal expert, advise ABC & Co. as to whether the offer is acceptable or not.

Solution:

As per section 141(3)(d)(i), a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner 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. However, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹1,00,000.

In the given case, M/s ABC & Co. is an audit firm having partners A, B and C all of whom are qualified Chartered Accountants.

Solved Cases

Mr. P is a relative of Mr. A and he is holding shares of X Ltd. of face value of ₹60,000 only (6,000 shares x ₹10 per share).

Therefore, M/s ABC & Co. is not disqualified for appointment as an auditor of X Ltd. as the relative of Mr. A (i.e., a partner of M/s ABC & Co.) is holding the securities in X Ltd. which is within the limit mentioned in proviso to section 141(3)(d)(i) of the Companies Act, 2013

Case 2

XYZ & Co. is an Audit Firm having partners X, Y and Z, Chartered Accountants. X, Y and Z are currently holding appointment as an Auditor in 3, 5 and 9 companies respectively. The firm has asked for your legal expertise to suggest the following:

a. The maximum number of audits remaining in the name of XYZ & Co.

b. The maximum number of audits remaining in the name of individual partners.

c. Can the firm accept the appointment as an auditor in 55 private companies having paid- up share capital less than ₹100 crore, 3 small companies and 2 dormant company?

d. How would your answer differ, if out of those 55 private companies, 45 companies are having paid-up share capital of ₹105 crore each?

Solution:

As per Section 141(3)(g) of the Companies Act, 2013, a person or a partner of a firm shall not be eligible for appointment as the auditor of a company if –

(i) Such person is in full time employment elsewhere; or

(ii) Such person or partner is, at the date of such appointment or reappointment, holding appointment as auditor of more than twenty companies, other than one person companies, dormant companies, small companies and private companies having paid up capital less than ₹100 crore.

a. In the given case, the firm having three partners is eligible to an overall ceiling of 3 × 20 = 60 company audits. Since the three partners, in their individual capacity currently holds the position of a company auditor in (3 + 5 + 9) = 17 companies, the firm is eligible to be appointed as the auditor of remaining (60 - 17) = 43 companies.

b. The partners in their individual capacity are eligible to the following maximum additional number of company audit assignments:

   Mr. X = 20 – 3 = 17

   Mr. Y = 20 – 5 = 15

   Mr. Z = 20 – 9 = 11

c. Since audit assignments in dormant companies, small companies and private companies having paid up capital less than ₹100 crore, are excluded from the above ceiling, the firm XYZ & Co. can accept the appointment as an auditor in 55 private companies having paid- up share capital less than ₹100 crore, 3 small companies and 2 dormant company.

d. If 45 companies out of the 55 companies are having paid-up share capital of ₹105 crore each, the firm will be eligible to accept the appointment in only 43 such companies.

Cost Audit 7.2

7.2.1 Concept and Definition of Cost Audit

In a competitive business world, decisions on pricing policy, product or service mix, utilization of idle capacity etc. often requires dependable cost data. Hence, an independent and critical appraisal of the cost records and cost accounts is imperative. Cost audit is the independent and critical examination of the cost data to authenticate the results relating to ascertainment of cost and adherence to the available regulatory guidelines.

According to the Institute of Cost and Management Accountants of England, cost audit represents the verification of cost accounts and a check on the adherence to cost accounting plan. Cost audit, therefore, comprises:

(a) Verification of cost accounting records such as the accuracy of the cost accounts, cost reports, cost statement, cost data and costing techniques, and

(b) Examination of these records to ensure that they adhere to the cost accounting principles, plans, procedures and objectives.

According to The Institute of Cost Accountants of India, cost audit is an independent examination of cost and other related information in respect of a product or group of products of an entity whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.

7.2.2 Importance of Cost Audit

The growing importance of cost audit can be attributed to the following facts:

a) Cost audit provides authentic data on cost data and thereby helps in making decisions on pricing policy, product mix, outsourcing, discontinuance of product etc.

b) Cost audit identifies the inefficiencies and thereby helps in improving the productivity.

c) Cost audit helps in ensuring the optimum utilization of limited resources. The benefits are extended to the customers.

d) Cost audit appraises the cost control mechanism followed in the organisation.

e) Audited cost data may form the basis for determining the standard cost data.

f) Government often decides on extending or abolishing tariff protection based on audited data on cost structure of the product.

7.2.3 Regulatory Framework of Cost Audit in India

Section 148(1) of the Companies Act 2013 authorizes the Central Government to make it mandatory, by order, the maintenance of cost records (relating to the utilisation of material or labour or to other items of cost as may be prescribed) for certain classes of companies.

Section 148(2) also empowers the Central Government to issue orders to make audit of cost records of above-mentioned companies mandatory.

Accordingly, the Ministry of Corporate Affairs issued the Companies (Cost Records and Audit) Rules 2014 on 30.06.2014 which was further amended through Companies (Cost Records and Audit) Amendment Rules 2014 and made effective from 31.12.2014. The Rules were further amended subsequently (The latest being the amendments in 2019).

This Rule has divided the list of companies required to maintain the cost records into two categories namely (i) regulated sector and (ii) non-regulated sector as follows:

A. Regulated Sectors

Sl. No.	Industry /Sector/ Product/Service	Customs Tariff Act Heading (wherever applicable)
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 natureand regulated by the Telecom Regulatory Authority of India under the Telecom Regulatory Authority of India Act, 1997 (24 of 1997); including activities that requires authorisation or license issued by the Department of Telecommunications, Government of India under Indian Telegraph Act, 1885 (13 of 1885);	Not applicable
2	Generation, transmission, distribution and supply of electricity regulated by the relevant regulatory body or authority under the Electricity Act, 2003 (36 of 2003);	Generation – 2716; Other Activity – Not Applicable
3	Petroleum products; including activities 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; Other Activity – Not Applicable
4	Drugs and pharmaceuticals;	2901 to 2942; 3001 to 3006.
5	Fertilisers;	3102 to 3105.
6	Sugar and industrial alcohol;	1701; 1703; 2207.

B. Non-regulated Sectors

Sl No	Industry/ Sector/ Product/ Service	CETA Heading (wherever applicable)
1	Machinery and mechanical appliances used in defense, 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; 8801 to 8805; 8901 to8908.
2	Turbo jets and turbo propellers;	8411
3	Arms and ammunitions and Explosives	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 ninety per cent or more by the Government or Government agencies	8710
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;	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	Iron and 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; (18 of 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	Coffee and tea;	0901 to 0902
13	Railway or tramway locomotives, rolling stock, railway or tramway fixtures and fittings, mechanical (including electro mechanical) traffic signaling equipment's of all kind;	8601 to 8608, 8609
14	Cement;	2523; 6811 to 6812
15	Ores and Mineral products;	2502 to 2522; 2524 to 2526; 2528 to 2530; 2601 to 2617
16	Mineral fuels (other than Petroleum), mineral oils etc.;	2701 to 2708
17	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
18	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.
19	Jute and Jute Products	5303, 5307, 5310
20	Edible Oil;	1507 to 1518
21	Construction Industry as per para No. (5) (a) as specified in Schedule VI of the Companies Act, 2013 (18 of 2013)	Not applicable.

22	Health services, namely functioning as or running hospitals, diagnostic centres, clinical centres or test laboratories;	Not applicable.
23	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
24	Milk powder;	0402
25	Insecticides;	3808
26	Plastics and polymers;	3901 to 3914; 3916 to 3921; 3925
27	Tyres and tubes;	4011 to 4013
28	Paper;	4801 to 4802
29	Textiles;	5004 to 5007; 5106 to 5113; 5205 to 5212; 5303; 5310; 5401 to 5408; 5501 to 5516
30	Glass;	7003 to 7008; 7011; 7016
31	Other machinery;	8402 to 8487
32	Electricals or electronic machinery;	8501 to 8507; 8511 to 8512; 8514 to 8515; 8517; 8525 to 8536; 8538 to 8547.
33	Production, import and supply or trading of following medical devices, namely: (i) Cardiac stents; (ii) Drug eluting stents; (iii) Catheters; (iv) Intra ocular lenses; (v) Bone cements; (vi) Heart valves; (vii) Orthopaedic implants; (viii) Internal prosthetic replacements; (ix) Scalp vein set; (x) Deep brain stimulator; (xi) Ventricular peripheral shud; (xii) Spinal implants; (xiii) Automatic impalpable cardiac deflobillator; (xiv) Pacemaker (temporary and permanent);	9018 to 9022
	(xv) Patent ductus arteriosus, atrial septal defect and ventricular septal defect closure device; (xvi) Cardiac re-synchronize therapy; (xvii) Urethra spinicture devices; (xviii) Sling male or female; (xix) Prostate occlusion device; and (xx) Urethral stents:	

Following are the important provisions of Companies Act 2013 and Companies (Cost Records and Audit) Rules 2014 as amended up to date.

1. Application of Cost Records [Rule 3]

Rule-3 of the Companies (Cost Records and Audit) Rules, 2014 provides that all companies under regulated and non-regulated list, engaged in the production of goods or providing services, having an overall turnover from all its products and services of ₹35 crore or more during the immediately preceding financial year, are required to include cost records in their books of account. These companies shall also include Foreign Companies defined in Sub-section (42) of Section 2 of the Act, but exclude a company classified as a Micro Enterprise or a Small Enterprise as per the turnover criteria provided under Micro, Small and Medium Enterprise Development, 2006.

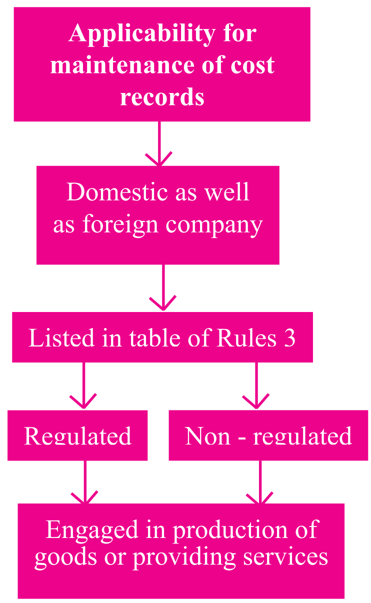

Figure 7.3 Applicability for Maintenance of Cost Records

2. Applicability for Cost Audit [Rule 4]

1) Every company specified in item (A) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees fifty crore or more and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees twenty-five crore or more.

2) Every company specified in item (B) of rule 3 shall get its cost records audited in accordance with these rules if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is rupees one hundred crore or more and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is rupees thirty-five crore or more.

3) The requirement for cost audit under these rules shall not apply to a company which is covered in rule 3; and

   (i). whose revenue from exports, in foreign exchange, exceeds seventy-five per cent of its total revenue; or (ii). which is operating from a special economic zone;

(iii). which is engaged in generation of electricity for captive consumption through Captive Generating Plant. **For this purpose, the term “Captive Generating Plant” shall have the same meaning as assigned in rule 3 of the Electricity Rules, 2005”.**

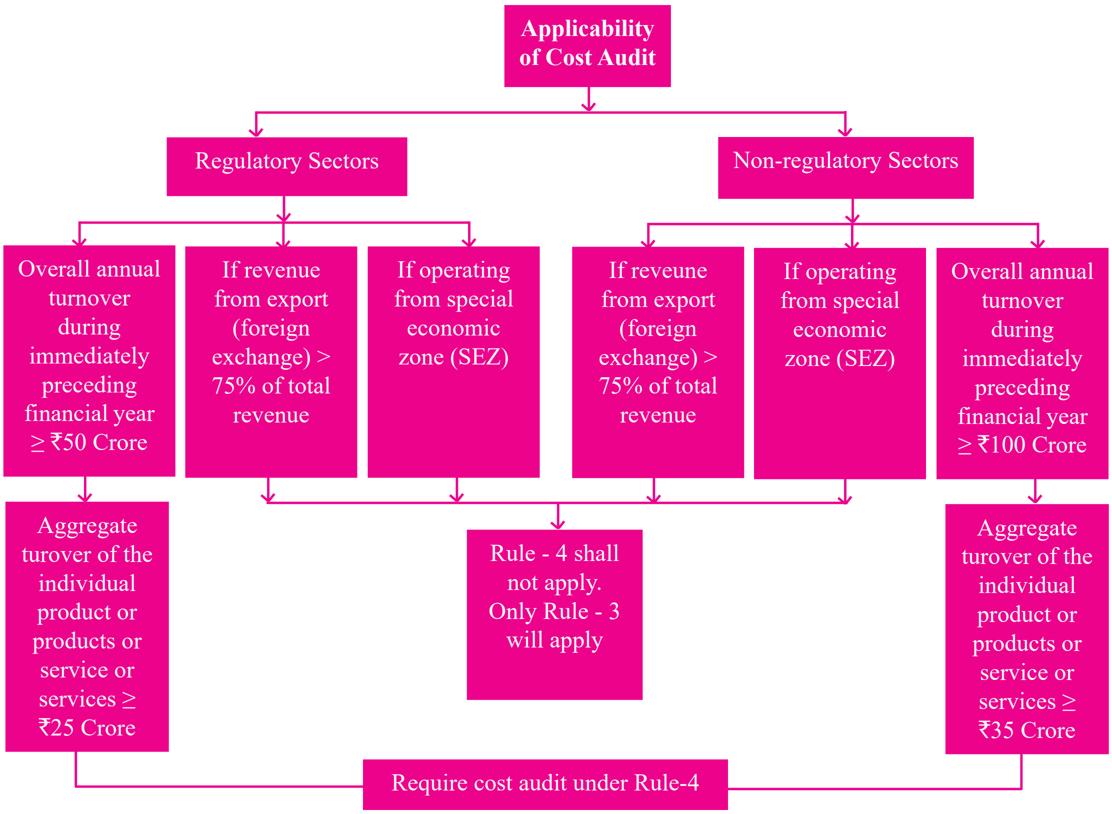

Figure 7.4: Applicability of Cost Audit

Section 148(4) of Companies Act, 2013 further states that an audit conducted under this section shall be in addition to the audit conducted under Section 143.

3. Maintenance of Records [Rule 5]

1) Every company under these rules including all units and branches thereof, shall, in respect of each of its financial year commencing on or after the 1st day of April, 2014, maintain cost records in form CRA-1.

   Provided that in case of company covered in serial number 12 and serial numbers 24 to 32 of item (B) of Rule 3 (i.e., Non-regulated sectors), the requirement under this rule shall apply in respect of each of its financial year commencing on or after 1st day of April, 2015.

2) The cost records referred to in sub-rule (1) shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis.

3) The cost records shall be maintained in such manner so as to enable the company to exercise, as far as possible, control over the various operations and costs to achieve optimum economies in utilisation of resources and these records shall also provide necessary data which is required to be furnished under these rules.

4. Appointment of Cost Auditor [Rule 6]

As per Section 148(3) of the Companies Act 2013, cost audit shall be conducted by a Cost Accountant who shall be appointed by the Board. No person appointed under Section 139 as an auditor of the company shall be appointed for conducting the audit of cost records. The auditor so appointed shall comply with the cost auditing standards.

Rule 6 of the Companies (Cost Records and Audit) Rules 2014 –

1) The category of companies specified in rule 3 and the thresholds limits laid down in rule 4, shall within one hundred and eighty days of the commencement of every financial year, appoint a cost auditor.

   Provided that before such appointment is made, the written consent of the cost auditor to such appointment, and a certificate from him or it, as provided in sub-rule (1A), shall be obtained.

1A) The cost auditor appointed under sub-rule (1) shall submit a certificate that -

   (a) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Act, the Cost and Works Accountants Act, 1959(23 of 1959) and the rules or regulations made thereunder;

   (b) the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Act, so far as may be applicable;

   (c) the proposed appointment is within the limits laid down by or under the authority of the Act; and

   (d) the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct."

2) Every company referred to in sub-rule (1) 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 30 days of the Board meeting in which such appointment is made or within a period of 180 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.

3) Every cost auditor appointed as such shall continue in such capacity till the expiry of 180 days from the closure of the financial year or till he submits the cost audit report, for the financial year for which he has been appointed.

   However, the cost auditor appointed under these rules may be removed from his office before the expiry of his term, through a board resolution after giving a reasonable opportunity of being heard to the Cost Auditor and recording the reasons for such removal in writing.

   Provided further that the Form CRA-2 to be filed with the Central Government for intimating appointment of another cost auditor shall enclose the relevant Board Resolution to the effect;

   Provided also that nothing contained in this sub-rule shall prejudice the right of the cost auditor to resign from such office of the company

3A) 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 within thirty days of occurrence of such vacancy and the company shall inform the Central Government in Form CRA-2 within 30 days of such appointment of cost auditor.

3B) The cost statements, including other statements to be annexed to the cost audit report, shall be approved by the Board of Directors before they are signed on behalf of the Board by any of the director authorised by the Board, for submission to the cost auditor to report thereon.

Note: in the case of companies which are required to constitute an audit committee, the Board shall appoint an individual, who is a cost accountant, or a firm of cost accountants in practice, as cost auditor on the recommendations of the Audit committee.

5. Disqualification of Cost Auditor

Persons disqualified u/s 141(3) shall not be appointed as the cost auditor of a company. Similarly, auditor of a company appointed u/s 139 shall not act as the cost auditor of the company.

6. Remuneration of Cost Auditor

As per Section 148(3) of the Companies Act 2013 read with Rule 14 of the Companies (Audit and Auditors) Rules 2014, the remuneration of the cost auditor shall be decided by the Board as recommended by the Audit Committee, if any, which shall be ratified by the shareholders subsequently. In the case of companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.

7. Rights and Duties of Cost Auditor

The rights, duties and obligations as applicable to the company auditors shall also apply to a cost auditor appointed under Section 148 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.

8. Submission of Cost Audit Report

As per Section 148(5) read with Rule 6 of the Companies (Cost Records and Audit) Rules 2014:

(a) Every cost auditor, who conducts an audit of the cost records of a company, shall submit the cost audit report along with his or its reservations or qualifications or observations or suggestions, if any, in Form CRA-3.

(b) The cost auditor shall forward his duly signed report to the Board of Directors of the company within a period of 180 days from the closure of the financial year to which the report relates and the Board of Directors shall consider and examine such report, particularly any reservation or qualification contained therein.

(c) The company covered under these rules shall, within a period of 30 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 in Extensible Business Reporting Language format in the manner as specified in the Companies (Filing of Documents and Forms in Extensible Business Reporting language) Rules, 2015 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014".

Provided that the Companies which have got extension of time of holding Annual General Meeting under section 96 (1) of the Companies Act, 2013, may file Form CRA-4 within resultant extended period of filing financial statements under section 137 of the Companies Act, 2013.

(d) If 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.

9. Forms Relevant to Cost Records and Cost Audit

Companies (Cost records and Audit) Rules 2014 provides for four different forms for separate purposes as follows:

(i) CRA-1 for the manner in which cost records shall be maintained.

(ii) CRA-2 for intimation of appointment of cost auditor by the company to Central Government

(iii) CRA-3 for cost audit report

(iv) CRA-4 for filing of cost audit report with the Central Government

10. Penal Provisions in Case of Default

According to Section 148(8), while complying with the aforesaid provisions if any default takes place –

(i) On the part of the company, the company shall be punishable with fine between ₹25,000 and ₹5,00,000 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 between ₹10,000 and ₹1,00,000. [sub-section (1) of Section 147]

(ii) 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.

11. Reporting Requirements of Cost Audit as per CRA-3

As per Companies (Cost Records and Audit) Rules 2014 as amended up to date, a cost auditor needs to report the following in CRA-3.

(a) Whether he has obtained all the information and explanations, which to the best of his knowledge and belief were necessary for the purpose of the audit.

(b) Whether in his opinion, proper cost records, as per rule 5 of the Companies (Cost Records and Audit) Rules, 2014 have been maintained by the company in respect of its product(s)/ service(s) under reference.

(c) Whether in his opinion, proper returns adequate for the purpose of the cost audit have been received from the branches not visited by him.

(d) Whether in his opinion, and to the best of his information, the said books and records give the information required by the Companies Act, 2013, in the manner so required.

(e) Whether in his opinion, the company has adequate system of internal audit of cost records which to his opinion is commensurate to its nature and size of the business.

(f) Whether in his opinion, information, statements in the annexure to the cost audit report give a true and fair view of the cost of production of product(s)/rendering of service(s), cost of sales, margin and other information relating to product(s)/service(s) under reference.

(g) Whether detailed unit-wise and product/service-wise cost statements and schedules thereto in respect of the product /service of the company duly audited and certified by him are kept in the company.

7.2.4 Illustrative Case Studies

Case 3

Mr. P, the cost auditor of ABC Ltd. who was appointed for financial year 2020-21, has resigned due to some personal reasons. As per the provisions of Companies Act, 2013, the company is required to constitute an audit committee. ABC Ltd. has asked for your opinion as a legal expert regarding the process of filling up the vacancy created. Advise ABC Ltd. on the required course of action.

Solution:

Rule 6 of the Companies (Cost Records and Audit) Rules 2014 states that 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 within thirty days of occurrence of such vacancy and the company shall inform the Central Government in Form CRA-2 within 30 days of such appointment of cost auditor.

In the given case the vacancy arising out of the resignation of the cost auditor is a casual vacancy. Hence, the BOD, after recommendation from the audit committee so existing, shall appoint the cost auditor within thirty days of occurrence of such vacancy and the company shall inform the Central Government in Form CRA-2 within 30 days of such appointment of cost auditor.

Secretarial Audit

7.3

7.3.1 Applicability and Conduct of Secretarial Audit

(a) The Companies Act 2013: As per the provision of Section 204(1) of the Companies Act, 2013 read with Rule 9 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014:

1. Every listed company;

2. Every public company having a paid-up share capital of 50 crore rupees or more; or

3. Every public company having a turnover of 250 crore rupees or more; or

4. Every company having outstanding loans or borrowings from banks or public financial institutions of 100 crore rupees or more.

- is required to annex with its Board's Report made in terms of Section 134(3) of the Companies Act, 2013, a Secretarial Audit Report, given by a Company Secretary in practice, in Form MR-3.

As per Section 204(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.

Moreover, Section 204(4) further provides that 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 liable to a penalty of two lakh rupees.

(b) SEBI Regulations: As per Regulation 24A of the SEBI(LODR) Regulations, 2015, every listed entity and its material unlisted subsidiaries incorporated in India shall undertake secretarial audit and shall annex a secretarial audit report given by a company secretary in practice, in such form as specified, with the annual report of the listed entity.

In addition to the above, every listed entity shall submit a secretarial compliance report in such form as specified, to stock exchanges, within sixty days from end of each financial year. (Amended by the SEBI (Listing Obligations and Disclosure Requirements) (Second Amendment) Regulations, 2021 w.e.f. 5.5.2021).

7.3.2 Qualification of a Secretarial Auditor

According to the provisions of Section 204, only a member of the Institute of Company Secretaries of India holding a certificate of Practice (i.e., PCS) is qualified to conduct secretarial audit of the company.

7.3.3 Appointment of Secretarial Auditor

As per Rule 8 of the Companies (Meetings of Board and its Powers) Rules, 2014, read with Section 179 of the Companies Act, 2013, secretarial auditor is required to be appointed by means of resolution 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.

The company shall report any change in the secretarial auditor during the financial year to the members through the Board's Report. The qualifications, observations or comments / remarks of the secretarial Audit Report shall be read at the annual general meeting of the company along with the explanation and comments of the Board of Directors (Clause 13 of Secretarial Standard 2).

7.3.4 Secretarial Audit Report

Section 204 of Companies Act, 2013 provides that Secretarial Audit Report is to be submitted in a format prescribed under Rules. As per sub-rule (2) of Rule 9 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014, the format of the Secretarial Audit Report shall be in Form MR-3. Section 134 and Sub-section (3) of Section 204 further provides that the Board of Directors, in its report, shall explain in full any qualification or observation or other remarks made by the company secretary in practice in the secretarial audit report.

In addition, Regulation 24A of the SEBI (LODR) Regulations, 2015 requires that every listed entity and its material unlisted subsidiaries incorporated in India shall undertake secretarial audit and shall annex a Secretarial Audit Report given by a company secretary in practice, in such form as specified, with the annual report of the listed entity. Every listed entity shall submit a Secretarial Compliance Report in such form as specified, to stock exchanges, within sixty days from end of each financial year. SEBI vide its Circular dated February 08, 2019 notified the formats for Annual Secretarial Audit Report and Annual Secretarial Compliance Report for listed entities and their material subsidiaries, effective from the financial year ended March 31, 2019.

7.3.5 Solved Cases

Case 4

P Ltd. is an unlisted public company with an authorised capital of ₹100 crore. The issued and paid-up capital of the company is ₹45 crore. During the financial year 2022-23, the company has been able to achieve a turnover of ₹225 crore. The company has taken a bank loan of ₹110 crore in the current financial year for business expansion. The company secretary of P Ltd. has asked for your opinion as a legal expert on whether the company is required to conduct a secretarial audit. Advise the company.

Solution:

As per the provision of Section 204(1) of the Companies Act, 2013 read with Rule 9 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014:

1. Every listed company;

2. Every public company having a paid-up share capital of 50 crore rupees or more; or

3. Every public company having a turnover of 250 crore rupees or more; or

4. Every company having outstanding loans or borrowings from banks or public financial institutions of 100 crore rupees or more.

In the given case, the company is an unlisted public company with paid up capital of ₹45 crore (less than ₹50 crore) and its turnover of ₹225 crore is also lower than the threshold of ₹250 crore. However, the company has an outstanding bank loan of ₹110 crore which is higher than the threshold of ₹100 crore. Thus, the company will need to conduct secretarial audit.

Audit of Various Items of Financial Statements (with Special Emphasis on Audit of Inventory and PPE)

7.4

7.4.1 Audit of Financial Statement Items - Concept

In India, the preparation of financial statements of companies are guided by accounting standards issued by The Institute of Chartered Accountants of India. These accounting standards constitute the broader framework of generally accepted accounting principles, also known as the Indian GAAP. In addition, the Companies Act, 2013, through Schedule III, provides the format to be followed while preparing the financial statements.

Audit of financial statements, therefore, refers to the process of examination of a company's financial statements and related disclosures in the 'Note to Accounts' section with respect to various items recorded in the financial statements.

7.4.2 Vouching and Verification

The traditional methods associated with the audit of financial statement items are known as Vouching and Verification.

Vouching refers to the examination of accuracy, authority and authenticity of transactions that appear in the books of accounts with the help of vouchers of these transactions. Thus, vouching examines whether –

(i) all transactions undertaken by the entity have been recorded and nothing has been purposefully left out.

(ii) transactions recorded in the books of accounts are supported by documentary evidence.

(iii) no fraudulent transaction has been recorded in the books of accounts.

(iv) transactions that have been recorded belong to the current accounting year (in case of accrual basis of accounting).

(v) necessary vouchers relating to entries recorded in books are with the client.

(vi) all transactions are properly authorised by the person responsible to do so.

(vii) transactions have been recorded at the correct value and such values have been calculated correctly.

(viii) transactions recorded in the books of accounts are related to the organisation.

(ix) proper accounting entries have been made against the transactions.

Verification, on the other hand, can be defined as a process of substantiation of assets and liabilities recorded in the books of account, by means of physical inspection and examination of legal and official documents, and then forming expert opinion as to the existence, ownership, possession, classification and valuation of assets and liabilities of an entity.

Thus, verification includes –

(i) Examination of existence of the assets or liabilities on the reporting date.

(ii) Examination of ownership and control of the asset or liabilities on the reporting date.

(iii) Examination of possession of the assets on the reporting date.

(iv) Examination of charges, if any, against the assets.

(v) Examination of accounting of assets or liabilities.

(vi) Examination of correctness of valuation of assets or liabilities.

(vii) Examination of adequacy of disclosures as required by the relevant regulation

Audit of financial statements applies both vouching and verification in examining various items of financial statements.

7.4.3 Role of Management Assertions in Designing the Audit Procedure in Audit of Financial Statements

The dictionary meaning of the term 'assertion' is 'a confident and forceful statement of fact or belief'. However, when used in the context of auditing, it refers to some implicit or explicit claims.

While preparing the financial statements of an entity, company's management makes various implicit or explicit claims i.e., assertions with regard to completeness, cut-off, existence/occurrence, valuation/ measurement, rights and obligations and presentation of assets, liabilities, income and expenditures and disclosure in accordance with the applicable accounting or financial reporting standards. Since an auditor is to appraise the truthfulness and fairness of financial performance and position as exhibited in the financial statements, he must design the audit procedure in such a way that these assertions by management are verified appropriately.

These assertions comprise the following:

Assertions with respect to Revenue and Expenses	Example (Purchase of Goods)
Occurrence	Recorded purchases represent goods actually received during the year.
Completeness	All purchases made during the year have been recorded and there is no understatement.
Cut-off	Purchase shall include all goods received and in transit as they belong to the relevant period.
Measurement	All purchases have been measured appropriately based on supporting vouchers.
Presentation and Disclosure	Required disclosures as per regulation, if any, have been appropriately done.

Assertions with respect to Assets and Liabilities	Example (Machinery)
Existence	The machinery included under the head 'Property, Plant and Equipment' as shown in the Balance Sheet do exist as at the period end.
Rights and Obligations	Company owns and controls the machinery.
Cut-off	Purchase and sale of machinery during the year are only included and affected in the machinery balance.
Completeness	All machinery owned and controlled by the organisation are included under the head 'Property, Plant and Equipment'.
Valuation	The machinery has been valued accurately following the valuation principles and depreciation charge is appropriate.
Presentation and Disclosure	Required disclosures as per the regulations, if any, have been appropriately done.

7.4.4 Audit of Income Statement Items

A. Revenue from Operation

Revenue from operation comprises sale of goods, sale of services and other operating revenues. Other operating revenue includes any revenue earned by the company from its operations other than its principal activities. For example, Discount Received, Bad Debt Recovery etc. For a finance company, revenue from operation primarily includes interest income and income from other financial services.

⊙ **Audit Procedure to be Followed**

Apart from evaluating the adequacy of internal control with respect to revenue related transactions, the auditor shall resort to the following audit procedure to audit the revenue from operations.

(a) Occurrence:

(i) The auditor should ensure that all revenue items recognised are genuine and no sale transactions have been recorded twice.

(ii) He may test check a few invoices with accounting entries. Further, he should check the sequence of sales invoices, review the recording of unusual transactions, verify the return transactions with sales invoice, challan, credit note and stock records.

(iii) He should also obtain confirmation from few customers to check whether the transactions are genuine.

(iv) He should ensure that no fake sale transactions have been recorded.

(v) For services, he must see that revenue has been recognised based on the policy undertaken.

(b) Cut-off

He shall see whether revenue from operation includes the sale made and services performed during the year only.

(c) Completeness

The auditor should verify that all sales effected during the year have been included in revenue. He should apply the cut-off procedure to ensure that revenues are recognised in the current accounting period and check if year end sale transactions have been tempered.

(d) Measurement

(i) The auditor shall see that revenues are accurately measured based on applicable Accounting Standards.

(ii) Trade discount allowed to the customers should be checked. No separate entry for trade discount should be passed in the books. If there is any significant variation in trade discount allowed to different customers, the auditor is required to inquire into the reason for such variations.

(iii) The sales tax, insurance charges, etc. collected through sales invoices must be recorded under separate accounts.

(e) Presentation and Disclosures

The auditor shall ensure the following disclosure for revenue from operation in respect of a company other than a finance company as per Schedule III (Part 2):

(i) Disclosure should be available for each class of goods.

(ii) Revenue from operations shall disclose separately in the notes revenue from - (a) Sale of products; (b) Sale of services; (c) Other operating revenues; Less: (d) Excise duty.

(iii) In respect of a finance company, revenue from operations shall include revenue from - (a) Interest; and (b)

Other financial services

(iv) Discount other than usual trade discount must be disclosed. Similarly, transactions with related parties should be separately disclosed in the Notes.

(v) In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.

B. Other Income

Other income comprises interest income (for companies other than a finance company), dividend income, net gain on sale of investments and other non-operating income such as royalties, lease rentals etc.

⊙ Audit Procedure to be Followed

The auditor shall resort to the following audit procedure to audit the other income:

(a) Occurrence

(i) The auditor shall obtain a list of new fixed deposits opened during the year along with the information on rate, tenure and date of investment.

(ii) He shall obtain a confirmation of interest income from bank. Also obtain a copy of Form 26AS of Income Tax to confirm the interest income and related TDS.

(iii) He should investigate the investment ledger further to see the new investments made in other securities such as corporate bonds, debentures and shares and check the interest and dividend income generated therefrom.

(iv) He should trace a sample of dividend/interest received from the cash book through dividend/interest warrants to investment certificates and their deposit into the bank.

(v) He should also check the net gain or loss on sale of investment based on relevant documents such as DEMAT and Trading Account details, transfer deeds etc.

(b) Cut-off

The auditor must ensure that interest income does not include any unearned interest and includes interest accrued on investment.

(c) Completeness

The auditor must ensure that all interest received and accrued and dividend received have been recorded and the recording has been done appropriately.

(d) Measurement

(i) The auditor must check the accuracy of interest calculation on new fixed deposits and fixed deposits existing on the opening date of the year.

(ii) He should also see that dividend income received is accurate.

(iii) In certain cases, dividends and interest are received by the client after deduction of tax at source. The auditor should ensure that dividends and interests are recorded at gross amounts.

(iv) If interest or dividend is received for the pre-acquisition period, the auditor should see whether proper adjustment has been made with the cost of investment for this preacquisition dividend or interest.

(e) Presentation and Disclosure

The auditor shall ensure the following disclosure as per Schedule III (Part 2):

(i) Other income shall be classified as: (i) Interest Income (in case of a company other than a finance company); (ii) Dividend Income; (iii) Net gain/loss on sale of investments; (iv) Other non-operating income (net of expenses directly attributable to such income).

C. Purchases

It is another important element of financial statements and is includes purchase of raw materials to be included in the cost of materials consumed in case of a manufacturing organisation and purchase of merchandise in case of a trading organisation. As a part of an audit exercise, the auditor examines the purchase transactions and related internal control to ensure that there is no material misstatement in the amount of purchase and accounts payable reported in the financial statements.

⊙ **Audit Procedure to be Followed**

The auditor shall resort to the following audit procedure to audit purchases:

(a) Occurrence

(i) The auditor must ensure that only genuine purchases have been recorded in the books of accounts. He may examine the purchase orders, goods received notes and purchase invoices to satisfy himself.

(ii) Photocopy of purchase invoices should not be allowed. Moreover, purchase invoices must be in the name of the entity.

(iii) He shall see whether all the purchases are approved by the relevant authority. The same is extremely important for purchases from related parties.

(b) Cut-off

The auditor shall see that only purchases during the year have been recognised as expense.

(c) Completeness

(i) He should apply the cut-off procedure to ensure that purchases effected during the year are only recognised in the current accounting period.

(ii) The auditor should see that purchase invoice should be booked only once the risk and reward incidental to the ownership has been transferred. He should be careful with delivery terms such as F.O.B and C.I.F etc.

(iii) The auditor must check the return transactions carefully based on relevant documents.

(iv) He shall ensure correct accounting for goods-in-transit.

(d) Measurement

(i) The auditor shall see that purchase transaction values have been correctly calculated considering the trade discount applied.

(ii) Information relating to input tax credit shall be verified. The auditor shall see that appropriate adjustments have been made in this respect.

(e) Presentation and Disclosure

The auditor shall see that the following disclosure as per Schedule III (Part 1) has been appropriately done:

(i) In the case of manufacturing companies, —

(1) raw materials under broad heads;

(2) goods purchased under broad heads;

(ii) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.

(iii) Transactions with related parties.

D. Employee Benefit Expenses

Employee benefit expenses represents the total amount payable by the organisation to its employees and essentially includes, apart from the wages and salaries in cash, all types of perquisites, post-employment benefits including gratuity, superannuation, leave encashment, provident fund contribution, ESI contribution as well as employee welfare expenses etc. In a company, often, these expenses constitute a significant portion of total cost and hence an auditor must put especial emphasis while auditing these items.

While conducting an audit of employee benefit expenses, an auditor must, at the beginning, obtain a detail understanding of the company's recruitment, promotion and retirement policies, remuneration schemes, various post-employment benefits. He should evaluate the internal control associated with these expenses. He should also apply substantive procedure to determine the reasonability of monthly cash outflow, consistency with the previous year's figures etc. so as to determine an expectation of monthly expenses and whether the same is consistent with peers.

⊙ **Audit Procedure to be Followed**

In addition, the auditor shall resort to the following audit procedure:

(a) Occurrence

(i) The auditor should ensure that all expenses included in the 'employee benefit expenses' are genuine.

(ii) He should obtain a complete list of employees with data on new hires, their appointment dates and remuneration terms and conditions.

(iii) For a sample of newly appointed employees, he may conduct a complete examination of their appointment and remuneration paid as per terms.

(iv) Similarly, he may collect a list of employees resigned or terminated during the year and see that their payments have been appropriately decided and settled.

(v) He should obtain the pay roll register and conduct and examination of reasonability of remuneration and investigate irregularities, if any.

(vi) He should also see that all adjustments such as outstanding salary, PF contribution, deposit of TDS, PF and ESI premium have been appropriately recorded.

(b) Cut-off

The auditor must ensure that only employee benefit expenses relating to current year have been recognised.

(c) Completeness

(i) The auditor shall see that all the employee benefit expenses have been appropriately recorded in the books of accounts.

(ii) He should also check whether all the amount of money deducted from salary have been duly deposited and if not, the same have been shown as a current liability.

(d) Measurement

(i) The auditor must see that the total amount of remuneration is correctly determined. He may conduct a test on a sample to check the same.

(ii) He should check whether statutory deductions have been accurate and post-employment benefits have been determined as per the policy adopted.

(e) Presentation and Disclosure

The auditor must see that the following disclosure requirements as per Schedule III (Part 1) have been duly complied with:

(i) Employee Benefits Expense shall be shown separately as (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses.

E. Depreciation and Amortisation

Depreciation is the charge representing the cost of a tangible asset allocated over its effective life. The similar charge for an intangible asset is known as amortization. Depreciation and amortisation constitute a significant portion of a company's total expenditure and hence have a direct bearing on profitability. Hence, the auditor needs to be extra careful in determining the appropriateness, accuracy and accounting of depreciation and amortization.

While conducting the audit of depreciation and amortization charges, the auditor should obtain a detail understanding of the organisation's depreciation policy, accounting policy relating to depreciation and should check the validity of the charge and calculation accuracy.

⊙ **Audit Procedure to be Followed**

In addition, the auditor shall resort to the following audit procedure:

(a) Occurrence

(i) The auditor shall obtain the fixed asset register and identify the items of assets acquired, sold and discarded during the year. This will help him to determine the items of assets eligible for depreciation and amortisation during the year.

(ii) He may select a sample of assets on materiality considerations and verify the rates and amount of depreciation and amortisation calculated.

(b) Cut-off

The auditor needs to ensure that depreciation is charged on the assets purchased from its date of put to use and not form purchase date. Moreover, he shall also see that, in case the company has a policy of charging depreciation on time basis, deprecation on items acquired during the year is calculated from the date of put to use to year end and for items sold, from the beginning of the year up to the date of sale.

(c) Completeness

(i) He must ensure that depreciation and amortisation have been charged on all eligible tangible and intangible assets respectively and no fake assets have been considered for this purpose.

(ii) The auditor shall see that the amount of depreciation and amortisation have been appropriately accounted in primary books and posted to appropriate accounts.

(iii) He shall also ensure that depreciation on revalued amount has been properly accounted from revaluation reserve.

(iv) He should also ensure that for any retrospective change in the method of depreciation, due effect has been given in the Income Statement.

(d) Measurement

(i) The auditor shall see that the rate of depreciation is consistent with the rates suggested in Schedule II and the amount of depreciation and amortisation has been calculated accurately based on the rates and time involved.

(ii) He shall ensure that the rates have been decided in conformity with the effective life of assets.

(iii) He should also see that residual value has been properly determined.

(iv) The auditor shall also see that in case of change in estimation of useful life or in case of impairment, the amount of depreciation has been calculated appropriately.

(e) Presentation and Disclosure

The auditor must see that the following disclosure requirements as per Schedule III (Part 1) have been duly complied with:

(i) Accounting policy for depreciation and amortisation.

(ii) Useful life of assets as per Schedule II.

(iii) Residual value and the method of depreciation.

F. Finance Cost

Generally, Finance Cost comprises of interest cost on structured debt instruments such as Debentures as well as traditional institutional finance such as Bank Loan, secured or unsecured. In order to conduct the audit of finance cost, the auditor must procure the schedule of loan and information relating to all structured debt instruments, the rate of interest applicable and the tenure of such loan based on which he shall be able to determine the amount of interest.

⊙ **Audit Procedure to be Followed**

In addition, the auditor shall resort to the following audit procedure:

(a) Occurrence

(i) The auditor shall see whether interest has been provided on all eligible debt instruments and loans.

(ii) He shall verify the amount of interest payment form bank statement and shall check the same with accounting entries in the cash book and general ledger.

(iii) He shall see that interest was paid and provided only in respect of loans outstanding either for a part of the year or for entire year.

(b) Cut-off

The auditor shall ensure that interest has been provided only for the period the loan was outstanding during the year.

(c) Completeness

The auditor shall ensure that interest due but not paid has also been considered as Accrued Interest and the same is appropriately accounted and shown in the financial statement.

(d) Measurement

(i) The auditor must verify the calculation of interest payable based on the rate, loan amount outstanding and the period for which the loan remains outstanding during the year.

(ii) He shall be extra careful with loan items repaid during the year and debentures redeemed during the year.

(e) Presentation and Disclosure

The auditor must see that the disclosure requirements as per Schedule III (Part 1) and various Accounting Standards (or Ind ASs) have been duly complied with.

G. Other Expenses

Other Expenses in the Statement of Profit and Loss include Power and Fuel, Rent, Repairs, Insurance, Travelling and Miscellaneous Expenses. These are some essential and incidental expenses to run the organisation. While conducting the audit of these expense, the auditor generally investigates whether the expenditure relates to the current accounting year, whether the same is a revenue expenditure and is valid as per the policy of the organisation, its classification in appropriate heading, authorisation and relevance for the business.

⊙ Audit Procedure to be Followed

In addition, the auditor shall resort to the following audit procedure:

(a) Occurrence

(i) The auditor needs to ensure that all expenditure charged against the revenue are genuine. For this purpose, he should vouch the expenditure based on relevant documents.

(ii) With respect to rent he should obtain a monthly expense schedule along with the rent agreements and verify whether the agreement is in the name of the company and whether the rent for all the months has been recorded.

(iii) With respect to power and fuel expenses, the auditor should collect a monthly expense schedule and see that the expense for all the months has been recorded.

(iv) With respect to insurance expenses, the auditor should obtain a summary of insurance policies taken along with their validity period and see that the expense shown is genuine.

(v) With respect to legal and professional expenses, the auditor should collect a consultation-wise summary and see that the expense is genuine. For monthly retainership agreements, he shall verify that expense for all 12 months has been recorded. For non-recurring expenses a test on selected sample may be preferable.

(vi) For all other expenses, the auditor shall conduct examination on selected sample of transaction to ensure their validity.

(b) Cut-off

The auditor should ensure that expenses charged against the revenue are related to current year only. He should be extra cautious with rent and insurance expenses as the often involve advance payments.

(c) Completeness

The auditor should ensure that the transactions are properly authenticated as per the policy of the company, appropriately classified and proper accounting entry has been done for their payment and adjustments (e.g., outstanding and prepaid expenses).

(d) Measurement

(i) In case of monthly expenses as per agreement, the auditor should verify the calculation of the expense and adjustment for outstanding and prepaid expense, if any. He should be extra careful with escalation clause and rent agreements terminated during the year. For other expenses he shall evaluate whether the same is reasonable based on the data available for past years. He may perform analytical procedures such as expenditure per unit of production analysis to assess overall reasonableness of expenditure.

(e) Presentation and Disclosure

The auditor must see that the disclosure requirements as per Schedule III (Part 1) have been duly complied with, especially whether other expenses have been classified in appropriate heads.

7.4.5 Audit of Balance Sheet Items

A. Property, Plant and Equipment

Property, Plant and Equipment constitute a significant portion of total assets of an entity. According to the Guidance Note on Audit of Property, Plant and Equipment issued by The Institute of Chartered Accountants of India, the term 'Property, Plant and Equipment' 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 administration purposes; and (b) are expected to be used during more than one period. Thus, PPE includes land, buildings, plant and equipment, furniture and fixture, vehicle, office equipment, computers etc. In addition to the Guidance note, audit process for PPE is also governed by the relevant Accounting Standard (AS 10 or Ind AS 16) in organisations which are required to comply with Accounting Standards.

- **Audit Procedure to be Followed**

(a) Existence

(i) The auditor must ensure physical verification of the assets to confirm that they exist and are under the possession of the client.

(ii) He must tally the physical verification report with the asset register maintained by the company as at the reporting date. He shall ensure that PPE additions up to the date of verification have been updated in the register.

(iii) He shall demand explanations for any discrepancies found in the above process.

(iv) He shall specifically ensure that assets that are not in the working condition have been accounted for as deletions.

(b) Rights and Obligations

(i) The auditor should verify that PPE additions have been approved by the responsible official and such additions are as per the capital expenditure budget approved by the board for the financial year concerned.

(ii) He shall also verify whether appropriate internal processes and procedures like inviting competitive quotations or floating tenders were done before finalising the vendor.

(iii) The auditor shall check that PPE purchase invoices are in the name of the client that entails the legal ownership. For land and building, the auditor shall verify the title deed of the property. In case any charge is created on any immovable property due to any loan taken from a bank or financial institution and hence the original title deed is with the lender, the auditor shall ask the management to obtain a written confirmation from the lender in this respect.

(iv) In relation to all deletions, he shall verify management's rationale for deletion. He may also seek any report from the technical expert, if any, that led to such decision of deletion.

(v) He shall also verify whether such deletions are appropriately authorised, followed the established internal procedures (like inviting tenders etc.) and properly recorded in the books of accounts.

(c) Cut-off

The auditor shall see that the Net Block of assets shown in the Balance Sheet comprises all assets existed and under the ownership of the company on the reporting date and depreciation pertains to the current period only.

(d) Completeness

(i) He shall also verify the PPE schedule (asset class wise) maintained by the management and tally the closing balances to the entity's books of accounts.

(ii) He should check the arithmetical accuracy of the movement in PPE schedule and reconcile the opening balance with the closing balance of each class of asset by considering the additions and disposals during the year.

(e) Valuation

(i) The auditor shall see that all items of PPE have been carried at cost less accumulated depreciation less accumulated impairment1 loss. The cost, for this purpose, includes all costs incurred to acquire or construct the PPE and all subsequent costs to replace part of it. However, day-to-day servicing cost should not be included. They should be charged to profit and loss.

(ii) He shall also verify the installation certificate to know the date of installation of the asset. This information will be important in calculating the pro-rata depreciation.

(iii) The auditor shall verify whether depreciation has been charged on all items except the freehold land. He shall also see that the depreciation method reflects the pattern in which the future economic benefits are expected to be derived from the assets. In case of company, the auditor shall also ensure that depreciation has been calculated in compliance with Schedule II of the Companies Act 2013.

(iv) He shall verify whether the management has undertaken any impairment assessment for any item of PPE and if so, the auditor shall verify the calculation of recoverable value and subsequent adjustment in the carrying amount of the said asset. He shall also check the accounting treatment.

(f) Presentation and Disclosure

(i) In case of a company, the auditor should ensure that the all items of PPE have been disclosed in the balance sheet of the company under the head 'Non-current Assets' and subhead 'Fixed Assets' as 'Tangible Asset' as per Schedule III of the Companies Act 2013.

(ii) He shall also ensure that all the relevant information has also been disclosed in the 'Notes to Accounts' section.

B. Patent and Copyright

A patent is an exclusive right granted by the Government to the manufacturer to dispose of or otherwise benefit from the result of the invention of a production process. It is an official document, which secures to an investor exclusive right to make, use and sell his invention. On the other hand, a copyright is an exclusive right granted by the Government to publish or republish a book, report, or any other literary work, music composition or other work of art etc. The right is primarily granted to the author of the literature or creator of the art work. However, the author/creator may transfer the same to any other person for using the same for commercial purpose. In India, copyright is valid for the lifetime of the author/creator and even fifty years after his death.

⊙ **Audit Procedure to be followed to verify the assertions**

(a) Existence

(i) A schedule of patents and copyright held by the company should be procured from the management.

(ii) The document of each patent and contract paper of each copyright should be physically verified by the auditor to ensure that it has been duly registered.

(iii) The auditor shall ensure that the patent is in active use in production of goods or rendering services.

(b) Rights and Obligations

(i) The ownership of patents and copyrights should be verified by inspection of the certificate of patent issued in the name of the client and the contract paper of copyright.

(ii) If it has been purchased, the agreement surrendering it in favour of the client should be examined.

(iii) The last renewal receipt should be examined to ascertain that the patent has not lapsed.

(iv) The auditor has to verify that renewal fees have been paid on due dates by being charged to revenue and not to the patent account.

(v) The auditor must ensure that the copyrights shown in the financial statement are yet to expire.

(c) Cut-off

The auditor shall see that the value of these assets shown in the Balance Sheet comprises all assets existed and under the ownership of the company on the reporting date and amortization pertains to the current period only.

(d) Completeness

(i) The auditor should check the patent and copyright register carefully in order to verify that all the items have been properly included therein. He must ensure that patents and copyrights acquired during the year has been entered in the register and items lapsed during the year has been removed properly.

(ii) He shall verify the arithmetical accuracy of the above movements in asset schedule.

(e) Valuation

(i) The auditor should ensure that patents and copyrights are being shown at cost less amortisation charges.

(ii) He shall also see that the amortisation rate follows the pattern in which the benefits are expected to be consumed.

(iii) In case it is purchased from a third party, the cost of the patent and copyright is the acquisition cost. Also, the cost of registration of the same in the client's name should be included in the valuation, while the renewal fees for patents should be charged off to revenue. The auditor should examine the same.

(iv) If the patent has been developed by the client in house, all development expenses, legal charges, including registration fees and other direct costs incurred in creating it, should be capitalized (as per Ind AS 38 or AS 26).

(v) The cost of patent should be written off over the legal term of its validity or over its useful commercial life, whichever is shorter. The cost of the copyright should be written off over the legal term of its validity.

(f) Presentation and Disclosure

(i) In case of a company, the auditor should ensure that the patents and copyright have been disclosed in the balance sheet of the company under the head 'Non-current Assets' and subhead 'Other Intangible Asset' as per Schedule III of the Companies Act 2013.

(ii) He shall also ensure that all the relevant information has also been disclosed in the 'Notes to Accounts' section.

C. Investments

Investments are the assets held by an enterprise for earning income by way of dividends, interest and rentals, for capital appreciation, or for other benefits to the investing enterprise. An investment constitutes a significant portion of the total assets. As per Schedule III of the Companies Act 2013, investments can be (a) Non-current investments or (b) Current Investments. An investment may be represented by investments in government securities, shares, debentures, mutual funds, etc.

⊙ Audit procedure to be Followed

(a) Existence

(i) The auditor shall collect a schedule of all short and long-term investments from the management with all possible details including their name, nature, investee entity, purchase price, date of purchase, tenure, date of interest payment (for debt securities), rate of interest (for debt securities), past year's rate of dividend (for share and mutual funds).

(ii) He shall tally the aggregate figure of the schedule with the figure shown in the balance sheet. He shall also examine the investment register and verify the amount shown in schedule with the register. The auditor must ensure that only those investments which belong to the client are shown in the balance sheet.

(iii) He shall physically verify all the certificates, and de-mat statement details to check that they are in the name of the client on the reporting date. Verification of certificates should be done in a single sitting to avoid producing same certificates more than once.

(iv) In case the certificate of investment is yet to be received, purchase of the same should be verified based on allotment advice, broker's note and receipt, etc. Similarly, for sale of investment between the balance sheet date and date of verification, broker's note may be checked. For sale of shares or other listed securities, trading account statement may be verified.

(v) In case investments are not held by the entity in its own custody, then a certificate should be obtained from the relevant authority.

(b) Rights and Obligations

(i) The auditor shall verify the Memorandum and Article of the company to determine the power of the company to invest the surplus funds outside.

(ii) By verifying all the certificates, he shall determine the rights of the company in respect of the investments made, especially, the interest and dividend.

(iii) The auditor shall also see that all interest has been duly received and included in income. Outstanding interest if any should be recalculated and verified with the figure shown.

(c) Cut-off

The auditor shall see that the value of investments shown in the Balance Sheet comprises all investments existed and under the ownership of the company on the reporting date.

(d) Completeness

(i) The auditor shall ensure that the schedule of investment is exhaustive.

(ii) He shall also ensure that all movements in the investment ledger have been appropriately recorded.

(e) Valuation

(i) The auditor shall see that all costs incurred in connection with purchase of investments have been capitalised. However, in case the investment is purchased at cum-interest price, he shall see that cost doesn't include the interest component.

(ii) He shall also see that bonus shares received by the company are recorded in the investment ledger without attributing any cost to it. In case of right shares purchased by purchasing the right also, the cost of right entitlement must also be capitalised.

(iii) He shall see that any pre-acquisition dividend is credited to the investment account itself and not considered in the Statement of Profit and Loss.

(iv) The auditor shall also verify that the value of the investment has been determined following the relevant accounting standards keeping in mind the nature of investments.

(f) Presentation and Disclosure

(i) In case of a company, the auditor should ensure that the investments have been disclosed in the balance sheet of the company under the head 'Non-current Assets' and 'Current Asset' within the subhead 'Financial Assets' as per Schedule III of the Companies Act 2013.

(ii) The auditor shall also ensure that all the relevant information has also been disclosed in the 'Notes to Accounts' section.

D. Inventories/Stock in Trade

Inventory includes raw materials, loose tools, spare parts, semi-finished goods or work-in- progress, packing materials as well as finished goods ready for sale. Even for some organisations it includes stock at branch (in case of branch accounting), stock with customers (in case of hire purchase accounting), stock with consignee (in consignment arrangement), stock with customer on sale or approval (in case of sales on approval).

The responsibility for properly determining the quantity and value of inventories rests with the management of the entity. The management satisfies this responsibility by carrying out appropriate procedures which include verification of all items of inventory at least once in every financial year. This responsibility is not reduced even where the auditor attends any physical count of inventories in order to obtain the audit evidence. However, mere presence at the time of physical stock count does not relieve the auditor from his duty, rather the auditor is required to follow a detailed procedure to verify the inventories.

⊙ **Audit Procedure to be Followed**

(a) Existence

(i) The auditor should review the client's plan to verify inventory physically. He shall see that the process is properly supervised. He must ensure that all stock count sheets are signed by a responsible official of the client.

(ii) Where the client follows periodic system stock count should be done at the end of the period. On the other hand, where the client follows perpetual system, stock count should be done at interim dates.

(iii) The auditor must satisfy himself about any inventory lying at public warehouses or with third party.

(b) Rights and Obligations

(i) The auditor shall also vouch recorded purchases to underlying documentation such as purchase invoice, purchase order, Goods Received Notes etc to determine that client is the owner of such goods.

(ii) He shall evaluate consignment agreement and any collateral agreement and examine the terms and conditions binding on the client.

(iii) He shall also obtain confirmation from the third parties for inventories lying with them.

(c) Cut-off

The auditor shall see that the value of investments shown in the Balance Sheet comprises all investments existed and under the ownership of the company on the reporting date.

(d) Completeness

(i) The auditor should perform analytical procedure to identify any abnormality.

(ii) He should collect non-financial information such as weights and measures and check the same with physical verification reports.

(iii) He shall also perform purchase and sale cut-off test to identify misappropriation near the year end. He shall also ensure that no item is omitted from inventories and no invalid item is included in inventories. For this purpose, information of all stock lying with customers (under hire purchase system or sale on approval system), at branch and with consignee must be procured and verified.

(iv) He shall reconcile physical inventory amounts with perpetual records including stores ledger. The value of the inventory should also be tallied with the amount recorded in the books as adjustment entry of closing stock.

(e) Valuation

(i) The auditor must determine the appropriateness of the method of issuing inventory (LIFO, FIFO, Weighted Average, etc.) for valuation purpose.

(ii) Value of raw materials must be examined based on the cost of purchase, carriage inwards, duties paid, market price of raw materials and estimated cost of disposal. The auditor shall see that lower of cost and NRV has been considered as the value. Relevant documents for this purpose would be purchase invoice, voucher for transport cost, etc.

(iii) He shall also ensure that work-in-progress has been valued considering the completed stage of production and all direct and relevant indirect costs (up to works cost).

(iv) He shall ensure that cost of finished goods includes all direct and relevant indirect costs. In case the finished goods are expected to fetch value lower than the cost, the auditor shall see that the same is valued at NRV.

(v) He shall also see that damaged goods are valued at net realisable value. Moreover, he shall ensure that all obsolete goods have been written off fully.

(f) Presentation and Disclosure

(i) In case of companies, as per Part I of Schedule III of the Companies Act, 2013 all items of inventories shall be included in the head ‘Current Assets’ under the subhead ‘Inventories’.

(ii) Additionally, in notes to accounts the following disclosures shall be made.

- 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 goods (g) Others (specify nature).
- Goods-in-transit shall be disclosed under the relevant sub-head of inventories.
- Mode of valuation shall be stated.

E. Loans

With reference to Part I of Schedule III of the Companies Act 2013, the format of Balance Sheet, loans represent long term as well as short term loans and advances.

Audit Procedure to be Followed

(a) Existence

(i) At first, the auditor must obtain separate schedules of long-term and short-term loans and advances. He should verify whether the balances shown in the schedule agree with the respective ledger accounts.

(ii) He should also attempt to obtain written confirmation from those who have been granted the loans and advances.

(iii) In case of claims made against insurance companies, railways, etc. the auditor should verify that only claims that were admitted have been shown as loans and advances. For this purpose, all the related correspondence has to be examined.

(iv) He shall also obtain the copies of statutory returns like IT return and GST return filed with appropriate authorities and verify whether the amount recorded as per the books tallies with the claims actually made.

(b) Rights and Obligations

(i) The auditor should see that loans and advances have been authorised by the Memorandum and Articles of Association.

(ii) He shall be extra cautious in verifying the authorisation for related party loans and advances.

(iii) In case loans and advances have been granted against any security, the auditor shall verify the mortgage deed for the terms and conditions. For unsecured loans, he shall judge the possibility of its recovery.

(iv) In case advances granted to the employees, the auditor shall examine whether the instalments have been deducted from their salary regularly.

(c) Cut-off

The auditor shall see that the value of loans shown in the Balance Sheet comprises all loans given by the company and outstanding on the reporting date.

(d) Completeness

(i) The auditor should see that all the loans and advances that are outstanding on the reporting date have been recorded.

(ii) He should also see that all the money recovered against the advances have been appropriately recorded against the respective advances.

(e) Valuation

(i) He shall obtain an aging schedule of different loans and a list of loans under litigations.

(ii) He should also verify the previous year's estimate of doubtful loans and after a discussion with the management verify the adequacy of the allowances for doubtful accounts during the current year.

(iii) The auditor shall also assess the movement of bad loans to Provision Account or write offs. He shall see that write-offs are properly authorised by a responsible official.

(f) Presentation and Disclosure

(i) In case of a company, the auditor must see that loans and advances have been shown under Non-current Assets and Current Assets under subheads Loans as per Part I of Schedule III of the Companies Act 2013.

(ii) He shall also ensure that all the relevant information has also been disclosed in the 'Notes to Accounts' section.

F. Trade Receivable

A receivable shall be classified as a trade receivable, if it is in respect of the amount due on account of goods and services rendered in the normal course of business, the term trade receivable suggests particularly the amount recoverable from customers, but in practice, it is applied to a wide range of claims which a business may carry as an asset in its books. Advances or loans cannot, however, be included under this head.

Audit Procedure to be Followed

(a) Existence

(i) The auditor should obtain a schedule of debtors duly signed by a responsible officer and examine it with reference to individual debtors' accounts.

(ii) The auditor should carry out an examination of the relevant records himself about the validity, accuracy and recoverability of the trade receivables balances.

(iii) The auditor should check the agreement of balances as shown in the schedules of trade receivable with those in the ledger accounts.

(iv) While examining the schedules of trade receivables with reference to the trade receivables' ledger accounts, the auditor should pay special attention to the following aspects:

- Where the schedules show the age of the debts, the auditor should examine whether the age of the debts has been properly determined.
- Where the amount outstanding are made up of items which are not overdue, having regard to the credit terms of the entity.
- Whether transfer from one account to another are properly evidenced.

(b) Rights and Obligations

(i) The auditor must ensure that the company has valid claims in respect to the amount shown as debtors.

(ii) He shall examine the bills and notes receivables to see whether those are legally held by the company.

(c) Cut-off

The receivable balance must represent the sundry debtors and other receivables held by the company on the reporting date only.

(d) Completeness

(i) The auditor should ensure that all debtors and receivables have been included in Trade Receivables. In case of dispute, he must obtain confirmation from debtors in this respect.

(ii) Inspect relevant correspondence such as court order declaring insolvency of a debtor. Correspondence between the client and his lawyer for bad debts written off.

(iii) Verification of subsequent realisations is a widely used procedure, even in cases where direct confirmation procedure is followed.

(e) Valuation

(i) The provision for bad and doubtful debts is to be recomputed and compared it with past period for assessing its reasonableness.

(ii) The calculation of discount on bills must be verified.

(iii) Rebates and discount allowed in excess of normal terms should be investigated.

(iv) Bad debt written off should be examined.

(f) Presentation and Disclosure

The auditor must ensure the following reclosures as per Part I of Schedule III with respect to "Trade Receivable" in notes to accounts:

(i) Trade receivables shall be sub-classified as:

  (a) Secured, considered good

  (b) Unsecured, considered good

  (c) Trade Receivables which have significant increase in Credit Risk; and

  (d) Trade Receivables - credit impaired.

(ii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iii) 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.

(iv) For trade receivables outstanding ageing schedule shall be given.

G. Cash and Cash Equivalents

Cash and Cash equivalent includes cash in hand, stamps in hand, balances held with bank in current accounts/ margin money accounts, cash credit accounts (debit balance), fixed deposits, and cheques in hand, etc. It is the most liquid form of assets of an organisation and hence utmost professional scepticism needs to be exercised while auditing such balances.

⊙ **Audit Procedure to be Followed**

(a) Existence

(i) The auditor shall exercise special care to verify cash balances. They shall be preferably checked by surprise. Physical verification of cash in hand would be utmost essential in this context.

(ii) If the company maintains any rough Cash Book or details of daily balances, the auditor shall perform test check to see that entries in the Cash Book are accurate. In case he finds any slip indicating temporary advance given to an employee which has been included in the cash balance, he should have them initiated by responsible official.

(iii) The auditor shall also perform a cash sensitivity analysis (by calculating total receipts and payments month wise) to determine if there is any abnormal variation in the same in a month. In such a case the auditor shall enquire into the same and demand explanation from the management.

(iv) He shall also obtain the Bank reconciliation Statements for every bank account as at the reporting date to rule out possibility of any error in the cash book. The BRSs must be signed by the accountant and approved by responsible official. He shall also ask the management to reconcile all discrepancies.

(v) He shall also communicate with the respective banks and obtain written confirmation regarding the balances held in different bank accounts and deposits.

(b) Rights and Obligations

The auditor shall verify that all the deposits are in the name of the client. For this purpose, the confirmation of the banker and certificate of such deposits shall be examined.

(c) Cut-off

The cash balances must represent the amount of cash and cash equivalents on the reporting date.

(d) Completeness

The auditor shall ensure confirmation of 100% of the bank accounts. He shall also be careful to include all items of cash in hand in the total balance.

(e) Valuation

In addition to performing the above steps, the auditor shall also see that all bank balances representing holding of foreign currencies have been appropriately restated at the exchange rate prevailing on the date of reporting.

(f) Presentation and Disclosure

The auditor shall ensure the disclosures as per the relevant Accounting Standards and Part 1 of Schedule III of the Companies Act 2013.

H. Share Capital

Every company starts with procurement of capital. In case of public limited companies, applications are invited for subscription to shares from the public. For this purpose, the company issues a prospectus or statement in lieu of prospectus. On receipt of applications, company makes allotment to eligible applicants and eventually they become the members of the company. Also, in this process companies often appoint underwriters to underwrite the issue. An auditor while auditing the Share Capital of the company must carefully examine all these related aspects.

⊙ Audit Procedure to be Followed

(a) Existence

(i) The auditor must conduct a reconciliation between the opening and closing balance of share capital to know whether there was any new issue, capitalisation or buyback of equity shares or redemption of preference share.

(ii) In case of change he must ensure that the revised capital is within the limit of authorised capital of the company.

(iii) He must examine that the transactions effecting the change in share capital are genuine and properly authorised. He should examine the resolutions of meetings of the BOD and shareholders for this purpose.

(b) Rights and Obligations

(i) He should ensure that the new issue satisfies all the regulatory requirements of Companies Act, 2013, SEBI regulations and guidelines.

(ii) In specific, he shall see that no shares have been issued at discount. In case shares have been issued at premium, he shall see that the balance of Share Premium has been utilised only for the purposes permitted.

(iii) With respect to issue of sweat equity shares, right shares, bonus shares etc. he shall ensure that the rules have been duly complied with.

(c) Cut-off

The balance of Share Capital must represent the amount of share capital on the reporting date.

(d) Completeness

The auditor must ensure that all changes made in share capital have been duly given effect and accounting entries are adequate.

(e) Valuation

The auditor must verify that the proceeds collected are correct. For this purpose, he shall verify the calculation of total proceeds received, its allocation to various heads and also underwriter's commission payable and settlement of their accounts with liability.

(f) Presentation and Disclosure

The auditor shall ensure the following disclosures as per the Part 1 of Schedule III of the Companies Act 2013:

- For each class of equity shares, the company must disclose (i) no. and amount of shares authorised, (ii) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid; (iii) par value per Share; (iv) a reconciliation of the number of shares outstanding at the beginning and at the end of the period, (v) the rights, preferences and restrictions attaching to each class of shares; shares in the company held by each shareholder holding more than five per cent. shares specifying the number of shares held, (vi) shares reserved for issue under options and contracts or commitments for the sale of shares or disinvestment, including the terms and amounts; (vii) terms of any securities convertible into equity shares issued along with the earliest date of conversion in descending order starting from the farthest such date; (viii) calls unpaid (showing aggregate value of calls unpaid by Directors and officers); (ix) forfeited shares (amount originally paid up), (x) shareholding of promoters etc.

I. Other Equity

As per Schedule III, Division 2, Other Equity comprises of the following elements:

(i) Share application money pending allotment;

(ii) Equity component of compound financial instruments;

(iii) Reserves and Surplus including Capital Total reserve, Securities Premium, Other Reserves and Retained Earnings;

(iv) Debt instruments through Other Comprehensive Income;

(v) Equity Instruments through Other Comprehensive Income;

(vi) Effective portion of Cash Flow Hedges;

(vii)Revaluation Surplus;

(viii)Exchange differences on translating the financial statements of a foreign operation;

(ix) Other items of Other Comprehensive Income;

(x) Money received against share warrants.

While some of the above sources are eligible for dividend payment, others must be utilised for specified purposes only – such as Securities Premium and Capital Redemption Reserve.

In Schedule III, Division I, these are however excluded or shown as separate line item.

⊙ Audit Procedure to be Followed

(a) Existence

(i) The auditor must trace and tally the opening balance of reserves with their closing balances and needs to identify the changes, if any.

(ii) In case there is addition during the year, such as issue of new shares at premium, transfer to General Reserve from current year's profit, revaluation profit etc., the auditor needs to ensure that such additions are genuine, properly authorised by appropriate resolutions in the meetings of BOD and members. Similarly, for any reduction in balances, the auditor needs to find out the resultant transaction and its validity.

(b) Rights and Obligations

The auditor must ensure that addition and utilisation of balances of various items have been in compliance with the relevant Act and Regulations. The utilization of reserves must be for specified purposes only, as applicable.

(c) Cut-off

The balance of each item of Other Equity must represent the amount of share capital on the reporting date only.

(d) Completeness

The auditor must ensure that all changes made in Other Equity items have been duly given effect and accounting entries are adequate.

(e) Valuation

The auditor must ensure that the additions and utilisations from various balances of Other Equity have been calculated appropriately. For example, in case of utilization of accumulated profits for dividend payment, the amount so utilised must satisfy the conditions laid down in Companies (Declaration and Payment of Dividend) Rules, 2014.

(f) Presentation and Disclosures

The auditor shall ensure the following disclosures as per the Part 1 of Schedule III of the Companies Act 2013:

(i) 'Other Reserves' shall be classified in the notes as-

- Capital Redemption Reserve;
- Debenture Redemption Reserve;
- Share Options Outstanding Account; and
- others- (specify the nature and purpose of each reserve and the amount in respect thereof);

(Additions and deductions since last balance sheet to be shown under each of the specified heads)

(ii) Retained Earnings represents surplus i.e balance of the relevant column in the Statement of Changes in Equity;

(iii) A reserve specifically represented by earmarked investments shall disclose the fact that it is so represented;

(iv) Debit balance of Statement of Profit and Loss shall be shown as a negative figure under the head 'retained earnings'. Similarly, the balance of 'Other Equity', after adjusting negative balance of retained earnings, if any, shall be shown under the head 'Other Equity' even if the resulting figure is in the negative; and

(v) Under the sub-head 'Other Equity', disclosure shall be made for the nature and amount of each item.

J. Borrowings

Borrowings represent loans of both long term and short term in nature. While long term borrowings are procured for business expansion or buying any fixed assets, short term borrowings are done mostly for working capital financing.

Audit Procedure to be Followed

(a) Existence

(i) The auditor should collect a schedule of all borrowings with details regarding the date of procurement of the loan, period of loan, rate of interest, amount of loan and assets pledged against the loan, if any.

(ii) He shall examine the loan agreements to ensure that the loans have been taken in name of the client. He shall tally the loan recorded with the loan agreement.

(iii) In case of bank loan, he shall obtain a confirmation from the bank regarding the amount of loan outstanding and shall tally the same with the balance of loan shown in the books.

(b) Rights and Obligations

(i) He must examine the Articles of Association and Memorandum of Association and take note of the rules and regulations in this respect. He shall ensure that the loan agreement adheres to all such rules.

(ii) He shall verify that the procurement of loan has been properly authorised. In case of a company, such authorisation must be in the form of a resolution of the Board.

(iii) He shall examine the loan agreements and take note of the conditions of such loan. He shall also verify that all such conditions are duly complied with.

(iv) The auditor should collect a certificate from the lender regarding the asset pledged with the lender and shall verify the information from the register of mortgage maintained by the client. He shall also enquire about the nature of the charge - fixed or floating as a pledged asset with fixed charge cannot be sold without the permission of the lender. The auditor shall verify any irregularities in this regard.

(c) Completeness

(i) The auditor shall ensure that information regarding all loans has been produced before him and no loan that was paid earlier in full has been shown as outstanding. Also, he must ensure that information about the assets pledged and the nature of charge is complete.

(ii) He shall verify all new loans taken during the year and check the minutes of the meetings of the Board for authorisation of the same.

(d) Valuation

(i) The auditor shall check whether the accounting policies and methods of recording the loan are appropriate and applied consistently.

(ii) He shall also examine whether the interest payable on such loan has been paid in due time and the same has been accounted for accordingly. In case any interest is outstanding, the auditor shall verify the same.

(iii) In case of amortizing loan (i.e., loans of which principal amount is repayable in instalments) taken by a company, the auditor shall determine the current maturities of the loan.

(e) Presentation and Disclosure

(i) The auditor must see that the outstanding amount of loan (non-current portion) has been shown under Non-Current Liabilities or Current Liabilities and under subhead Borrowings as per Part 1 of Schedule III of the Companies Act 2013.

(ii) In case of long-term amortizing loans, the auditor shall see that all current maturities (instalments falling due within next twelve months) are shown under the head Current Liabilities and disclosure of the same is given in form of a footnote.

(iii) He shall also ensure that all restrictive covenants (i.e., conditions) are appropriately disclosed in the financial statements.

(iv) The auditor shall also see that the charge has been appropriately reported in the Balance Sheet.

(v) In case the value of the security falls short of the amount of loan outstanding, he shall examine whether the loan is classified as secured only to the extent of market value of the security.

K. Trade Payable

The term 'Trade Payable' comprises both trade creditors (i.e., sundry creditors) as well as bills payable. This represents the liability of an organisation to its suppliers.

a. Sundry Creditors

⊙ **Audit Procedure to be followed to verify the assertions**

(a) Existence

(i) At first, the auditor shall examine whether an effective internal control system exists in the organisation relating to the transactions with creditors.

(ii) He shall collect a schedule of trade creditors from the management with all possible details including the name of the creditor and amount payable. He shall verify the same with the balance of individual creditor's account in the ledger.

(iii) With prior permission from the client, he shall collect confirmation from some selected creditors regarding the amount payable to them. Such information shall be checked with the balances of creditors.

(iv) If the ledgers are maintained under self-balancing system, information from the General Ledger shall be cross verified from the Creditors' Ledger Control/ Adjustment Account.

(b) Rights and Obligations

The auditor shall also examine that all the terms and conditions of the contract with the supplier have been duly complied. He shall ensure that the goods purchased have actually been received and/or services have been provided in due course. For this purpose, Goods Inward Book may be examined.

(c) Cut-off

The balance of sundry creditors must represent only the balances outstanding on the date of reporting.

(d) Completeness

(i) The auditor shall ensure that no trade creditor is excluded from the schedule. He may collect a confirmation from the management in this respect.

(ii) He shall be extra cautious while verifying the transactions near the end of the year.

(e) Valuation

(i) The auditor shall see that the total of balances as per the schedule of creditors tallies with the total of balances of all creditors' account.

(ii) He may select a few sample credit sale transactions and shall verify the correctness of recording the same based on invoice, Goods Received Note, Purchase Day Book and respective ledger heads.

(iii) The auditor shall also verify the transactions relating to return of goods from Return Outward Book and see that the same has been correctly posted to creditors' accounts.

(iv) In case any discount is received from the supplier, the same shall be examined from the correspondence with creditors. Its accounting treatment shall also be verified.

(v) If any amount payable to a specified creditor remains outstanding for long or if any cheque issued to a creditor is not encashed for long, the same should be examined to avoid possibility of fraud.

(f) Presentation and Disclosure

The auditor shall ensure the following disclosures as per Part 1 of Schedule III of the Companies Act 2013.

(i) In case of a company, the auditor must see that the total balance of creditors has been shown under Current Liabilities and under subhead Trade Payables as per Schedule III of the Companies Act 2013. It shall further be segregated into (i) total outstanding dues of micro enterprises and small enterprises; and (ii) total outstanding dues of creditors other than micro enterprises and small enterprises.

(ii) He shall also ensure that all the relevant information has also been disclosed in the 'Notes to Accounts' section.

b. Bills Payable

These are negotiable instruments used by creditors to discharge their liabilities. Basically, a creditor accepts a bill in favour of the debtor i.e., the client in this case.

⊙ **Audit Procedure to be followed to verify the assertions**

(a) Existence

(i) The auditor shall collect a schedule of bills payable from the management with all possible details including the name of the creditor and amount payable, date when the bill will become due etc. He shall verify the same from Bills Payable Book and Bills Payable Account. He shall specifically ensure that the bills are still outstanding and their due date has not expired.

(ii) He shall also see that the acceptance and dishonour of bills have been recorded in the respective creditors account.

(b) Rights and Obligations

(i) He shall examine the bills payable and identify the conditions therein. He shall see that the conditions have been duly complied with. He must also see that they met the legal requirements.

(ii) In case acceptance of a bill creates any charge on any asset, the auditor shall see that the same has been reported in the Balance Sheet.

(c) Cut-off

The balance of Bills Payable must represent only the balances outstanding on the date of reporting.

(d) Completeness

(i) The auditor shall see that the schedule collective from the management is exhaustive and no bills payable is excluded from it. He may collect a written confirmation from the management in this respect.

(ii) The auditor shall be extra cautious to verify that no bill which has already expired has been included in the above schedule.

(e) Valuation

(i) The auditor shall ensure that total of the schedule tallies with the balance of the bills payable account.

(ii) To verify the dishonoured bills, the auditor shall examine the correspondence between the client and the creditor. He shall also verify the notification issued by the notary public and bank statement.

(iii) In case of renewal of bills dishonoured, the auditor shall examine the correspondence between the client and the creditor. If any interest was payable for such renewal, he shall see that the same has been properly recorded in the creditor's account.

(f) Presentation and Disclosure

(i) In case of a company, the auditor must see that the total balance of bills payable has been shown under Current Liabilities and under subhead Trade Payables as per Schedule III of the Companies Act 2013. It shall further be segregated into (i) total outstanding dues of micro enterprises and small enterprises; and (ii) total outstanding dues of creditors other than micro enterprises and small enterprises.

(ii) He shall also ensure that all the relevant information has also been disclosed in the 'Notes to Accounts' section.

7.4.6 Audit of Some Special Transactions

A. Alteration of Share Capital [Section 61]

The audit procedure to be applied in this context are:

(i) The auditor must confirm that alteration was authorised by articles.

(ii) He shall verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.

(iii) He shall verify that alteration had been effected in copies of Memorandum, Articles, etc.

(iv) He shall obtain the reasons for which the memorandum of the company is altered.

(v) He shall 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) He has to confirm that the alter share capital's denomination should be more than rupee one.

(vii)He has to verify that proper accounting entries have been passed. Register of members may also be checked to see that the necessary alterations have been effected therein.

B. Issue of Bonus Shares [Section 63]

The audit procedure to be applied in this context are:

(i) The auditor must confirm that issue of Bonus Share was authorized by articles.

(ii) He shall verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.

(iii) He shall check that the company has issue fully paid-up bonus shares to its members only.

(iv) He shall confirm that the issue of bonus shares shall not be made by capitalising reserves created by the revaluation of assets.

(v) He shall 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) He must 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)He shall check whether the partly paid-up shares are made fully paid-up.

(viii)He must check whether the bonus shares shall not be issued in lieu of dividend.

C. Splitting of Shares

The audit procedure to be applied in this context are:

(i) The auditor shall confirm that alteration was authorised by articles.

(ii) He should verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.

(iii) He should verify that alteration had been effected in copies of Memorandum, Articles, etc.

(iv) He should verify that proper accounting entries have been passed. Register of members may also be checked to see that the necessary alterations have been effected therein.

D. Re-issue of Forfeited Shares

The audit procedure to be applied in this context are:

(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) He should vouch the amounts collected from persons to whom the shares have been allotted and verify the entries recorded from re-allotment. The 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) He should 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. The auditor needs to ensure the same.

E. Issue of Debentures [Section 71]

The term "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. Debenture is an important source of long-term debt capital of a company.

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.

The audit procedure to be applied in this context are:

(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.

F. 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.

The audit procedure to be applied in this context are:

(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.

G. Payment of Dividend

⊙ **Provisions of Companies Act, 2013 Regarding Payment of Dividend**

Dividend is the part of the divisible profits of the company which is actually paid to the shareholders. Companies Act, 2013 provides detailed provisions regarding declaration and payment of dividend as follows:

I. Sources of Dividend:

As per Section 123(1), 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:

II. Transfer to Reserves:

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.

III. Payment of Dividend out of Accumulated Profit:

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 free reserves, such declaration of dividend shall not be made except in accordance with such rules as may be prescribed in this behalf.

Accordingly, Companies (Declaration and Payment of Dividend) Rules, 2014 provides that in the event of inadequacy or absence of profits in any year, a company may declare dividend out of free reserves subject to the fulfilment of the following conditions:

(i) The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year: However, this rule will not be applicable to a company, which has not declared any dividend in each of the three preceding financial years.

(ii) The total amount to be drawn from such accumulated profits shall not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

(iii) The amount so drawn shall first be utilised to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.

(iv) The balance of reserves after such withdrawal shall not fall below fifteen per cent of its paid-up share capital as appearing in the latest audited financial statement.

Section 123(1) further provides that -

(i) No dividend shall be declared or paid by a company from its reserves other than free reserves.

(ii) 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.

Note: 'Free Reserves' for this purpose shall mean such reserves which are available for distribution as dividend. It shall not include any amount representing unrealised gains, notional gains or revaluation of assets, 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.

IV. Interim Dividend

The Board of Directors of a company may declare interim dividend during any financial year or at any time during the period from closure of financial year till holding of the annual general meeting out of the surplus in the profit and loss account or out of profits of the financial year for which such interim dividend is sought to be declared or out of profits generated in the financial year till the quarter preceding the date of declaration of the interim dividend.

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.

V. Procedure of Dividend Payment:

Section 123(4) states that 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.

Moreover, as per Section 123(5), 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. However, the company may capitalise its profits or reserves 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.

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.

VI. Restriction on Declaration of Dividend:

As per Section 123(6), 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.

VII. Unpaid Dividend

Section 124 of the Companies Act, 2013 states that -

(1) 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.

(2) 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 web-site of the company, if any, and also on any other web-site of the company, if any, and also on any other web-site approved by the Central Government for this purpose, in such form, manner and other particulars as may be prescribed.

(3) 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 ensure to the benefit of the members of the company in proportion to the amount remaining unpaid to them.

(4) Any person claiming to be entitled to any money transferred under sub-section (1) to the Unpaid Dividend Account of the company may apply to the company for payment of the money claimed.

(5) 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.

(6) All shares in respect of which dividend has not been paid or claimed for seven consecutive years or more shall be transferred by the company in the name of Investor Education and Protection Fund along with a statement containing such details as may be prescribed:

Provided that any claimant of shares transferred above shall be entitled to claim the transfer of shares from Investor Education and Protection Fund (IEPF) in accordance with such procedure and on submission of such documents as may be prescribed.

(7) If a company fails to comply with any of the requirements of this section, such company shall be liable to a penalty of one lakh rupees and in case of continuing failure, with a further penalty of five hundred rupees for each day after the first during which such failure continues, subject to a maximum of ten lakh rupees and every officer of the company who is in default shall be liable to a penalty of twenty-five thousand rupees and in case of continuing failure, with a further penalty of one hundred rupees for each day after the first during which such failure continues, subject to a maximum of two lakh rupees.

According to Section 125(5), any person claiming to be entitled to any unclaimed dividend may apply to the authority of IEPF for the payment of the money claimed.

VII. Punishment for Failure to Distribute Dividends [Section 127]

Once a dividend is declared, a company must pay such dividend or at least post the warrant in respect thereof to every shareholder entitled to the payment of such dividend within a period of thirty days from the declaration of the dividend.

However, if the company fails to do so, then every director of the company shall, if he is knowingly a party to the default, be punishable with imprisonment which may extend to two years and with fine which shall not be less than one thousand rupees for every day during which such default continues.

Moreover, the company shall be liable to pay simple interest at the rate of eighteen per cent per annum during the period for which such default continues.

However, no offence under this section shall be deemed to have been committed:

(i) where the dividend could not be paid by reason of the operation of any law;

(ii) where a shareholder has given directions to the company regarding the payment of the dividend and those directions cannot be complied with and the same has been communicated to him;

(iii) where there is a dispute regarding the right to receive the dividend;

(iv) where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder; or

(v) where, for any other reason, the failure to pay the dividend or to post the warrant within the period under this section was not due to any default on the part of the company.

⊙ **Audit Procedure for Final Dividend**

(i) The auditor should examine the Articles of Association of the company to ascertain the differential rights of the shareholders, if any.

(ii) The auditor should also examine the minute book of directors' and shareholders' meetings to verify the dividend was properly recommended by the directors and whether it was passed by a resolution in the shareholders' meeting.

(iii)The auditor should verify whether the amount of dividend paid was calculated accurately.

(iv) He should ensure that the provisions of Companies Act, 2013 and Companies (Declaration and Payment of Dividend) Rules, 2014 have been complied with.

(v) Based on the bank statements, the auditor must verify whether the total amount of dividend was transferred to a separate bank account in a scheduled bank within five days from the declaration of such dividend and whether dividend was paid to shareholders only out that account.

(vi) The auditor must ensure that dividend has been paid to the rightful owner. He should verify the Dividend Register and bank statements for this purpose. The auditor shall also reconcile the amount of dividend warrants outstanding with the Dividend Register and the balance in the Bank Account.

(vii)The auditor shall also verify whether sufficient effort was made by the management to distribute the dividend within 30 days from its declaration and shall enquire into all the cases where the dividend could not be paid within such time.

If the auditor comes across any irregularities regarding the above areas, he shall immediately enquire into the matter with the management and if not satisfied, shall also bring such irregularities to the notice of the shareholders.

⊙ **Audit Procedure for Interim Dividend**

(i) The auditor should examine the Articles of Association of the company to ascertain whether payment of interim dividend is permitted by the articles or not.

(ii) The auditor should also examine the minute book of directors' meeting to verify resolution approving the payment of interim dividend.

(iii) The auditor must critically appraise the justification in paying interim dividend based on interim accounts.

(iv) The amount of interim dividend shall be deposited in a scheduled bank in a separate account within five days from the date of declaration of such dividend.

(v) The auditor must ensure that dividend has been paid to the rightful owner. He should verify the Dividend Register and bank statements for this purpose. The auditor shall also reconcile the amount of dividend warrants outstanding with the Dividend Register and the balance in the Bank Account.

Audit Procedure for Unpaid Dividend

(i) The auditor should collect a statement or list containing every detail regarding the unpaid dividend such as the names of the shareholders, dividend payable to them, dividend warrant number, reason for the dividend remaining unpaid etc.

(ii) The auditor shall conduct an enquiry to identify whether there was any fault on the part of the company and if so, what action has been taken against the company.

(iii) The auditor shall verify the statement provided by the management in this respect with other supporting documents like Dividend Register, Returned Warrants, bank statement, etc. and shall determine whether the dividend amount has been accurately calculated.

(iv) The auditor shall also verify whether the unpaid dividend has been transferred to a separate account namely Unpaid Dividend Account within seven days from the expiry of 30 days allowed for declaration and payment of dividend.

(v) The auditor must verify whether there is any fault on the part of the company and if so whether they have deposited the interest and the penalty.

(vi) The auditor shall also verify whether the company has published the details of unpaid dividend in its own website and also in other website(s) approved by the government for this purpose.

(vii) Any payment of previously unpaid dividend must be verified by the auditor to see that the same has been paid to the rightful owner.

(viii) In case any amount of dividend is remaining unpaid for more than seven years, the auditor shall verify whether the same along with the interest accrued thereon has been transferred by the company to IEPF.

(ix) The auditor shall also verify whether all the shares in respect of which unpaid dividend has been transferred to IEPF, have also been transferred to such fund.

Audit Report, Report vs. Certificate, Reporting Requirements under Companies Act, Contents of the Reports and Modifications in the Report (with Coverage of CARO)

7.5

7.5.1 Concept and Definition of Audit Report

After conducting an audit of an organisation, it is the duty of the auditor to communicate, to the appointing authority, his opinion on the exhibition of true and fair view of financial performance and financial position of the organisation. Audit report is the written communication on the part of the auditor to convey his opinion to the client.

According to Lancaster, 'a report is a statement of collected and 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.'

The preparation of audit report is essentially the last step in an audit assignment.

7.5.2 Audit Certificate

An audit certificate is a written confirmation of the exactness of the facts stated therein and does not involve any estimate or opinion. When an auditor certifies a statement, it implies that the contents of that statement are measurable and that he has verified the accuracy of the data.

According to Dicksee, a certificate is something that 'makes certain' and is thus necessarily limited to facts capable of absolute verification.

7.5.3 Audit Report vs. Audit Certificate

Audit certificates are fundamentally different from audit reports, though they are issued by the same auditor. The following are the differences between an audit report and an audit certificate.

Sl. No.	Points of Distinction	Auditor's Report	Auditor's Certificate
1.	Definition	An audit report is a document written in a standard format through which the auditor expresses his opinion regarding the reliability and correctness of an entity's financial statements.	An auditor's certificate is a written confirmation of the accuracy of the facts stated therein.
2.	Nature	It is an expression of opinion about the financial statements.	It is a confirmation of correctness and accuracy about some matters.
3.	Basis of audit	The report is based on assumptions and estimations	The certificate is based on actual figures and facts.
4.	Scope	The scope of the report is large.	Its scope is limited.
5.	Advice	In audit report, there is a scope of giving constructive advice to the company.	No scope of constructive advice exists in the case of the certificate.

6.	Basis	Audit report is based on facts, assumptions and estimations.	Audit certificate is based on actual figures.
7.	Guarantee	Audit report is an opinion by the auditor and does not guarantee the accuracy of the financial statements	Audit certificate is a formal statement by the auditors which guarantee the accuracy of the facts stated therein.
8.	Time of issue	The report is submitted to the appointing authority only after the audit is complete.	Certificates are issued as and when required.
9.	Liability of auditor	As a report is merely an opinion, if it is not correct, the auditor may not be held responsible, unless he is found to be negligent to his duty.	In case of the wrong certificate, the auditor will be held responsible.
10.	Format	Audit report has to be presented in prescribed format.	Audit certificate is not required to be presented in any standard format.

7.5.4 Essential Characteristics of a Good Audit Report

The following are the essential characteristics of a good audit report:

a) **Simplicity:** An audit report should be simple and easily understandable to the users. It should be written is simple language and should be self-explanatory.

b) **Clarity:** The audit report should be clear and unambiguous. The auditor must clearly mention, in his report, the purpose of audit, sources of information, his findings and overall opinion.

c) **Brevity:** The report should be brief and specific. While everything relevant must be disclosed, the report should avoid unnecessary detailing.

d) **Firmness:** The report should firmly state whether, in the opinion of the auditor, the financial statements represent the true and fair view of the performance and state of affairs of the business.

e) **Objectivity:** The audit report should always be based on objective evidences. It is very much required to reduce or eliminate biases, prejudices, or subjective evaluations by relying on verifiable data.

f) **Disclosure:** The audit report should properly disclose all relevant facts and the truth. The relevance should be decided based on materiality of the concerned item.

g) **Impartiality:** The report should be unbiased. The recommendations must be impartial and objective.

h) **Information-based:** Only relevant and accurate information should be included in the audit report.

i) **Timeliness:** The report should be prepared and presented within the stipulated time. This will help in timely decision making.

7.5.5 Contents of Audit Report

The basic requirements of an audit report are guided by three regulatory sources, namely, the Companies Act, 2013, the Standards on Auditing and Companies (Auditor's Report) Order, 2020. These are discussed in the following sections.

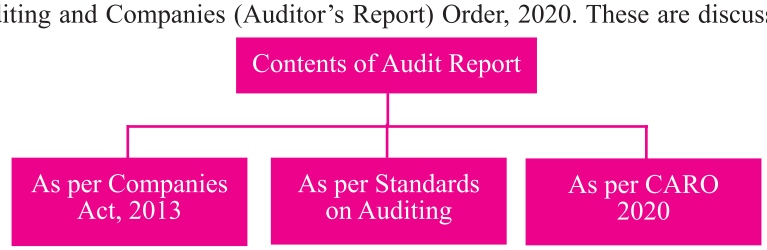

Figure 7.5: Sources of Guidelines on the Contents of Audit Report

7.5.5.1 Requirements as per the Companies Act, 2013

The Companies Act, 2013 requires every limited company to get its accounts audited by a qualified auditor. The auditor critically appraises the books of accounts of the company and submit his report to the members of the company at the AGM. In this context, Section 143 and some other Sections of Companies Act, 2013 require the auditor to report on include the following in his audit report.

1. As per Section 143(2), the auditor, in his report, shall report whether to the best of his knowledge and information and as per his opinion, the accounts and the financial statements represent 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.
2. According to Section 143(3), the auditor's report shall also state -
   (a) whether he has sought and obtained all the information and explanations from the management 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 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.
3. Section 143(4) states that in case 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 thereof.
4. As per Section 143(5), in case of a Govt. company, where the CAG has issued any direction to the auditor appointed by it, the auditor, among other things, shall include (a) the directions issued by the CAG (b) the action taken thereon and its impact on the accounts and financial statement of the company.
5. According to Section 143(12), if the auditor of a company, in the course of his audit work, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government.
6. The auditor's report shall also include a statement on the matters prescribed by Companies (Auditor's Report) Order.
7. As per Rule 11 of Companies (Audit and Auditors) Rules 2014, the auditor's report shall also include his views and comments on the following matters:

(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.

(d) [omitted by subsequent amendment]

(e) (i) Whether the management has represented that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;

(ii) Whether the management has represented, that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and

(iii) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.

(f) Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.

(g) Whether the company, in respect of financial years commencing on or after the 1st April, 2022, has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and the same has been operated throughout the year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention.

7.5.5.2 Basic Elements/ Contents of Audit Report as per Standards on Auditing

As per SA-700 (Revised), Forming an Opinion and Reporting on Financial Statements, the basic elements of an audit report are as follows:

a) Title: In order to differentiate the audit report from other reports, it must have an appropriate title such as - Independent Auditor's Report.

b) Addressee: The auditor's report should be appropriately addressed as per the terms of engagement. Respective law, regulation or terms of engagement generally specify the person to whom the report is to be addressed. Normally, an audit report is addressed to the appointing authority. For example, in a public limited company, the audit report is addressed to the members i.e., shareholders.

c) Auditor's Opinion: The first section of the auditor's report shall include the opinion of the auditor and shall be named accordingly. This opinion section shall mention the name of the client, the fact that financial statements have been audited, the titles of the financial statements, reference to the summary of significant accounting policies and other explanatory information and the date and period of the financial statements audited.

d) Basis for Opinion: This section shall explain the basis for holding such opinion. Accordingly, it shall -

(i) state that the audit has been conducted with applicable Standards on Auditing.

(ii) refer to the section that describes auditor's responsibilities under the Standards on Auditing.

(iii) Include a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in this context.

(iv) State whether the auditor believes that the audit evidences obtained by him is sufficient and appropriate to provide a basis for the auditor's opinion.

e) **Report on Going Concern Assumption:** Where applicable, the auditor shall report in accordance with SA 570 (Revised) on Going Concern assumption.

f) **Key Audit Matters:** In case of audit of complete set of general-purpose financial statements of a listed entity, the auditor needs to communicate the key audit matters in accordance with SA 701. These are matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. For instance, valuation of goodwill and other long-term assets, valuation of financial instruments, etc. Law or regulation may also require communication of key audit matters for other entities as well. Additionally, the auditor may also decide to communicate key audit matters for those who are of significant public interest

g) **Responsibilities for the Financial Statements:** The report of an auditor should also include a section with heading 'Management's Responsibilities for the Financial Statements'. According to SA 200, management, and where appropriate, those charged with governance should accept responsibility for the preparation of financial statements and also for the internal control currently in force in the organisation. An auditor's report must include reference to both responsibilities as it helps to explain the users the premise behind the audit conducted.

Accordingly, this section of the audit report shall describe management's responsibility for:

(i) the preparation of the financial statements according to the applicable financial reporting framework and for the design, implementation and maintenance of an appropriate internal control relevant to the preparation of the financial statements that are free from material misstatement, whether due to fraud or error.

(ii) assessing the entity's ability to continue as a going concern and whether the going concern basis of accounting is appropriate. SA 210 requires an auditor to agree management responsibilities in an engagement letter or other suitable form of written agreement.

h) **Auditor's Responsibilities for the Audit of the Financial Statements:** This section of the auditor's report shall state that:

(i) The objectives of the auditor are to:

- Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
- Issue an auditor's report that includes the auditor's opinion.

(ii) State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists; and

(iii) State that misstatements can arise from fraud or error, and either:

- Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or
- Provide a definition or description of materiality in accordance with the applicable FRF.

In addition to the above, the section shall further:

(i) State that, as a part of an audit in accordance with SAs, the auditor has exercised professional judgement and maintained professional scepticism throughout the audit.

(ii) State that the auditor's responsibilities are:

- to identify and assess the risk of material misstatements.
- to obtain an understanding of internal control.
- to evaluate the appropriateness of accounting practices followed and reasonableness of accounting estimates.
- to comment on the appropriateness of management's use of going concern concept and whether there is any uncertainty that may cast significant doubt on the entity's ability to continue as a going concern.

i) **Other Reporting Responsibilities:**

a) If the auditor addresses other reporting responsibilities in the auditor's report that are in addition to the auditor's responsibilities under the SAs. These other reporting responsibilities shall be addressed in a separate heading titled "Report on Other Legal and Regulatory Requirements".

b) In case these other reporting responsibilities address the same topics as required by the SAs, the other reporting responsibilities may be presented in the same section as the related report elements required by the SAs.

j) **Signature of the Auditor:**

a) The report is signed by the auditor (i.e., the engagement partner) in his personal name.

b) Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm.

c) The partner/proprietor signing the audit report also needs to mention his membership number assigned by The Institute of Chartered Accountants of India.

d) They also include the registration number of the firm, wherever applicable.

k) **Place of Signature:** The auditor's report shall name specific location. It is ordinarily the city where the audit report is signed.

l) **Date of the Auditor's Report:** The date on which the auditor signs the report expressing his opinion on the financial statements of an entity is the date of the auditor's report.

7.5.5.3 Contents of Audit Report as per Companies (Auditor's Report) Order 2020

A. Notification

The Ministry of Corporate Affairs, Government of India notified Companies (Auditor's Report) Order 2020 on 25th February, 2020. This order was issued in supersession of Companies (Auditor's Report) Order 2016. Accordingly, CARO 2020 is applicable for all statutory audits commencing on or after 1st April, 2021 corresponding to the financial year 2020-21 and the matters specified therein shall be included in each report made by the auditor under Section 143 of the Companies Act, 2013 on the account of every company to which CARO 2020 applies.

B. Eligible Companies

It shall apply to every company including a foreign company as defined in clause (42) of Section 2 of the Companies Act, 2013 (18 of 2013) [hereinafter referred to as the Companies Act], 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 in clause (62) of section 2 of the Companies Act and a small company as defined in clause (85) of section 2 of the Companies Act; and

(v) 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 one crore rupees as on the balance sheet date and which does not have total borrowings exceeding one crore rupees 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 (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

C. Matters to be Included in Auditor's Report

⊙ **Non-current Assets [Clause 3(i)]**

a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of Property, Plant and Equipment and full particulars of intangible assets;

b) whether these Property, Plant and Equipment have been physically verified by the management at reasonable intervals; and 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 all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company. If not, provide the details thereof in the prescribed format.

d) whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets;

e) whether any proceedings have been initiated or are pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and rules made thereunder, if so, whether the company has appropriately disclosed the details in its financial statements.

⊙ **Inventory [Clause 3(ii)]**

a) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account;

b) whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;

⊙ **Investment, Providing Guarantee/security, Granting Loan or Advances [Clause 3(iii)]**

a) whether during the year the company has made investments in, provided any guarantee or security or granted any loans or advances in the nature of loans, secured or unsecured, to companies, firms, Limited Liability Partnerships or any other parties, if so, -

(i) whether during the year the company has provided loans or provided advances in the nature of loans, or stood guarantee, or provided security to any other entity [not applicable to companies whose principal business is to give loans], if so, indicate-

(A) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to subsidiaries, joint ventures and associates;

(B) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to parties other than subsidiaries, joint ventures and associates;

b) whether the investments made, guarantees provided, security given and the terms and conditions of the grant of all loans and advances in the nature of loans and guarantees provided are not prejudicial to the company's interest;

c) in respect of loans and advances in the nature of loans, whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;

d) 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;

e) whether any loan or advance in the nature of loan granted which has fallen due during the year, has been renewed or extended or fresh loans granted to settle the overdues of existing loans given to the same parties, if so, specify the aggregate amount of such dues renewed or extended or settled by fresh loans and the percentage of the aggregate to the total loans or advances in the nature of loans granted during the year [not applicable to companies whose principal business is to give loans];

f) whether the company has granted any loans or advances in the nature of loans either repayable on demand or without specifying any terms or period of repayment, if so, specify the aggregate amount, percentage thereof to the total loans granted, aggregate amount of loans granted to Promoters, related parties as defined in clause (76) of Section 2 of the Companies Act, 2013;

- **Loan to Director and Investment by the Company [Clause 3 (iv)]**

In respect of loan, investment, guarantees and security, whether provisions of Sections 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.

- **Acceptance of Deposits [Clause 3 (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 New Act and the rules framed thereunder, where applicable, have been complied with. If not, the nature of contraventions should be stated. If an order has been passed by Company Law Board 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.

- **Maintaining Cost Records [Clause 3 (vi)]**

Where maintenance of cost records has been specified by the Central Government under sub-section (l) of Section 148 of the New Act, whether such accounts and records have been made and maintained.

- **Statutory Dues [Clause 3 (vii)]**

a) Is the company regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income tax, sales tax, wealth tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues with the appropriate authorities? And if not, the extent of the arrears of outstanding statutory dues as at 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 by the auditor.

b) In case dues of income tax or sales tax or wealth tax or service tax or duty of customs or duty of excise or value added tax or cess have not been deposited on account of any dispute, then the amount involved and the forum where dispute is pending shall be mentioned.

- **Disclosure of Unrecorded Income [Clause 3 (viii)]**

  Whether any transactions not recorded in the books of account have been surrendered or disclosed as income during the year in the tax assessments under the Income Tax Act, 1961 (43 of 1961), if so, whether the previously unrecorded income has been properly recorded in the books of account during the year;

- **Repayment of Loan [Clause 3 (ix)]**

  a) whether the company has defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender, if yes, the period and the amount of default to be reported

  b) whether the company is a declared wilful defaulter by any bank or financial institution or other lender;

  c) whether term loans were applied for the purpose for which the loans were obtained; if not, the amount of loan so diverted and the purpose for which it is used may be reported;

  d) whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated;

  e) whether the company has taken any funds from any entity or person on account of or to meet the obligations of its subsidiaries, associates or joint ventures, if so, details thereof with nature of such transactions and the amount in each case;

  f) whether the company has raised loans during the year on the pledge of securities held in its subsidiaries, joint ventures or associate companies, if so, give details thereof and also report if the company has defaulted in repayment of such loans raised;

- **Utilisation of IPO/ Further Public Offer etc. [Clause 3 (x)]**

  a) whether moneys raised by way of initial public offer or further public offer (including debt instruments) during the year 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;

  b) whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of non-compliance;

- **Reporting of Fraud [Clause 3 (xi)]**

  a) whether any fraud by the company or any fraud on the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated;

  b) whether any report under sub-section (12) of section 143 of the Companies Act has been filed by the auditors in Form ADT-4 as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the Central Government;

  c) whether the auditor has considered whistle-blower complaints, if any, received during the year by the company;

- **Nidhi Company [Clause 3 (xii)]**

  a) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1: 20 to meet out the liability;

b) whether the Nidhi Company is maintaining ten per cent. unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;

c) whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof;

- **Related Party Transaction [Clause 3 (xiii)]**

  Whether all transactions with the related party are in compliance with Sections 177 and 188 of the Companies Act, 2013 whereas applicable and whether the details have been disclosed in the financial statement etc., as required by the applicable accounting standard.

- **Internal Audit [Clause 3 (xiv)]**

  a) whether the company has an internal audit system commensurate with the size and nature of its business;

  b) whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor;

- **Non-Cash Transaction [Clause 3 (xv)]**

  a) Whether the company has entered into any non-cash transaction with the director or person concerned with him.

  b) If so, whether the provision of Section 192 of the Companies Act, 2013 has been complied with.

- **Registration of the Company, Nature of the Company [Clause 3 (xvi)]**

  a) whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 (2 of 1934) and if so, whether the registration has been obtained;

  b) whether the company has conducted any Non-Banking Financial or Housing Finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India as per the Reserve Bank of India Act, 1934;

  c) whether the company is a Core Investment Company (CIC) as defined in the regulations made by the Reserve Bank of India, if so, whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria;

  d) whether the Group has more than one CIC as part of the Group, if yes, indicate the number of CICs which are part of the Group;

- **Cash Losses [Clause 3(xvii)]**

  whether the company has incurred cash losses in the financial year and in the immediately preceding financial year, if so, state the amount of cash losses;

- **Resignation of Statutory Auditor [Clause 3(xviii)]**

  whether there has been any resignation of the statutory auditors during the year, if so, whether the auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors;

- **Information about Financial Assets and Liabilities etc. [Clause 3(xix)]**

  On the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities, other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans, whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report that company is capable of meeting its liabilities existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date;

- **Unspent CSR Expenditure Amount [Clause 3(xx)]**

  a) whether, in respect of other than ongoing projects, the company has transferred unspent amount to a Fund specified in Schedule VII to the Companies Act within a period of six months of the expiry of the financial year in compliance with second proviso to sub-section (5) of section 135 of the said Act;

  b) whether any amount remaining unspent under sub-section (5) of section 135 of the Companies Act, pursuant to any ongoing project, has been transferred to special account in compliance with the provision of sub-section (6) of section 135 of the said Act;

- **Qualification/Adverse Remarks [Clause 3(xxi)]**

  Whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports of the companies included in the consolidated financial statements, if yes, indicate the details of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks.

- **Reasons to be Stated for Unfavourable or Qualified Answers [Clause 4]**

  a) Where, in the auditor's report, the answer to any of the questions referred to in the previous paragraph, is unfavourable or qualified, the auditor's report shall also state the basis for such unfavourable or qualified answer, as the case may be.

  b) 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.

7.5.6 Auditor's Opinion in Audit Report

7.5.6.1 Different Types of opinion

The opinions expressed in audit reports issued by statutory auditors can broadly be divided into two categories – (A) Unmodified Opinion and (B) Modified Opinion.

A. Unmodified opinion: An audit report with an unmodified opinion is also known as 'Clean Report' or 'Unqualified Report'. An auditor expresses an unmodified opinion when he is satisfied that the financial statements exhibit a true and fair view of the state of affairs and operations in an enterprise during the period. To be more specific, an auditor issues an unmodified opinion when he finds that –

(i) The Financial Statements have been prepared using the Generally Accepted Accounting Principles, which have been consistently applied;

(ii) The Financial Statements comply with relevant statutory requirements and regulations;

(iii) There are adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable; and

(iv) 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 Statement.

B. **Modified Opinion:**

While forming an opinion in accordance with SA 700 (Revised), if the auditor concludes that a modification to the auditor's opinion on financial statements is necessary, he shall express a modified opinion. SA 705, Modifications to the Opinion in the Independent Auditor's Report, suggests two such circumstances when an auditor should appropriately modify his opinion on the financial statements. These are:

(i) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatements; or

(ii) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatements.

There can be three types of modified opinions – (1) Qualified Opinion, (2) Adverse Opinion and (3) Disclaimer of Opinion.

1. Qualified Opinion

An auditor expresses qualified opinion on financial statements when:

(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, either individually or in aggregate, are material but not pervasive (i.e., not highly significant);

(b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base his opinion, but concludes that the possible effects of undetected misstatements on the financial statements could be material but not pervasive.

Note: Meaning of the term 'Pervasive'.

The term 'pervasive' is used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

(i) Are not confined to specific elements, accounts or items of the financial statements;

(ii) If so confined, represent or could represent a substantial proportion of the financial statements; or

(iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.

In case of a qualified opinion, the heading of the 'Basis for Opinion' paragraph must be modified as 'Basis for Qualified Opinion'.

Some situations when an auditor should express a qualified opinion are:

(i) Non-adherence to AS-2 with regard to inventory valuation at the lower of cost and net realisable value.

(ii) Auditor being prevented by the management from observing the counting of physical inventory where such action is material to the financial statements.

2. Adverse Opinion

An auditor expresses adverse opinion on financial statements when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, either individually or in aggregate, are both material and pervasive to the financial statements.

In case of an adverse audit report the heading of the 'Basis for Opinion' paragraph must be modified as 'Basis for Adverse Opinion'.

Some situations when an auditor should express an adverse opinion are:

(i) Financial statements were prepared on going concern basis even after planning to cease the operation of the company within next six months.

(ii) Inadequate provision for doubtful debts.

3. Disclaimer of Opinion

The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

An audit report with a disclaimer of opinion must include the ‘Basis for Disclaimer’.

Situations leading to reporting with a disclaimer of opinion are:

(i) Auditor was prevented by the management from (a) observing the counting of physical inventory and (b) performing other procedures such as requesting external confirmation of debtors and creditors, and bank account balances.

(ii) Non-receipt of branch audit reports from a significant number of branches.

7.5.6.2 Deciding on Appropriate Modified Opinion

As per SA 705, the objective of an auditor should be to express clearly an appropriately modified opinion on financial statements if the situation so demands. The decision on an appropriate modified opinion depends on two factors - (a) the nature of matter that gives rise to the modification and (b) auditor’s judgement about the pervasiveness of the effects on the financial statements.

The following table explains such a decision by the auditor.

Nature of matter that gives rise to the modification Auditor’s judgement about the pervasiveness of the effects on the financial statements

Material but not pervasive Material as well as pervasive	Auditor’s judgement about the pervasiveness of the effects on the financial statements	
	Material but not pervasive	Material as well as pervasive
Financial statements are misstated	Qualified Opinion	Adverse Opinion
Inability to obtain sufficient appropriate audit evidence	Qualified Opinion	Disclaimer of Opinion

7.5.6.3 Audit Report with ‘Emphasis of Matter’ and ‘Other Matter’ Paragraphs

(b) any other matter that is relevant to users’ understanding of the audit, the auditor’s responsibilities or the auditor’s report.,

for the former and an ‘Other Matter’ paragraph for the latter.

A. ‘Emphasis of Matter’ Paragraph

As per SA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report, if the auditor, having formed an opinion on the financial statements, thinks it necessary to draw users’ attention to a matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users’ understanding of the financial statements, he can do so by way of clear additional communication in the auditor’s report by including an ‘Emphasis of Matter’ paragraph provided:

a) The auditor would not be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter; and

b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term 'Emphasis of Matter';

b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and

c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

(i) An uncertainty relating to the future outcome of exceptional litigation or regulatory action.

(ii) A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.

(iii) Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.

(iv) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

B. 'Other Matter' Paragraph

If the auditor, having formed an opinion on the financial statements, considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the auditor shall include an Other Matter paragraph in the auditor's report, provided:

a) This is not prohibited by law or regulation; and

b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading 'Other Matter', or other appropriate heading.

Circumstances in which an 'Other Matter' paragraph may be necessary are:

a) When the matter is relevant to Users' Understanding of the Audit;

b) When the matter is relevant to Users' Understanding of the Auditor's Responsibilities or the Auditor's Report;

c) While reporting on more than one set of financial statements;

d) When there is restriction on distribution or use of the auditor's report.

7.5.6.4 Illustrations of Auditor's Reports with Modifications to the Opinion

Appendix of SA 705 (Revised) provides a number of illustrations on Auditor's Reports with Modifications to the Opinion as follows:

- **Illustration 1:** An auditor's report containing a qualified opinion due to a material misstatement of the financial statements.
- **Illustration 2:** An auditor's report containing an adverse opinion due to a material misstatement of the consolidated financial statements.
- **Illustration 3:** An auditor's report containing a qualified opinion due to the auditor's inability to obtain sufficient appropriate audit evidence regarding a foreign associate.
- **Illustration 4:** An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements.
- **Illustration 5:** An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements.

Illustration 1 is discussed below:

Qualified Opinion due to a Material Misstatement of the Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed company (registered under the Companies Act, 2013) using a fair presentation framework.
- The financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general-purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.11
- Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements (i.e., a qualified opinion is appropriate).
- The relevant ethical requirements that apply to the audit are The Institute of Chartered Accountants of India's Code of Ethics and the provisions of the Companies Act, 2013.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).
- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements

A. Qualified Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 20XX, and the statement of Profit and Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)).

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2XXX and profit/loss, (changes in equity) and its cash flows for the year ended on that date.

B. Basis for Qualified Opinion

The Company's inventories are carried in the Balance Sheet at ₹ XXX. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from the Accounting Standards prescribed under section 133 of the Companies Act, 2013. The Company's records indicate that, had management stated the inventories at the lower of cost and net realizable value, an amount of ₹ xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by ₹ xxx, and income tax, net income and shareholders' funds would have been reduced by ₹ xxx, ₹ xxx and ₹ xxx, respectively.

We conducted our audit in accordance with Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by The Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and we have fulfilled our other ethical responsibilities in accordance with these requirements and The Institute of Chartered Accountants of India's Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

C. Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the Basis for Qualified Opinion section we have determined the matters described below to be the key audit matters to be communicated in our report.

[Description of each key audit matter in accordance with SA 701.]

D. Responsibilities of Management and Those Charged with Governance for the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

E. Auditor's Responsibilities for the Audit of the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

F. Other Matter

We did not audit the financial statements/information of ________(number) branches included in the standalone financial statements of the Company whose financial statements / financial information reflect total assets of ₹_____ as at 31st March, 20XX and total revenues of ₹ _______ for the year ended on that date, as considered in the standalone financial statements. The financial statements/information of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of these branches, is based solely on the report of such branch auditors.

Our opinion is not modified in respect of this matter.

G. Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

For XYZ & Co

Chartered Accountants

(Firm's Registration No.)

Signature

(Name of the Member Signing the Audit Report)

(Designation17)

(Membership No. XXXXX)

Place of Signature:

Date:

Report on Internal Financial Control over Financial Reporting

7.6

7.6.1 Concept of Internal Financial Control

Internal Financial Control came into existence to promote risk management and governance process within the organisation so that instances of organised frauds.

As per Section 134(5)(e), the term 'internal financial controls' means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

The importance of a sound internal financial control is paramount. Existence of adequate internal financial control not only reduces the burden of the auditor but also provides reasonable assurance about the appropriateness of the accounts and the results generated therefrom.

7.6.2 Report on Internal Financial Control

As per Sec 143(3)(i) of Companies Act 2013, the report of the auditor should state as to whether the company has adequate Internal Financial Control system in place and the operating effectiveness of such controls.

Again, Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the Board of Directors' report of all companies to state the details in respect of adequacy of internal financial controls with reference to the "financial statements".

7.6.3 Reporting on Internal Financial Control over Financial Reporting – Auditor's Responsibility

As mentioned earlier, Sec 143(3)(i) of Companies Act, 2013 requires that the report of the auditor should state as to whether the company has adequate Internal Financial Control system in place and the operating effectiveness of such controls.

Further, Rule 10A of Companies (Audit & Auditors) Rules 2014 states that:

a) For the financial years commencing on or after 1st April 2015, the report of the auditor should state about existence of adequate Internal financial controls and its operating effectiveness.

b) The auditor of a company may voluntarily include the statement referred to in this rule for the financial year commencing on or after 1st April 2014 and ending on or before 31st March 2015.

As per the Guidance Note issued by The Institute of Chartered Accountants of India in this respect -

- The auditor's objective in an audit of internal financial controls over financial reporting is to express an opinion on the effectiveness of the company's internal financial controls over financial reporting and the procedures in respect thereof are carried out along with an audit of the financial statements.

- Globally, auditor's reporting on internal controls is together with the reporting on the financial statements and such internal controls reported upon relate to only internal controls over financial reporting.

Accordingly, the term 'internal financial controls' wherever used in this Guidance Note in the context of the responsibility of the auditor for reporting on such controls under Section 143(3)(i) of the Act, per se implies and relates to internal financial controls over financial reporting.

Therefore, 'internal financial controls over financial reporting' shall mean 'A process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that –

(i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and

(iii) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

An auditor needs to conduct an audit of IFC-FR though a proper planning followed by testing the design effectiveness of control and operating effectiveness of control and thereafter report on IFC over Financial Reporting.

The Guidance Note also provides that reporting on the adequacy and operating effectiveness of IFC-FR would apply even in case of consolidated financial statements, for the respective components included in the consolidated financial statements only if it is a company under the 2013 Act. However, reporting on IFC will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

National Financial Reporting Authority (NFRA) 7.7

7.7.1 Background

In order to incorporate governance, the quality of accounting and auditing is critical. Keeping this in mind, the Central Government established the 'National Advisory Committee on Accounting Standards' (NACAS) under Section 210A of the Companies Act of 1956 to advise it on the formulation and laying down of accounting standards and auditing procedures. The NACAS was replaced by the National Financial Reporting Authority (NFRA) under the new Companies Act of 2013. The National Financial Reporting Authority (NFRA) is a quasi-judicial organisation that oversees accounting and auditing issues.

7.7.2 Constitution

The National Financial Reporting Authority (NFRA) was constituted on 1st October,2018 by the Government of India under Sub Section (1) of section 132 of the Companies Act, 2013. The body will comprise of one Chairman who will be an eminent individual with competence in accounting, auditing, finance, or law as Chairperson. In addition, there can be a maximum of 15 members.

7.7.3 NFRA Structure

The following committees will make up the NFRA:

(i) Accounting Standards Committee;

(ii) Auditing Standards Committee

(iii) Enforcement Committee.

7.7.4 Functions and Duties of NFRA

As per Section 132(2) of the Companies Act, 2013, the duties of the NFRA are to:

(i) Recommend accounting and auditing policies and standards to be adopted by companies for approval by the Central Government;

(ii) Monitor and enforce compliance with accounting standards and auditing standards;

(iii) Oversee the quality of service of the professions associated with ensuring compliance with such standards and suggest measures for improvement in the quality of service;

(iv) Perform such other functions and duties as may be necessary or incidental to the aforesaid functions and duties.

Sub Rule (1) of Rule 4 of the NFRA Rules, 2018, provides that the Authority shall protect the public interest and the interests of investors, creditors and others associated with the companies or bodies corporate governed under Rule 3 by establishing high quality standards of accounting and auditing and exercising effective oversight of accounting functions performed by the companies and bodies corporate and auditing functions performed by auditors.

7.7.5 NFRA's Role in Auditing

A. Recommending Auditing Standards

As mentioned earlier, NFRA recommends auditing policies and standards to be adopted by companies for approval by the Central Government. For this purpose, the Authority –

(a) shall receive recommendations from the Institute of Chartered Accountants of India on proposals for new accounting standards or auditing standards or for amendments to existing accounting standards or auditing standards;

(b) may seek additional information from the Institute of Chartered Accountants of India on the recommendations received under clause (a), if required.

Further, the Authority shall consider the recommendations and additional information in such manner as it deems fit before making recommendations to the Central Government.

B. Monitoring and Enforcing Compliance with Auditing Standards

(1) For the purpose of monitoring and enforcing compliance with auditing standards under the Act by a company or a body corporate governed under Rule 3, the Authority may:

  (a) review working papers (including audit plan and other audit documents) and communications related to the audit;

  (b) evaluate the sufficiency of the quality control system of the auditor and the manner of documentation of the system by the auditor; and

  (c) perform such other testing of the audit, supervisory, and quality control procedures of the auditor as may be considered necessary or appropriate.

(2) The Authority may require an auditor to report on its governance practices and internal processes designed to promote audit quality, protect its reputation and reduce risks including risk of failure of the auditor and may take such action on the report as may be necessary.

(3) The Authority may seek additional information or may require the personal presence of the auditor for seeking additional information or explanation in connection with the conduct of an audit.

(4) The Authority shall perform its monitoring and enforcement activities through its officers or experts with sufficient experience in audit of the relevant industry.

(5) The Authority shall publish its findings relating to non-compliances on its website and in such other manner as it considers fit, unless it has reasons not to do so in the public interest and it records the reasons in writing.

(6) The Authority shall not publish proprietary or confidential information, unless it has reasons to do so in the public interest and it records the reasons in writing.

(7) The Authority may send a separate report containing proprietary or confidential information to the Central Government for its information.

(8) Where the Authority finds or has reason to believe that any law or professional or other standard has or may have been violated by an auditor, it may decide on the further course of investigation or enforcement action through its concerned Division.

C. Power to Investigate

In addition to the above, the Authority also enjoys power to -

(i) investigate any matter of professional or other misconduct under sub-section (4) of section 132 of the Act;

(ii) undertake investigation into any matter on the basis of its compliance or oversight activities; or

(iii) undertake suo-motu investigation into any matter of professional or other misconduct, after recording reasons in writing for this purpose.

If, during the investigation, the Authority has evidence to believe that any company or body corporate has not complied with the requirements under the Act or rules which involves or may involve fraud amounting to rupees one crore or more, it shall report its findings to the Central Government.

On the commencement of these rules-

(a) the action in respect of cases of professional or other misconduct against auditors of companies referred to in rule 3 shall be initiated by Authority and no other institute or body shall initiate any such proceedings against such auditors:

Provided that no other institute or body shall initiate or continue any proceedings in such matters of misconduct where the Authority has initiated an investigation under this rule;

(b) the action in respect of cases of professional or other misconduct against auditors of companies or bodies corporate other than those referred to in rule 3 shall continue to be proceeded with by the Institute of Chartered Accountants of India as per provisions of the Chartered Accountants Act, 1949 and the regulations made thereunder.

Exercise

A. Theoretical Questions

Multiple Choice Questions

1. Any casual vacancy in a govt. company is filled by the CAG of India within _________ days.
   A. 15
   B. 30
   C. 45
   D. 60
2. Which of the following is not a content of audit report as per CARO?
   A. Inventory
   B. Acceptance of deposit
   C. Recruitment of employees
   D. Repayment of loan
3. No audit firm shall be appointed or reappointed as auditor for more than two terms of __________ consecutive years.
   A. 3
   B. 5
   C. 7
   D. 10
4. Each qualified chartered accountant not in full time employment can be the auditor of at most _________companies.
   A. 10
   B. 15
   C. 20
   D. 30
5. Which of the following is not a content of audit report?
   A. Signature of the auditor
   B. Date of the report
   C. Attachment of audit evidences
   D. Auditor's address
6. An auditor shall submit a unmodified report when ______________.
   A. The financial statements exhibit true and fair view
   B. The financial statements are partially correct
   C. The financial statements are incomplete
   D. The financial statements are unavailable

7. Cost Audit is covered under
   - A. Section 204
   - B. Section 148
   - C. Section 139
   - D. None of the above
8. Secretarial Audit is covered under section
   - A. Section 204
   - B. Section 148
   - C. Section 139
   - D. None of the above
9. An Audit Committee should have a minimum of _________ number of directors.
   - A. 4
   - B. 3
   - C. 5
   - D. 6
10. A cost auditor submits his report along with reservations and observations in Form No.
   - A. CRA 1
   - B. CRA 2
   - C. CRA 3
   - D. CRA 4

[Answer: B; C; B; C; C; A; B; A; B; C]

- **State whether the following statements are true or false.**

1. An audit report should have a proper title.
2. Appointment of a statutory company auditor is governed by Section 139 of Companies Act, 2013.
3. Application for removal of a company auditor before the expiry of his term is to be made to the Central Govt. in form no. ADT-1.
4. SA 705 deals with modifications to the opinion in the independent auditor's report.
5. In case of a partnership firm the maximum no of companies to which the firm can be appointed as the auditor shall be limited to 10 companies.
6. An audit report is addressed to the authority appointing the Auditor.
7. The auditor gives a clean report when he doesn't have any significant reservation in respect of matters contained in the Financial Statements.
8. A disclaimer of opinion is issued by the auditor when he cannot form an overall opinion about the matters contained in the Financial Statements.
9. The Branch Auditor shall prepare report on the Accounts of the Branch examined by him and send it to Audit Committee.

10. Casual vacancy in the office of Cost Auditor is filled by Board of Directors.

[Answer: T; T; F; T; F; T; T; F; T; T]

Fill in the Blanks

1. Audit report reflects the work done by the ____________.
2. The audit report should be signed in the personal name of the _____________.
3. For any default on the part of the company to deposit to the unpaid dividend account within the stipulated time, the company needs to pay interest @ ______ p.a.
4. The first auditor of a Govt. Company is appointed by the shareholders of the company at the general meeting.
5. Secretarial audit is conducted by__________.
6. Cost Records are to be maintained as per Form ____________.
7. Reappointment of company auditor is guided by ________ of the Companies Act, 2013.

[Answer: auditor; auditor; 12%; CAG; company secretary; CRA-1; 139(9)]

Short Essay Type Questions

1. Discuss the provisions of Companies Act, 2013 as regards reporting of frauds by Company Auditor.
2. Discuss about the manner in which rotation of Auditors may be done by the company on expiry of their term.
3. Discuss the disqualification of a Company Auditor.
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. Who can conduct the Secretarial Audit and which company have to undergo such?
8. Discuss about the applicability of secretarial audit for companies.
9. Write Short Notes:

   (i) Auditor’s duty regarding unclaimed dividend

   (ii) Responsibility of a Joint Auditor

   (iii) Auditor’s duty regarding Issue of Debentures

   (iv) Audit’s duty regarding bonus issue

   (v) Branch Audit

Essay Type Questions

1. Discuss the provisions of Companies Act, 2013 as regards reporting of frauds by Company Auditor.
2. Discuss about the manner in which rotation of Auditors may be done by the company on expiry of their term.
3. What is the procedure to be followed for fixing the remuneration of a Cost Auditor?
4. Distinguish between ‘Audit Report’ and ‘Audit Certificate’.

5. Discuss the functions and power of the Audit Committee.
6. Discuss the procedure for appointment for first Auditor of the Company and his tenure.
7. Discuss the relevant provisions of Companies (Cost Records and Audit) Rules 2014 on applicability of Cost Audit to different sectors.
8. What is a qualified Audit Report? Discuss the circumstances when an Auditor shall qualify his report.
9. Discuss the qualifications of a Company Auditor.
10. Discuss the provisions of Companies Act regarding resignation of an auditor.
11. Discuss the provisions of Companies Act regarding remuneration of an auditor.
12. Discuss the provisions of Companies Act regarding ceiling on the number of audit assignments.
13. Discuss the disqualification of a Company Auditor.
14. How a company auditor is removed from his office?
15. Discuss the rights of a company auditor
16. What do you mean by Joint Audit? Discuss the advantages and disadvantages of Joint Audit.
17. Discuss the audit procedure to be followed for the audit of:
    (i) Inventory
    (ii) Property, Plant and Equipment
    (iii) Borrowings
    (iv) Trade Receivable
18. Discuss the audit procedure to be followed for the audit of:
    (i) Employee Benefits
    (ii) Purchases
    (iii) Revenue from Operation
    (iv) Depreciation and Amortisation
19. What is the procedure for appointment of cost auditor under the Companies Act, 2013?
20. Who can be appointed as a cost auditor?
21. What are the eligibility criteria for appointment as a cost auditor?
22. Who can conduct the Secretarial Audit and which company have to undergo such?
23. Discuss about the applicability of secretarial audit for companies.
24. Discuss auditor's responsibility for reporting on Internal Financial Control over Financial Reporting.
25. State the functions of NFRA.
26. Discuss the role of NFRA in monitoring and enforcing compliance with auditing standards.
27. Write Short Notes:
    (i) Auditor's duty regarding unclaimed dividend

(ii) Responsibility of a Joint Auditor

(iii) Auditor's duty regarding Issue of Debentures

(iv) Audit's duty regarding bonus issue

(v) Branch Audit

28. Discuss the functions and power of the Audit Committee.

29. Discuss the procedure for appointment for first Auditor of the Company and his tenure.

30. Discuss the relevant provisions of Companies (Cost Records and Audit) Rules 2014 on applicability of Cost Audit to different sectors.

31. What is a qualified Audit Report? Discuss the circumstances when an Auditor shall qualify his report.

32. Discuss the qualifications of a Company Auditor.

33. Discuss the provisions of Companies Act regarding resignation of an auditor.

34. Discuss the provisions of Companies Act regarding remuneration of an auditor.

35. Discuss the provisions of Companies Act regarding ceiling on the number of audit assignments.

36. How a company auditor is removed from his office?

37. Discuss the rights of a company auditor

38. What do you mean by Joint Audit? Discuss the advantages and disadvantages of Joint Audit.

39. Discuss the audit procedure to be followed for the audit of:

(i) Inventory

(ii) Property, Plant and Equipment

(iii) Borrowings

(iv) Trade Receivable

40. Discuss the audit procedure to be followed for the audit of:

(i) Employee Benefits

(ii) Purchases

(iii) Revenue from Operation

(iv) Depreciation and Amortisation

41. Discuss auditor's responsibility for reporting on Internal Financial Control over Financial Reporting.

42. State the functions of NFRA.

43. Discuss the role of NFRA in monitoring and enforcing compliance with auditing standards.

⊙ Unsolved Cases

1. In 2017, Mr. X, Mr. Y and Mr. Z, three qualified chartered accountants established a partnership firm XYZ & Co. Till the financial year 2019-20, the firm mostly handled the audit of sole proprietorship organisations and a few partnership firms and LLPs. In the financial year 2021-22, they got their first corporate client ABC Enterprise Ltd. All the three partners are confident enough to carry out the new

assignment effectively as they have a very efficient team of audit clerks. However, they also feel that they should be extra cautious this time as every aspect of statutory audit is well regulated by the relevant provisions of Companies Act 2013. They have, therefore, approached you to guide them in comprehending the relevant provisions of Companies Act 2013 in discharging their duties in an appropriate manner.

a. Suggest them about their duties to prepare and submit report on financial statements of the company as per Section 143 of the Act.

b. Suggest them about their duty to report any fraud to the Central Government as per Section 143 of the Act.

2. ABC & Co. has been appointed as the statutory auditor of X Ltd. from the financial year 2020-2021. X Ltd. is a well-established company and has a track record of following a stable dividend policy over the years. The company pays interim dividend every year based on its quarterly results up to second quarter and also declares additional dividend as the final dividend in its AGM. With respect to the current year, the company has already declared and paid an interim dividend @ 10% of the paid-up equity share capital in the month of October 2020. The AGM of the company is scheduled on 10.09.2021 where the BODs are going to recommend a final dividend of another 15% over and above the interim dividend already paid, thus taking the total dividend payment to 25% of the paid-up equity share capital for the financial year 2020-2021.

   Since, this is the first ever corporate audit assignment for ABC & Co., the partners seek your valuable expertise in the process of conducting an audit of payment interim dividend and the upcoming final dividend.

   a. Advise ABC & Co. on an auditor’s duty in conducting the audit of interim dividend.

   b. Advise ABC & Co. on an auditor’s duty in conducting the audit of final dividend.

References

1. Auditing and Assurance (2e) by Sana, Sarkar, Biswas & Das, McGraw Hill Publication
2. Fundamentals of Auditing by S K Basu, Pearson Publication
3. Companies Act, 2013
4. Company (Audit and Auditor) Rules, 2014
5. Company (Cost Records and Audit) Rules, 2014
6. Companies (Auditor’s Report) Order 2020
7. Chartered Accountants Act, 1949
8. Banking Regulation Act, 1949
9. Life Insurance Act, 1956

Auditing of Different Types of Undertakings

8

This Module includes

Auditing of Different Types of Undertakings

SLOB Mapped against the Module

To gain an insight into the auditing mechanism in undertakings other than companies. (CMLO 4 a)

Module Learning Objectives:

After studying this module, the students will be able to –

- Develop an understanding of how to frame an audit programme of an educational institution.
- Understand the areas to be appraised while conducting an audit of a healthcare institution.
- Understand the aspects to be covered while auditing an organisation from hospitality sector.
- Develop an understanding of auditing aspects of banks and co-operative societies.
- Understand the areas to be appraised while conducting an audit of a local self-government.

Introduction

8

Accounting largely depends on the nature of the organisation. The accounting methods as well as the final financial statements vary in their form and content across organisations. Since an auditor needs to comment on the true and fair view of the financial performance and financial state of affairs only after careful inspection of accounting records and financial statements prepared therefrom, he must adopt audit procedures that perfectly suits the very nature of accounting process adopted in an organisation. The same audit procedures cannot be blindly applied to every single audit assignment.

Moreover, many of the organisations other than the companies, have their own regulatory framework which prescribes for specific requirements with respect to accounting and reporting. For examples, in India banks are largely regulated by the Banking Regulation Act, 1949 as well as Reserve Bank of India Act, 1934 apart from many other individual Acts and Regulations. Co-operative societies in India are governed by Co-Operative Societies Act, 1912. Local self-governments such as Municipalities and Panchayats are guided by the Constitution of India as well as various State Municipalities Act.

In addition, nature of the industry to which a firm belongs, policy adopted by an organisation also determines the scope of audit. Hence, the audit procedures to be planned by the auditor must also consider these factors.

Audit of Educational Institutions

8.1

Educational institutions of any state in India are generally established and run under the Societies Registration Act 1960 or Public Trust Act of the state concerned. Similarly, central educational institutions are guided by the respective regulations issued by the Ministry of Education from time to time. In some cases, large educational institutions like universities are established by Central or State governments by enacting special legislation. Accordingly, the audit of accounts of these institutions is carried out as per the provisions of the legislation or the Trust Deed concerned. In addition, various circulars issued by the Central or State Government for institutions are also considered relevant in this respect. The audit procedure for these institutions must consider the following aspects:

a) **Understand the Constitution:** Study the Trust deed, Regulation or Act under which the institution has been established and should take note of the provisions regarding the maintenance of accounts. In case of State or Central University, established under the Special Act, study the regulations framed under the Act.

b) **Assess the Internal Control System:** Normally, these institutions have a well-organised internal control system. So, evaluate the internal control system associated with acquisition and maintenance of assets, authorization of transactions, etc. before finalising the audit programme.

c) **Consult the Minute Book:** Carefully examine all notices and minutes of the meeting of Governing Body (in case of colleges), Senate, Syndicate, Court and Council (in case of universities) and other committees which affect the accounts and finance of the institute. Confirm that the decisions taken for operation of bank accounts, approval of expenditure etc. have been duly complied with.

d) **Consult the Budget:** Check the budget allocation to different heads and confirm that all amount sanctioned beyond budget has been duly approved.

e) **Verify the Receipts Related Transactions:**

(i) **Tuition Fees:** Tally the counterfoils of fee receipt with fee register to see whether they have been duly recorded or not. Check the register to identify whether all the students have paid their fees in due time. If any student has deposited the fees beyond the due date, check whether late fine has been charged or not and whether the same has been properly recorded. See whether all collections are deposited in the bank account at the end of the day. Total up the various columns of the Fees Register for each month or term to ascertain that fee paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.

(ii) **Admission Fees:** 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.

(iii) **Other Fees:** Verify the collection of other fees such as library fees, session fees or development fees, fees for hostel etc. based on the counterfoils and fee registered and ensure that the fees have been accounted for in appropriate heads.

(iv) See that all arrears on account of fees, fines, etc. have been taken into consideration at the end of accounting period.

(v) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.

(vi) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.

(vii) Verify grants received from Government or other organisations based on the sanction letter and bank statement.

(viii) Ensure that donation received, if any, has been acknowledged and recorded properly in the books of accounts.

(ix) Check income from letting out institutional properties based on the counterfoil of receipts issued to parties.

(x) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

f) Verify the Payments Related Transactions:

(i) Verify the salary and wages paid to the employees. In case of Govt. or aided colleges, verify that the claims have been properly prepared and the amount sanctioned has been distributed to the right person. Check the calculation and accounting of arrear salary and see whether the deductibles from salary, such as Provident Fund Contribution and Income Tax deducted at source, have been deposited with the authority concerned in due time and if not, whether the same have been accounted for appropriately.

(ii) Examine whether all the expenditure associated with special events like seminar or symposium etc. has been accounted for by matching the expenditure in this regard against the amount obtained from any organisation or sanctioned by the institution itself.

(iii) Vouch all the regular expenses such as electricity, telephone or broadband bills, travelling expenses, etc. based on available vouchers and accounting records.

(iv) Vouch purchase of fixed assets, expenditure for construction of college buildings based on the available vouchers, resolution of the meetings of purchase/finance committee. Similarly, utilization of grants for purchase of fixed assets, library books and laboratory equipment must be separately vouched.

(v) Vouch the refund of Caution Deposit from the students based on receipts and accounting records.

(vi) Examine the payments on account of hostel facilities including repairs and mainte-nance of hostel building, electricity charges, purchase of food items etc.

(vii) 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.

g) Verification of Assets and Liabilities:

(i) Conduct physical verification of tangible fixed assets as shown in the Fixed Asset Register. Verify investments based on Investment Register.

(ii) Check whether depreciation and amortization has been provided as per the policy adopted.

(iii) Verify the refund of TDS in respect of interest on investment, if any.

(iv) Carefully examine all outstanding liabilities such as electricity and telephone bills outstanding, TDS and PF not yet deposited.

(v) 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.

(vi) 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.

h) Verification of Financial Statements: Verify that the financial statements (i.e., Income and Expenditure Account and Balance Sheet) have been prepared in the form and manner as specified by the regulatory authority complying with the account standards and applicable legal requirements.

Audit of Healthcare Organisations 8.2

Healthcare Organisations primarily include hospitals and nursing homes. They are established to provide medical services to the public. There may be hospitals run and funded by the Government or local authorities or by any charitable trust. These are generally non-profit seeking organisations. However, hospitals may also be established by private sector organisations. These are profit seeking organisations (and are popularly known as private nursing homes). Since healthcare organisations largely differs from other commercial organisations on account of their business processes, an auditor needs to prepare a sound audit plan to cover typical aspects of these organisations. Accordingly, the audit procedure must highlight the following steps:

a) **Understand the Constitution:** Study all the relevant documents to determine its nature and ownership structure (i.e., trust, partnership or company). Study the trust deed (in case of trust), partnership agreement (in case of partnership business) and articles and memorandum of association (in case of a company) and accordingly identify the rules and regulation relating to its management and process of preparation of accounts.

b) **Assess the Internal Control System:** Evaluate the internal control system associated with acquisition and maintenance of assets, authorisation of transactions, etc. and determine the scope of the audit work.

c) **Consult the Minute Book:** Carefully examine the notices and minutes of the meeting of Board of Directors, Managing Committee and other committees (such as purchase committee) and identify the decisions which may affect the accounting. Confirm that the decisions undertaken with respect to operation of bank accounts, approval of expenditure, etc. have been duly complied with.

d) **Verify the Receipts Related Transactions:**

(i) In case of a hospital run by state government or any local authority, vouch the grants received from the state or the local authority based on Govt. Orders, sanction letters, counterfoil of receipts.

(ii) Vouch collection from patients admitted to the paying beds based on the Patient Admission Registrar and counterfoil of receipts/ copies of bills.

(iii) Vouch collection from various pathological tests based on the counterfoils of receipts/ copies of bills.

(iv) Vouch donations based on the counterfoils of receipts.

(v) In case hospitals having guest houses, assess the collections based on the register, counterfoils of receipts and accounting entries.

(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.

e) **Verify the Payments Related Transactions:**

(i) Verify that all capital expenditure associated with machineries, furniture, vehicle, etc. is approved and supported by documentary evidences such as counterfoils cheque, invoices, tenders, etc.

(ii) Vouch the salary paid to staff based on attendance register, payroll, etc. Examine that the appointment of casual staff and payment of their salaries are duly authorized.

(iii) Verify doctor's remuneration should be verified based on the list of visits and operations performed.

(iv) Verify the purchases of pathological test kits, X-ray plate and other consumables based on tenders, orders placed and invoices received.

(v) Vouch all other overhead expenses like telephone bills, electricity bills, fuel bills, etc. based on appropriate documentary evidences.

f) **Verification of Assets and Liabilities:**

(i) Verify the stock registers of medicines, food items and other equipment and check their valuations.

(ii) Conduct physical verification of fixed assets and investments based on Fixed Asset Register and Investment Register respectively.

(iii) Check the adequacy of depreciated and its accounting.

(iv) Collect the list of all liabilities and verify them based on the contracts and arrear bills.

g) **Verification of Financial Statements:**

(a) Verify that the financial statements have been prepared in the manner and format appropriate to the nature (profit seeking or non-profit seeking) and ownership structure of the organisation.

Audit of Organisations in Hospitality Sector

8.3

Hospitality sector covers a wide range of organisations which can broadly be divided into four categories, viz. (A) Food and Beverages i.e., Restaurants, (B) Travel and Tourism, (C) Lodging i.e., Hotels and Guest Houses and (D) Recreation such as Cinema Halls, Theme Parks etc. Since, the organisations in the above categories largely differ in their business processes, auditing procedures will certainly be different for each of them, barring a few common areas. The steps to be followed are discussed below:

- **Steps Common for All Organisations**

  a) Understand the ownership structure of the organisation (such as sole proprietorship, partnership, private limited companies or public limited companies) and determine the regulatory requirements to be examined relating to management as well as accounting.

  b) Evaluate the internal control system and determine the nature, timing and the extent of the audit procedures.

  c) Check that the organisation has a valid licence from an appropriate authority to run the business.

- **Steps Common for the Category**

  A. Restaurants (Food and Beverages)

  a) Verify the total revenue recognised based on the daily and monthly sales report.

  b) Check that the revenue has been realised in cash based on bank statements. Check whether arrears written off, if any, has been duly approved by the person responsible.

  c) Vouch all payments made to suppliers based on documentary evidences such as orders placed, invoices and bank records.

  d) Carefully examine the petty cash book. Any irregularity should be examined further.

  e) Vouch payments on account of rent, electricity and other overhead expenses.

  f) Vouch the payment of salary based on payroll, attendance register and bank records.

  g) Carefully examine the valuation of stock. Large writing off of any perishable item should be carefully examined.

  h) Conduct physical verification of fixed assets and investments based on Fixed Asset Register and Investment Register respectively.

  i) Check the adequacy of depreciated and its accounting.

  j) Collect the list of all liabilities and verify them based on the contracts and arrear bills.

B. Travel and Tourism

a) Vouch the collections from customers based on their booking details, counterfoil of receipts etc. Determine arrears, if any, at the end of the year.

b) Vouch revenue out of commissions from various companies and tour partners.

c) Vouch the payment made on account of tour bookings (divided into Air Travel, Rail, Road, Sea etc.), hotel accommodations.

d) Vouch transactions related with cancellation of bookings.

e) Check that discounts offered to individual customers are approved by the competent authority.

f) All overhead expenses including electricity bills, telephone and broadband bills, taxes to local authorities, etc. should be vouched based on the respective bills.

g) Verify the salary paid to permanent staff based on their payroll, attendance records and leave applications. Payment of incentives should be checked carefully.

h) Conduct physical verification of fixed assets and investments based on Fixed Asset Register and Investment Register respectively.

i) Collect the list of all liabilities and verify them based on the contracts and arrear bills.

C. Hotels and Guest Houses (Lodging)

a) Vouch the collections from boarders based on their check-in and check-out information recorded in the register, counterfoils of bills and cash book.

b) Verify the room rent receipts and daily occupancy reports. Ask for proper clarification for differential rent charged from any boarder. Be careful while verifying the adjustment of unrealised room rent, cancellation charges of booking accommodation at the time of closing of accounts.

c) Vouch collections on account of special events such as conferences, wedding ceremony etc. separately based on counterfoil of receipts and cash book.

d) Income from bar, casino, health centre, etc. associated with the hotel should be vouched based on counterfoils of bills and cash book. Vouch the rent from shops situated in the premises of the hotel, if any.

e) Vouch transactions relating to purchase of food materials, drinks and other materials. Check whether the payments have been made based on purchase orders or contracts, invoice, etc.

f) Verify the salary paid to permanent staff based on their payroll. Salary paid to casual and contractual employees should be verified based on documentary evidences like authorisation by management.

g) All overhead expenses including electricity bills, telephone and broadband bills, taxes to local authorities, etc. should be vouched based on the respective bills.

h) Carefully examine the valuation of stock. If possible, remain physically present at the time of stock taking.

i) Conduct physical verification of fixed assets and investments based on Fixed Asset Register and Investment Register respectively. Check the adequacy of depreciation and its proper accounting.

j) Collect the list of all liabilities and verify them based on the contracts and arrear bills.

D. Recreations

I. Cinema Halls

a) Check whether appropriate control is in force over tickets of different denominations. Verify whether unsold tickets are kept under lock and key under the responsibility of any official.

b) Vouch the collections based on daily sales report of tickets and entries in the cash book.

c) Check whether collections from advance bookings have been duly adjusted.

d) Vouch collections on account of rental income due to hiring of the hall for special events based on the respective contract and counterfoil of receipt.

e) Vouch collection from sale of drinks, refreshments etc based on their daily sales report and entries in the cash book.

f) Check whether the entertainment tax collected as a part of the ticket value has been appropriately accounted and deposited within due dates. See that entertainment tax collected but not deposited has been considered as a liability in the financial statement.

g) Vouch payments relating to hiring of films based on relevant contract with the distributor and receipts.

h) Vouch payment on account of advertisement with the advertising agencies based on the agreements and receipts.

i) Payment to suppliers of refreshments should be vouched based on orders placed, invoices and entries in the cash book.

j) Vouch salary paid to staff based on payroll, attendance register and leave applications. Appointment of casual staff must be verified based on appointment letter issued by the responsible authority only.

k) Conduct physical verification of fixed assets and investments based on Fixed Asset Register and Investment Register respectively. Check the adequacy of depreciation and its proper accounting.

II. Amusement Park

a) Check whether appropriate control is in force over tickets of different denominations. Verify whether unsold tickets are kept under lock and key under the responsibility of any official.

b) Vouch the collections based on daily sales report of tickets and entries in the cash book.

c) Check whether collections from advance bookings have been duly adjusted.

d) Vouch collection from sale of drinks, refreshments etc based on their daily sales report and entries in the cash book.

e) Vouch payment on account of advertisement with the advertising agencies based on the agreements and receipts.

f) Payment to suppliers of refreshments should be vouched based on orders placed, invoices and entries in the cash book.

g) Vouch salary paid to staff based on payroll, attendance register and leave applications. Appointment of casual staff must be verified based on appointment letter issued by the responsible authority only.

h) Conduct physical verification of fixed assets and investments based on Fixed Asset Register and Investment Register respectively. Check the adequacy of depreciation and its proper accounting.

Audit of Banks

8.4

8.4.1 Importance of Banking Institutions in Economy

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. Under the able leadership of RBI, the banking institutions in the country are working in a competitive environment and their regulatory framework is aligned with the international best practices. As a result, 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.

8.4.2 Different Types of Banks

In India, banks are generally classified into the following broad categories:

a) Commercial Banks

b) Regional Rural Banks

c) Co-operative Banks

d) Development Banks

e) Payment Banks

f) Small Finance Banks

Though all of them are guided by RBI, they are fundamentally different with respect to their nature, mode of operation and power and target customer group.

8.4.3 Regulatory Framework of Banks in India

In India, banks are guided by a whole host of Acts and associated Rules. However, not all are applicable to each and every banking institutions. These are as follows:

a) Banking Regulation Act, 1949

b) Companies Act, 2013

c) State Bank of India Act, 1955

d) State Bank of India Act (Subsidiary Banks) Act, 1959

e) Regional Rural Banks Act, 1976

f) Information Technology Act, 2000

g) Prevention of Money Laundering Act, 2002

h) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980

i) Credit Information Companies Regulation Act, 2005

j) Payment and Settlement Act, 2007

In addition, Reserve Bank of India Act, 1934 also affect the functioning of banks in India.

8.4.4 Form and Content of Financial Statements of a Bank

Section 29(1) and (2) of Banking Regulations Act, 1949 deal with the form and content of financial statements of a banking company. The provisions are applicable to nationalised banks, State Bank of India and Regional Rural Banks.

Accordingly, every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

8.4.5 Statutory Audit in Banks

As per section 30(1) of Banking Regulations Act, 1949, the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies.

Accordingly, the auditor of a banking company is to be appointed at AGM of the shareholders. The auditor of a nationalised bank is to be appointed by the bank concerned acting through its Board of Directors. The auditor of State Bank of India (SBI) is appointed by the CAG of India while the auditors of Regional Rural Banks are appointed by the bank concerned with the approval of the Central government.

The remuneration of the auditor, so appointed, is fixed as per Section 142 of Companies Act, 2013 in case of banking companies while in case of nationalised banks, the remuneration is fixed by RBI in consultation with the Central government.

The power of an auditor in a bank is almost similar to that of a company auditor.

8.4.6 Auditor's Report - Content

The auditor of a nationalised bank is primarily required to comment on the following aspects in its report to the Central Government:

a) whether the financial statements present a true and fair view of the affairs of the bank and whether all necessary explanation and information has been made available to him;

b) whether or not the transactions of the bank, which have come to his notice, have been within the powers of that bank;

c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit; and

d) any other matter which he considers should be brought to the notice of the Central Government.

Audit of other banks require more or less the same assessment. In addition, the auditor of a banking company requires to report the matters covered by Section 143 of the Companies Act, 2013. However, Companies (Auditor's Report) Order, 2020 is not applicable to a banking company.

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. 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.

8.4.7 Auditing Aspects of Banks' Financial Statements

Apart from the general considerations such as confirming the validity of his appointment, communicating with the previous auditor, agreeing on the terms of audit engagements etc. the auditor should consider the following aspects in conducting the audit of a bank.

- **General Issues:**

  a) Understand the Bank and its Environment: Obtain an understanding of the bank and the control environment to identify and assess risk and develop an audit plan to determine the effectiveness of controls and address specific risk issues.

  b) Understand the Accounting Process: Obtain an understanding of the accounting process – computerised or manual – of the bank.

  c) Understand the Risk Management Process: Obtain a clear understanding of the process adopted by the bank for managing financial as well as operational risks.

  d) Develop a detail audit plan.

  e) Determine audit materiality

  f) Obtain a detail understanding of the relevant BASEL framework applicable for the bank.

  g) Determine the extent of reliance on reports of previous auditor, RBI reports, internal audit report etc.

- **Specific Issues:**

  A. Advances: In relation to advances made by bank an auditor needs to review the followings:

  (i) Ensure that the internal control is in place in relation to advances made.

  (ii) Scrutinise the subsidiary, ledger, & control accounts

  (iii) Ensure the proper documentation of account.

  (iv) Scrutinise the overdue account and scheme for recovery of such amount.

  B. Cash in hand: The auditor should

  (i) Ensure that the internal control is in place.

  (ii) Visit the bank branch and inspect physical cash and ensure that it tallies with the bank's cash book balance.

  (iii) Verify the amount of foreign currency held by bank and its translation at market rate on the date at which financial statement is prepared.

  C. Balance with RBI: The auditor should

  Inspect the ledger balance in each account with (a) bank confirmation certificates from Reserve Bank of India and (b) Reconciliation Statement.

  D. Balance with Other Bank: The auditor should

  (i) Inspect the reconciliation statement to ensure that no debit or credit for interest have been taken to

Revenue account to the year.

(ii) Examine the large transition and balances with banks outside India.

(iii) Ensure that they are converted at market rate as on financial statement preparation date.

E. Money at call & short notice: He should

(i) Examine the system of authorisation for money at call and short notice.

(ii) Ensure that call loan made by bank are not netted off against call loan received by it.

(iii) Ensure that money market lending for more than 6th days are not classified under this head but as a deposit or advance based on their nature of lending.

F. Fixed and other Assets: He should

The auditor has to ensure the following while auditing the fixed assets held by banks:

(i) Ensure that accounting method of bank is appropriate and ownership document is adequate.

(ii) Examine with reference to schedule of fixed assets to find new assets acquired.

(iii) Examine sale deed in relation to sale of assets by bank.

(iv) Ensure appropriateness of basis of revaluation of fixed assets.

(v) Ensure compliance of Section 9 of Banking Regulation Act, 1949.

G. Barrowings: He should

(i) Ensure that the amount has been properly disclosed for borrowing in India from RBI and barrowing from outside India.

(ii) Ensure that the rate of interest is commensurate with the duration of borrowing.

(iii) Verify whether the barrowings of money at call and short notice are property authorized.

H. Deposits: He should

(i) Ensure that the interest accrued but not due on deposits has not been taken under other liabilities and provision

(ii) See whether there is any instance of window dressing.

I. Capital: He should

(i) Examine the opening balance of capital.

(ii) Examine the special resolution of shareholders' meeting or MOA about increase in authorized capital during the year.

(iii) Examine the prospectus regarding increase in subscribed/ paid up capital.

(iv) Examine the Government notification for any fresh contribution from them.

J. Reserve and Surplus: He should

(i) Examine the opening balance of different type of reserve, addition/ deduction from reserves, reason for appropriation from such account and dividend paid by bank.

(ii) In respect of foreign branch ensure compliance with foreign laws.

K. Bills Payable:

(i) He should Evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following:

- Drafts, mail transfers, traveller's cheques, etc., should be made out in standard printed forms.
- Unused forms relating to drafts, traveller's cheques, etc., should be kept under the custody of a responsible officer.

(ii) 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.

(iii) The signatures on a demand draft should be checked by an officer with the specimen signature book.

(iv) 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.

(v) 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. 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. Cases of frequent cancellation and reissuance of drafts, pay orders, etc., should be carefully looked into by a responsible official.

L. Contingent Liabilities:

(i) 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:

(ii) 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.

(iii) 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.

(iv) The auditor should also examine whether in case of LCs (Letter of Credits) for import of goods, 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.

(v) He should also 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.

(vi) He must perform 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.

(vii) He should 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.

(viii) He should also review whether comfort letters issued by the bank has been considered for disclosure of contingent liabilities.

M. 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.

N. Treasury Operation-Foreign Exchange and Derivatives:

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.

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.

Audit of Co-Operative Societies

8.5

8.5.1 Unique Features of Co-Operative Societies

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 organisation, 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.

8.5.2. Statutory Audit Requirement in Co-Operative Societies

As per Section 17 of the Co-Operative Societies Act, 1912 -

(i) 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.

(ii) 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.

(iii) 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.

(iv) Here, 'Registrar' means a person appointed to perform the duties of a Registrar of co-operative societies under this Act.

The following additional points should be kept in mind while auditing a 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 person who has served as an auditor in the Co-operative Department of Government, may also be appointed as the auditor.

(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.

Generally, the following records are maintained by co-operative societies -

- **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 shareholding: 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 ₹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 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 of Co-operative Societies Act, 1912, 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):

- Central or State Co-operative Bank,

- Any securities specified in Section 20 of the Indian Trusts Act, 1882.
- Any shares, securities, bonds or debentures of any other Co-operative society with limited liability.
- 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;
- In any other manners as duly permitted by the requisite authority.

It shall be the duty of the auditor to 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-operative 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 of Co-operative Societies Act, 1912, 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.

8.5.3 Steps to be Taken by an Auditor of a Co-Operative Society

a) General Points: In general, while conducting audit of Co-operative society, the auditor needs to look into the following: -

- The auditor should carefully go through the bye-laws of the society and see that they are being observed both in letter and spirit.
- He should examine the Register of Members of the society and individual shareholdings.
- 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.

b) 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.

c) Audit of Expenditure:

- 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.
- He should vouch the payment of loans from the loan agreements entered into with borrower members.

- He should vouch establishment expenses with reference to the resolutions of the Managing Committee, agreements with the persons concerned, and money receipts obtained from them.

d) Other points:

- 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.
- 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.
- 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.

Audit of Local Self-Government

8.6

In India, local self-government refers to governmental jurisdictions below the level of the state. With the introduction of 73rd and 74th amendments to the Indian Constitution, the local self-governance system has been recognised as the formal system of governance at the local level in both rural and urban areas throughout the country. In addition, state legislations also have given power to these organisations.

The urban local self-governance bodies are further divided into Municipal Corporation or Nagar Nigam, Municipality or Nagar Palika and Notified Area Council or Town Panchayat or Nagar Panchayat. Similarly, the rural self-governance in India is structured in three layers, viz. Gram Panchayat (at village level), Panchayat Samiti (at block level) and Zilla Parishad (at district level). All these local bodies are operated by representatives elected through a democratic process by participation of every Indian citizen.

Both urban and rural local bodies are vested with a long list of functions delegated to them by the state governments. Grants are issued by the States and these are to be utilized by the local bodies within the set parameters to execute the sanctioned projects. In addition, several local taxes are also the sources of revenue for them and they employ such funds for development and maintenance of public assets and similar other works. For example, urban local bodies are required to perform functions including general administration and revenue collection, public health, public safety, education, public works, and others such as interest payments. Similarly, rural local bodies are primarily required to help plan, coordinate, monitor and wherever required regulate the implementation of various national programmes. The responsibility of maintaining the assets created through various programmes also lies on them.

Since these organisations deal with public money, audit or the accounts of these bodies are of immense importance to ensure transparency and accountability.

The major objective of audit of Municipalities and Panchayats are enumerated below:

a) To ensure on the fairness and correctness of contents in the Financial Statement

b) To report on adequacy of Internal control

c) To ensure value of money is fully received on amount spent.

d) To detect the frauds and errors.

Accordingly, the auditor is supposed to consider the following general points in conducting the audit of local bodies:

a) Ensure that his appointment is in line with the respective regulation of the local body and approved by the appropriate authority.

b) Obtain a detail understanding of the rules and regulations that governs the operations, especially the financial control and accounting of the organisation.

c) Consult the relevant documents, minutes and resolutions of various meetings of different committees.

d) With regards to various government schemes which are implemented through local bodies, check the utilization of grant, appropriate authorization being maintained throughout and adequacy of accounting.

e) Apply in depth investigation in areas with potential fraud such as revenue collection, various waiver schemes, use of casual labour etc.

f) Whenever there is a provision of funds, ensure that the expenditure is incurred from the provision and the same has been authorized by the competent authority.

g) Ensure that where huge financial expenditure is involved, the schemes are running economically and is expected to generate the targeted outcome.

Exercise

A. Theoretical Questions

- **Multiple Choice Questions**

1. Which of the following is not a part of urban self-governance system in India?
   A. Municipal Corporation
   B. Town Panchayat
   C. Municipality
   D. Municipal Society
2. Which of the following is not a part of rural self-governance system in India?
   A. Gram Panchayat
   B. Gram Parishad
   C. Panchayat Samiti
   D. Zilla Parishad
3. The amendments that gave the local self-governance in India the constitutional protection are _______ and ________.
   A. 53 and 54
   B. 63 and 64
   C. 73 and 74
   D. 83 and 84
4. According to the Central Co-operatives Societies Act, ______ of the profits of a co-operative society should be transferred to a Reserve Fund before distribution of dividend or payment of bonus to its members.
   A. 20%
   B. 25%
   C. 30%
   D. 35%

[Answer: 1-D; 2-B; 3-C; 4-B]

- **State whether the following statements are true or false.**

1. The Banking Regulations Act, 1949 is an important source of regulation in case of banks.
2. The educational institutions in India are mostly structured as Public Trusts.
3. The rural self-governance in India is structured in four layers.
4. Statutory audit requirements have been covered in Co-Operative Societies Act, 1912.
5. Companies (Auditor's Report) Order, 2020 is not applicable to a banking company.

[Answer: True; True; False; True; True]

- **Fill in the blanks:**

1. Auditor in a co-operative society is appointed by the _________ of Co-operative Societies.
2. Section __________ of Banking Regulations Act, 1949 dealwith the form and content of financial statements of a banking company.

3. In case of nationalised banks, the remuneration of an auditor is fixed by ____________.
4. The auditor of a banking company is to be appointed by the ____________.

[Answer: Registrar; 29; RBI; shareholders]

Short Essay Type Questions

1. Write a short note on audit of a hotel.
2. Write a short note on audit of a travelling agency.
3. Write a short note on audit of a cinema hall.
4. Write a short note on audit of a restaurant.
5. Write a short note on audit of Local Bodies.

Essay Type Questions

1. While carrying an audit of a Bank how will you deal with each of the following?
   a) Advances
   b) Balance with other banks
   c) Money at call and short notice
   d) Fixed Assets
   e) Bills sent for collection
   f) Contingent liabilities
   g) Bills Payable
   h) Borrowings and Deposits
2. Mention the special steps involved in conducting the audit of college?
3. What are the points which you as an Auditor would look into while auditing the accounts of a hospital?
4. Discuss the important points in an audit of Co-operative Society.

Unsolved Case

You have been appointed as the auditor of Imperial University for the financial year 2021-22. The University has 3 campuses located in Mumbai, Ahmedabad and Kolkata. It conducts 5 Year integrated courses in different subjects and also offer Ph.D. programme. There are both domestic and foreign students. The university offers hostel facilities to all its students for which separate fees are collected. All the fees are collected up-front on semester basis and students need to pay fine if the fees are not paid within 15th of the first month of the concerned semester. The caution deposit for the course is payable only if a student completes his/her course. The University regularly conducts symposiums, conferences and workshops in which faculty members and students of other institutions also participate. Prepare a detail audit programme with respect to the receipt related transactions for this audit engagement.

References

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2. Fundamentals of Auditing by S K Basu, Pearson Publication
3. Banking Regulation Act, 1949
4. Companies Act, 2013
5. Co-Operative Societies Act, 1912