

## THE COMPANY AUDIT - II

---

### BASIC CONCEPTS

The Chapter deals with the provisions relating to company accounts, some specific items of financial statements relating to companies and audit thereof.. The important sections outlined herein are as follows:

**Section 53** Service of documents on members by company.

**Section 56** Matters to be stated and reports to be set out in prospectus

**Section 60A** Shelf prospectus

**Section 60B** Information memorandum

**Section 69** Prohibition of allotment unless minimum subscription received

**Section 73** Allotment of shares and debentures to be dealt in on stock exchange

**Section 75** Return as to allotments.

**Section 76** Power to pay certain commissions and prohibition of payment of all other commissions, discounts, etc

**Section 77A** Power of company to purchase its own securities.

**Section 77B** Prohibition for buy-back in certain circumstances.

**Section 78** Application of premiums received on issue of shares.

**Section 79** Power to issue shares at a discount

**Section 79A** Issue of sweat equity shares

**Section 80A** Redemption of irredeemable preference shares, etc.

**Section 81** Further issue of capital

**Section 93** Payment of dividend in proportion to amount paid-up.

**Section 94** Power of limited company to alter its share capital.

**Section 94 A** Share capital to stand increased where an order is made under section 81(4)

**Section 100** Special resolution for reduction of share capital.

## Auditing and Assurance

---

**Section 108** Transfer not to be registered except on production of instrument of transfer.

**Section 109A** Nomination of shares.

**Section 109B** Transmission of shares.

**Section 110** Application for transfer.

**Section 111** Power to refuse registration and appeal against refusal.

**Section 117A** Debenture trust deed.

**Section 117B** Appointment of debenture trustees and duties of debenture trustees.

**Section 166** Annual general meeting

**Section 198** Overall maximum managerial remuneration and managerial remuneration in case of absence or inadequacy of profits.

**Section 205** Dividend to be paid only out of profits.

**Section 205A** Unpaid dividend to be transferred to special dividend account.

**Section 205 B** Payment of unpaid or unclaimed dividend.

**Section 205C** Establishment of Investor Education and Protection Fund.

**Section 206** Dividend not to be paid except to registered shareholders or to their order or to their bankers.

**Section 206A** Right to dividend, rights shares and bonus shares to be held in abeyance pending registration of transfer of shares.

**Section 207** Penalty for failure to distribute dividends within thirty days

**Section 208** Power of company to pay interest out of capital in certain cases.

**Section 209** Books of account to be kept by company.

**Section 209 A** Inspection of books of account, etc., of companies.

**Section 210** Annual accounts and balance sheet.

**Section 210A** Constitution of National Advisory Committee on Accounting Standards

**Section 211** Form and contents of balance sheet and profit and loss account.

**Section 212** Balance sheet of holding company to include certain particulars as to its subsidiaries.

**Section 215** Authentication of balance sheet and profit and loss account.

**Section 217** Board's report.

**Section 222** Construction of references to documents annexed to accounts.

**Section 227** Powers and duties of auditors

**Section 291** General powers of Board.

**Section 292** Certain powers to be exercised by Board only at meeting.

**Section 293** Restrictions on powers of Board.

**Section 293(A)** Prohibitions and restrictions regarding political contributions.

**Section 294** Appointment of sole selling agents to require approval of company in general meeting.

**Section 295** Loans to directors, etc.

**Section 297** Board's sanction to be required for certain contracts in which particular directors are interested.

**Section 299** Disclosure of interests by director.

**Section 300** Interested director not to participate or vote in Board's proceedings.

**Section 301** Register of contracts, companies and firms in which directors are interested.

**Section 309** Remuneration of directors.

**Section 314** Director, etc., not to hold office or place of profit.

**Section 370** Loans, etc., to companies under the same management.

**Section 372** Purchase by company of shares, etc., of other companies.

**Section 541** Liability where proper accounts not kept.

***For details refer to the Companies Act, 1956***

### Question 1

*Comment on the following:*

- (a) *The surplus arising from a change in the basis of accounting was set off by X Ltd., against a non-recurring loss.*
- (b) *Z Ltd. gave a guarantee to the Court for payment of excise dues of Rs.10 lakhs for one of its subsidiaries. According to the company, since the guarantee was given on behalf of its subsidiary, no disclosure was required.*

## Auditing and Assurance

---

### Answer

**(a) Adjustment and disclosure of surplus on account of changes in the basis of accounting and non-recurring losses**

AS 5 on “Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies” states that any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change.

Transactions which are of an abnormal or non-recurring nature, may also be considered material, even though *prima facie*, they do not appear to be material.

Materiality is an important and relevant consideration in determining whether or not such exclusion/non-disclosure will distort the true and fair view of the financial statements. Thus, it would be important that users must know the quantum of non-recurring loss. In offsetting and aggregating items, care needs to be taken to ensure that material items are not offset against each other.

Accordingly, it would not be prudent to set off the surplus emanating from a ‘change in the basis of accounting’ against a ‘non-recurring loss’. Accordingly, it would be better to disclose surplus on account of change in the basis of accounting and non-recurring loss separately.

**(b) Disclosure of guarantee given by a company on behalf of its subsidiary: Z Ltd.,** in its books of account is required to record a contingent liability of Rs.10 lakhs for the guarantee given by it for payment of excise dues of its subsidiary, to the Court. In the event, the subsidiary failed to meet its obligation, Z Ltd. would be required to pay Rs.10 lakhs to the authorities concerned.

AS 4 also states that the existence and amount of guarantees undertaken by an enterprise are generally disclosed in financial statements by way of a note, even though the possibility that the loss will occur, is remote.

Thus, the amount of any guarantee given by a company on behalf of its subsidiary is required to be stated and where practicable, the general nature of such contingent liability, if material, be specified. Accordingly, the views expressed by the company cannot be accepted.

### Question 2

*Comment on the “Credit for the profit arising out of a hire-purchase sale was fully adjusted in the year of sale”.*

**Answer**

**Adjustment of profit arising on hire-purchase sale transaction:** The nature of a hire-purchase transaction makes it absolutely clear that a person does not become owner till the last instalment has been paid.

As per AS 9 on "Revenue Recognition", credit for the amount of profit arising from hire purchase sales is not taken into account until the instalments of sales price have been realised.

Therefore it is distributed proportionately over the hire purchase period. Accordingly, in the instance case, credit for the amount of profit arising from hire purchase sale is not to be taken into account until the last instalment of sales price have been realised. It is not proper to take the entire difference between the total hire purchase consideration and the cash value of the relevant asset to the profit and loss account at the time of delivery of goods. Instead this difference is recognised in various accounting periods proportionately on the basis of hire purchase consideration outstanding during the accounting period. Accordingly, in cases where profit arising on a hire purchase sale has been adjusted fully in the year of sale, a provision equal to the amount of profit which has not accrued should be created. The amount of provision so made should also be deducted from the "hire purchase debtors" for purposes of disclosure in the balance sheet.

**Question 3**

*Comment on the Interest on share capital was paid to the shareholders as the company had a long gestation period before it could become operational.*

**Answer**

**Payment of interest out of capital:** Section 208 of the Companies Act, 1956 permits payment of interest to shareholders out of capital, where there is a long gestation period. Payment of interest on capital is, however, capitalised as part of cost of construction of the project. The auditor should ensure that following conditions have been complied whenever such interest has been paid:

- (i) Payment is authorised by the Articles or by special resolution of shareholders in general meeting;
- (ii) Payment is approved by the Central Government;
- (iii) It is paid only for the period determined by the Central Government not exceeding six months after the half-year in which the project has been completed.
- (iv) The rate shall not exceed 12% p.a. or such other rate as may be prescribed by the Government.

## Auditing and Assurance

---

- (v) The payment of interest shall not operate as a reduction of the amount paid-up on the shares in respect of which it is paid.

### Question 4

*As an auditor comment on the following situations:*

- (a) *A company had acquired a 10 Tonner delivery van valued at Rs.6.5 lakhs on instalment basis from a dealer. During the year, the company paid Rs.1.5 lakhs being the instalment for the year and provided depreciation on the said amount paid.*
- (b) *A sum of Rs.15,000 per month has been paid as remuneration to a Director, who is not in the whole-time employment of the company.*
- (c) *A company received a subsidy of Rs.1 crore for establishing an undertaking in the backward/notified area.*

### Answer

- (a) **Purchase of van on instalment basis:** The delivery van was purchased at Rs.6.5 lakhs on instalment basis and accordingly, the property passed on to the purchaser immediately whereas in the case of hire-purchase basis, property in goods passes only after payment of last instalment.

Therefore, the gross book value of the delivery van will be Rs.6.5 lakhs. Depreciation should, thus, be provided on Rs.6.5 lakhs and not on the instalment amount of Rs.1.5 lakhs paid. Under the circumstances, the auditor will have to qualify the audit report.

- (b) **Remuneration paid to a Director:** Under section 309 (4) of the Companies Act, 1956, a Director who is not in the whole-time employment of the company, may be paid on a monthly/quarterly/annual basis with the approval of the Central Government or by way of commission if the company passes a special resolution.

However, the remuneration so paid shall not exceed: (i) 1% of the net profits of the company if the company has a managing or whole-time director or a manager; or (ii) 3% of the net profits of the company in any other case. However, company with the approval of the Central Government in general meeting may approve payment exceeding these specified percentages.

Therefore, the auditor has to examine whether the sum paid confirm to the above norms and requirements. In case, the payment has not been so approved and sanctioned, the Directors who have approved payment of the said Rs.15,000 p.m. would have to personally reimburse the amount or the amount in excess paid. A qualification is also called for in the audit report as well.

- (c) **Subsidy received by the company:** The Company had received a subsidy of Rs.1 crore, for establishing an undertaking in the backward/notified area.

The accounting treatment of such subsidy shall depend upon the nature and purpose for which it has been given. As per AS 12 on "Accounting for Government Grants", the grant given for acquisition of fixed assets is in the nature of promoter's contribution.

As per facts of the case, the grant has been given with reference to the total investment in the undertaking by way of contribution towards its total capital outlay for the establishment of the undertaking which is having similar characteristics to those of promoter's contribution.

In such cases, no repayment is ordinarily expected and thus the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

Accordingly, the amount of Rs.1 crore should be kept in a special reserve account and treated as a part of shareholders' funds.

### Question 5

- (a) *The interest of a director in a transaction, entered into by the company has not been disclosed in the records maintained by the company.*
- (b) *The auditor is responsible for failure to disclose the affairs of the company kept out of books and concealed from him.*

### Answer

- (a) **Non-disclosure of interest of directors in records maintained by the company**

A company is required to maintain a register under section 301 in terms of section 297 of the Companies Act, 1956. While auditing the company accounts, the CARO 2003 requires the auditor to verify such transactions.

It is quite likely that there may be situations where the company has not properly maintained the register required to be maintained by it under section 301.

In such a case, the auditor should obtain the necessary information regarding the loans taken by the company from companies, firms or other parties in which the directors are interested, from the management of the company. However, while reporting on this clause, the auditor should clearly mention the fact of non-maintenance/improper maintenance of the aforesaid register.

If the interest of a director in a transaction, entered into by the company has not been disclosed in the record maintained by the company, as required by Section 301 of the

## Auditing and Assurance

---

Companies Act, 1956 the auditor would not be responsible for failure to track down the frauds, provided also that there did not exist any circumstances to arouse his suspicion that some information had been held back deliberately and had duly reported the violation of the legal requirements. So long as there is no such suspicion, he is only expected to exercise normal caution and care.

### **(b) Responsibility of auditor in case of concealment of facts**

SA 240 on Fraud and Error states that the auditor in forming his opinion carries out procedures designed to obtain evidence that will provide reasonable assurance that the financial information is properly stated in all material respects.

Consequently, the auditor seeks reasonable assurance that fraud or error which may be material to the financial information has not occurred or that, if it has occurred, the effect of fraud is properly reflected in the financial information or the error is corrected.

The auditor, therefore, should so plan his audit that he has a reasonable expectation of detecting material misstatements in the financial information resulting from fraud and error. The degree of assurance of detecting errors would normally be higher than that of detecting fraud, since fraud is usually accompanied by acts specifically designed to conceal its existence.

The risk of not detecting material misstatement resulting from fraud is greater than the risk of not detecting a material misstatement resulting from error, because fraud usually involves acts designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Unless the auditor's examination reveals evidence to the contrary, he is entitled to accept representations as truthful and records and documents as genuine.

However, the auditor should plan and perform his audit recognising that he may encounter conditions or events during his examination that would lead him to question whether fraud or error exists.

The auditor is not responsible for failure to disclose the affairs of the company kept out of the books and concealed from him which could not be known in the ordinary course of exercise of reasonable care and diligence.

However, it is his duty to check the books for finding out that the position, as shown by the books of accounts, is true and substantially correct.

### **Question 6**

*Write a short note on - the Sweat Equity Shares.*

### Answer

**Sweat Equity Shares:** The Companies (Amendment) Act, 1999 recognised that in the wake of globalisation of corporate sector, the employees will have to be rewarded suitably to share in the growth of a company.

By insertion of new section 79A, the employees may be compensated in the form of 'Sweat Equity Shares'. "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called. The auditor may see that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions are fulfilled:

- (i) the issue of sweat equity shares is authorised by a special resolution passed by the company in the general meeting;
- (ii) the resolution specifies the number of shares, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;
- (iii) not less than one year has, at the date of the issue elapsed since the date on which the company was entitled to commence business;
- (iv) the sweat equity shares of a company whose equity shares are listed on a recognised stock exchange are issued in accordance with the regulations made by the Securities and Exchange Board of India in this behalf.

However, in the case of a company where equity shares are not listed on any recognised stock exchange, the sweat equity shares are issued in accordance with the prescribed guidelines.

### Question 7

*As an auditor, what would you do in the following situations:*

- (a) *One customer from whom Rs.5 lacs are recoverable for credit sales gives a motor car in full settlement of the dues. The directors estimate that the market value of the motor car transferred is Rs.5.25 lacs. As on the date of the balance sheet the car has not been registered in the name of the auditee.*
- (b) *The company had borrowed Rs.100 lacs from ICICI, which it is unable to repay on the due date. The accrued unpaid interest on the same is Rs.25 lacs. There is a stipulation that on default in repayment, there would be a penal interest payable, which would amount to Rs.10 lacs. The company has applied to ICICI for*

## Auditing and Assurance

---

*rescheduling the repayment and waiver of a part of the accrued interest and the penal interest. As on the date of audit, the said application is still pending.*

*Based on this application, the management does not wish to provide for the accrued interest and the penal interest.*

### Answer

- (a) **Determination of cost in case of exchange of assets:** An enterprise may acquire an asset through exchange process. In the instant case, the company has acquired a motor car from a customer in exchange of amount due from him.

However, the motor car has not been registered in the name of the company on the date of the balance sheet. Having regard to the principle of substance over form, the auditor should see that the transaction is recorded though the car is not registered in the name of the auditee. As far as determination of the cost is concerned, AS 10 broadly lays down the following principle:

“When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident. An alternative accounting treatment that is sometimes used for an exchange of assets, particularly when the assets exchanged are similar, is to record the asset acquired at the net book value of the asset given up; in each case an adjustment is made for any balancing receipt or payment of cash or other consideration.” (Para 11.1)

Consequently, it shall be more appropriate to record the cost of motor car at Rs.5 lacs since the value of asset given up is more clearly evident than the fair value of assets acquired i.e. motor car which happens to be estimation on the part of directors. Accordingly, the customer's account should also be credited by Rs.5 lacs.

*Note: However, directors may revalue the asset and write up the value of motor car to Rs.5.25 lacs. Then Rs.25,000 should be transferred to Revaluation Reserve.*

- (b) **Non-provision of Interest:** The non-provision of accrued unpaid interest amounting to Rs.25 lacs as also the penal interest amounting to Rs.10 lacs payable to ICICI by the management is not the proper accounting treatment since the company has been unable to repay on the due date and penal interest is also payable in case of default as per terms of the contract.

The contention of the management is not tenable simply because application for rescheduling the repayment and waiver of a part of the accrued interest and the penal interest has been made to the ICICI.

In any case, a company has to follow accrual system of accounting as per section 209(3)(d) of the Companies Act, 1956. As a matter of fact, the auditor must ensure that provisions for the entire amount of accrued interest as also the penal interest has been made since the same has not been waived on the date of audit.

Since the management does not wish to provide the above amounts, the auditor shall have to qualify the audit report as per the Institute's statement on the subject. The qualification paragraph must bring out clearly the quantitative impact of non-provision of interest on the profits.

### Question 8

*State briefly, how you will audit the following in a joint stock company:*

- (a) *Issue of shares for consideration other than cash.*
- (b) *Buy-back of shares by the company.*
- (c) *Splitting of one share of the face value of Rs.10 into 10 shares of Re.1 each.*

### Answer

#### (a) Issue of shares for consideration other than cash

- (i) Study of the contract pursuant to which the issue is made to determine how many shares are agreed to be issued and for what value and the nature and other details of the consideration.
- (ii) Examination of the prospectus to see the substance of the contract and the relevant terms of the issue including the mode of payment of the purchase consideration in case of an issue to a vendor of the business or payability of commission to the underwriters or payability of the preliminary expenses.
- (iii) Examination of the Board's minutes to see the adoption of the relevant contract, the decision to issue shares for a consideration other than cash and the actual allotment of shares.
- (iv) Verification of the filing of the copy of the contract or the relevant terms of the contract where the contracts is not in writing with the Registrar of Companies within a period of 30 days after the date of the allotment. [as per section 75(1B) of the Companies Act, 1956.]
- (v) Ensuring that proper accounting entry has been passed to record the acquisition of the assets or the business or payment of the expenses (any of these may constitute the consideration) on the one hand and the issue of shares on the other. Incidentally, if any premium or discount is involved, seeing that appropriate adjustment entry has been passed therefor.

## Auditing and Assurance

---

Sometimes, in view of the nature of transaction, it may be difficult to know whether an allotment is for cash or for a consideration other than cash, for instance, allotment of shares in adjustment of a debt owed by the company. In such a case, if the allotment is made in adjustment of a bonafide debt payable in money at once, the allotment should be considered as against cash.

This position should be kept in view when inquiring into matters stated in section 227(1A). Again if the shares are allotted on a cash basis, though the amount is actually paid later, it should constitute an allotment against cash.

### **(b) Buy-back of shares by the company**

- (i) Ensure that the buy-back has been done only out of the company's free reserves or its securities premium account or out of the proceeds of any shares or other specified securities other than out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.
- (ii) Check authorisation in the Articles of Association which is a prerequisite of any buyback.
- (iii) Examine special resolution passed in the general meeting authorising buyback.
- (iv) Ascertain that quantum of buy-back is either equal to or less than 25% of the total paid up share capital and free reserves but in case of buy-back of equity shares in any financial year it should not exceed 25% of its total paid-up equity capital in that financial year.
- (v) Check that the debt equity ratio should not be more than 2 : 1 except in cases where Central Government allows higher ratio for a class or classes of companies.
- (vi) Ensure that shares or other specified securities to be bought back should be fully paid-up.
- (vii) Buy-back should be completed within 12 months from the date of passing the special resolution.
- (viii) Ascertain that declaration of solvency in Form No.4A was filed with the SEBI and/or the Registrar of Companies before making buy-back but subsequent the passing of the special resolution.
- (ix) See that SEBI (buy-back of securities) Regulations, 1998 have been followed by listed company.

**(c) Splitting of shares of face value from Rs.10 to Re.1 per share**

- (i) Confirm that alteration was authorised by articles.
- (ii) Verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.
- (iii) Verify also with reference to Form No.5 filed with the ROC.
- (iv) Verify that alteration had been effected in copies of Memorandum Articles, etc.
- (v) Verify that proper accounting entries have been passed. Register of members may also be checked to see that the necessary alteration have been effected therein.

**Question 9**

*Explain the difference between Reserves and Provision.*

**Answer**

**Reserves and Provisions**

*Reserves:* Reserve denotes retained profits. In other words, certain sum or sums are set apart out of the profits earned for specific or general purposes, and this constitutes reserve (or reserves).

These reserves are not available for dividend purposes in the year concerned. However, subject to decision of the Board of Directors, there can be appropriation out of reserves created in the past for dividend purposes, provided such reserves are not capital reserves.

If there is no profit, no reserve can be created and, basically, reserves are at the disposal of the undertaking; they are not required to be maintained for meeting possible losses or expenses. The term "reserve" has been negatively defined in Part III of Schedule VI to the Companies Act, 1956 as not including any amount written off or retained by way of providing for diminution, renewals or diminution in value of assets or retained by way of providing for any known liability.

*Provision:* Provision, on the other hand, represents a charge for an estimated expense or loss or for shrinkage in the cost of an asset or the accrual of a liability.

Except for provision for dividend which is appropriation of profits, provisions are meant to meet expected losses and expenses for which the amount is uncertain.

Profit cannot be ascertained unless the necessary provisions are first made. Part III of Schedule VI to the Companies Act, 1956 has defined "provision" to mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot

## Auditing and Assurance

---

be determined with substantial accuracy. Amounts provided for depreciation, renewals or diminution in value of assets are expenses and losses.

Hence, the character of provision is of an expense or loss which must be charged against the revenue so as to arrive at the true and fair profit or loss. Since reserve is retained profit, it is necessarily an appropriation of profit obtained after charging all the expenses and losses including provisions. It, therefore, cannot include anything which is properly chargeable as expense or loss, i.e., provision.

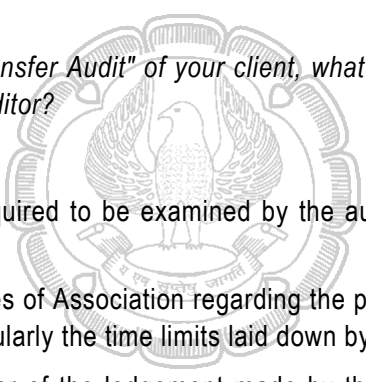
However, if amounts are provided in excess of the needs, the excess should be treated as reserve. For example, the company may provide for depreciation at the rate of 25% as against the statutory rate of 15%. The excess of depreciation to the extent of 10% would be treated as reserve even though the entire 25% has been a charge to the profit and loss account. For creation of reserve, existence of profit is a must while provision is necessary even where there is a loss so as to correctly reflect the operating results of the enterprise.

### Question 10

*In carrying out the "Share Transfer Audit" of your client, what aspects would be required to be examined by you as an auditor?*

### Answer

The following aspects are required to be examined by the auditor in conducting the share transfer audit:

- 
- (i) Inspection of the Articles of Association regarding the prescribed form of transfer and other provisions, particularly the time limits laid down by the Articles or law.
  - (ii) Notification by transferor of the lodgement made by the transferee and inspects the objections received, if any. Also see, where calls due or not paid, whether transfer can be refused under the articles and whether any transfer was so refused.
  - (iii) Examining in the case of particularly partly-paid shares, where the application for registration was made by the transferor, a notice was sent to the transferee and registration was effected only on receipt of 'non-objection' received from him.
  - (iv) Scrutiny of transfer forms, noting specially:
    - (a) That in every case, the application for transfer was made in the prescribed form and the prescribed authority (contemplated in Clause 1A of Section 108) had stamped the date on which it was presented to it; also that it was delivered to the company:
      - (i) In case of 'quoted' shares before the Register of Members were closed for the first time subsequent to the transfer within twelve months from

the date of presentation of the application to the prescribed authority whichever is later.

- (ii) In any other case within two months from the date of such presentation.
- (b) That each transfer form is properly executed and bears the proper stamp duty.
- (c) That the name of the company is correctly stated on the form.
- (d) That where the consideration for transfer appears to be inadequate, an inquiry was made by the company for ascertaining the reasons therefor. (This is not necessary if the transfer form bears the seal of the Collector of Stamps.)
- (e) That the alterations, if any, have been suitably initiated; and
- (f) That the name and address of the transferee have been recorded completely and fully for purposes of correspondence.
- (v) Comparison of the signatures of each transferor on the transfer form with his signature on the original application for shares or on the transfer form (if the shares were acquired on a transfer).
- (vi) Ascertaining that none of the transferees is disqualified from holding shares in the company.
- (vii) Vouching the entries in the Shares Transfer Journal by reference to the transfer forms, noting in each case:
  - (a) the name of transferor;
  - (b) the name and address of the transferee;
  - (c) the number and class of shares transferred; and
  - (d) the distinctive numbers, if any, of the shares transferred.
- (viii) Verification of postings from the Share Journal to the Register of Members.
- (ix) Inspection of each transfer as to names, addresses, occupations, form of document, description, number (in words), distinctive number of shares, stamp, date, signature, witnesses, etc.
- (x) Check whether the transfer to firms, etc. has been rejected or not and whether notes of trust has been entered in the share register.
- (xi) Noting transferor's name, etc. and class, number and distinctive number of shares, as stated in the transfers, with old certificates and Register of Members. See that old certificates were cancelled.

## Auditing and Assurance

---

- (xii) Inspection of the power of attorney and specimen signatures if transfer executed by an agent.
- (xiii) Inspection of letters of indemnity for lost certificates and ensuring that duplicate certificates have been issued on proper authority.
- (xiv) Where part of the shares have been transferred, the issue of balance certificates to the transferors should be seen and confirm that the distinctive number of shares have been correctly stated.
- (xv) Refer to the minute's book to ensure that all transfers recorded in the share transfer journal have been approved by the Board.
- (xvi) Checking of counterfoils of new certificates.
- (xvii) Reconciliation of the amount of transfer fees collected with the total number of transfers lodged and verifying that the amount of transfer fees have been accounted for.
- (xiii) Reconciliation of the total number of shares of different classes issued by the company with the total amount of capital issue and its sub-divisions by extracting balances of shares held by different members from the Register of members.
- (xix) Ensuring that provisions of Section 113 regarding registration of share certificate have been complied with.
- (xx) Ensuring that, in case of transfers, registration whereof was refused, the notice of refusal was sent to the transferor and the transferee within a period of two months giving reasons for such refusal (Section 111).
- (xxi) Ensuring that, in case of any share transactions by directors, corresponding entries have been made in the Register of Directors' shareholding.

### Question 11

*Explain 'Option on Share Capital'.*

### Answer

**Option on Share Capital:** Part I of Schedule VI to the Companies Act, 1956 requires disclosure of the particulars of any option on unissued share capital. An option on shares arises when a person has acquired a right under an agreement with the company to subscribe for share in the company if he so chooses. Such options generally arise under the following circumstances:

- (i) Under the promoter's agreements, subsequently ratified by the company;
- (ii) Collaboration agreement;

- (iii) Loan agreements, debenture deeds (Refer to Section 81 of the Companies Act, 1956);
- (iv) Other contracts, such as for supply of capital goods and/or merchandise.

**Question 12**

*Give your comments and observations on the following:*

- (a) *A company has not provided depreciation on machinery on the plea that the machinery has been maintained in excellent condition and is as good as new.*
- (b) *A company, whose accounting year ends on 31st March, 2009 has placed an order with Globe Machinery Limited, Bombay for a machinery costing Rs.20 lakhs against cash payment during the month of June, 2009. The company has added a foot-note to the Balance Sheet as at 31st March, 2009 showing separately that a capital contract has been entered into which requires the payment of Rs.20 lakhs in cash.*
- (c) *A company has scrapped a semi-automatic part of a machine (not entirely written off) and replaced with a more expensive fully automatic part, which has doubled the output of the machine. At the same time the machine was moved to a more suitable place in the factory, which involved the building of a new foundation in addition to the cost of dismantling and re-erection. The company wants to charge the whole expenditure to revenue.*
- (d) *A company has made additions to its factory buildings by its own workmen, at a cost of Rs.4,50,000 for wages and materials. The lowest estimate from an outside contractor to carry out the same work was for Rs.6,00,000. The directors contend that as they were fully entitled to employ an outside contractor, it is reasonable to debit the Factory Building Account with Rs.6,00,000.*

**Answer**

- (a) **Non-Provision of Depreciation:** The machinery is as good as new. The plea of the management of the company not to provide for depreciation on its assets in a particular year on account of the reason that the company has maintained the machinery in an excellent way during the year is not acceptable because as per the definition of depreciation given in AS 6 on "Depreciation Accounting", "depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes".

Thus, depreciation also arises due to efflux of time and, therefore, depreciation should be provided irrespective of whether the assets were maintained very well during the year. Hence, the mere fact that the assets have been maintained

## Auditing and Assurance

---

excellently during the year is not an acceptable ground for the management not to provide for depreciation.

- (b) **Payment on Account of Capital Contract:** The placement of an order for the purchase of a machinery against cash, to be delivered in the next year is a capital commitment and, thus, as such there is no necessity for making a provision in the year of order.

However, the capital commitment for which no provision is made, the company will have to comply with the disclosure requirements and, thus, a note is to be added to the Notes to the Accounts stating that a capital contract has been entered into which would require the payment of Rs.20 lakhs in cash. It is just nothing but a contingent liability on capital account. Therefore, the treatment accorded by the company is correct.

- (c) **Treatment of Expenditure Incurred on Machinery:** The written down value of the semi-automatic part is required to be written off to the revenue. The whole expenditure incurred in purchasing the fully automatic part and in repositioning the machine is required to be treated as capital expenditure since the amount incurred has increased the earning capacity of the machine.

A clear distinction shall have to be made as to the nature of expenditure which leads to benefits in the future periods by increasing the earning capacity of the machine. In the instant case, it is clear that such expenditure can not be treated revenue at any cost because of the enhanced earning capacity of the machine in the future. In fact, the output of the machine has almost doubled and the machine has been moved to a more suitable place. Therefore, the company's contention to charge whole expenditure to revenue is not justifiable.

- (d) **Additions to Factory Buildings:** The contention of the Board to debit the Factory Building Account by Rs. 6,00,000 is incorrect. Despite the fact that addition to factory buildings have been made at a cost of Rs.4,50,000. In the case of a fixed asset which is held for the purpose of earning income and not for resale, it would be improper to value the asset in excess of the amount which has been paid for it. The additions made to the factory buildings must appear in the balance sheet at a figure not exceeding its actual cost to the company.

AS 10 on "Accounting for Fixed Assets", makes clear that gross book of self-constructed fixed assets should be computed on the basis actual cost incurred/allocated. Even internal profits, if any, are eliminated in arising at such costs. Hence the Board's contention is not correct.

**Question 13**

*Write a short note on- the Audit of Capital Reserve.*

**Answer**

**Audit of Capital Reserve:** A capital reserve is a reserve which is not available for distribution as dividend. The auditor should examine that the head 'capital reserves' does not include any amounts as are regarded as free for distribution as dividend. In the case of a company, if there is a capital profit on reissue of forfeited shares, it is to be shown under capital reserves.

The following are the duties for the Auditor in connection with the capital profit, which are not normally available for distribution to the shareholders unless:

- a. The Articles of the company permit such a distribution,
- b. It has been realised in cash.
- c. The assets value remaining after distribution of the profit will be not less than the book value so that share capital and reserves remaining after the distribution will be fully represented by the remaining assets.

Revaluation reserve is also not available for dividends. Further, the bonus share cannot be issued by capitalisation of revaluation reserve. If any company does so, the auditor should qualify his report.

It may however, be noted that revalued capital profits are distributable in the same way as other profits and that it is not necessary to comply condition (a) and (b) above. This is because AS 10 requires that any profit on sale of fixed asset has to be routed through the profit and loss account. A clear distinction should be made between capital profits and capital receipts. The latter cannot be distributed by way of dividend at all.

Auditor should also ensure that presentation and disclosure requirements of Part I of Schedule VI to the Companies Act, 1956 have been complied with.

**Question 14**

*As a Company Auditor how would you react to the following situations?*

- (a) *A publishing company undertook repair and overhauling of its machinery at a cost of Rs.250 lakhs to maintain them in good condition and capitalised the amount as it is more than 25% of the original cost of the machinery*
- (b) *Inventories of a Car manufacturing company include the value of items, required for the manufacture of a model which was removed from the production line five years back, at cost price.*

## Auditing and Assurance

---

- (c) *Interest on loan borrowed to purchase machinery which has been installed two years back is still debited to Machinery Account.*
- (d) *Sale value of scrap items adjusted against Miscellaneous Expenditure*
- (e) *Insurance claim of Rs. 2 lakhs received stands included under Miscellaneous Income.*
- (f) *Rs. 5 lakhs paid by a pharma company to the legal advisor defending the patent of a product treated as Capital Expenditure.*

### Answer

- (a) **Amount Incurred to Repair and Overhaul the Machinery:** The money spent on the repair and overhaul of the machinery can be treated as capital expenditure, irrespective of the amount, only if it results in increasing the earning capacity or reduction in the cost of production. In this case, neither the earning capacity has increased nor there is any reduction in the cost of production.

In the absence of both these criteria, it is to be treated as revenue expenditure. The mere fact that maintenance expenditure is more than 25% of the original cost of the machinery would not change its nature, i.e. in revenue expenditure.

If any expenditure of a revenue nature is treated as capital, then it would have the effect of inflating the profit for the year. Consequently, the auditor would be required to qualify his report.

- (b) **Inventory valuation:** AS 2 on "Valuation of Inventories" provides that the cost of inventories may not be recoverable if those inventories are damaged, have become wholly or partially obsolete, or if their selling prices have declined.

Accordingly, the auditor should examine whether appropriate allowance has been made for the defective, damaged, obsolete and slow-moving inventories in determining the net realisable value.

In this case, items required for the manufacture of a model which has been withdrawn from the production line five years ago are included in the stock at cost price resulting in overstatement of inventory and profit. As it appears from the facts given that the net realisable value of these items is likely to be much lower than the cost at which these are being shown in the books of account.

Accordingly, it becomes necessary to write down the inventory to 'net realisable value' if the items of inventories become wholly or partially obsolete. Under the circumstance, the auditor should qualify the report appropriately.

- (c) **Borrowing costs:** AS 16 on “Borrowing Costs” permits capitalisation of borrowing costs in case certain conditions are fulfilled, viz., costs are directly attributable to the acquisition, construction or production of an qualifying asset.

A qualifying asset is one which necessarily takes a substantial period of time to get ready for its intended use or sale. As such, interest on loan borrowed to purchase the machinery which has already been installed two years back should not be debited to machinery account since this would result in the overstatement of the value of machinery and profit.

The auditor would be required to qualify the report bringing out quantitative impact on the assets and profit.

- (d) **Treatment of revenue of scrap items:** Sale value of scrap is an item of miscellaneous income and adjusting such income against miscellaneous expenditure is not proper.

AS 5 on, “Net Profit or Loss for the Period, Prior Period Items and changes in Accounting Policies” requires that when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Therefore, requirements in regard to the profit and loss account of a company, it should disclose clearly credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature.

The auditor should see that the revenue has been disclosed properly in the financial statement since such an adjustment would fail to explain the performance of the company.

- (e) **Amount received on account of Insurance claim:** The principle laid down in AS 5 that even those items of income and expense which are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance may be disclosed separately.

However, money received from the insurance company is against a specific loss. It has to be adjusted against the loss. The auditor should check the adjustment of the amount received in short of the value of actual loss as per the insurance policy.

In respect of claim against an asset, the profit and loss account should be debited with the shortfall of the claim against the book value. If the claim was lodged in the

## Auditing and Assurance

---

previous year but no entries were passed, entries in the profit and loss account should be appropriately described.

- (f) **Legal expenses incurred by the company:** Legal expenses of Rs. 5 lakhs incurred to defend the patent of a product of the pharma company is revenue expenditure pertaining to the asset since by this expenditure neither any enduring benefit can be obtained in future in addition to what is presently available nor the capacity of the asset would be increased.

Payment of legal fees is normally revenue expenditure irrespective of the amount involved unless same is incurred to bring any new asset into existence. Hence, treating such expenditure as capital expenditure is incorrect. This would result in overstatement of the value of asset and profit and calls for qualification in the audit report.

### Question 15

*As an auditor comment on the following situations/statements:*

- (a) *The sale and purchases of investments of A Ltd., was controlled through a committee. Shri B sold some of the investments without discussing the same with the other members of the committee as they were out of station and Shri B believed that its price would fall and the company would suffer a loss if it is not sold. A Ltd. earned a profit of Rs.1 lakh from such sale.*
- (b) *The company due to liquidity crises sold and leased back the same vehicles from leasing companies. In the notes to accounts, the company stated 'Vehicles taken on lease repayable in 46 instalments of Rs.26,650 each'.*
- (c) *No depreciation provided on a machinery costing Rs.50 lakhs imported three years back, since it is yet to be put into use.*
- (d) *A portion of Share Premium utilised to declare 40% dividend.*

### Answer

- (a) **Sale of Investments without Proper Authorisation:** There should be proper authority for sale of investments. Detailed records regarding disposal of investments should be maintained along with proper documentation.

In the instant case, Mr. B had sold the investments without discussing the matter with the other committee members. This matter, therefore, needs to be addressed by the auditor as purchase and sale can only be authorised by the Committee.

The fact that Mr. B believed that the prices would fall and the company would suffer a loss if the investments are not sold is not good enough for Mr. B to act as per his

discretion. A profit of Rs. 1 lakh from such sale is also not a sufficient reason to act since one can not rule out the possibility of earning higher profits. The formation of the Committee by A Ltd, to control sale and purchase of investments is, perhaps, one of the best aspects of internal control system to eliminate the possibility of manipulation, if any, in sale and purchase of investments. The statutory auditor may however, examine whether there have been any other instances involving non-observance of internal control system and procedures. In any case, the Committee must approve the transaction and authorise the same from the view point of the statutory auditor.

- (b) **Sale and Leaseback of Vehicles:** Under a lease agreement, the lessee acquires the right to use an asset for an agreed period of time in consideration for payment of rent to the lessor. The legal ownership of the asset remains with the lessor.

In the instant case, the company had sold vehicles to two leasing companies to meet its liquidity crises and took them back on lease. In the notes to the accounts it had disclosed about instalments payable to different leasing companies, but without disclosing the true nature of the transaction as covered by AS 19, "Leases".

The transaction entered into by the company is a classic case of sale and leaseback transaction. In case of such transactions, the sale price of assets and lease rentals normally do not represent fair value since the same are negotiated as a package. In case such a transaction is an operating lease and it is clear that the rentals and the sale price are established at fair value, then in effect it is a normal sale transaction and any profit or loss is normally recognised immediately.

If the sale price is below fair value, any profit or loss is recognised immediately, except that, if the loss is compensated by future rentals at below market price, it is deferred and amortized in proportion to the rental payments over the useful life of the asset.

If the sale price is above fair value, the excess over fair value is deferred and amortized over the useful life of the asset.

Therefore, it would be important for the auditor to determine whether the amount of instalments payable is fair having regard to sale price of assets. In case the leaseback is a finance lease, it is not appropriate to regard an excess of sales proceeds over the carrying amount as income.

Such excess is deferred and amortised over the lease term in proportion to the depreciation of the leased asset. Similarly, it is not appropriate to regard a deficiency as loss. Such deficiency is deferred and amortised over the lease term.

## Auditing and Assurance

---

Further, disclosure shall have to be made separately of such transaction in terms of AS 5.

The auditor should, therefore, suitably qualify his report since proper disclosures have not been made as per the requirement of accounting standards.

- (c) **Non-provision of depreciation:** As per AS 6 on "Depreciation Accounting", depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes.

Thus, depreciation has to be charged even in case of these assets which are not used at all during the year but by mere effluxion of time provided such assets qualify as depreciable assets. When the machinery has been imported by one entity, it means it was intended to be used for the purpose of business.

Depreciation in respect of this machinery ought to have been provided in the accounts for all the previous years. If there is an intention to use an asset, though it may not have actually been used, it is a 'constructive' or 'passive' use and eligible for claim of depreciation.

Further Part-II of Schedule VI to the Companies Act requires that if no provision is made for depreciation, the fact that no provision has been made and quantum of arrears of depreciation computed in accordance with Section 205(2) of the Companies Act should be disclosed. Provision of depreciation is essential to show a true and fair picture of financial statement.

Thus, the auditor should ensure compliance with all these requirements.

- (d) **Utilisation of Share Premium:** Section 78 of the Companies Act, 1956 deals with application of premium received on issues of shares. Section 78(1) required creation of Securities Premium Account and states that the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if the premium account were paid-up share capital of the company. Sec. 78(2) lays down that the securities premium account may be applied by the company:
- (a) in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares;
  - (b) in writing off the preliminary expenses of the company;
  - (c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; or

- (d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

Thus, it is clear from the above that share premium can be utilised only for specific purposes. Further, section 205 of the Companies Act, 1956 also specifies the sources from which dividends can be paid and requires the same to be only paid out of past profits, general reserve or any other free reserve. Hence, declaration of dividends out of share premium is not proper and, consequently, the auditor shall have to qualify the audit report

### Question 16

*Give your comments on the following:*

*No cost accounting records are maintained though the company is required to maintain the same.*

### Answer

**Non-maintenance of Cost Records:** Section 209(1)(d) of the Companies Act, 1956 requires that every company shall maintain books of accounts containing particulars relating to the utilisation of material or labour or to other items of cost if such class of companies are notified by the Central Government.

As per the CARO, 2003, where maintenance of cost records has been prescribed by the Central Government, auditor of the company is specifically required to state whether such accounts and records as prescribed have been made and maintained.

Though the auditor is not required to conduct detailed audit but the auditor is expected to conduct a general review of the cost records to determine whether the prescribed accounts and records are *prima facie* complete. Therefore whether cost audit is ordered or not the auditor should report upon the non-maintenance of the cost records.

### Question 17

*Comment on the following:*

- (a) *ABC Ltd. has not deposited provident fund contributions of Rs.20 lakhs to the authorities, but accounted in the books.*
- (b) *Asian Overseas Oil Ltd.'s oil wells were damaged in Iraqi war in November, 2009. Claim preferred with the Insurance Companies for total loss. Pending the settlement by the Insurance Companies for total loss. Pending the settlement by the Insurance Companies neither any provision nor any disclosure has been made in 2009-10 accounts.*

## Auditing and Assurance

---

- (c) *Sundry debtors of a company as at 31-3-10 include Rs.10 lakhs from M/s Unreliable Traders, who have been declared as insolvent on 4-4-2010.*
- (d) *Directors of Speedway Ltd. declared a final dividend of 30% for 2008-09 in their meeting held on 11-8-2009.*
- (e) *During the year under audit, A Ltd. credited to the Profit & Loss Account, the entire profit of Rs. 5 lakhs on the sale of land not required for its use. You are informed that the directors would like to propose dividend out of the above profit*
- (f) *In spite of the internal control weakness commented upon by the audit manager, no further tests need to be carried out, as the purchase and sales figure as a percentage of gross profit was same as in the previous year. The audit manager's comments were in regard to control over purchases and sales.*

### Answer

- (a) **Non-Deposit of Provident Fund Dues:** The auditor's report under CARO, 2003 has to specifically state whether the company is regular in depositing provident fund dues with the appropriate authority and, if not, the extent of arrears of provident fund shall be indicated by the auditor. The auditor may also ascertain the period since which dues have not been paid. In this case, the failure of ABC Ltd. to deposit provident fund of Rs. 20 lakhs will be reported by the auditor in CARO, 2003 issued u/s 227(4A) of the Companies Act, 1956. In indicating the arrears, the period to which the arrears relate should preferably be also given.

- (b) **Non-Provision of Losses:** Part-III of Schedule VI to the Companies Act, 1956 requires that a company shall make provision for all those known liabilities, the amount of which cannot be ascertained with substantial accuracy.

This is a case of non provision of loss in the accounts resulting in overstatement of profit in the accounts for 2009-10. The company must estimate the loss and provide the same in the accounts so as to reflect a true and fair view of the state of affairs of the company. While estimating the amount for provision, the company may take into account the probable amount of recovery from the claim lodged by it.

In any case, a proper disclosure explaining the loss incurred and the subsequent position relating to that has also not been made by the company. Under the circumstances, the auditor shall have to issue a qualified report.

- (c) **Non-provision of Sundry Debtors on Account of Insolvency:** According to AS 4, "Contingencies and Events Occurring after the Balance Sheet Date", any significant event occurring after the date Balance Sheet date but before the date of approval of financial statements by the Board requires adjustments to assets/liabilities as on the

date of Balance Sheet in case additional evidence is available in respect of conditions existed on the date of the balance sheet. In this case, the debtors balance has to be suitably adjusted since conditions existed on the date of the balance sheet in respect of which additional evidence has been provided by the insolvency of M/s Unreliable Traders. Thus, the auditor must ascertain that requirements of AS 4 have been followed.

In case of non-observance of the same, the auditor should qualify the report.

- (d) **Declaration of Final Dividend by the Board of Directors:** As per provisions of the law, the final dividend of a company shall be declared only by the shareholders based on the recommendation of Board of Directors. The Board can only propose the dividend which shall become final only after approval by shareholders at the AGM.

The Board is empowered to declare the interim dividend only. Hence in the given case, the action of Speedway Ltd.'s directors is not in accordance with the law and the auditor should have qualified his report to this effect. The auditor would also have to confirm whether the provision for the same has been made in Part II of Schedule VI to the Companies Act, 1956.

- (e) **Declaration of Dividend out of Capital Profit:** Profit of Rs. 5 lakhs on the sale of land is a capital profit in case it represents the excess of sale value over the original cost of the asset. The question whether such a profit can be distributed as dividend has been considered in legal cases, viz., Lubbock v. The British Bank of South America Ltd. And Foster v. The New Trinidad Lake Asphalt Co. Ltd. Based on the Court judgements, it is argued that capital profits can be distributed by a company only if certain conditions are fulfilled. However, Accounting Standard 10 on "Accounting for Fixed Assets" requires that any gain arising from disposal of fixed assets should be recognised in the profit and loss account. Moreover, section 205 of the Companies Act, 1956 does not make any distinction between capital profit and other profit. Thus, all profits which can properly be taken to the profit and loss account are 'profit' for the purposes of section 205 and are distributable. Therefore, the directors can declare dividend out of the above profit.

- (f) **Performing Appropriate Audit Procedures Due to Weaknesses in Internal Control System:** The audit manager's observation that internal control over purchases and sales were weak after evaluating the system should be quite pertinent for the auditor.

However, the auditor's judgement that no further tests need to be carried out since purchase and sale as a percentage of gross profit were same as in the previous year cannot be accepted since the same percentage may be a coincidence.

## Auditing and Assurance

---

As a matter of fact, while performing analytical procedures when no deviations are reported, it is necessary to investigate such a situation in more detailed manner to ascertain the reasons for same percentage. It is quite possible that the absolute figures might have changed in the same proportion. In fact, such a state of affairs calls for conducting further audit tests in detail since there might have been attempts by the management to manipulate figures.

Therefore, the audit team would have to rely more on test of details of transactions and balances than on drawing their conclusions on analytical procedures.

In fact, the auditor should carry out substantive tests in more detail to ensure that transactions are genuine and valid and, thus, supported by sufficient and appropriate evidence.

### Question 18

*As an auditor, comment on the following situation statement:*

*Ganga-Kaveri Project Ltd. was incorporated on 1.7.2009. During the year ended 31.3.2010 there was no manufacturing or trading activity except raising of share capital, purchase of land, acquisition of plant and machinery and construction of factory sheds. Therefore the Chief Accountant of the company contends that for the relevant year there was no need to prepare a statement of profit or loss or any other statement except a Balance Sheet as at 31.3.2010.*

### Answer

**Preparation of Financial Statements:** As per facts of the case, Ganga-Kaveri Project Ltd. did not carry any manufacturing or trading activity except raising of share capital, purchase of land, acquisition of plant and machinery, etc. Section 210 (3) of the Companies Act, 1956 requires preparation of the profit and loss account from the period beginning with the incorporation of the company.

Though the company did not carry any manufacturing or trading activity but the company has carried on certain activities like construction of factory shed, acquisition of plant and machinery. etc. In such a case, it is necessary to provide for depreciation and other expenses.

The mere fact that there was no manufacturing or trading activity cannot be the basis for not preparing the profit and loss account. Therefore, the contention of the Chief Accountant is not correct.

**(Note:** Alternatively, it may be argued that as per the Guidance Note on Treatment of Expenditure During Construction Period, preparation of profit and loss account during the period of construction might be somewhat misleading as it may give an impression to the lay

shareholder that the company was engaged in revenue operation during the period and has suffered substantial loss in these operations.

To overcome this type of situation, the requirements of Part II of Schedule VI to the Companies Act, 1956, relating to disclosure of specific items of expenditure have to be complied with. These requirements can be suitably met if the relevant items of expenditure requiring specific disclosures are given under the heading "Development Account-Expenditure during Construction Period" or "Statement of Incidental Expenditure during Construction Period".)

### Question 19

*Write a short note on Disclosure requirements of bank balances of a limited company*

### Answer

#### Disclosure Requirements for Bank Balance

As per Part I of Schedule VI to the Companies Act, 1956, the disclosure requirements for bank balance are as under:

- (i) Bank balance with scheduled bank.
- (ii) Bank balance with banks other than scheduled banks.

The other particulars are to be stated are as under:

- (a) Balances lying with scheduled banks in current accounts, call accounts, deposit accounts.
- (b) Where the balance is with non-scheduled bank, the name of the banker, balances lying with such bankers on current accounts, call accounts and deposit accounts, the maximum amount outstanding with them during the year should be specified.
- (c) the nature of the interest, if any, of any director or his relative [or the managing agent/secretaries and treasurers of any associate of the latter] in each of the bankers (other than Scheduled Banks) referred to in (b) above.]

### Question 20

*As an auditor, comment on the following situations/statements:*

*Z Ltd. had the following items under the head "Reserves and Surplus" in the Balance Sheet as on 31<sup>st</sup> March, 2010:*

## Auditing and Assurance

---

|                            | Amount<br>Rs. in lacs |
|----------------------------|-----------------------|
| Securities Premium Account | 80                    |
| Capital Reserve            | 60                    |
| General Reserve            | 90                    |

The company had an accumulated loss of Rs. 40 lacs on the same date, which it has disclosed under the head "Profit and Loss Account" on the assets side of the Balance Sheet.

### Answer

**Debit Balance of Profit and Loss Account:** Part I of Schedule VI to the Companies Act, 1956 requires that the debit balance of Profit and Loss Account shall be shown as deduction from the uncommitted reserves, if any. Hence, the accumulated loss of Rs.40 lakhs should be deducted from the General Reserve of Rs.90 lakhs, and the net amount of Rs.50 lakhs should be shown as General Reserve on the Liabilities side of the Balance Sheet. Securities Premium Account and Capital Reserves are not uncommitted reserves and, thus, these shall also be shown on the liabilities side of the balance sheet under the heading of "Reserves and Surplus". In the present case, the disclosure requirements of Schedule VI to the Act have not been followed and, accordingly, the auditor should modify his report

### Question 21

Write a short note on - Capital Redemption Reserve.

### Answer

**Capital Redemption Reserve:** As per Section 80 of the Companies Act, 1956 where preference shares are redeemed otherwise than out of a fresh issue, these shall be out of profits, otherwise available for dividends, be transferred to a reserve fund called Capital Redemption Reserve Account, an amount equal to the nominal value of the shares redeemed. The provisions of the Companies Act, 1956, relating to the reduction of share capital of a company shall apply as if the Capital Redemption Reserve account were paid up share capital of the company. The Capital Redemption Reserve Account may be applied by the company in paying up in issued share of the company to be issued to members of the company as fully paid up bonus shares. Capital Redemption Reserve should be disclosed under the head "Reserves & Surplus" on the Liabilities side of the Balance Sheet as per Part-I of Schedule VI to the Companies Act, 1956.

### Question 22

*As an auditor, comment on the following:*

*M/s Bonafide Ltd. has taken a Group Gratuity Policy from an Insurance Company. During accounting year 2008-09 it received a communication from the said Insurance Company informing that premium amount for the accounting year 2007-08 was less charged by Rs.75 lacs on account of arithmetical error on the part of Insurance Company. M/s Bonafide Ltd. paid the said sum of Rs. 75 lacs during the accounting year 2008-09 by debiting the same to Prior Period Expenses.*

### Answer

**Prior Period Expenses:** Accounting Standard 5 defines the prior period items as income or expenses which arise in the current period as a result of errors or omission in the preparation of the financial statements of one or more prior period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts or oversight. In this case, there has been arithmetical mistake of Rs.75 lacs in computing the amount of premium.

Though in this case there was no error or omission on the part of M/s Bonafide Ltd. and the error was on the part of the Insurance Company. But it is the management of the enterprise which is responsible for preparation of financial statements. Thus, the expenditure of Rs.75 lacs pertains to prior period and to be debited to Prior Period Expenses. Therefore, the accounting treatment accorded by the management is appropriate. The auditor should, however, ensure that the nature of mistake, i.e., insurance premium as well as amount of Rs.75 lacs has been disclosed separately in such a manner that its impact on the current profit or loss can be perceived.

### Question 23

*As an auditor, comment on the following situations/statements:*

- (a) *The surplus arising from sale of investment was set-off against a non-recurring loss and was not disclosed separately.*
- (b) *The register of members of AP Ltd. has not been written up-to-date and as a result, the balances in the register do not agree with the amount of issued Share Capital.*

### Answer

- (a) **Disclosure of Surplus on Sale of Investments:** AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changing in Accounting Policies" prescribes the classification and disclosure of items in the statement on profit and loss account. AS 5 requires separate disclosure of prior period item, extraordinary items, etc. distinctly

## Auditing and Assurance

---

so as to reflect the financial position of enterprise for better understanding of users of financial statements. In the instant case, the setting-off of surplus arising from sale of investments against a non-recurring item is not proper because such an adjustment fails to disclose the performance of enterprise. Though, sale of investments (even if such investments are long-term) is an ordinary activity of the enterprise, the AS 5 requires that, "When items of income and expenses within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately". Accordingly the auditor should modify his report bringing out the impact of adjusting surplus on investments against loss on non-recurring items.

- (b) **Maintenance of Statutory Register:** Register of members is a statutory book, which should be maintained by every company. The auditor should ascertain whether the company updates the register and then examine whether it is in agreement with the amount of issued capital. Because in the audit of share capital, it constitutes one of the internal documentary evidence. The auditor may also consider applying alternative audit procedures because if the company fails to update the register and the auditor fails to obtain sufficient appropriate audit evidence, the auditor may qualify his report.

### Question 24

*What are the special considerations in an audit of a Limited Company?*

### Answer

#### Special Consideration in and Audit of Limited Company

##### 1. **Initial Verification**

- (a) Examine basic documents, viz., Memorandum of Association and Articles of Association of the company, prospectus issued, etc.
- (b) Check the certificate of incorporation and certificate of commencement of business.
- (c) Examine transactions entered into by the company with reference to the date of these certificates.
- (d) Verify the contracts entered into with vendors or other persons for purchase of property, payment of commission, etc.

2. **Board's Duties**

- (a) Ensure that Board of Directors act well within their powers and no ultra vires act is ratified.
  - (b) Also check that the Board has not exercised the powers that are to be exercised by the members in their General Meeting.
  - (c) Verify that only acts that can be delegated are in fact delegated to others and that the Board takes decisions only by resolutions at properly constituted meetings.
  - (d) Inspect minutes of meetings of Board of Directors.
  - (e) Verify whether the Board has obtained sanction of the Central Government, wherever applicable, e.g., increase in remuneration to Directors in excess of specified amounts.
3. Compliance with relevant provisions of the Companies Act, 1956 relating to share capital; provision relating to Board provisions relating to accounts and audit, etc.
4. Compliance with provisions relating to Sections 224 to 233.

**Question 25**

*How will you vouch and/or verify Re-issue of Forfeited Shares?*

**Answer**

**Re - issue of forfeited shares**

- (i) The auditor should ascertain that the board of directors has the authority under the Articles of Association of the company to reissue forfeited shares. Check the relevant resolution of the Board of Directors.
- (ii) Vouch the amounts collected from persons to whom the shares have been allotted and verify the entries recorded from re-allotment. Auditor should check the total amount received on the shares including received prior to forfeiture, is not less than the par value of shares.
- (iii) Verify that computation of surplus amount arising on the reissue of shares credited to Capital Reserve Account and
- (iv) Where partly paid shares are forfeited for non-payment of call, and re-issued as fully paid, the reissue is considered as an allotment at a discount and compliance of the provisions of Section 79 is essential.

## Auditing and Assurance

---

### Question 26

*Answer the following:*

*Board of Directors of Natraj Ltd. wants to transfer an amount of Rs.31.50 lacs lying in unpaid dividend account to their Profit and Loss account on the plea that it is 3 years old and no shareholder is expected to turn up and claim the same.*

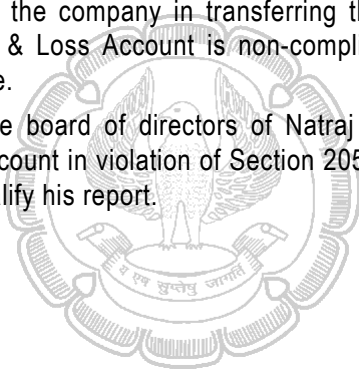
### Answer

According to Section 205A, of the Companies Act, 1956 it is compulsory for a company to transfer the amount of dividend, which remains unpaid or unclaimed within 30 days of the declaration, to a special bank A/c to be opened in any scheduled bank.

Furthermore, if the money so transferred to the unpaid dividend remains unclaimed for a period of seven years from the date of such transfer, such money should be transferred to Investor Education and Protection Fund established under Section 205C of the Act.

In the instant case, action of the company in transferring the amount after 3 years from unpaid dividend A/c to Profit & Loss Account is non-compliance of the section and may invite imprisonment and/or fine.

The auditor should advise the board of directors of Natraj Ltd., not to transfer the said amount to its Profit & Loss Account in violation of Section 205A and if the board of directors does not agree, he should qualify his report.



### EXERCISES

#### Question 1

As an auditor how you would react to the following situations?

- (a) Calls in Arrears included an amount of Rs 20,000 due from Directors of the company. The Articles of Association provided for charging interest on calls in arrears. The company did not provide interest on the amount due from Directors.
- (b) One of the manufacturing unit of B Ltd. equal to 40% of the total assets was destroyed in a fire for which there was no insurance cover. The chief accountant of the company contends that the destruction of the unit took place only after the date of the Balance Sheet and therefore there was no need to make disclosure of loss in the annual accounts as at the Balance Sheet date
- (c) A public limited company has issued Debentures which are guaranteed by the Government of India both as to the repayment of the principal and interest but not secured by any charge on the assets of the company and disclosed the same as 'Secured Loans' in the Balance sheet.

#### Question 2

You client has sought your opinion to correctly account for and/or disclose the following matters. State your views with reasons for the same:

- (a) The amount payable to suppliers of machinery under deferred payment arrangement has been shown as current liabilities. The company accepted the bills drawn by the supplier and offered its other fixed assets as a collateral security.
- (b) The debit balance in the profit and loss account is shown as a deduction from investment allowance reserve on the liabilities side of the Balance Sheet.
- (c) Sundry debtors include charges made for returnable packing cases.
- (d) The value of land and building was not separately disclosed. Also a major repair of the roof amounting to Rs. 1, 00,000 was carried out during the year/, without which the building would have become unusable.
- (e) Assets purchased under hire-purchase system were reflected at their full value and the outstanding installments payable have been included under Sundry Creditors.

#### Question 3

Explain the points to be considered while vouching Shares issued at a discount.