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CMA (Inter)

Paper 12 – Company Accounts & Audit

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SECTION A: ACCOUNTS OF JOINT STOCK COMPANIES [50 MARKS]

Study Note | Accounting of Shares and Debentures

1.1 Introduction

Company

A Company is a separate legal entity registered under Companies Act, 2013

Company consists of individuals, called shareholders by virtue of holding the shares of a company,

Shareholders are authorised by law to elect a board of directors

Through Board of Directors , the Companyt performs its activities as an artificial person.

SALIENT FEATURES

- **Incorporated Association - Invisible/ Intangible / Existing only in the eyes of law**
  - A company comes into existence only through registration under Companies Act. It is regarded as an **artificial legal person**.

- **Separate Legal Entity**
  A company **can contract, sue and be sued in its incorporated name**

and capacity.

- **Perpetual Existence**
- Existence independent of its members. It continues to be in existence despite the death, insolvency or change of members

- **Common Seal**
- Company is not a natural person. In order to enable the company to sign its documents, it is provided with a legal tool called 'Common Seal'.

- **Limited Liability**
- The liability of every shareholder is limited to the amount he has agreed to pay (fully paid up value of shares) to the company on the shares allotted to him.

- **Distinction between ownership and management**
- Ownership – Shareholders.
- Management: Board of Directors, appointed by the shareholders

Why 'Company' form of organisation?

Large amount of money, modern technology, large human contribution etc. is required to increase the scale of operations so as to provide goods and services to the ever-increasing needs of the growing population of consumers, which is not possible to arrange under partnership or proprietorship. This led to the inception of the concept of 'Company' or 'Corporation'.

TYPES OF COMPANIES

1. **Government Company** - Section 2(45) of the Companies Act, 2013

   - Any Company in which **not less than fifty-one per cent of the paid-up share capital** is held by
     - the Central Government, or
     - 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**.

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2. **Foreign Company -** Section 2 (42) of the Companies Act, 2013,

Any company or body corporate **incorporated outside India** which –

- ✓ Has a **place of business in India** whether by itself or through an agent physically or through electronic mode; and
- ✓ Conducts any business activity in India in any other manner.

3. Private Company - Section 2(68) of the Companies Act, 2013

A company which by its articles,

- **restricts the right to transfer its shares**;
- **Prohibits any invitation to the public to subscribe for <u>any securities</u>** of the company.
- Shares of a Private Company are not listed on Stock Exchange.
- <u>Exception</u>
  - ❖ One Person Company limits the number of its members to two hundred. Joint membership will be considered as single member
  - ❖ Employees – Present & past holding shares are not considered as members

4. **Public Company -** Section 2(71) of the Companies Act, 2013

- A company which is not a private company;
- Subsidiary of company which is not a private company shall also be considered as public company even where such subsidiary company continues to be a private company in its articles.
- A unlisted public company.
- No Minimum Paid-up Share Capital

Note:The minimum paid-up share capital requirement of INR 1,00,000 (in case of a private company) and INR 5,00,000 (in case of a public company) has been done away with under Companies Act, 2013.

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5. **One Person Company -** Section 2 (62) of the Companies Act, 2013

   A company which has **only one person as a member.**

6. **Small Company -** Section 2(85) of the Companies Act, 2013

   - A company, **other than a public company**
     - **paid-up share capital**
       - does not exceed **Rs.50 lakhs** or
       - such higher amount as may be prescribed which shall not be more than **Rs.5 Crores**; or
     - **turnover** (as per its last profit and loss account)
       - does not exceed **Rs.2 Crores** or
       - such higher amount as may be prescribed which shall not be more than **Rs.20 crores**

Note: The status of a company as a Small Company may change from year to year.

7. **Listed Company -** Section 2 (52) of the Companies Act, 2013

   A company which has any of its **securities listed on any recognised stock exchange.**

8. **Unlisted Company**

   The company, whose shares are **not listed on any recognised stock exchange.** An unlisted company can be a public company or a private company.

9. **Company limited by Shares -** Section 2(22) of the Companies Act, 2013

   Liability of its members is **limited by the memorandum to the amount, if any, unpaid** on the shares respectively held by them.

10. **Company limited by Guarantee -** Section 2(21) of the Companies Act, 2013

    Liability of its members **limited by the memorandum to such amount as the members may respectively undertake to contribute** to the assets of the company in the event of its being wound up.

11. **Unlimited Company -** Section 2 (92) of the Companies Act, 2013

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A company **not having any limit on the liability of its members.**

12. **Holding Company -** Section 2 (46) of the Companies Act, 2103

A company of which one or more other companies companies are subsidiary companies.

13. **Subsidiary Company** - Section 2(87) of the Companies Act, 2013

- A company in which the holding company:
  - **Controls** the **composition of the Board of Directors** (i.e. power to appoint or remove all or a majority of the directors); or
  - **Exercises or controls >** ½ of the **total share capital** either on its
    - own or
    - together with one or more of its subsidiary companies.
- **Deemed Subsidiary Company** - indirect control through the subsidiary company (ies).

MAINTENANCE OF BOOKS OF ACCOUNTS – Section 128

- **Who should maintan** : Every company
- **Where to maintain** : Registered office
  - **What to maintain** : Books of accounts and other relevant books and papers and financial statement for every financial year **which g**ive a true and fair view of the state of the affairs of the company
- **Whose books** : Company's, Branch office's or Company's other offices, explaining the transactions effected both at the registered office and its branches
- **How to maintain** :
  - **Method of Accounting**- Accrual basis and according to the double entry system of accounting
  - **Mode** – Physical or electronic

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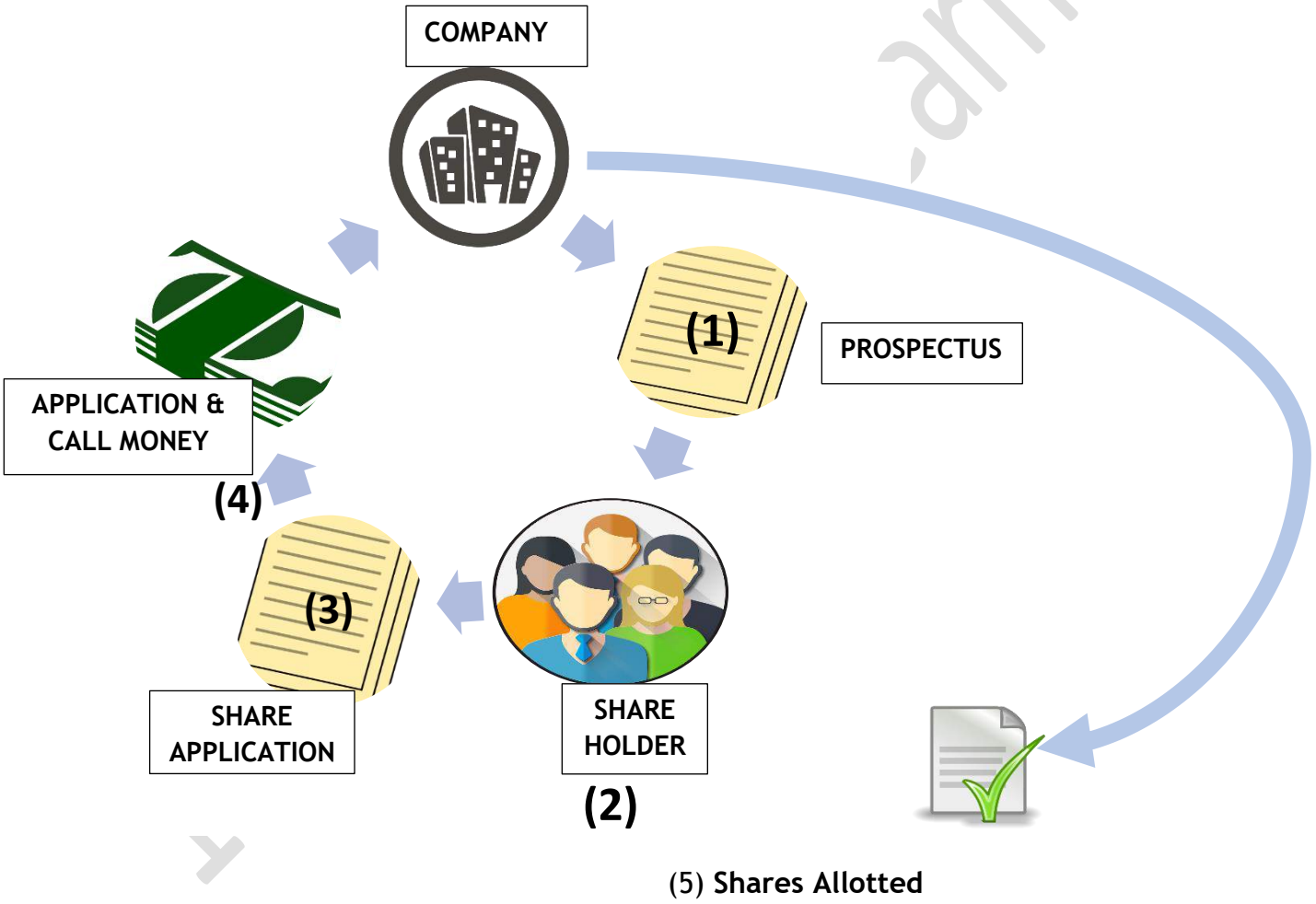
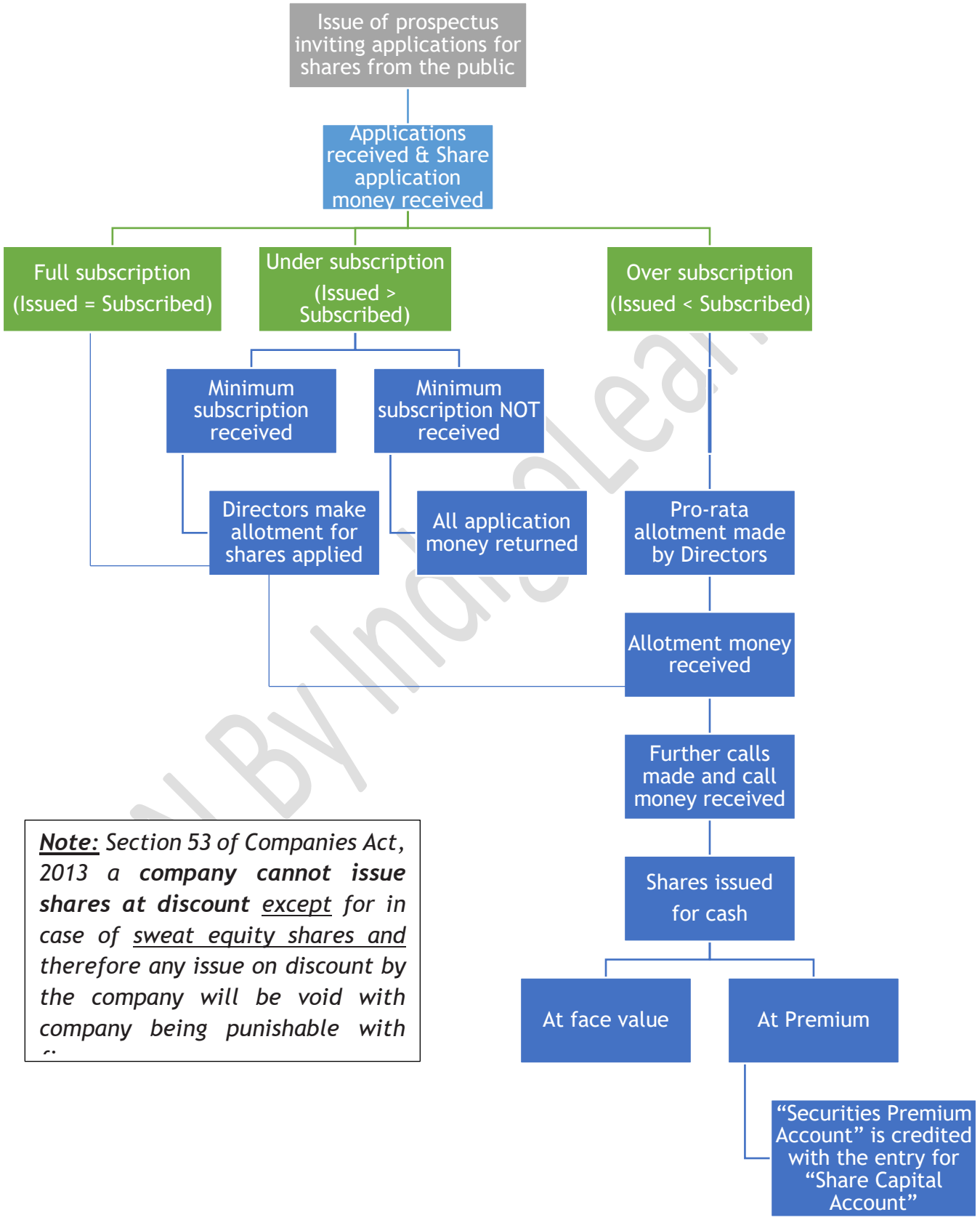
1.2 Issue of Share

Procedure for raising funds through equity





Note: *Section 53 of Companies Act, 2013 a* ***company cannot issue shares at discount*** *except for in case of sweat equity shares and therefore any issue on discount by the company will be void with company being punishable with*

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INTRODUCTION

Capital

Funds provided by the owners.

Business Organization	Ownership	Type of Capital	Liability of Owners
Sole - Proprietorship	Proprietor	Capital	Unlimited
Partnership	Partners	Partners' Capital	Unlimited
Company	Shareholders	Share Capital	Limited to issue price of shares held

SHARE CAPITAL

- **Share**

  Total capital of the company is divided into a number of small indivisible units of a fixed amount called shares. The capital of the company is called 'Share Capital'

- **Face / Nominal Value of Share**

  The fixed value of a share printed on the share certificate.

- **Share Price**

  Issue price *- The value at which the share is issued [Face (+) Premium, if any*

  (-) Discount, if any]

  Book building *- Process through which company determines it's share prices. Under this method company determines a price band of its shares and on the basis of bids received from potential investors at various prices within the price band finally fixes its issue price*

  Market Price *- The value at which the share is traded on the stock exchange*

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SHARE CAPITAL - Categories

Authorised Share Capital or Nominal Capital

- It is the maximum limit of capital which a company is authorised to raise during its lifetime
- It is mentioned in 'Capital Clause' of the "Memorandum of Association"
- It is disclosed on the face of the Balance Sheet at face value

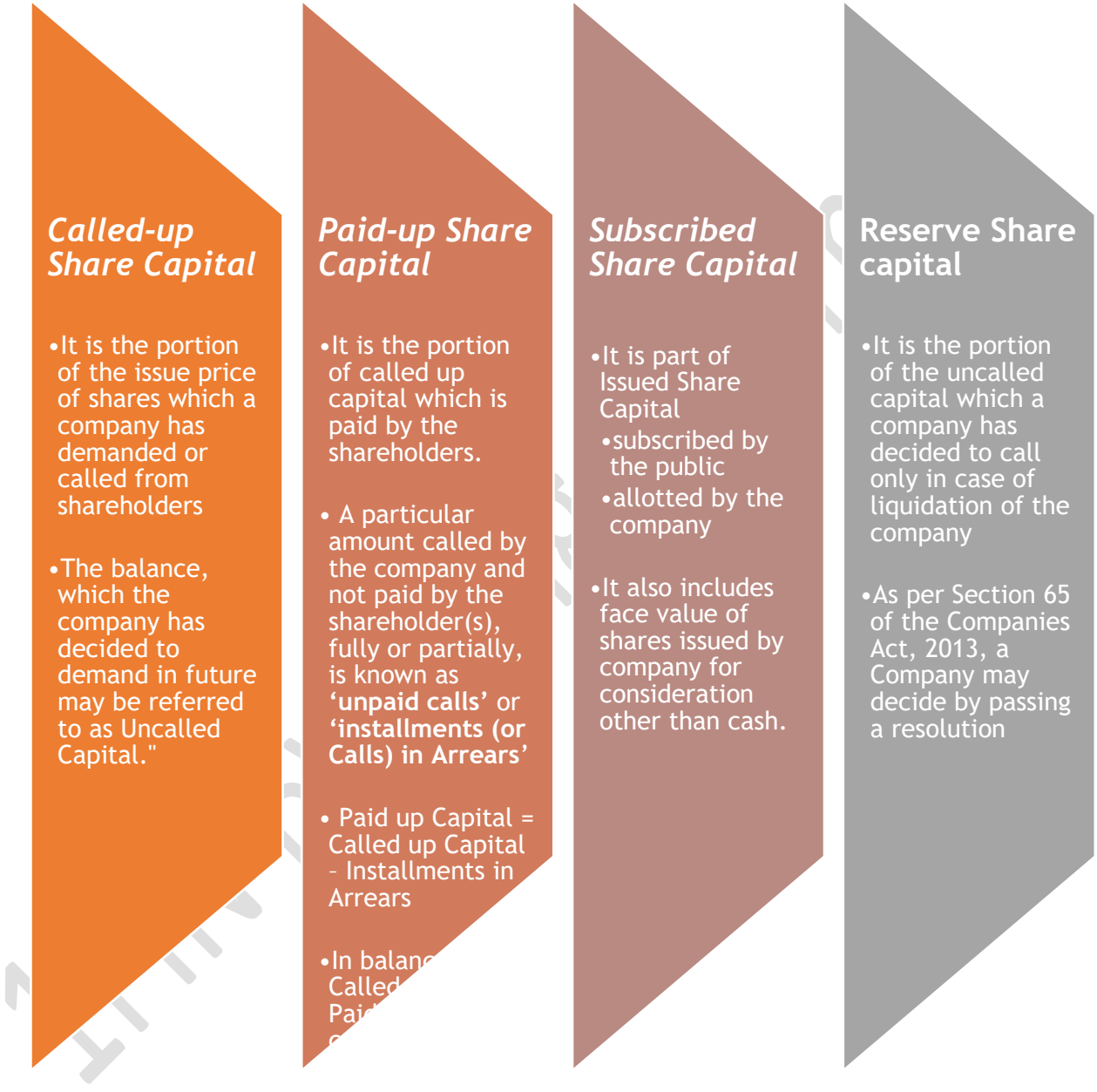
Issued Share Capital

- It is the portion of the authorised capital issued by the company
- It includes the nominal value of shares issued for
  - Cash
  - Consideration other than Cash to
    - Promoters
    - Others
- The remaining portion of the Authorised Share capital which is not issued either in cash or consideration may be termed as **'Un-issued Capital'**

Subscribed Share Capital

- It is part of Issued Share Capital
  - subscribed by the public
  - allotted by the company
- It also includes face value of shares issued by company for consideration other than cash.

SHARE CAPITAL - Categories

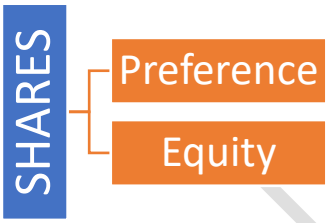


1. Authorised Capital = Issued Capital + Unissued Capital.
2. Subscribed Capital differs based on subscription type
   - **Fully Subscribed:** Subscribed Capital = Issued Capital
   - **Over Subscribed:** Subscribed Capital > Issued Capital
   - **Under Subscribed:** Subscribed Capital < Issued Capital
3. Called up Capital = Paid up Capital + Calls in arrears if any - Calls in advance if any

❖ **Calls in advance**

been paid by shareholder. It is shown separately, in the Balance Sheet as liability of the company under the heading 'Current Liabilities' until the calls are made and the amount actually becomes payable by the shareholder.

Types of Shares



Preference Shares

As per Section 43 of the Companies Act, 2013, Preference shareholders

- are assured of a **preferential dividend at a fixed rate** during the life of the company.
- carry a preferential **right over other shareholders to be paid first in case of winding up** of the company.

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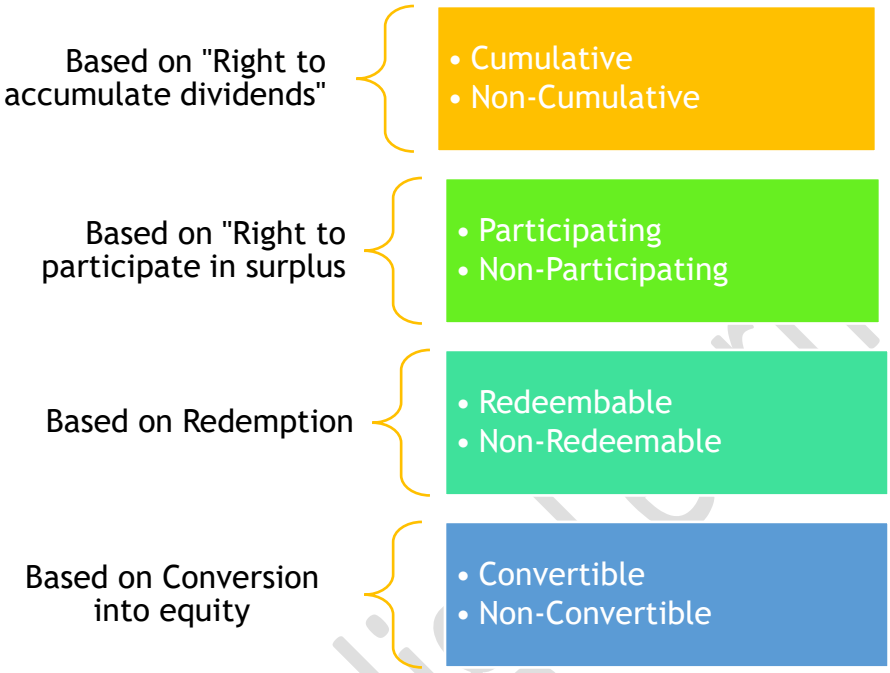
Type of Preference Shares



(a) Cumulative Preference Shares

- It carries the right to a fixed amount of dividend or dividend at a fixed rate.
- Dividend on these shares accumulates unless it is paid in full
- The arrears of dividend are then shown in the balance sheet as a contingent liability.
- In India, a preference share is considered cumulative unless otherwise stated.
- If arrears of dividend are outstanding for a period more than two years, holders of such shares can vote on every resolution on every matter in the general body meeting of the shareholders.

(b) Non-cumulative Preference Shares:

- It carries with it the right to a fixed amount of dividend.
- Dividend on these shares does not accumulate in the year with no profits
- The right to dividend expires every year.

(c) Participating Preference Shares

- These shares give the right to participate in the surplus profits, if any, after the equity shareholders
  - Every year for dividend at a stipulated rate
  - At the time of winding up for distribution of profits (a pre-determined proportion)

(d) Non-participating Preference Shares

- No additional rights in profits and in the surplus on winding-up,
- Unless otherwise specified, the preference shares are generally non-participating.

(e) Redeemable Preference Shares

- The company will repay after the fixed period or even earlier at company's discretion.
- The repayment on these shares is called redemption and is governed by Section 55 of the Companies Act, 2013.

(f) Non-redeemable Preference Shares

- No redemption arrangement agreed upon.
- According to Section 55, no company limited by shares shall issue irredeemable preference shares or preference shares redeemable after the expiry of 20 years from the date of issue.
- A Company may issue preference shares redeemable after 20 years for such infrastructure projects as may be specified, under the Companies Act, 2013.

(g) Convertible Preference Shares

- These shares give the right to get converted into equity shares at the shareholder's option.

(h) Non-convertible Preference Shares

- No right to get his holding converted into equity share
- Preference shares are non-convertible unless otherwise stated.

Special Points related to Preference Shares:

- They enjoy preferential rights in the matter of :
  - Payment of dividend, and
  - Repayment of capital
- Generally, holders of these shares do not get voting rights
- The cost of raising preference share capital is cheaper than raising debt
- The Companies Act, 2013 prohibits the issue of any preference share which is irredeemable.
- Preference shares are cumulative and non-participating unless expressly stated otherwise.
- Unless mentioned otherwise Preference Shares are Non-Cumulative, Non Participating, Non- Convertible and Redeemable in nature.
- Dividend is generally cumulative.

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Equity Shares

Those shares, which are not preference shares are called Equity Shares.

Special Points for Equity Shares

- These shares **carry voting rights.**
- **No preferential rights** in the matter of payment of dividend or repayment of capital
- **Dividend on equity shares is recommended by the Board** of Directors and may vary from year to year.
- Rate of dividend depends upon the dividend policy and the availability of profits after satisfying the rights of preference shareholders.
- Companies Act, 2013 permits issue of **equity share capital with differential rights** as to dividend.

Types of Equity Shares



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ISSUE OF SHARES FOR CASH

Private Companies	Public Companies
• Private Placement	• Issue Prospectus • Invite General Public to subscribe for Shares • Receive Share applications and Application money (Section 39 Application money ≥ 5% of nominal value) • Allot Shares to subscribers as per SEBI guidelines (*A company cannot proceed to allot shares unless **minimum subscription** is received by the company*

❖ Minimum Subscription

A public limited company cannot make any allotment of shares unless

- ➢ minimum subscription stated in the prospectus has been subscribed and
- ➢ application money for such shares has been paid to and received by the company.

The **amount of minimum subscription** to be disclosed in prospectus by the Board of Directors should consider the following

(a) **Preliminary expenses**,
(b) **Commission payable on issue of shares**,
(c) Cost of **fixed assets** purchased or to be purchased,
(d) **Working capital requirements**, and
(e) Any other expenditure for the day to day operation of the business.

Guidelines of the Securities Exchange Board of India (SEBI)

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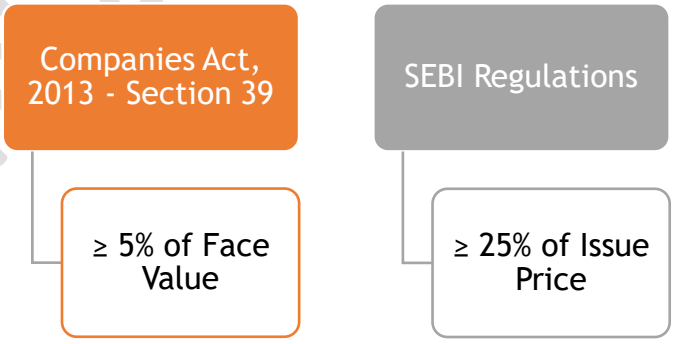
- **Minimum subscription** to be received in an issue shall **not be less than 90%** of the offer through offer document.
- **Non receipt of the minimum subscription of 90%** of the issue, all application moneys received shall be refunded:
  - Non-underwritten Issue – within 15 days of the closure of the issue; and
  - Underwritten Issue – within 7 days of the closure of the issue
  - Underwritten issue where minimum subscription including devolvement obligations paid by the underwriters is not received – within 60 days of the closure of the issue.
- The company has the **right to reject or accept an application** fully or partially.
  - **Accepted applications** – Shareholders have to pay "Allotment Money"
  - **Rejected applications** – Application money is refunded by the Company (delayed refunds shall be paid with interest)
- **'Calls'** (subsequent instalments of the issue price) made by company as given in prospectus.

Note: The issue price of shares is generally received by the company in instalments:

First instalment	**Application Money**
Second Instalment	**Allotment Money**
Third Instalment	**First Call Money**
Fourth Instalment	**Second Call Money and so on.**
Last Instalment	**Final Call Money**

Application money



Section 24 of the Companies Act, 2013 - Matters related to issue and transfer of securities will be administered by the SEBI and not by the Company Law Board. Thus the application money has to be minimum of 25% of Issue price.

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SUBSCRIPTION OF SHARES

❖ Full Subscription

Number of shares offered for subscription = Number of shares actually subscribed by the public

❖ Under Subscription

Number of shares offered for subscription > Number of shares actually subscribed by the public.

Important Note: shares can be allotted, in this case, only when the minimum subscription is received.

- *Minimum subscription received ➔ Proceed for allotment*
- *Minimum subscription not received ➔ Refund the amount received on application, as per guidelines*

❖ Over Subscription

Number of shares offered (Public issue) < Number of shares actually subscribed by the public.

- Applications rejected ➔ application money refunded
- Applications accepted
    - All shares applied are allotted ➔ No refund
    - Part of the shares applied are allotted ➔ excess amount received can be used for allotment or call money

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JOURNAL ENTRIES – ISSUE OF SHARES

Event	Entry	Debit (Rs.)	Credit (Rs.)	Remarks
(1) Receipt of Application Money	Bank A/c Dr.	xxxx		Actual amount received.
	To Share Application Money A/c		xxxxx	Actual amount received.
	(Being application money received)			
(1a) Refund of Application money to applicants)	Share Application A/c Dr.	xx		Actual amount refunded
	To Bank A/c		xx	
	(Being application money refunded)			
(2) Allotment of Share	Share Allotment A/c Dr.	xxxx		Amount due on allotment
	Share Application A/c Dr.	xxxx		Application amount received on allotted shares
	To Share Capital A/c		xxxxxx	Amount due on allotment and application
	(Being the sum due on allotment and application money transferred to capital account)			
(2a) A part of shares applied for are allotted	Share Application A/c Dr.	xxxx		
	To Share Allotment A/c **		xxxx	Application money accepted for allotment

	To Shares Calls in advance A/c		xxx	Amount from application money adjusted for future calls
	To Bank A/c		xx	Excess amount to be refunded
	(Being application money adjusted) ** Credited to Share Capital A/c subsequently			
(3) Receipt of allotment money	Bank A/c Dr.	xxxx		Amount actually received on allotment.
	To Share Allotment A/c		xxxx	
	(Being money received on allotment)			
(4) Call being made	Share Call A/c Dr.	xxx		Amount due on the call
	To Share Capital A/c		xxx	
	(Being share call made due at Rs……)			
(5) Receipt of Call Money	Bank A/c Dr.	xxxx		Amount called actually received
	To Share Call A/c		xxxx	
	(Being share call money received)			

Note: *Sometimes separate Application and Allotment Accounts are not prepared and entries relating to application and allotment monies are passed through a combined account "Share Application & Allotment Account".*

SHARES ISSUED AT DISCOUNT

Shares are issued at DISCOUNT, if Issue Price < Nominal or Par Value

Discount = Nominal Value - Issue Price

Example:

Nominal Value (a)	Issue Price (b)	Discount (Rs.) (c) = (a-b)	Discount % (d)= [(c) ÷ (a)]100
100	100	0	N.A
100	98	2	2%
100	110	N.A	N.A
250	200	50	20%

Important Note: As per Section 53 of the Companies Act, 2013, a Company **cannot issue shares at a discount except in the case of issue of sweat equity shares** (issued to employees and directors). Thus, any issue of shares at discount shall be void (if issued to general public).

SHARES ISSUED AT PREMIUM

Shares are issued at PREMIUM, if Issue Price > Nominal or Par Value

Premium = Issue Price -Nominal Value

Example:

Nominal Value (a)	Issue Price (b)	Premium (Rs.) (c) = (b-a)	Premium % (d)= [(c) ÷ (a)]100
100	100	0	N.A

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100	120	20	20%
100	90	N.A	N.A
250	350	100	40%

Premium is generally called with the amount due on allotment, sometimes with the application of money and rarely with the call money

❖ *Securities Premium Account*

- Premium amount is credited to a separate account called Securities Premium Account.
- It is not a part of share capital. Rather, it represents a gain of a capital nature to the company.
- It is shown under the heading, "Reserves and Surplus", which is further shown as "Shareholders' Funds" in the Balance Sheet as per Schedule III.

❖ Utilisation of Securities Premium Account

It may be used by the company as given under **Section 52** of the Companies Act, 2013:

(a) Towards issue of un-issued shares of the company to be issued to members of the company as fully paid **bonus securities.**

(b) To **write off preliminary expenses** of the company.

(c) To **write off the expenses of, or commission paid, or discount allowed on any of the securities** or debentures of the company.

(d) To provide for premium on the redemption of redeemable preference shares or debentures of the company.

(e) For the purchase of own shares or other securities i.e. **Buy back of shares**.

Note Companies whose financial statements comply with the accounting standards prescribed for them under Section 133 of the Companies Act, 2013.

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JOURNAL ENTRIES – ISSUE OF SHARES AT PREMIUM

(1) Premium amount called with Application Money

Event	Entry	Debit (Rs.)	Credit (Rs.)	Remarks
(1) Receipt of Application Money	Bank A/c Dr.	Xxxx		Total application money + Premium amount
	To Share Application Money A/c		xxxxx	Actual amount received.
	(Being application money received for _____ shares @ Rs._____ per share including premium)			
(2) Allotment of Share	Share Application A/c Dr.	Xxxx		No. of shares x Application money per share
	To Share Premium A/c Dr.		xxxx	No. of shares allotted x Premium per share
	To Share Capital A/c		xxxxxx	No. of shares allotted x Nominal Value per share
	(Being the application money transferred to capital account)			

(2) Premium amount called with Allotment Money

Event	Entry	Debit (Rs.)	Credit (Rs.)	Remarks
(1) Receipt of Application Money	Bank A/c Dr.	Xxxx		Total application money + Premium amount

	To Share Application A/c		xxxxx	Actual amount received.
	(Being application money received for _____ shares @ Rs._____ per share including premium)			
(2) Allotment of Share	Share Application A/c Dr.	Xxxx		No. of shares x Application money per share
	Share Allotment A/c Dr.	Xxxx		No. of shares allotted x Allotment & Premium amount per share
	To Share Capital A/c		xxxxxx	No. of shares allotted x Application & allotment amount per share
	To Share Premium A/c Dr.		xxxx	No. of shares allotted x Premium per share
	(Being Amount due on allotment of shares @ Rs.____per share including premium)			
(3) Allotment money received	Bank A/c Dr.	Xxxx		Actual amt received
	To Share Allotment Money A/c		xxxxx	Total allotment money + Premium amount
	(Being money received including premium consequent upon allotment)			

OVER SUBSCRIPTION AND PRO-RATA ALLOTMENT

Number of shares offered (Public Issue) < Number of shares actually subscribed by the public.

Reasons for oversubscription

- *investors' confidence in the company,*
- *previous performance of the company*
- *general economic conditions,*
- *pricing of the issue etc*

Allotment for oversubscription

- ✓ Shares can be allotted to the applicants by a company in any manner it thinks proper.
  - Some Applicants rejected in full and remaining accepted in full➔ application money refunded to such applicants
  - Multiple applications by the same person not considered ➔ application money refunded for applications
  - All Applications accepted ➔ allotment done on pro-rata basis i.e. 'Pro-rata allotment' means allotment in proportion of shares applied for.

Example

Shares offered to public	10,000
Applications received	12,000
Ratio	12,000:10,000 i.e. 6:5
For every 6 shares applied, 5 shares are allotted	

- ✓ Excess amount received is treated as an advance against allotment and calls and thereby adjusted against the amount due on allotment or calls.
- ✓ Surplus money after making adjustment against future calls is returned to the applicants.
- ✓ The applicants are informed about the allotment procedure through an advertisement in leading newspapers.

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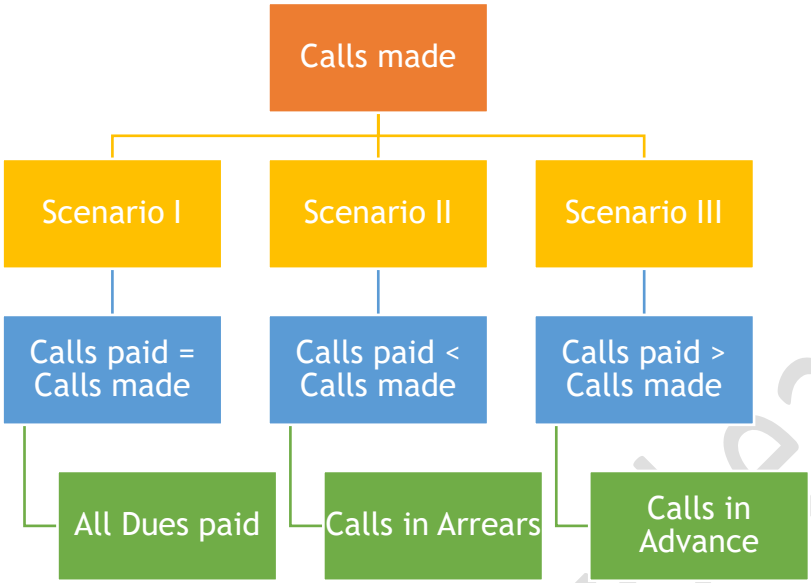
JOURNAL ENTRIES – OVER SUBSCRIPTION (PRO-RATA ALLOTMENT)

Event	Entry	Debit (Rs.)	Credit (Rs.)	Remarks
(1) Rejected applications	Share Application A/c Dr.	xxxx		Application money x no. of shares rejected
	To Bank A/c		xxxxx	Actual amount received.
	(Being application money refunded for rejected applications as per Board's Resolution No….dated….)			
(2) Pro-rata Allotment	Share Application A/c Dr.	xxxx		Total money received – (No. of shares allotted x Application money per share)
	To Share Allotment A/c		xxxxxx	No. of shares allotted x Allotment money per share
	(Being excess application money adjusted against allotment money as per Board's Resolution No….dated….)			

CALLS IN ADVANCE & CALLS IN ARREARS



❖ Calls in Arrears

- The total unpaid amount on one or more instalments called but shareholder failed to pay is known as *Calls-in-Arrears* or *Unpaid Calls*.
- It is the uncollected amount of capital from the shareholders;
- It is shown by way of deduction from 'called-up capital' to arrive at paid-up value of the share capital.

❖ Calls in Advance

- Amount not yet called up but paid by shareholders is known as Calls-in-advance.
- Interest at a rate not exceeding 12 % p.a. is to be paid on such advance call money.
- This amount is credited in Calls-in-Advance Account and shown separately under Current Liabilities

❖ Interest on Calls in Arrears & Calls in Advance

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Interest on Calls in Arrears	Interest on Calls in Advance
Receivable by the Compay from the Shareholders	Payable by the Company to Shareholders
Maximum Rate (Table F prescribed) is 10%	Maximum Rate (Table F prescribed) is 12%
Interest period = Call due date to actual money receipt date	Inerest period = Actual money receipt date to Call due date
Directors have right to waive off such interest on their discretion	Shareholders are not entitled to dividend on calls in advance
Income - credited to P&L A/c as a nominal account	Expense - debited to P&L A/c

JOURNAL ENTRIES – CALLS IN ADVANCE & CALLS IN ARREARS

Event	Entry		Debit (Rs.)	Credit (Rs.)	Remarks
(1a) Calls in Arrears after call made	Calls in arrears A/c	Dr.	xx		Amount of Unpaid Calls
	Bank A/c	Dr.	xxxx		Amount received
	To Share Allotment A/c			xxx	Total allotment money due
	To Share Calls A/c			xxxx	Total allotment money due
	(Being call money/ allotment money received on .... shares at ` per share.)				
(1b) Calls in Arrears received	Bank A/c	Dr.	xx		Amount of Unpaid calls received
	To Calls in Arrears A/c			xx	
	(Being unpaid calls received)				

(2a) Calls in Advance received	Bank A/c Dr.	xxx		Call amount received in advance
	To Calls in Advance A/c		xxx	
	(Being excess application money received)			
(2b) Call made	Calls in Advance A/c Dr.	xxx		Call amount received in advance
	Bank A/c Dr.	xx		Remaining call money received, if any
	To Particulars Call A/c		xxxx	Call money due
	(Being call in advance adjusted and call money due received)			
(3a) For interest receivable on Calls-in-Arrears	Shareholder's A/c Dr.	xxx		
	To Interest on Calls in arrears A/c		xxx	
	(Being interest on calls in arrears at the rate of _____% due)			
(3b) For receipt of interest	Bank A/c Dr.	xxx		
	To Shareholder's A/c		Xxx	
	(Being interest money received)			
(4a) For interest payable on Calls-in-Advance due	Interest on Calls-in-AdvanceA/c Dr.	xxx		Amount of interest due for payment
	To Shareholder's A/c		xxx	
	(Being interest on calls in advance due)			
(4b) For payment of interest	Shareholder's A/c Dr.	xxx		Amount of interest paid
	To Bank A/c		xxx	
	(Being interest money received)			

Illustrations

Illustration – 1

A company had an authorised capital of Rs.10,00,000 divided into 1,00,000 equity shares of Rs.10 each. It decided to issue 60,000 shares for subscription and received applications for 70,000 shares. It allotted 60,000 shares and rejected remaining applications. Up to 31-3 -2017, it has demanded or called Rs.9 per share. All shareholders have duly paid the amount called, except one shareholder, holding 5,000 shares who has paid only Rs.7 per share.
Prepare a balance sheet assuming there are no other details.

Illustration – 2

A company invited applications for 10,000 equity shares of Rs.50 each payable on:

1. Application Rs.15;
2. Allotment Rs.20,
3. on first and final call Rs.15.

Applications are received for 10,000 shares and all the applicants are allotted the number of shares they have applied for and instalment money was duly received by the company.
Show Journal entries in the books of the company.

Illustration – 3

On 1st April 2017, A Ltd. issued 43,000 shares of Rs. 100 each payable as follows:

- Rs.20 on application;
- Rs.30 on allotment;
- Rs.25 on 1st October 2017; and
- Rs. 25 on 1st February 2018

By 20th May, 40,000 shares were applied for and all applications were accepted. Allotment was made on 1st June. All sums due on allotment were received on 15th July; those on 1st call was received on 20th October.
Journalise the transactions when accounts were closed on 31st March 2018.

Illustration – 4

Pant Ltd. invited applications for 50,000 equity shares at Rs.50 each, which are payable as on application Rs.20, on allotment Rs.10 and on first and final call Rs.20. The company received applications for 60,000 shares. The directors accepted application for 50,000 shares and rejected the rest.
Show Journal entries if company refunded the application money to rejected applicants and allotment money was received for 45,000 shares.

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1.3 Right Issue

RIGHT ISSUE

- ★ Right issue is an issue of rights to a company's existing share- holders that entitles them to buy additional shares directly from the company in proportion to their existing holdings, within a fixed time period.
- ★ This way the voting and governance rights of the existing shareholders is not diluted.
- ★ In a right offering, the subscription price at which each share may be purchased is generally at a discount to the current market price.
- ★ Rights are often transferable, allowing the holder to sell them in the open market.
- ★ They have an implicit right to renounce this right in favor of someone else (unless the articles restrict such a right), or even reject it completely. When the existing shareholder charges for the renouncement, it is called the value of right.
- ★ The difference between the cum-right and ex-right value of the share is the value of the right.

PROVISIONS UNDER COMPANIES ACT, 2013

★ **Sec 62(1) - Conditions for issuing letter of offer**

The offer is made by a notice to shareholder which consists the following:

- ➢ The number of shares offered
- ➢ The time limit not being less than fifteen days and not exceeding thirty days from the date of the offer within which the offer should be accepted.
- ➢ If time limit expires, the offer is deemed to be declined
- ➢ Unless the articles 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 favor of any other person.
- ➢ After the expiry of the time specified in the notice or on receipt of earlier intimation of rejection from the shareholder the Board of Directors may dispose of them in a manner which is not disadvantageous to the shareholders.

★ **Exceptions to Sec 62** –Cases where shares are issued by a company, but not be offered to the existing shareholders –

1) To employees under a scheme of employees' stock option subject to certain specified conditions
2) To any persons, either for cash or for a consideration other than cash, if the

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price of such shares is determined by the valuation report of a registered valuer subject to certain specified conditions.

3) When companies borrow money through debentures / loans and give their lender an option to convert them into equity shares.
4) In a special situation where the loan has been obtained from the government, and government in public interest, directs the debentures / loan to be converted into equity shares.

COMPUTATION OF VALUE OF RIGHT

Book value of a share = Net worth (as per books) ÷ Number of shares

Market price, which exists before the rights issue, is termed as Cum-right Market Price of the share.

The market price of the shares after further issue of shares (right issue) is termed as Ex- right Market Price of the shares.

This price is going to prevail after the further issue of shares is executed

Ex-right value of the shares = [Cum-right value of the existing shares + (Rights shares X Issue Price)] ÷ (Existing Number of shares + Number of right shares)

Value of right = Cum-right value of share – Ex-right value of share

Market value of a company's shares represents the present value of future cash flows expected to be earned from the share in the form of dividends and capital gains from expected future share price appreciation.
The Ex-right value of the share is also known as the average price.
The accounting treatment of rights share is the same as that of issue of ordinary shares.

Journal entries	
Upon the issue of Right shares Bank A/c To Equity Share Capital A/c	 Dr.
In case shares are offered at premium Bank A/c To Equity Share Capital A/c To Securities premium A/c	 Dr.

RIGHT OF RENUNCIATION

★ Right of renunciation refers to the right of the shareholder to surrender his right to buy the securities and transfer such right to any other person.

★ Shareholders that have received right shares have three choices

- ➢ They can act on the rights and buy more shares as per the particulars of the rights issue;
- ➢ They can sell them in the market; or
- ➢ They can pass on taking advantage of their rights (i.e., reject the right offer).

★ The renunciation of the right is valuable and can be monetized by the existing shareholders in well-functioning capital market which is known as 'value of right'.

★ Value of right = Cum-right value of share – Ex-right value of share

ADVANTAGES OF RIGHT ISSUE

1) Enables the existing shareholders to maintain their proportional holding in the company and retain their financial and governance rights.
2) It works as a deterrent to the management, which may like to issue shares to known persons with a view to have a better control over the company's affairs.
   - The existing shareholders are not affected by the dilution because getting new shares at a discounted value from their cum-right value will compensate decrease in the value of shares.
3) Right issue is a natural hedge against the issue expenses normally incurred by

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the company in relation to public issue.

4) Right issue has an image enhancement effect, as public and shareholders view it positively.
5) The chance of success of a right issue is better than that of a general public issue and is logistically much easier to handle.

DISADVANTAGES OF RIGHT ISSUE

1) The right issue invariably leads to dilution in the market value of the share of the company.
2) The attractive price of the right issue should be objectively assessed against its true worth to ensure that you get a bargained deal.

1.4 Bonus Issue

BONUS ISSUE

★ Bonus issue means an issue of free additional shares to existing shareholders, without the additional inflow of cash.
★ It is based upon the number of shares that the shareholder already owns.
★ With bonus issue
  - ➢ The number of shares increases
  - ➢ There is no change in net worth of the company
  - ➢ There is no change in ratio of number of shares held.
★ Also known as Capitalization of profits, as it involves converting free reserves into paid up capital. {Free reserves are those which are otherwise available for distribution as dividends}
★ If it exceeds the authorized share capital, then a resolution is passed in General meeting for increasing the authorized capital.

PROVISIONS UNDER COMPANIES ACT, 2013

★ **Sec 63(1)** - a company may issue fully paid-up bonus shares to its members, in any manner out of –
  - ➢ its free reserves.
  - ➢ the securities premium account; or
  - ➢ the capital redemption reserve account.

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★ However, **no issue** of bonus shares shall be made by capitalizing reserves created by the **revaluation of assets. [Also provided in Regulation 94 of** SEBI (Issue of Capital and Disclosure Requirements) Regulations,2009:

★ **Sec 63(2) -** No company shall capitalise its profits or reserves for the purpose of issuing fully paid-up bonus shares unless –

1) It is authorised by its articles.
2) It has, on the recommendation of the Board, been authorised in the general meeting of the company.
3) It has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it.
4) It has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus.
5) The partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;

> ★ Free reserves may be used for paying up amounts unpaid on shares held by existing shareholders, though securities premium account and capital redemption reserve cannot be used.

★ The company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same. [Rule 14 of Companies (Share Capital and Debentures) Rules, 2014]

★ **Sec 63(3) -** The bonus shares shall not be issued in lieu of dividend. **[Also provided in Regulation 94 of** SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009

PROVISIONS UNDER SEBI REGULATIONS

A listed company, while issuing bonus shares to its members, must comply with the following requirements under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009:

★ **Regulation 92- Conditions for Bonus Issue**

- Points 1, 3, 4 and 5 provided in Sec 63(2) (mentioned above) are also provided in regulation 92.

★ **Regulation 93 - Restriction on bonus issue**

- Every listed company must make reservation of same class equity shares in favor of the holders of outstanding compulsorily convertible debt instruments, if any, in proportion to the convertible part thereof.
- Such reserved shares shall be issued at the time of conversion of such convertible debt instruments on the same terms or same proportion at which the bonus shares were issued.

★ **Regulation 94 – Bonus shares provision**

- The bonus issue shall be made from
  - free reserves built out of the genuine profits or
  - securities premium collected in cash only
- The bonus issue shall not be made from reserves created by revaluation of fixed assets
- The bonus share shall not be issued in lieu of dividend.

★ **Regulation 95 - Completion of bonus issue**

- Implementation of bonus issue
  - Within 15 days from the date of approval of the issue by its board – when bonus issue is announced after the approval of its board of directors and not requiring shareholders' approval
  - within 2 months from the date of the meeting of its board - where the issuer is required to seek shareholders' approval.
- Once the decision to make a bonus issue is announced, the issue cannot be withdrawn.

Journal entries	
Upon the sanction of an issue of bonus shares	
Capital Redemption Reserve A/c	Dr.
Securities Premium A/c	Dr.
General Reserve A/c	Dr.
Profit & Loss A/c	Dr.
To Bonus to Shareholders A/c	

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Upon issue of bonus shares Bonus to Shareholders A/c Dr. To Share Capital A/c	
Upon the sanction of bonus by converting partly paid shares into fully paid shares General Reserve A/c Dr. Profit & Loss A/c Dr. To Bonus to Shareholders A/c	
On making the final call due Share Final Call A/c Dr. To Share Capital A/c	
On adjustment of final call Bonus to Shareholders A/c Dr. To Share Final Call A/c	

Illustrations

Illustration – 1

Particulars	Amount (Rs.)
40,000 Equity shares of Rs. 10 each	4,00,000
Capital Redemption Reserve	55,000
Securities Premium (collected in cash)	30,000
General Reserve	1,05,000
Surplus i.e. credit balance of Profit and Loss Account	50,000

The company decided to issue to equity shareholders bonus shares at the rate of 1 share for every 4 shares held and for this purpose, it decided that there should be the minimum reduction in free reserves. Pass necessary journal entries.

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Illustration – 2

Following is the extract of the Balance Sheet of Solid Ltd. as at 31st March, 20X1:

Particulars	Amount (Rs.)
Authorised capital:	
10,000 12% Preference shares of Rs. 10 each	1,00,000
1,00,000 Equity shares of Rs. 10 each	10,00,000
	11,00,000
Issued and Subscribed capital:	
8,000 12% Preference shares of Rs. 10 each fully paid	80,000
90,000 Equity shares of Rs. 10 each, Rs. 8 paid up	7,20,000
Reserves and Surplus:	
General reserve	1,60,000
Revaluation reserve	35,000
Securities premium (collected in cash)	20,000
Profit and Loss Account	2,05,000
Secured Loan:	
12% Debentures @ Rs. 100 each	5,00,000

On 1st April, 20X1 the Company has made final call @ Rs. 2 each on 90,000 equity shares. The call money was received by 20th April, 20X1.

Thereafter the company decided to capitalize its reserves by way of bonus at the rate of one share for every four shares held. Show necessary entries in the books of the company and prepare the extract of the Balance Sheet immediately after bonus issue if the company has passed necessary resolution at its general body meeting for increasing the authorized capital.

Illustration – 3

A company offers new shares of Rs. 100 each at 25% premium to existing shareholders on one for four bases. The cum-right market price of a share is Rs. 150. Calculate the value of a right. What should be the ex-right market price of a share?

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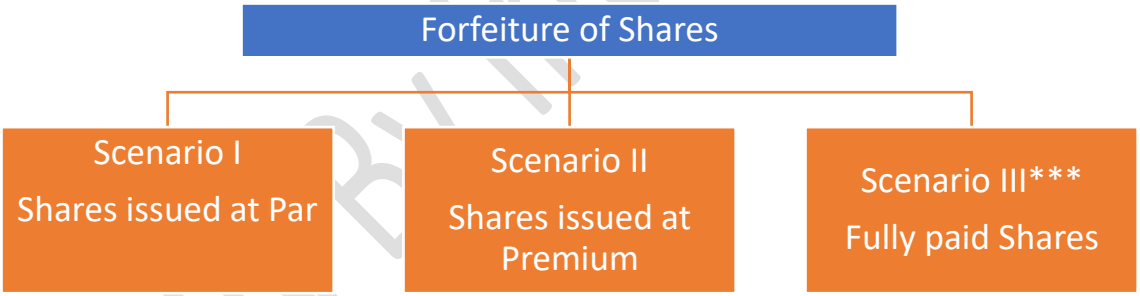
1.6 Forfeiture of Shares

FORFEITURE OF SHARES

- Forfeiture of shares is the action taken by a company to cancel the shares, WHEN shareholders fail to pay their allotment and/or calls on the due dates
- The directors are usually empowered by the Articles of Association to forfeit those shares by strictly following the rules and regulations in the Articles of Association
- Proper notice to the defaulting shareholder(s) should be served.
- Directors also have the right to cancel such forfeiture before the forfeited shares are re-allotted.
- When shares are forfeited, the title of such shareholder is extinguished but the amount paid to date is not refunded to him.
- The shareholder then has no further claim on the company.



*** *Forfeiture for non-payment of calls, premium, or the unpaid portion of the face value of the shares is one of the many causes for which a share may be forfeited. But fully paid-up shares may be forfeited for realization of debts of the shareholder if the Articles specifically provide it.*

JOURNAL ENTRIES – FORFEITURE OF SHARES

Important Amounts to consider:

(i) Amount **called-up (i.e., amount credited to capital)** in respect of forfeited

shares.

(ii) Amount already **received** in respect of those shares.

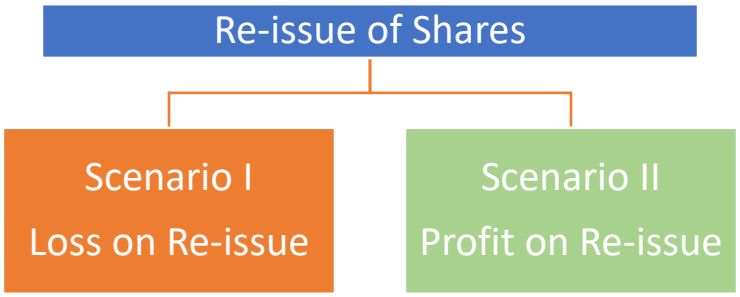
(iii) Amount **due but has not been received** in respect of those shares.

Event	Entry	Debit (Rs.)	Credit (Rs.)	Remarks
(1a) Forfeiture of shares issued at Par *- No Calls-in-Arrears*	Share Capital A/c Dr.	xxxx		No. of forfeited shares x called-up value per share
	To Forfeited Shares A/c		xxx	Amount already received on forfeited shares
	To Share Allotment A/c		xxx	IF amount due but not paid
	To Share Call A/c		xx	IF amount due but not paid
(1b) Forfeiture of shares issued at Par *- With Calls-in-Arrears*	Share Capital A/c Dr.	xxxx		No. of forfeited shares x called-up value per share
	To Calls in Arrears A/c		xx	Total Amount due but not paid
	To Forfeited Shares A/c		xxx	Amount already received on forfeited shares
(2a) Forfeiture of shares issued at Premium *- IF*	Share Capital A/c Dr.	xxx		Call amount received in advance
	Securities Premium A/c Dr.			Amount of Security premium not received

Premium NOT received	To Forfeited Shares A/c		xxx	Amount already received on forfeited shares
	To Share Allotment A/c		xxx	IF amount due but not paid
	To Share Call A/c		xx	IF amount due but not paid
***(2a) Forfeiture of shares issued at Premium** – IF Premium received*	Share Capital A/c Dr.	xxx		Call amount received in advance
	To Forfeited Shares A/c		xxx	Amount already received on forfeited shares
	To Share Allotment A/c		xxx	IF amount due but not paid
	To Share Call A/c		xx	IF amount due but not paid
***Note**: If the premium has already received by the company, it cannot be cancelled even if the shares are forfeited in the future:*				

RE-ISSUE OF FORFEITURE OF SHARES

- ✓ A forfeited share is merely a share available to the company for sale and remains vested in the company as an obligation to dispose it off.
- ✓ Reissue of forfeited shares is not allotment of shares but only a sale. In practice, forfeited shares are disposed off, by auction.
- ✓ These shares can be re-issued at any price so long as the total amount received (from the original allottee and the second purchaser) for those shares is not less than the amount in "Calls-in-arrears" on those shares.



❖ Important Points

- Loss on re-issue should not exceed the forfeited amount.
- When the shares are re-issued at a loss, such loss is to be debited to "Forfeited Shares Account".
- If the loss on re-issue is less than the total amount forfeited, the surplus should be transferred to Capital Reserve.
- When only a portion of the forfeited shares are re-issued, then the profit made on re-issue of such portion of shares only must be transferred to Capital Reserve.
- If the shares are re-issued at a price which is more than the face value of the shares, the excess amount will be credited to Securities Premium Account.
- The forfeited amount on shares (amount originally paid-up) not yet reissued should be shown under the heading 'share capital.'
- If the re-issued amount and forfeited amount (taken together) exceeds the face value of the shares re-issued, it is not necessary to transfer such amount to Securities Premium Account.
- The credit balance of forfeited shares account cannot be considered a surplus until the shares forfeited have been re-issued, because the company may, on re-issue, allow the discount to the new purchaser equivalent to the amount held in credit in this regard in the forfeited shares Account

❖ Calculation of Profit on Re-issue of Forfeited Shares

Example

No.of shares forfeited	120
Nominal value of each share	Rs.10
Paid up amount on each forfeited share	Rs.5

First Re-Issue 50 shares (Rs.6 per share collected to make it fully paid up)

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Amount received	[50x 6]	Rs.300
Amount transferred from Shares forfeited A/c to Share Capital A/c	No. of shares x (Nominal Value – Amount received on re-issue) i.e. [50 (10 – 6)]	Rs.200
Surplus on Re-issue: Amount transferred to Capital Reserve	Amount in Shares Forfeited A/c for shares re-issued – Amount transferred to Share Capital A/c i.e. [(50x5)-Rs.200]	Rs.50
Amount carried forward in Shares Forfeited A/c	Total Value of Shares Forfeited – Amount transferred to Share Capital on re-issue – Surplus transferred to Capital Reserve [(120x5) – Rs.200 – Rs.50]	Rs.350

JOURNAL ENTRIES – FORFEITURE OF SHARES

Event	Entry	Debit (Rs.)	Credit (Rs.)	Remarks
(1) Re-issue of shares	Bank A/c Dr.	xx		Actual amount received
	Forfeited Shares A/c Dr.	xxx		Profit on re-issue
	To Share Capital A/c		xxx	
	(Being the re-issue of…. shares @ Rs….. each as per Board's Resolution No…. dated.)			
(2) Surplus transferred to	Forfeited Shares A/c Dr.	xxxx		
	To Capital Reserve A/c		xx	

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Capital Reserve A/c	(Being the profit on re-issue, transferred to capital reserve).			

ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH

- A public limited company generally, issue their shares for cash but it may issue shares
  - in a **direct exchange** for land, buildings or other **assets**.
  - **in payment for services rendered** by promoters, lawyers in the formation of the company.
- These shares should be **shown separately under 'Share Capital'**.
- Within specified time of allotment, the **company must produce before the Registrar** a **written contract of sale of service** in respect of which shares have been allotted.

When assets are purchased in exchange of shares

Assets Account Dr.
To Share Capital Account

Illustrations

Illustration – 1

Mr. Long who was the holder of 2,000 preference shares of Rs.100 each, on which Rs. 75 per share has been called up could not pay his dues on Allotment and First call each at Rs.25 per share. The Directors forfeited the above shares and reissued 1500 of such shares to Mr. Short at Rs. 65 per share paid-up as Rs.75 per share.
Give Journal Entries to record the above forfeiture and re-issue in the books of the company.

Illustration – 2

Beautiful Co. Ltd issued 30,000 equity shares of Rs.10 each payable as

- Rs.3 per share on Application,
- Rs.5 per share (including Rs.2 as premium) on Allotment and

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- Rs.4 per share on Call.

All the shares were subscribed. Money due on all shares was fully received except from Ram, holding 500 shares, who failed to pay the Allotment and Call money and Shyam, holding 1,000 shares, who failed to pay the Call Money. All those 1,500 shares were forfeited. Of the shares forfeited, 1,250 shares (including whole of Ram's shares) were subsequently re-issued to Jadu as fully paid up at a discount of Rs.2 per share.

Pass the necessary entries in the Journal of the company to record the forfeiture and re-issue of the share. Also prepare the Balance Sheet of the company.

Illustration – 3

Shreyas Ltd. did not receive the first call on 10,000 equity shares @ Rs. 3 per share which was due on 1.7.2016. This amount was received on 1.4.2017.

Open Calls in arrears account and journalise the entries in the books of the company on 1.7.2016 and 1.4.2017. Also show an extract of Balance Sheet on 31.3.2017.

Illustration – 4

Rashmi Limited issued at par 1,00,000 Equity shares of Rs.10 each payable:

- Rs.2.50 on application;
- Rs.3 on allotment;
- Rs. 2 on first call and balance on the final call.

All the shares were fully subscribed. Mr. Nair who held 10,000 shares paid full remaining amount on first call itself. The final call which was made after 3 months from first call was fully paid except a shareholder having 1000 shares who paid his dues amount after 2 months along with interest on calls in arrears. Company also paid interest on calls in advance to Mr. Nair.

Give journal entries to record these transactions

1.7 Buy Back of Shares

Objectives

I. Understanding buyback – meaning, objectives and conditions
II. Provisions of Companies Act 2013 relating to it
III. Accounting entries to record buyback + points to remember for exams
IV. Other Aspects from exam point of view

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Meaning

Buyback = purchase, by a company, of its own shares/securities

Implication: Shares bought back are cancelled, hence there is reduction of capital

Primary Objectives

- To increase EPS
- To increase promoters' holding
- To enhance share price on stock exchange (when the management thinks that it is less than its worth)
- To pay surplus cash to shareholders if not needed in business

Key Conditions

- Buyback can be made out of
  (a) free reserves
  (b) securities premium or
  (c) proceeds of issue of other shares/securities (but not earlier issue of same kind of shares/securities being bought back)

- Shares should be fully paid up. Partly paid up shares cannot be bought back

- It must meet Shares outstanding test, Resource test, Debt ratio test (explained below)

- End use restriction: company cannot buy for purpose of investment.

RELEVANT PROVISIONS OF COMPANIES ACT 2013:

A. Balance Sheet conditions

1. Buyback must meet Share Outstanding test i.e. buyback in a financial year must be =< 25% of company's total number of outstanding shares in that financial year

2. Buyback must meet Resource test i.e. must use amount =< 25% of company's total paid up capital + free reserves

3. Buyback must meet Debt equity ratio test i.e. after buyback, ratio of debt owed by the company (secured & unsecured / long term & short term) to total of paid up capital + free reserves should not be more than 2:1

   Exception: Ratio may be higher in respect of certain class of shares, if so prescribed by Central Government

4. Premium payable on buyback (buyback price less par value) to be adjusted from free reserves and / or securities premium [revaluation reserve, which represents unrealised profit, cannot be used]

5. Where shares are purchased out of free reserves / securities premium, transfer amount = nominal value of shares to Capital Redemption Reserve (CRR) Account (details of which to be disclosed in balance sheet)
   To clarify: CRR is not required to be created when funds of fresh issue are being utilized for paying shareholders on buyback

6. CRR A/c may be used to issue fully paid up bonus shares (hence, is not a free reserve)

7. Company to ensure that at least 50% of the amount earmarked for buyback to be utilized for the same

B. Procedural requirements

8. Buyback must be authorized by Articles of Association

9. Buyback must be authorized by special resolution passed in general meeting. Notice for such meeting to be accompanied by an explanatory statement specifying prescribed details viz. class of shares to be bought back & amount, need for buyback, all material facts relating to buyback etc.

Exception to above two conditions: Where buyback is 10% or less of paid up capital + free reserves & is authorized by a board resolution passed at directors' meeting

10. Buyback must be completed within 12 months from date of passing special resolution/resolution passed by the board of directors

11. In case of listed shares, company to file a solvency declaration with ROC and SEBI to the effect that company is capable of meeting its liabilities and will not become insolvent within 1 year of date of declaration

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12. Company to physically destroy shares post buyback

13. Maintain register of shares bought back. To record date of cancellation, consideration paid, other particulars as prescribed

14. In case of listed shares, file prescribed return with ROC and SEBI

C. Other provisions

15. Buyback must meet SEBI regulations when listed shares are being bought back

16. Buyback may be:
    - From existing security holder proportionately
    - From open market (cannot exceed 15% of paid up capital + free reserves)
    - By purchasing securities issued to employees (pursuant to stock option / sweat equity)

17. Further shares of same kind cannot be issued for 6 months, unless by way of bonus or towards discharge of subsisting obligations viz. warrants, ESOPs, conversion of preference shares etc.

18. Non-compliance of above provisions / other SEBI regulations to be punishable with specified fine (1-3 lakh rupees), imprisonment (upto 3 years) or both

19. Buyback must not be made directly or indirectly through subsidiaries or other investment companies

20. Buyback cannot be made if there is a financial default like default in payment of interest or dividend, repayment of deposit or loan installment, redemption of debentures etc.

21. Buyback cannot be made within 1 year from date of closure of previous buyback

22. Meaning of free reserves – Reserves, which as per latest audited balance sheet, are available for distribution as dividend
    - ✓ Includes securities premium
    - × Does not include any unrealized gains / notional gains / revaluation of assets (whether shown as reserve or otherwise)

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- Does not include any change in carrying value of asset / liability recognized in equity / P&L on measurement of asset / liability at fair value

ACCOUNTING ENTRIES:

1. To record amount due on buyback, including cancelling share capital

   Equity share capital A/c Dry
   Premium payable on buyback A/c Dr
   To Equity shares buyback A/c

   Remember:
   (i) Ensure that exam question specifies shares being bought back are fully paid. Otherwise, make suitable assumption.
   (ii) Where question clearly specifies number of shares being bought back, whether the three tests are being met need not be checked.

2. To adjust premium payable on buyback from free reserves

   Securities Premium A/c
   Revenue or General Reserve A/c
   Profit and Loss A/c Dr
   To Premium payable on buyback A/c

   Remember:
   (i) Follow the order as mentioned above while adjusting premium payable
   (ii) Ensure there is sufficient balance as per the facts given in exam question. Else, utilize the next in line free reserves.

3. To transfer appropriate amount to CRR A/c

   Revenue or General Reserve Dr
   To Capital Redemption Reserve A/c

   Remember: Amount to be transferred = Amount debited in Equity share capital A/c in #1 above

4. To record payment on buyback

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Equity shares buyback A/c Dr
To Bank

Remember:

(i) Do a quick check if there are sufficient balances - existing or from having sold investments etc. – as per exam question

(ii) Ensure that proceeds of a previous issue of same class of shares, if any, are not required to be used.

OTHER ASPECTS:

Questions may specify other events like redemption of preference shares, issue of shares against ESOPs granted etc. Pls take due note and pass necessary journal entries.

1. Questions may require preparing balance sheet as well post journal entries. Remember to update relevant closing balances like equity capital, bank balance, securities premium and / or free reserves – all of which would have reduced balances at year end.

2. Where exam question asks to determine maximum how many shares can be bought back), compute using following tests, i.e.

   (i) Shares Outstanding test: Maximum buyback can be upto 25% of shares outstanding.
   E.g. Company has 10,000 shares of Rs 10 each fully paid up. Buyback can be made upto 2,500 shares only as per this test.

   (ii) Resources test: Maximum buyback can be upto 25% of paid up capital + free reserves
   E.g. Company has 10,000 shares of Rs 10 each fully paid up. Buyback is to be made at Rs 50 per share. Existing free reserves = Rs 150,000.
   Thus, Paid up capital + free reserves = 100,000 + 150,000 = 250,000.
   25% thereof = 62,500
   Buyback price per share = 50
   Buyback can be made upto 1,250 (62,500/50) shares as per this test.

   (iii) Debt ratio test: After buyback, debt: capital+free reserves should be 2:1 or less.
   Remember, CRR is not a free reserve (has limited purposes).

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Since this is a post buyback test, some backward calculations would need to be made to calculate permissible buyback limits.

E.g. If Debt is 1200, capital + free reserves post buyback should be at least 600. Existing capital + free reserves = 750

Thus, 150 is available for buyback. However, the same has to be used:

- To cancel nominal value of equity that is being bought back. Say, Rs. X
- To adjust premium payable, if any, on buyback. Say Rs. 2X in this case
- To transfer to CRR as well. The amount to be transferred to CRR is same as nominal value of shares. Thus, another Rs. X

Therefore, 150 = 4X

And X = 150/4 = Rs 37.5 which is the total face value of shares that can be bought back. Divide it by face value of one share (Rs 10 or 100 or whatever is specified in question) to arrive at number of shares that can be bought back.

Lowest number of shares from 3 tests above would be the maximum number of shares that can be bought back.

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Illustrations

Illustration - 1

M Ltd. furnishes the following summarized balance sheet as at 31st March 2011.

Liabilities	**Rs. in ('000)**	**Rs. in ('000)**
Equity and liabilities		
Share capital:		
Authorized capital:		5,000
Issued and subscribed capital		
3,00,000 equity shares of Rs.10 each fully paid up	3,000	
20,000 9% preference shares of Rs.100 each	2,000	
(**issued two months back for the purpose of buy back**)		5,000
Reserves and surplus:		
Capital reserves	10	
Revenue reserves	4,000	
Securities premium	500	
Profit and loss account	1,800	6310
Non- current liabilities – 10% debentures		400
Current liabilities and provisions		40
Total		**11,750**
Assets	Rs. in ('000)	**Rs. in ('000)**
Fixed Assets Cost	3,000	
Less: Provision for depreciation	250	**2,750**
Non-current investments at cost		**5,000**
Current assets, loans and advances (including cash and bank balances)		**4,000**
Total		**11,750**

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The company passed a resolution to buy back 20% of its equity capital @Rs.15 per shares. For this purpose, it sold its investments of Rs.30 lakhs for Rs.25 lakhs. You are required to pass necessary journal entries.

Illustration - 2

Anu Ltd. (a non-listed company) furnishes you with the following summarized balance sheet as on 31st March 2011.

	Rs. (in crores)	**Rs. (in crores)**
Sources of funds		
Share capital:		
Authorised		100
Issued:		
12% redeemable shares of Rs. 100 each fully paid	75	
Equity shares of Rs.10 each fully paid	25	100
Reserves and surplus:		
Capital reserves	15	
Securities premium	25	
Revenue reserves	260	300
Total		**400**
Application of Funds		
Fixed assets: cost	100	
Less: Provision for depreciation	(100)	Nil
Non-current investments at cost (Market value Rs 400 Cr.)		100
Current assets	340	
Less: Current liabilities (Trade Payables)	(40)	300
Total		400

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The company redeemed preference shares on 1st April 2011. It also brought back 50 lakhs equity shares of Rs. 10 each at Rs.50 per shares. The payment for the above were made out of the huge bank balances, which appeared as a part of current assets. The company redeemed preference shares on 1st April 2011. It also brought back 50 lakhs equity shares of Rs. 10 each at Rs.50 per shares. The payment for the above were made out of the huge bank balances, which appeared as a part of current assets.
You are asked to:

(i) pass journal entries to record the above.
(ii) prepare balance sheet as at 1.04.2011

Illustration – 3
Dee Ltd. (a non-listed company) furnishes the following summarized balance sheet as at 31st March 2011.

Liabilities	**Rs. ('000)**	**Rs. ('000)**
Share capital: Authorised capital		30,00
Issued and subscribed capital: 2,50,000 equity shares of Rs.10 each fully paid up 2,000, 10% preference shares of Rs.100 each	25,00 2,00	
(issued two months back for the purpose of buy back)		
Reserves and surplus: Capital reserves	10,00	
Revenue reserves	30,00	
Securities premium Profit and loss account	22,00 35,00	97,00
Current liabilities and provision		14,00
Total		**1,38,00**
Assets		
Fixed assets		93,00
Investments		30,00

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Current assets, loans and advances (including cash and bank balances)		15,00
Total		1,38,00

The company passed a resolution to buy back 20% of its equity capital @ Rs. 50 per shares. For this purpose, it sold all of its investment for Rs.22, 00,000.
You are required to pass necessary journal entries and prepare the balance sheet.

Illustration - 4
Perrotte Ltd. (a non- listed company) has the following capital structure as on 31.03.2011.

	Particulars	**Rs. (in crores)**	**Rs. (in crores)**
(1)	Equity shares capital (shares of Rs.10 each fully paid)		330
(2)	Reserves and surplus		
	General reserves	240	_
	Securities premium account	90	_
	Profit and loss account	90	_
	Infrastructure development reserves	180	600
(3)	Loan funds		1,800

Shareholders of Perrotte Ltd. on the recommendation of their Board of Directors, have appeared on 12.09.2011 a proposal to buy back the maximum permissible number of equity shares considering the large surplus funds available at the disposal of the company.

The prevailing market value of the company's shares is Rs.25 per shares and in order to induce the existing shareholders to offer their shares for buy back, it was decided to offer a price of 20% over market. You are also informed that the infrastructure development reserves are created to satisfy income-tax Act requirements.

You are required to compute the maximum number of shares that can be brought back in the light of the above information and also under a situation where the loan funds of the company were Rs.1, 200 crores or Rs. 1,500 crores. Assuming that the

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buyback is completed by 09.12.2011, show the accounting entries in the company's books in each situation.

1.8 Issue and Redemption of Preference Shares and Debentures

INTRODUCTION

- ★ Redemption is the process of repaying an obligation, at pre-arranged amounts and timings.
- ★ These shares are issued on the terms that shareholders will at a future date be repaid the amount which they invested in the company (along with frequent payment of a specified amount as return on investment during the tenure of the preference shares).
- ★ The redemption date is the maturity date, which specifies when repayment takes place and is usually printed on the preference share certificate.

REASONS FOR ISSUING REDEEMABLE PREFERENCE SHARES

1. There is difficulty in issuing equity shares, if shares are not traded in stock market and potential investors are skeptical in investing money.
2. Utilizing surplus funds in redeeming capital when they cannot use more beneficially.

SEC 55 OF COMPANIES ACT, 2013

1) Issue of Preference shares should be authorized by Articles.
2) Such shares should be redeemable within a period not exceeding 20 years from the date of issue.
3) Only fully paid up shares can be redeemed.

> Note –
> If the question has partly paid shares, then due entry for final call and receipt entry is passed before redemption entry.
> If the question has both the fully paid and partly paid shares, then only fully paid is considered for redemption.

4) If any premium is payable on redemption, the same shall be provided for out of the profits of the company or out of the company's securities premium account, before

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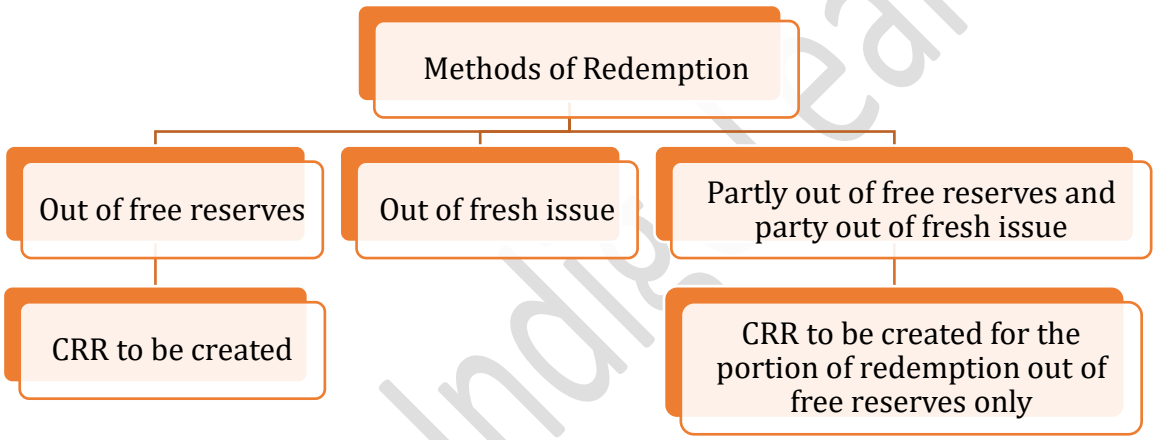
such shares are redeemed.

5) However, in case of companies which are prescribed and who comply with sec 133 of Companies act 2013, premium payable on redemption, shall be provided for out of the profits of the company only. i.e... Securities premium cannot be used.
6) Shares can be redeemed out of profit of the company which would otherwise be available for dividend or out of proceeds of fresh issue of shares made for the purpose of redemption.
7) Where shares are proposed to be redeemed out of the free reserves, a sum equal to the nominal amount of the shares redeemed should be transferred to a reserve account called Capital Redemption Reserve Account (CRR A/c)



CREATION OF CRR (CAPITAL REDEMPTION RESERVE), AND FRESH ISSUE

1) CRR can be used only for issuing fully paid bonus shares only.
2) The objective of creating CRR is to provide assurance or security to creditors/ bankers, etc.
3) Some examples of Free reserves are – General reserve, Profit and loss a/c, Surplus a/c, Residuary reserve, Dividend equalization reserve, Excess provision created etc. There is no order in which free reserves are to be utilized to create CRR.
4) Fresh issue can be either of equity shares or preference shares.
5) The proceeds of a fresh issue of shares will not include the amount of securities premium for the purpose of redemption of preference shares. (securities premium can be utilized only as per Sec 52* of Companies Act, 2013)
6) Proceeds from the issue of Debentures cannot be utilized.
7) Companies may have sufficient investments, which can be sold, in the market to arrange funds for redemption of preference shares.
8) When shares are redeemed by combination of Fresh Issue and capitalisation of Undistributed Profits:

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Amount to be Transferred to Capital Redemption Reserve	
Face value of shares redeemed	xxx
Less: Proceeds from new issue	xxx
	xxx

Proceeds to be collected from New issue	
Face value of shares redeemed	xxx
Less: Profits available for distribution as dividend	xxx
	xxx

* **Sec 52 of Companies Act, 2013** - The securities premium account may be applied by the company -

(a) Towards issue of un-issued shares of the company to be issued to members of the company as fully paid bonus securities

(b) To write off preliminary expenses of the company

(c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company

(d) To provide for premium on the redemption of redeemable preference shares or debentures of the company.

(e) For the purchase of its own shares or other securities.

Certain class of Companies whose financial statements comply with the Accounting Standards as prescribed under Section 133 of the Companies Act, 2013, can't apply the securities premium account for the purposes (b) and (d) mentioned above.

REASONS FOR ISSUE OF EQUITY SHARES FOR THE PURPOSE OF REDEMPTION

1) When the company realizes that the capital is needed permanently, and issue of Equity Shares are better as they don't carry any fixed rate of dividend.

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2) When the balance of free reserves is insufficient.
3) When the liquidity position of the company is not good enough.

ADVANTAGES AND DISADVANTAGES OF REDEMPTION OF PREFERENCE SHARES BY ISSUE OF FRESH EQUITY SHARES

Advantages	**Disadvantages**
1. No cash outflow of money	1. There will be dilution of future earnings
2. New equity shares may be valued at a premium	2. Shareholding in the company is changed
3. Shareholders retain their equity interest	

Journal entries
When new shares are issued at par Bank A/c Dr. To Share Capital A/c (Being the issue of ……. shares of Rs.…….each for the purpose of redemption of Preference shares, as per Board's Resolution No…… dated……..)
When new shares are issued at premium Bank A/c Dr. To Share Capital A/c To Securities premium A/c (Being the issue of ……. shares of Rs.…….each at a premium of Rs.…….each for the purpose of redemption of preference shares as per Board's Resolution No…. dated……)

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When preference shares are redeemed at par Redeemable Preference Share Capital A/c Dr. To Preference Shareholders A/c (Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)	
When preference shares are redeemed at a premium Redeemable Preference Share Capital A/c Dr. Premium on Redemption of Preference Shares A/c Dr. To Preference Shareholders A/c (Being the amount payable on redemption of preference shares (with premium on redemptions) transferred to Preference Shareholders Account	
When payment is made to preference shareholders Preference Shareholders A/c Dr. To Bank A/c (Being the amount paid on redemption of preference shares)	
For adjustment of premium on redemption Profit and Loss A/c Dr. To Premium on Redemption of Preference Shares A/c (Being Premium on redemption transferred to P&L A/c)	

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ADVANTAGES AND DISADVANTAGES OF REDEMPTION OF PREFERENCE SHARES BY CAPITALISATION OF UNDISTRIBUTED PROFITS

Advantages	Disadvantages
1. No change in the percentage of equity shareholding of the company	1. There may be a reduction in liquidity
2. Surplus funds can be used	

Journal entries
Entry for redemption of Preference shares (at par or at premium), payment to preference shareholders and adjustment of premium on redemption with the Profit and loss account is same as given above.
For transferring nominal amount of shares redeemed to Capital Redemption Reserve Account General Reserve A/c Dr. Profit and Loss A/c Dr. To Capital Redemption Reserve A/c (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act).

COMPLIANCE OF SEC.55 UNDER VARIOUS SCENARIOS

Scenarios	Compliance with Sec 55
1. When redemption is done with Company's own resources	Create CRR equal to the value of nominal value of shares issued. (Even if they are redeemed at premium)
2. When redemption is done by fresh issue of new shares	New shares are issued such that nominal value of shares issued = nominal value of shares redeemed.

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	When Equity shares are not fully called up, only the called-up portion is considered for computing the balance of P&L to be utilized.
3. When minimum fresh issue of shares needs to be computed	**Step 1 -** Ascertain maximum amount of reserves and surplus available for redemption from the balance sheet and additional information given in the question. **Step 2** - Adjust premium on redemption payable out of profits in the reserves. **Step 3** - Minimum Proceeds of Fresh Issue of shares = Nominal value of preference shares to be redeemed – Maximum amount of reserve and surplus available for redemption **Step 4** - Minimum Number of Shares = Minimum proceeds to comply with Section 55÷ Face value of one share (Fraction is rounded off to next higher figure) In step 4, face value is considered even if shares are issued at premium. However, in case of issue of share at a discount, discounted value is considered.
4. When shares are issued at premium and redemptions is also at premium	When Securities premium including premium on fresh issue is comparatively more than premium on redemption, profits available for redemption are not required for paying premium on redemption of preference shares. Thus, in the above equation, premium on redemption is not adjusted in maximum amount of reserves and surplus available for redemption.
5. When shares are issued at premium and redemptions is also at premium. (The premium on issue is higher than the premium on redemption)	Follow the steps given in scenario 3

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6. When the cash available for redemption is short	**Step1** - Fresh issue (Rs.) = Amount payable to preference shareholders – amount available **Step 2** - Fresh issue (no. of shares) = Fresh issue (above) ÷ issue price per share (including premium)

REDEMPTION OF FULLY CALLED BUT PARTLY PAID-UP PREFERENCE SHARES

★ **When calls-in-arrears is received by the company**

On receipt of amount of unpaid calls		
	Bank A/c	Dr.
	To Calls in arrears A/c	

After receipt of calls in arrears, the shares become fully paid up and, then, company can proceed with redemption in the normal course.

★ **In case of Forfeited Shares**

When calls in arrears is not received and redemption is due, the board may decide to forfeit the shares. The below forfeiture entry is passed before redemption entry.

On forfeiture of shares		
	Share Capital A/c	Dr.
	To Share forfeiture A/c	
	To Calls in arrears A/c	

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Illustrations

Illustration – 1

Hinduja Company Ltd. had 5,000, 8% Redeemable Preference Shares of Rs. 100 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of Rs. 10 each fully paid up at par.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Illustration – 2

C Ltd. had 10,000, 10% Redeemable Preference Shares of Rs. 100 each, fully paid up. The company decided to redeem these preference shares at par, by issue of sufficient number of equity shares of Rs. 10 each at a premium of Rs. 2 per share as fully paid up.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Illustration – 3

The Board of Directors of a Company decide to issue minimum number of equity shares of Rs. 9 to redeem Rs. 5,00,000 preference shares. The maximum amount of divisible profits available for redemption is Rs. 3,00,000. Calculate the number of shares to be issued by the company to ensure that provisions of Section 55 are not violated. Also determine the number of shares if the company decides to issue shares in multiples of Rs. 50 only.

Illustration – 4

The Balance Sheet of X Ltd. as on 31st March, 20X3 is as follows:

Particulars		Amount (Rs.)
EQUITY AND LIABILITIES		
1. Shareholders' funds		
a Share capital		2,90,000
b Reserves and Surplus		48,000
2. Current liabilities		
Trade Payables		56,500
	Total	**3,94,500**
ASSETS		
1. Fixed Assets		

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Tangible asset		3,45,000
Non-current investments		18,500
2. Current Assets		
Cash and cash equivalents (bank)		31,000
	Total	**3,94,500**

The share capital of the company consists of Rs. 50 each equity shares of Rs. 2,25,000 and Rs. 100 each Preference shares of Rs. 65,000 (issued on 1.4.20X1). Reserves and Surplus comprises Profit and Loss Account only.

In order to facilitate the redemption of preference shares at a premium of 10%, the Company decided:

1. to sell all the investments for Rs.15,000.
2. to finance part of redemption from company funds, subject to, leaving a bank balance of Rs. 12,000.
3. to issue minimum equity share of Rs. 50 each at a premium of Rs. 10 per share to raise the balance of funds required.

You are required to pass:

The necessary Journal Entries to record the above transactions and prepare the balance sheet as on completion of the above transactions.

Illustration – 5

The following are the extracts from the Balance Sheet of ABC Ltd. as on 31st December, 20X1.

Particulars	Amount (Rs.)
Share capital:	
40,000 Equity shares of Rs. 10 each **fully paid**	Rs. 4,00,000
1,000,10% Redeemable preference share s of Rs. 100 each **fully paid**	Rs. 1,00,00
Reserve & Surplus:	
Capital reserve	Rs. 50,000
Securities premium	Rs. 50,000

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General reserve	Rs. 75,000
Profit and Loss Account	Rs. 35,000

On 1st January 20X2, the Board of Directors decided to redeem the preference shares **at par** by utilization of reserve.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Illustration – 6

C Limited had:

3,000, 12% Redeemable Preference Shares of Rs. 100 each, fully paid up
The company had to redeem these shares at a premium of 10%
It was decided by the company to issue the following: • 25,000 Equity Shares of Rs. 10 each at par • 1,000 14% Debentures of Rs. 100 each

The issue was fully subscribed, and all amounts were received in full. The payment was duly made. The company had sufficient profits.

Show Journal Entries in the books of the company.

Illustration – 7

The capital structure of a company consists of:

Particulars	**Amount (Rs.)**
20,000 Equity Shares of Rs. 10 each **fully paid up**	
1,000 8% Redeemable Preference Shares of Rs. 100 each **fully paid up** (issued on 1.4.20X1).	
Undistributed reserve and surplus stood as:	
General Reserve	Rs. 80,000
Profit and Loss Account	Rs. 20,000

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Investment Allowance Reserve (out of which Rs. 5,000, not free for distribution as dividend)	Rs. 10,000
Securities Premium	Rs. 2,000
Cash at bank	Rs. 98,000

Preference shares are to be redeemed at a Premium of 10% and for the purpose of redemption, the directors are empowered to make fresh issue of Equity Shares at par after utilizing the undistributed reserve and surplus, subjected to the conditions that a sum of Rs. 20,000 shall be retained in general reserve and which should not be utilized.

Pass Journal Entries to give effect to the above arrangements and show how the relevant items will appear in the Balance Sheet of the company after the redemption carried out.

Illustration - 8

The Balance Sheet of XYZ as at 31st December, 20X1 inter alia includes the following:

Particulars	**Amount (Rs.)**
50,000, 8% Preference Shares of Rs. 100 each, **Rs. 70 paid up**	35,00,000
1,00,000 Equity Shares of Rs. 100 each **fully paid up**	1,00,00,000
Securities Premium	5,00,000
Capital Redemption Reserve	20,00,000
General Reserve	50,00,000

Under the terms of their issue, the preference shares are redeemable on 31st March, 20X2 at 5% premium.

In order to finance the redemption, the company makes,
Rights issue of 50,000 equity shares of Rs. 100 each at Rs. 110 per share

Rs. 20 being payable on application
Rs. 35 (including premium) on allotment

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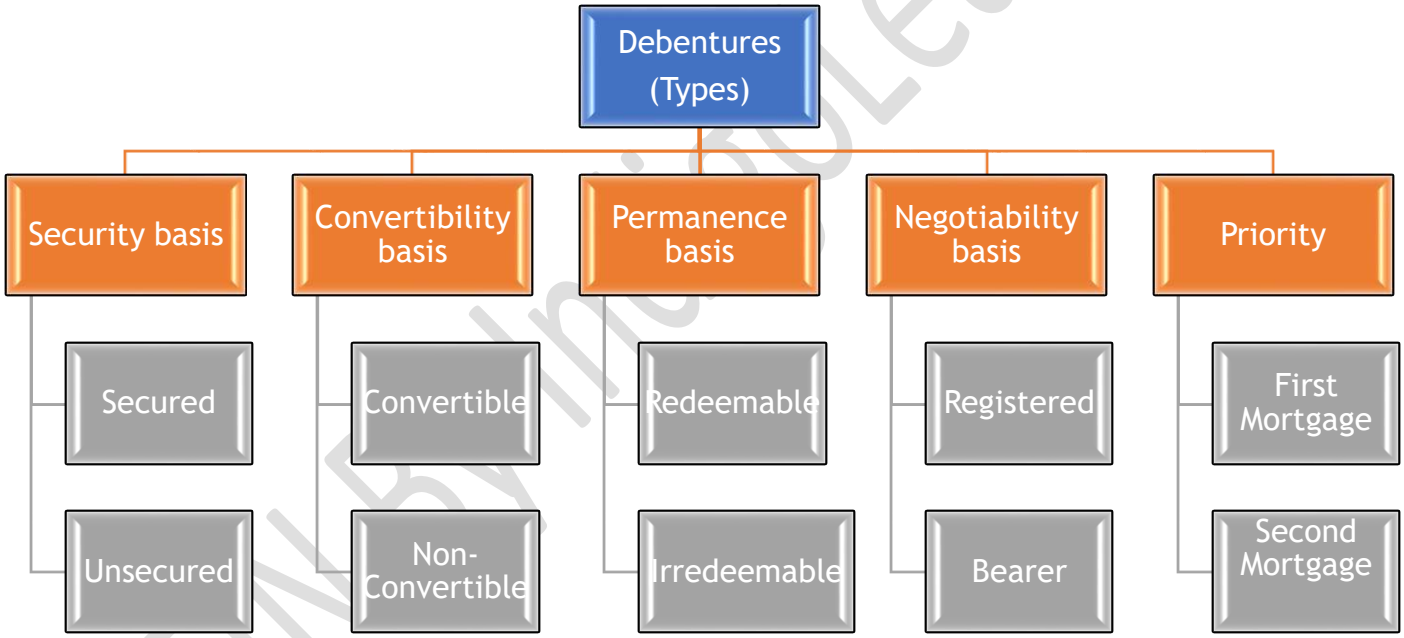
Balance on 1st January, 20X3

1. The issue was fully subscribed, and allotment made on 1st March, 20X2. The money due on allotment were received by 31st March, 20X2.
2. The preference shares were redeemed after fulfilling the necessary conditions of Section 55 of the Companies Act, 2013.

You are asked to pass the necessary Journal Entries and show the relevant extracts from the balance sheet as on 31st March, 20X2 with the corresponding figures as on 31st December, 20X1

Issue of Debentures



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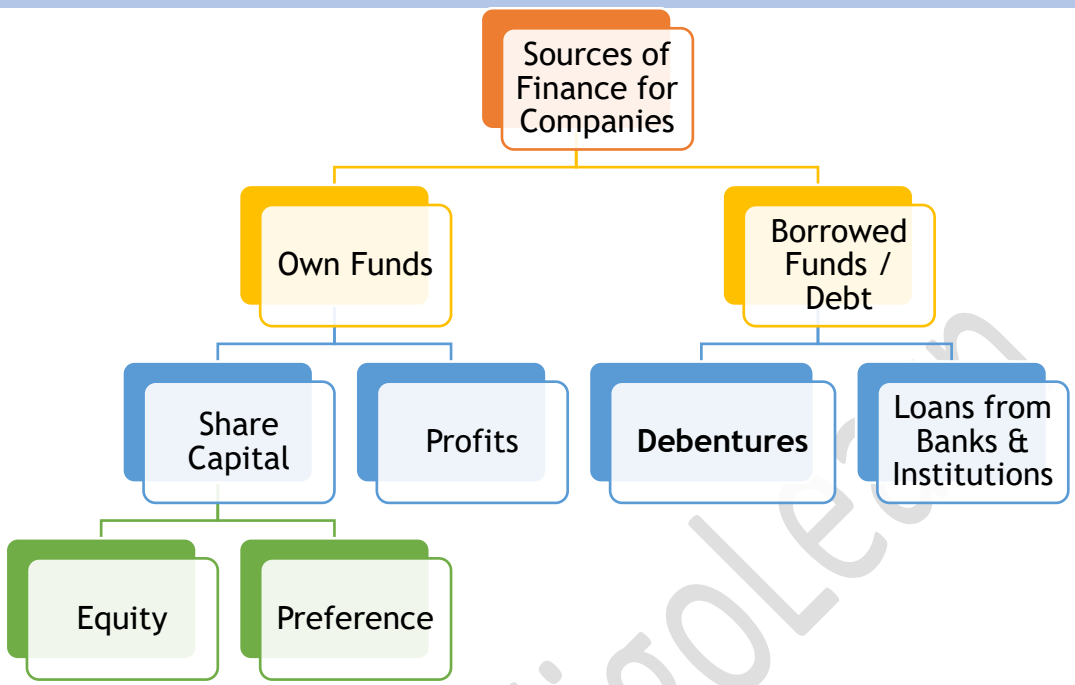
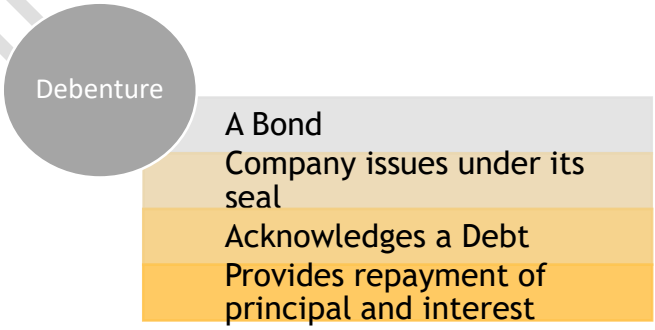
Introduction



❖ Debenture

It is one of the most commonly used debt instrument issued by the company to raise funds for the business. Reason for opting Debentures: Benefits of Debt financing

- ✓ reduces the cost of the capital
- ✓ helps in designing appropriate capital structure of the company.



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.

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Thus, debenture may be Secured Debenture or Unsecured Debenture. Those debentures that have charge on the assets of the company are called “Secured Debentures”

❖ Charge on Assets

- It is a right of a lender (debenture holder, in this case) to be paid from a borrower's (Company’s) **assets** if the debt is not paid on time as promised.
- The nature of the charge and the assets charged are described in the Bond.
- The charge is not valid unless registered with the Registrar, and the certificate registering the charge is printed on the bond.
- It is also customary to create a trusteeship in favour of one or more persons in the case of mortgage debentures.
- The trustees of debenture holders have all powers of a mortgage of a property and can act in whatever way they think necessary to safeguard the interest of debenture holders.

Note: No company shall issue any debentures carrying any voting rights.

❖ Features of Debentures

- It is a fixed interest-bearing **security** where interest falls due on specific dates.
- **Interest** is payable at a **predetermined fixed rate**, regardless of the level of profit.
- The original sum is
  - repaid at a specified future date or
  - converted into
    - shares or
    - other debentures.
- It may or may not create a charge on the assets of a company as security.
- It is a document which evidences a loan made to a company.
- It can generally, be bought or sold through the stock exchange at a price above or below its face value.

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DISTINCTION BETWEEN DEBENTURES AND SHARES

Difference	Debentures	Shares
Holders - status	Creditors of the company.	Owners of the company.
Voting Rights	No voting rights Thus, no threat to the existing control of the company.	Holders have voting rights and thus issue will dilute the existing control
Return on Investment for the holder	Interest is paid at a pre- determined fixed rate.	Dividend is paid at (i) a variable rate for equity shares (ii) fixed rate for preference shares
Payment of Interest	Payable whether there is any profit or not. Interest on debentures has to be paid	Payable only if profits are there.
Deductible expense	Interest is charge against profits and they are deductible as an expense in determining taxable profit of the company.	Dividends are appropriation of profits and these are not deductible.
Types	Secured/Unsecured; Redeemable/ Irredeemable; Registered/Bearer; Convertible / Non-convertible, etc.	Equity Shares; Preference Shares.
Presentation in financial statements	"Long Term Borrowings" in the Company's Balance Sheet	"Shareholder's Fund" in the Company's Balance Sheet. Shares are shown under detailed in 'Share Capital' of Notes to Accounts.
Convertibility	Debentures can be converted into other debentures or shares as per the terms of issue of debentures.	Shares cannot be converted into other shares in any circumstances.

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Forfeiture	Debentures cannot be forfeited for non-payment of call moneys.	Shares can be forfeited for non-payment of allotment and call moneys.
Redemption	At maturity, debenture holders get back their money as per the terms and conditions of redemption.	(i) Equity shareholders: cannot get back their money before the liquidation of the company (ii) Preference shareholders: can get back their money before liquidation .
Winding up	At the time of liquidation, debenture holders are paid-out before the shareholders.	At the time of liquidation shareholders are paid at last, after paying debenture holders, Trade payable, etc.

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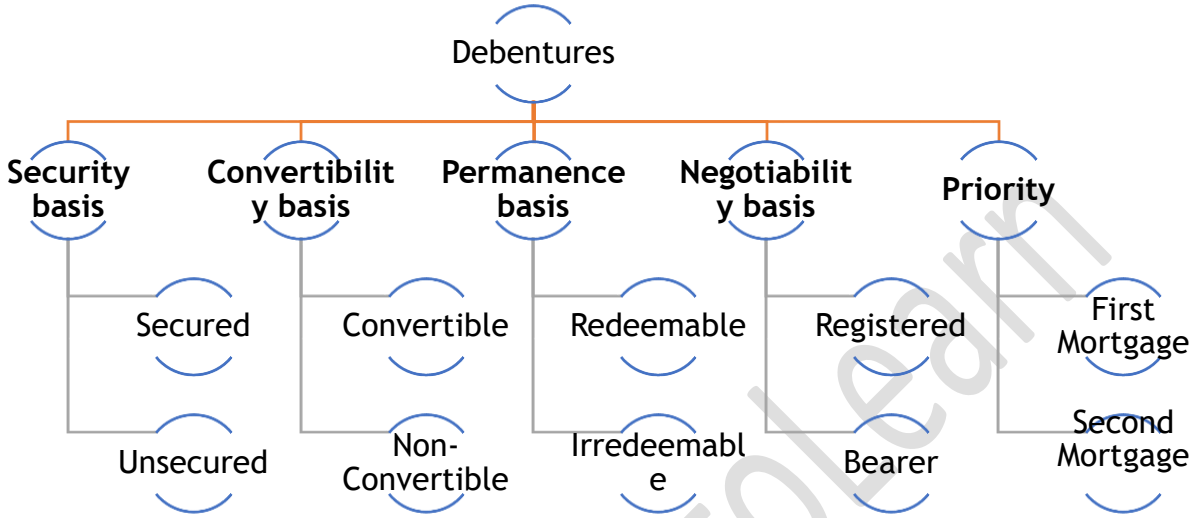
TYPES OF DEBENTURES



1. Based on Security
   (a) ***Secured Debentures:*** These are **secured by a charge** upon some or all assets of the company. There are two types of charges:

   (i) ***Fixed charge***: It is a **mortgage on specific assets**. These assets cannot be sold without the consent of the debenture holders. The sale proceeds of these assets are utilized first for repaying debenture holders; and

   (ii) **Floating charge**: It generally covers **all the assets of the company** including future one.

   (b) ***Unsecured or "Naked" Debentures:*** These are not secured by any charge upon any assets. A company merely promises to pay interest on due dates and to repay the amount due on maturity date.
2. Based on Convertibility
   (a) ***Convertible Debentures***: These will be **converted into equity shares** (either at par or premium or discount) after a certain period of time from the date of its issue. These debentures may be fully or partly convertible.

   (b) ***Non-Convertible Debentures***: These cannot be converted into shares in future. As per the terms of issue, these debentures are repaid.
3. Based on Permanence

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(a) ***Redeemable Debentures:*** These are **repayable** as per the terms of issue.

(b) ***Irredeemable Debentures:*** These are **not repayable** during the lifetime of the company i.e. they are repaid at the time of liquidation. These are also called perpetual debentures.

4. Based on Negotiability

(a) ***Registered Debentures:*** These are payable to a registered holder whose name, address and particulars of holding is recorded in the Register of Debenture holders. They are not easily transferable. Debenture interest is paid either to the order of registered holder as expressed in the warrant issued by the company or the bearer of the interest coupons.

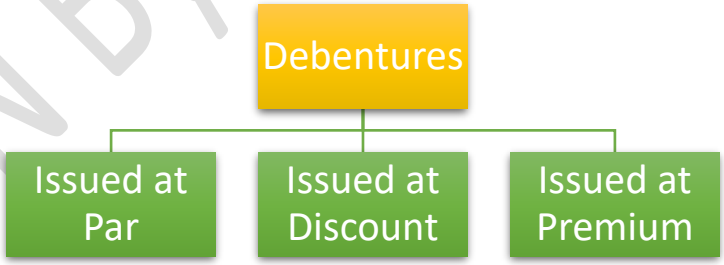
(b) ***Bearer Debentures:*** These are transferable by delivery. These are **negotiable instruments payable to the bearer**. No kind of record is kept by the company in respect of the holders of such debentures. Therefore, the interest on it is paid to the holder irrespective of any identity. No transfer deed is required for transfer of such debentures.

5. Based on Priority

(a) ***First Mortgage Debentures:*** These are payable first, out of the property charged.

(b) ***Second Mortgage Debentures:*** These are payable after satisfying the first mortgage debentures.

ISSUE OF DEBENTURES



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ISSUE OF DEBENTURES – JOURNAL ENTRIES

Debentures issued at Par

The debentures which are issued at par are issued at the same price as their nominal value

Event	Entry	Debit (Rs.)	Credit (Rs.)	Remarks
(1) Cash received on application	Bank A/c Dr.	xxxx		
	To Debentures Application A/c		xxxx	
	(Being money received on __% debentures @ Rs.___ each)			
(2) Excess money refunded or adjusted for future calls	Debenture Application A/c Dr.	xxx		
	To Bank A/c		xx	Amount refunded
	To Debenture Allotment A/c		xxx	Amount adjusted for allotment
	(Being excess money adjusted as per Board's resolution No..... dated.....			
(3) Debentures Allotted	Debenture Application A/c Dr.	xxxx		
	To ..... % Debenture A/c		xxxx	
	(Being the allotment of ....% Debentures of Rs..... each as per Board's resolution No..... dated.....)			
(4) Allotment money	Debenture Allotment A/c Dr.	xxxx		
	To ....% Debentures A/c		xxxx	

being called	(Being allotment money being called)			
(5) Allotment money being received	Bank A/c Dr.	xxxx		
	To Debenture Allotment A/c		xxxx	
	(Being allotment money received)			
(6) Debenture Call money being called	Debenture Calls A/c Dr.	xxxx		
	To ….. % Debentures A/c		xxxx	
	(Being call money made due)			
(7) Call money received	Bank A/c Dr.	xxxx		
	To Debenture Calls A/c		xxxx	
	(Being call money received)			

Debentures issued at Premium

- The debentures, which are issued at a premium, are issued at a higher price than their nominal value.
- Debentures are issued at a premium by a company when the market rate of interest is lower than the debentures interest rate.
- *The premium on debentures is credited to 'Securities Premium Account' as 'Debentures' are covered in the definition of 'securities' u/s 2(h) of the Securities Contracts (Regulation) Act.*
- *Utilisation of such Debenture Premium is restricted as it is governed by Section 52 of the Companies Act, 2013.*

Event	Entry	Debit (Rs.)	Credit (Rs.)	Remarks
(1) Cash received on application	Bank A/c Dr.	xxxx		
	To Debentures Application A/c		xxxx	
	(Being money received on __% debentures @ Rs.___ each)			

(2) Excess money refunded or adjusted for future calls	Debenture Application A/c Dr.	xxx		
	To Bank A/c		xx	Amount refunded
	To Debenture Allotment A/c		xxx	Amount adjusted for allotment
	(Being excess money adjusted as per Board's resolution No…… dated……			
(3) Debentures Allotted	Debenture Application A/c Dr.	xxxx		
	To …… % Debenture A/c		xxxx	
	To Securities Premium A/c		xx	Difference between issue and nominal value
	(Being the allotment of ….% Debentures of Rs….. each and Premium amount transferred to Securities Premium A/c as per Board's resolution No….. dated……)			
(4) Allotment money being called	Debenture Allotment A/c Dr.	xxxx		
	To ….% Debentures A/c		xxxx	
	(Being allotment money being called)			
(5) Allotment money being received	Bank A/c Dr.	xxxx		
	To Debenture Allotment A/c		xxxx	
	(Being allotment money received)			
(6) Debenture Call money being called	Debenture Calls A/c Dr.	xxxx		
	To ….. % Debentures A/c		xxxx	
	(Being call money made due)			
	Bank A/c Dr.	xxxx		

(7) Call money received	To Debenture Calls A/c		xxxx	
	(Being call money received)			

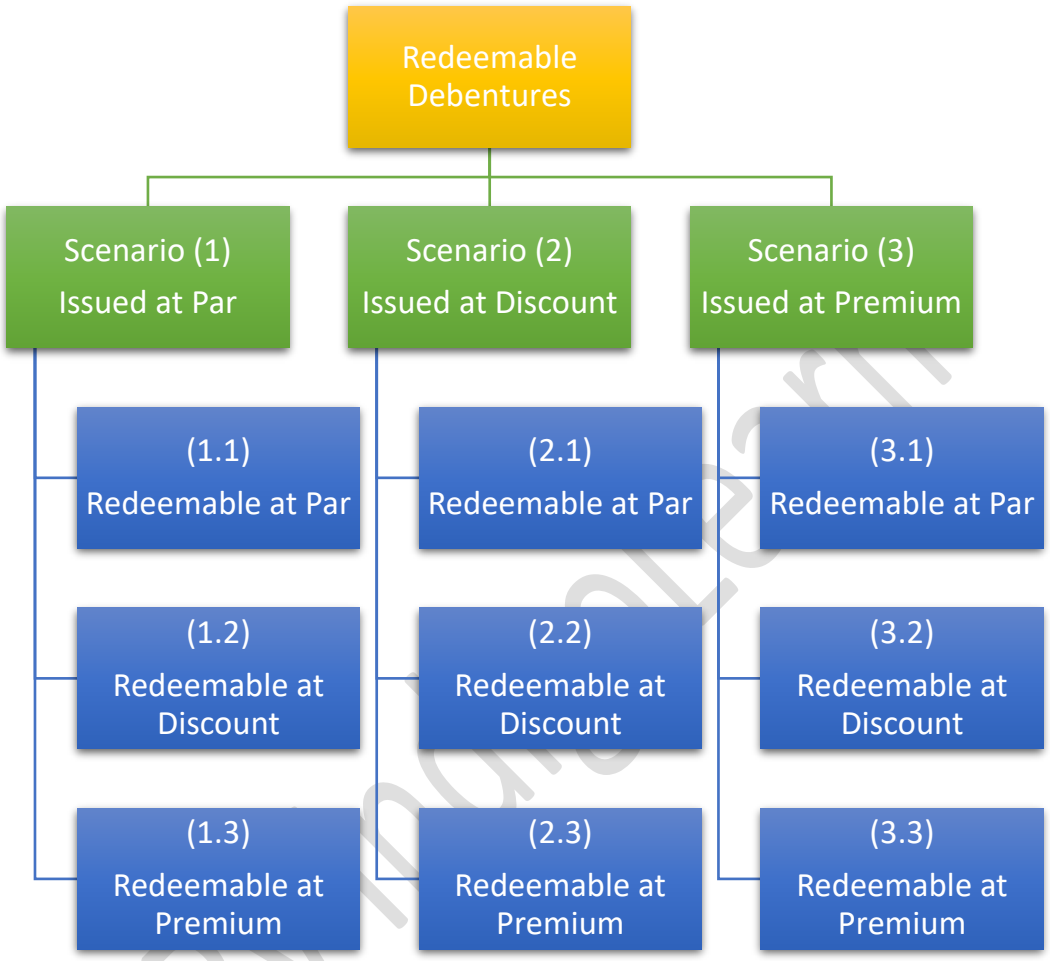
Debentures issued at Discount

- The debentures which are issued at a discount are issued at a lower price than nominal value
- The Companies Act does not impose any restriction on the price at which debentures can be issued. Unlike shares, there is no limit for discount on issue of debentures.
- The company issues debentures at a discount when the market rate of interest is higher than the debenture interest rate.
- The difference between the nominal value of debentures and cash received is transferred to "Discount on Issue of Debentures Account".
- Such "Discount on Issue of Debentures" is written-off proportionately in subsequent years by charging to the Statement of Profit and Loss. It is considered a normal practice to amortize discount on issue of debentures over the period of benefit, i.e., normally 3 to 5 years.
- The Discount on issue of debentures is considered as incremental interest expense. The true expense (net borrowing cost) for a particular accounting period is, therefore, the total interest payment plus the discount written off.

Event	Entry	Debit (Rs.)	Credit (Rs.)	Remarks
(1) Cash received on application	Bank A/c Dr.	xxxx		
	To Debentures Application A/c		xxxx	
	(Being money received on __% debentures @ Rs.___ each)			
(2) Excess money refunded or	Debenture Application A/c Dr.	xxx		
	To Bank A/c		xx	Amount refunded

adjusted for future calls	To Debenture Allotment A/c		xxx	Amount adjusted for allotment
	(Being excess money adjusted as per Board's resolution No…… dated……			
(3) Debentures Allotted	Debenture Application A/c Dr.	xxxx		
	Discount on Issue of Debentures A/c Dr.	xx		Difference between issue price and nominal value
	To …… % Debenture A/c		xxxx	
	(Being the allotment of ….% Debentures of Rs….. each and Discount amount transferred to Discount on Issue of Debentures A/c as per Board's resolution No….. dated……)			
(4) Allotment money being called	Debenture Allotment A/c Dr.	xxxx		
	To ….% Debentures A/c		xxxx	
	(Being allotment money being called)			
(5) Allotment money being received	Bank A/c Dr.	xxxx		
	To Debenture Allotment A/c		xxxx	
	(Being allotment money received)			
(6) Debenture Call money being called	Debenture Calls A/c Dr.	xxxx		
	To ….. % Debentures A/c		xxxx	
	(Being call money made due)			
(7) Call money received	Bank A/c Dr.	xxxx		
	To Debenture Calls A/c		xxxx	
	(Being call money received)			

ISSUE OF REDEEMABLE DEBENTURES – JOURNAL ENTRIES



Scenario	Entry	Debit (Rs.)	Credit (Rs.)	Remarks
(1.1) ***Issued at Par Redeemed at Par***	Bank A/c Dr.	xxxxx		
	To Debenture Application A/c		xxxxx	Application money
	(Being application money received)			
	Debenture Application A/c Dr.	xxxxx		Application money
	To ____% Debenture A/c		Xxxxx	

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	(Being application money transferred to Debenture A/c)			
(2.1 & 2.2) ***Issued @ Discount*** ***Redeemed @ Par/ Discount***	Bank A/c Dr.	xxxxx		The difference between the amount received and amount payable in future is considered as loss on issue on debentures and is to be written-off over the life of debentures.
	To Debenture Application A/c		xxxxx	
	(Being application money received)			
	Debenture Application A/c Dr.	xxxxx		
	Discount on issue of debentures A/c Dr.	xx		
	To ____% Debenture A/c		xxxxx	
	(Being application money transferred to Debenture A/c on allotment)			
(3.1 & 3.2) ***Issued @ Premium*** ***Redeemed @ Par/Discount***	Bank A/c Dr.	xxxxx		The gain on paying less than what is received in this scenario will not be recognised in the books at the time of issue of debentures as per the conservatism concept.
	To Debenture Application A/c		xxxxx	
	(Being application money received)			
	Debenture Application A/c Dr.	xxxxx		
	To ____% Debenture A/c		xxxxx	
	To Securities Premium A/c		xx	
	(Being application money transferred to Debenture A/c on allotment)			
(1.3) ***Issued @ Par*** ***Redeemed @ premium***	Bank A/c Dr.	xxxxx		The redemption premium is recorded as a loss on issue of debentures allotment time. Debenture Redemption Premium A/c is a personal account
	To Debenture Application A/c		xxxxx	
	(Being application money received)			
	Debenture Application A/c Dr.	xxxxx		
	To ____% Debenture A/c		xxxxx	
	(Being application money transferred to Debenture A/c)			
	Bank A/c Dr.	xxxx		

	Loss on issue of debenture A/c Dr. (Amount equal to redemption premium)	xxxx		representing company's liability.
	To __% Debenture A/c		xxxxx	
	To __% Debenture Redemption Premium A/c		xxxxx	
	(Being call made subsequent to allotment)			
(2.3) ***Issued @ Discount*** ***Redeemed @ premium***	Bank A/c Dr.	xxxxx		The difference between the redemption price and par value plus difference between the issue price and par value is treated as discount/loss on issue of debentures
	To Debenture Application A/c		xxxxx	
	(Being application money received)			
	Debenture Application A/c Dr.	xxxxx		
	To ____% Debenture A/c		xxxxx	
	(Being application money transferred to Debenture A/c)			
	Bank A/c Dr.	xxxx		
	Discount/Loss on issue of debenture A/c Dr. (Amount equal to discount on issue + premium on redemption)	xxxx		
	To __% Debenture A/c		xxxxx	
	To _% Debenture Redemption Premium A/c (Amount equal to premium payable on redemption)		xxxxx	
	(Being call made subsequent to allotment)			
(3.3) ***Issued @ premium***	Bank A/c Dr.	xxxxx		The premium received at the time of issue of debentures is credited to Securities
	To Debenture Application A/c		xxxxx	
	(Being application money received)			
	Debenture Application A/c Dr.	xxxxx		

Redeemed @ premium	To ____% Debenture A/c		xxxxx	premium account and premium paid at the time of redemption is a loss to be provided at the time of issue of debentures
	(Being application money transferred to Debenture A/c)			
	Bank A/c Dr.	xxxx		
	Discount/Loss on issue of debenture A/c Dr. (Amount equal to premium on redemption)	xx		
	To __% Debenture A/c		xxxxx	
	To Securities Premium A/c (Amount equal to premium on issue)		xx	
	To _% Debenture Redemption Premium A/c (Amount equal to premium payable on redemption)		xx	
	(Being call made subsequent to allotment)			

DEBENTURES AS COLLATERAL SOCIETY

Collateral security = Secondary or Supporting security for a loan

- Under this arrangement, the borrower agrees that a particular asset or a group of assets of the company, will be realized and the proceeds there from will be applied to repay the loan in the event that the amount due, cannot be paid.
- Sometimes companies issue their own debentures as collateral security for a loan or a fluctuating overdraft.
  - When the loan is repaid on the due date, these debentures are at once released with the main security.
  - In case, the company cannot repay its loan and the interest thereon on the due date, the lender becomes the debenture holder who can exercise all the rights of a debenture holder.
- ***The holder of such debentures is entitled to interest only on the amount of loan, but not on the debentures.***

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Accounting Entries

There are two methods of showing these types of debentures in the accounts of a company.

➢ Method 1

No entry is made in the books of account of the company at the time of making issue of such debentures.

In the 'Notes to Accounts' of Balance Sheet, the fact of the debentures being issued and outstanding is **shown by a note under the liability secured**.

➢ Method 2

Under this method, the following accounting **entry is made to record the issue** of such debentures:

Debentures Suspense A/c	Dr.	
To …..% Debentures A/c		
(Being the issue of…debentures collaterally as per Board's Resolution No…..dated)		

The Debentures Suspense Account will appear on the assets side of the Balance Sheet under Other Non- Current Assets and Debentures on the liabilities side of the Balance Sheet. When the loan is repaid, the entry is reversed in order to cancel it.

Students should note that the Method 1 is much more logical from the accounting point of view. Therefore, it is advised to follow Method 1.

DEBENTURES IN CONSIDERATION OTHER THAN FOR CASH

Debentures, just like shares, can also be issued for consideration other than for cash, such as for purchase of land, machinery, etc.

In this case, the following entries are passed:

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(a) Sundry Assets A/c	Dr.	[Assets taken over]
To Sundry Liabilities A/c		[Liabilities assumed]
To Vendors Account		[Purchase consideration]

(Being the assets and liabilities taken over)

(b) Vendors A/c Dr.

To Debentures A/c

(Being the issue of….% debentures to satisfy purchase consideration)

Further it should be noted that these debentures can be issued at par, premium and at discount. In each case the second entry for issue of debentures would be done accordingly i.e. "Securities Premium A/c" will be created in case of 'issued at premium' or "Discount on Issue of Debentures A/c" will be created in case of 'issued at discount'.

Number of debentures to be issued is calculated as follows:-

1. When debentures are issued at par

$$\text{No. of Debentures} = \frac{\text{Purchase Consideration}}{\text{Par Value}}$$

2. When debentures are issued at premium

$$\text{No. of Debentures} = \frac{\text{Purchase Consideration}}{\text{Par Value + Premium}}$$

3. When debentures are issued at discount

$$\text{No. of Debentures} = \frac{\text{Purchase Consideration}}{\text{Par Value - Discount}}$$

TREATMENT OF DISCOUNT / LOSS ON ISSUE OF DEBENTURES

The discount on issue of debentures is amortised over a period between the issuance date and redemption date.

It should be written-off in the following manner depending upon the terms of redemption:

(a) If the debentures are **redeemable after a certain period of time**, the total

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amount of discount should be written-off equally throughout the life of the debentures **(applying the straight-line method).** The main advantage of this method is that it spreads the burden of discount equally over the years.

(b) If the debentures are **redeemable at different dates**, the total amount of discount should be written-off in the ratio of benefit derived from debenture loan in any particular year **(applying the sum of the year's digit method).** This method is suitable when debentures are redeemed by unequal instalments.

The accounting entries would be as follows :

Profit and Loss A/c Dr.
To Discount on Issue of Debentures A/c
(Being the amount of discount on issue of debentures written-off)

Loss on issue of debentures is also a capital loss and should be written off in a similar manner as discount on debentures issued.

In the balance sheet both the items (Discount and Loss) are shown as Non-current/ current assets depending upon the period for which it has to be written off.

INTEREST ON DEBENTURES

- Interest payable on Debentures is treated as a charge against the profits of the company.
- Interest on debenture is paid periodically and is calculated at coupon rate on the nominal value of debentures.
- The company will pay interest net of tax to the debenture holders because the company is under obligation to deduct tax at source at the rates applicable under tax rules from time to time.
- The companies will deposit the tax so deducted with income tax authorities.

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Following accounting entries are to be recorded in this regard:

Event	Entry	Debit (Rs.)	Credit (Rs.)	Remarks
(1) For making interest due	Interest A/c Dr.	xxx		
	To ….% Debentures holders' A/c		xxx	
	(Being interest due on debentures)			
(2) Payment of interest and deduction of tax at source (TDS)	…% Debentures holders' A/c Dr.	xxx		
	To TDS Payable A/c		xxx	
	To Bank A/c		x	
	(Being interest paid to the debenture holders after deducting tax at source)			
(3) Payment of TDS	TDS Payable A/c Dr.	x		
	To Bank A/c		x	
	(Being TDS deducted from interest on debentures paid)			
(4) Interest charged to P&L A/c	Profit & Loss A/c Dr.	xxx		
	To Interest A/c		xxx	
	(Being interest charged as expense to P&LA/c)			

Illustrations

Illustration – 1

Agrotech Ltd. issued 150 lakh 9% debentures of Rs.100 each at a discount of 6%, redeemable at a premium of 5% after 3 years payable as:

- Rs.50 on application and
- Rs. 44 on allotment.

Record necessary journal entries for issue of debentures.

Illustration – 2

Simmons Ltd. issued 1,00,000, 12% Debentures of Rs.100 each at par payable in full on application by 1st April, Application were received for 1,10,000 Debentures. Debentures were allotted on 7th April. Excess money refunded on the same date. You are required to pass necessary Journal Entries (including cash transactions) in the books of the company.

Illustration – 3

X Ltd. obtains a loan from IDBI of Rs.1,00,00,000, giving as collateral security of Rs.1,50,00,000 (of Rs.10 each), 14%, First Mortgage Debentures.

Illustration – 4

HDC Ltd issues 1,00,000, 12% Debentures of Rs.100 each at Rs.94 on 1st January 2017. Under the terms of issue, the debentures are redeemable at the end of 5 years from the date of the issue.
Calculate the amount of discount to be written-off in each of the 5 years.

Redemption of Debentures

- ★ A debenture is an instrument issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest
- ★ It's a long-term debt for the company. They are commonly secured by charge. Thus, they appear under "Secured Liabilities".
- ★ If a charge has been created on any or the entire asset of the company, the nature of the charge and the asset charged therein are described in the bond. The certificate registering the charge with the registrar is also printed on the bond.
- ★ A trusteeship in favor of one or more persons in the case of mortgage debentures is created. The trustees of debenture holders can take any action necessary to safeguard the interest of debenture holders.
- ★ It earns a fixed income in form of interest. Interest is payable by the company whether it earns profit or not.
- ★ The procedure for issue of debentures is similar to that of issue of shares. Thus, the amount can be collected in lumpsum along with application or in instalments.

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- ★ In case of oversubscription, the excess applications must be rejected, and the amount should be refunded. The excess money cannot be adjusted as in case of shares.
- ★ They can be issued for
  - ➢ Cash
  - ➢ Consideration other than cash.
  - ➢ As collateral security.
- ★ They can be issued at
  - ➢ Par
  - ➢ Premium
  - ➢ At discount
- ★ The terms of redemption should also be accounted at the time of issue. Redemption of debentures at a premium is a known loss at the time of issue of debentures as the terms of issue generally contain such provisions for redemption.

PROVISION OF COMPANIES ACT 2013

- ★ **Sec.71(1)** - A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. Provided the issue of convertible debentures is approved by a special resolution passed at a duly convened general meeting.
- ★ **Sec.71 (2)** -No company can issue any debentures which carry any voting rights.
- ★ **Sec.71(4)-**The company should create a debenture redemption reserve account (DRR) out of free reserves and the amount credited to such account should not be utilized by the company for any purpose other than the redemption of debentures.

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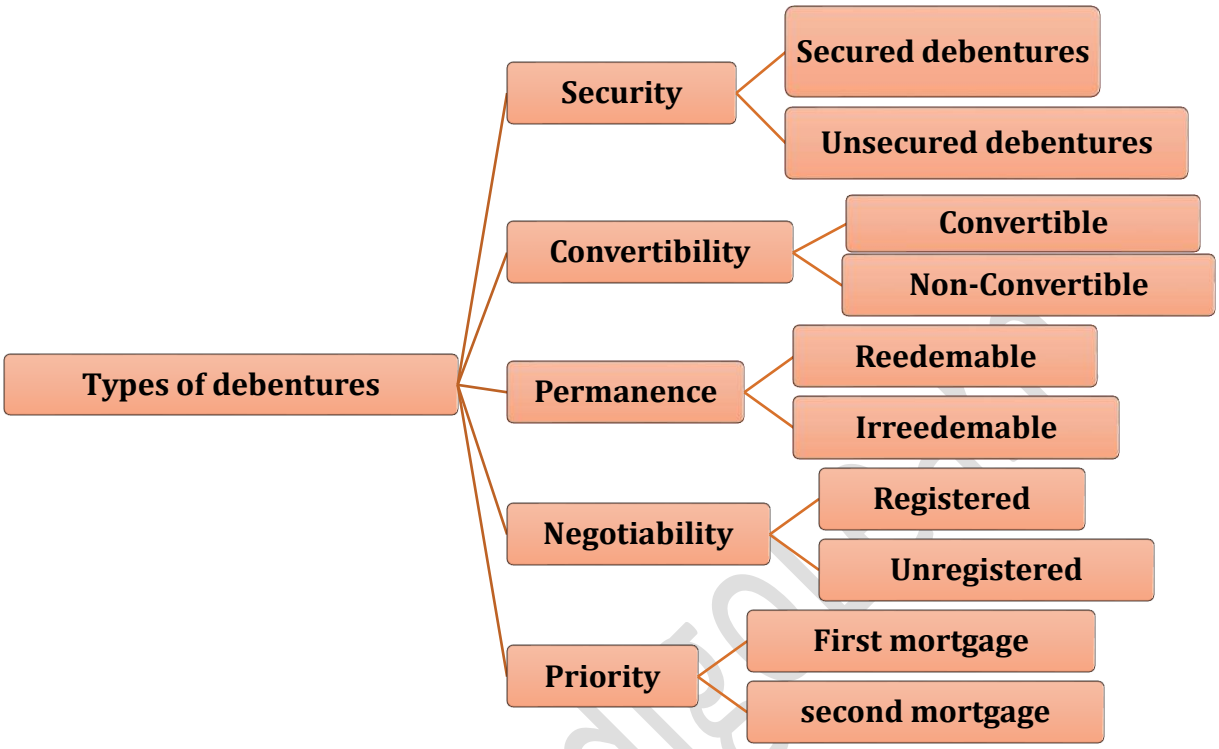
TYPES OF DEBENTURES



Redeemable debentures - Debentures, which can be redeemed or for which payment is made after a specified time are called Redeemable debentures.
These are redeemable-

(i) At the expiry of a specified period either at par or at a premium;
(ii) By purchasing in the open market at any time at the price prevailing in the market; and
(iii) By annual drawings.

Irredeemable debentures - When the issuing company does not fix any date by which debentures can be redeemed, and the holders of such debentures cannot demand payment from the company so long as it is a going concern it is called irredeemable debentures. Usually such debentures are repayable after a long period of time or when the company decides to wind up.

First debentures: - Those debentures, which are repaid before other debentures are paid out, are called First debentures.

Second debentures: - Those debentures, which are paid after the payment towards the First debenture, are called Second debentures.

Convertible debentures: - Those debentures, which are given the option to convert

the debentures fully or partly into equity shares after a specified time, are called Convertible Debentures. If the debentures are fully converted, then it is called as 'Fully Convertible debentures. those which are partly convertible are called 'Partly Convertible debentures.

Non-convertible Debentures: - The debentures that cannot be converted into equity shares such are non-convertible debentures.

Mortgage Debentures: - Debentures, which are secured either on a particular asset [called fixed charge], or on the general assets of the company [called floating charge], are called Mortgage debentures.

Unsecured / Naked Debentures: - Those debentures which are not secured, are called naked debentures. Companies with very good standing can issue such debentures.

Registered Debentures – Those which are registered with the Registrar

Unregistered Debentures – Those which are not registered with the registrar.

DEBENTURE REDEMPTION RESERVE – SEC 71 OF COMPANIES ACT 2013

(1) Where a company issues debenture under this section, it should **create a Debenture Redemption Reserve (DRR) account** out of its profits which are available for distribution of dividend **every year** until such debentures are redeemed.

(2) If Debentures are **redeemed at a premium**, DRR is created for an amount including redemption amount.

(3) The amounts credited to the debenture redemption reserve **should not be utilized** by the company except for the purpose aforesaid.

(4) The company should **pay interest and redeem the debentures** in accordance with the terms and conditions of their issue.

(5) In **case of failure** by the company, the **Tribunal** may, on the application of any or all the holders of debentures or debenture trustee and, after hearing the parties concerned, direct, by **order**, the company to redeem the debentures forthwith by the payment of principal and interest due thereon.

(6) The company can create an investment out of the amount set aside for the reserve. It will be called **Debenture Redemption Reserve Investment**.

(7) Interest earned on DRR investments will be credited to profit and loss account.

(8) In **last year**, the Debenture Redemption Reserve Investments are **encashed** and the amount so obtained is used for the redemption of debentures.

(9) Any **profit or loss** made on the encashment of Debenture Redemption investments is also transferred to **Profit & Loss account**.

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(10) The **balance** of Debenture Redemption Reserve is subsequently transferred to General Reserve.

INVESTMENT OF DEBENTURE REDEMPTION RESERVE (DRR) AMOUNT

Rule 18(7) of Companies (Share Capital and Debentures) Rules, 2014 prescribes the following conditions:

- ★ Every company required to create DRR should before the 30th day of April of each year, deposit or invest, as the case may be, a sum which should not be less than 15% of the amount of its debentures maturing during the year ending on the 31st day of March next following in any one or more of the following methods, namely:
  - ➢ in deposits with any scheduled bank, free from charge or lien;
  - ➢ in unencumbered securities of the Central Government or of any State Government;
  - ➢ in unencumbered securities mentioned in clauses (a) to (d) and (ee) of Section 20 of the Indian Trusts Act, 1882;
  - ➢ in unencumbered bonds issued by any other company which is notified under clause (f) of Section 20 of the Indian Trusts Act, 1882;
- ★ The amount deposited or invested, as the case may be, above should not be utilized for any purpose other than for the repayment of debentures maturing during the year referred to above, provided that the amount remaining deposited or invested, as the case may be, should not at any time fall below 15% of the amount of debentures maturing during the 31st day of March of that year.

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★ Ministry of Corporate Affairs has made the following clarification on adequacy of Debenture Redemption Reserve (DRR):

		Pre August 16, 2019	Post August 16, 2019
1	For debentures issued by All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures	No DRR is required	No DRR is required
2	For other Financial Institutions (FIs) and NBFCs registered with RBI and for housing finance companies registered with National Housing Bank	25% of the value of outstanding debentures issued through public issue. No DRR is required in the case of privately placed debentures.	No DRR is required
3	For debentures issued by listed companies including manufacturing and infrastructure companies.	25% of the value of outstanding debentures issued through public issue. Also 25% DRR is required in the case of privately placed debentures by listed companies	No DRR is required (irrespective of public or Private Issue)
4	For unlisted companies issuing debentures on private placement basis,	DRR will be 25% of the value of outstanding debentures.	DRR will be 10% of the value of outstanding debentures

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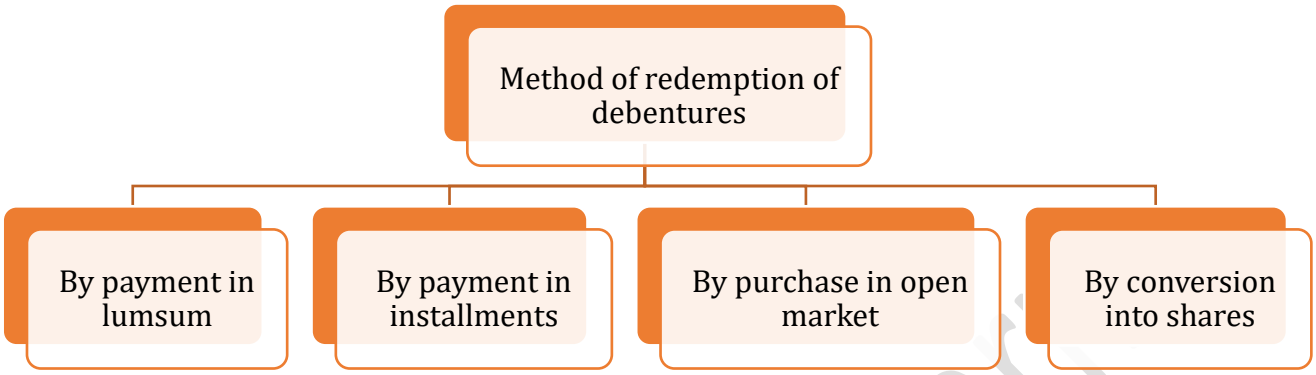
METHODS OF REDEMPTION



By payment in lumpsum

Under payment in lumpsum method, at maturity or at the expiry of a specified period of debenture the payment of entire debenture is made in one lot or even before the expiry of the specified period

By payment in Instalments

Under payment in installments method, the payment of specified portion of debenture is made in installments at specified intervals

ACCOUNTING FOR DEBENTURE REDEMPTION FUND AND INVESTMENT

Journal entries
1. **At the end of First Year**
For setting aside the fixed amount of profit for redemption Profit and Loss A/c Dr. To Debenture Redemption Reserve A/c (Being transfer of profits to Debenture redemption reserve A/c)
For investing the amount set aside for redemption

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Debenture Redemption Reserve Investment A/c To Bank A/c (Being amount invested in DRR investment A/c)	Dr.
2. At the end of second year and subsequent years other than last year	
For receipt of interest on Debenture Redemption Reserve Investments Bank A/c To Interest on Debenture Redemption Reserve Investment A/c (Being interest on investment received)	Dr.
For transfer of Interest on Debenture Redemption Reserve Investment (DRRI) to profit and loss account. Interest on Debenture Redemption Reserve Investment A/c To Profit & Loss A/c (Being interest on investment transferred to P&L A/c)	Dr.
For setting aside the fixed amount of profit for redemption Profit and Loss A/c To Debenture Redemption Reserve A/c (Being transfer of profits to Debenture redemption reserve A/c)	Dr.
For investments of the amount set aside for redemption and the interest earned on DRRI Debenture Redemption Reserve Investment A/c To Bank A/c (Being amount invested in DRR investment A/c)	Dr.
3. At the end of last year	
For receipt of interest Bank A/c	Dr.

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To Interest on Debenture Redemption Reserve Investment A/c (Being interest on investment received)
For transfer of interest on Debenture Redemption Reserve Investment to Profit and loss account. Interest on Debenture Redemption Reserve Investment A/c Dr. To Profit and loss A/c
For setting aside the fixed amount of profit for redemption Profit and Loss A/c Dr. To Debenture Redemption Reserve A/c
For encashment of Debenture Redemption Reserve Investments Bank A/c Dr. To Debenture Redemption Reserve Investment, A/c
For the transfer of profit/loss on realization of Debenture Redemption Reserve Investments **(i)** In case of Profit Debenture Redemption Reserve Investment A/c Dr. To profit and loss A/c Or
(ii) In case of Loss Profit and loss A/c Dr To Debenture Redemption Reserve Investment, A/c
For amount due to debenture holders on redemption Debenture A/c Dr To Debenture holder's A/c

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For payment to debenture holders Debenture holder's A/c Dr To Bank A/c
For transfer of balance in DRR to General Reserve Debenture Redemption Reserve A/c Dr. To General reserve A/c

ACCOUNTING FOR PURCHASE OF DEBENTURES IN THE OPEN MARKET

A company, if authorized by its Articles of Association, can buy its own debentures in the open market.
This can be categorized as follows:

For immediate cancellation

When the company cancels the debentures so purchased, it amounts to redemption of debentures. It means after cancellation; redemption is automatic, and these debentures cannot be reissued.

For investment in the form of own debentures

If the company purchases its debentures from open market and holds them for some time before cancellation, such debentures are known as own debentures. Own debentures are held by company as investment and may be resold till cancellation. After cancellation, the debentures are said to be redeemed and cannot be resold.

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Accounting treatment for purchase of own debentures for immediate cancellation.

Journal entries	
On purchase and cancellation of debentures Debentures A/c (with the amount paid) To Bank A/c (Being debentures purchased in the open market and cancelled immediately)	Dr.
If there is any difference between the nominal value of the debentures cancelled and the price paid for them, In case of profit Debenture A/c To Bank A/c To Profit on redemption of debentures A/c (Being debentures purchased in the open market for immediate cancellation and profit made on the same)	Dr.
Transferring the above profit to Capital reserve A/c Profit on redemption of debentures A/c To Capital Reserve A/c	Dr.
In case of loss Debenture A/c Loss on redemption A/c To Bank A/c (Being debentures purchased in the open market for immediate cancellation and Incurred loss on the same)	Dr. Dr.
Transferring the above loss to Capital reserve A/c or P&L A/c or Securities premium A/c Profit and Loss A/c Or Securities Premium A/c Or Capital Reserve A/c	Dr.

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To Loss on redemption A/c	Dr.
	Dr.

ACCOUNTING FOR REDEMPTION BY CONVERSION

Journal entries	
When shares are issued at Par	
Debentures A/c	Dr.
To Share Capital A/c	
(Being debentures converted in …… (no. of) Equity shares of Rs…. each)	
When shares are issued at premium	
Debenture A/c	Dr.
To Share capital A/c	
To Securities premium A/c	
(Being debentures converted in …… (no. of) Equity shares of Rs…. Each issued at a premium of Rs……each)	

Illustrations

Illustration – 1

X Ltd. issued 1,00,000; 9% Debentures of Rs.50 each at a premium of 10% on 30thJune, 2019 redeemable on 31st March 2021.The issue was fully subscribed. The Company decided to create DRR on 31st March,2020 and invest in Fixed Deposit Earnings interest @ 10% p.a. on 1st April 2020 to meet the legal requirement. Tax was deducted at source (TDS) by bank @ 10%.

Pass journal entries for issue and redemption of debentures along with interest on investment.

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Illustration – 2

On January 1, Rama Ltd., had 500 Debentures of Rs.100 each outstanding in its books carrying interest at 6% per annum. DRR balance is standing in books at 12,500/-. In accordance with the powers in the deed, the directors acquired debentures from the open market for immediate cancellation as follows:

March 1	Rs.5,000 at 98.00/- (cum interest)
Aug. 1	Rs. 10,000 at 100.25/- (cum interest)
Dec. 15	Rs. 2,500 at 98.50/- (ex-interest)

Debenture interest is payable half-yearly, on 30th June and 31st Dec.

Show ledger accounts of Debenture and Debenture interest for the first year, ignoring income-tax.

Illustration – 3

The following balances appeared in the books of Paradise Ltd as on 1-4-20X1:

1. 12 % Debentures Rs. 7,50,000
2. Balance of DRR Rs. 1,00,000
3. DRR Investment 1,12,500 represented by 10% 1,125 Secured Bonds of the Government of India of Rs. 100 each.

Annual contribution to the DRR was made on 31st March every year. On 31-3-20X2, balance at bank was Rs. 7,50,000 before receipt of interest. The investment was realised at par for redemption of debentures at a premium of 10% on the above date.

You are required to prepare the following accounts for the year ended 31st March, 20X2:

1. Debentures Account
2. DRR Account
3. DRR Investment Account
4. Bank Account

Debenture Holders Account.

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Illustration – 4

Sencom Limited issued Rs.1,50,000 5% Debentures on 30th September Year 0 on which interest is payable half yearly on 31st March and 30th September. The Company has power to purchase debentures in open market for cancellation thereof.

The following purchases were made during the year ended 31st December Year 2 and the cancellation were made on the same date. On 31st December Year 1, balance in the DRR of the Company was Rs.25,000 and investments made for the purpose of redemption were Rs.20,000.

The purchase details are:

- 1st March Year 2 – Rs.25,000 nominal value purchased for Rs.24,725 ex-interest.
- 1st September Year 2– Rs.20,000 nominal value purchased for Rs.20,125 cum-interest.

You are required to draw up the following accounts up to the date of cancellation:

(i) Debentures Account and
(ii) Own Debenture (Investment) Account.

Ignore Taxation.

Illustration – 5

The following balances appeared in the books of Paradise Ltd as on 1-4-20X1:

1. 12 % Debentures Rs. 7,50,000
2. Balance of DRR Rs. 1,00,000
3. DRR Investment 1,12,500 represented by 10% 1,125 Secured Bonds of the Government of India of Rs. 100 each.

Annual contribution to the DRR was made on 31st March every year. On 31-3-20X2, balance at bank was Rs. 7,50,000 before receipt of interest. The investment was realised at par for redemption of debentures at a premium of 10% on the above date.

You are required to prepare the following accounts for the year ended 31st March, 20X2:

1. Debentures Account
2. DRR Account
3. DRR Investment Account
4. Bank Account

Debenture Holders Account.

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Illustration – 6

The Summarized Balance Sheet of BEE Co. Ltd. as on 31st March, 20X1 is as under:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Share Capital:		Freehold property	1,15,000
Authorized:			
30,000 Equity Shares of Rs. 10 each	3,00,000		
		Stock	1,35,000
		Trade receivables	75,000
Issued and Subscribed:		Cash	30,000
20,000 Equity Shares of Rs. 10 each fully paid	2,00,000		
		Balance at Bank	2,00,000
Profit and Loss Account	1,20,000		
12% Debentures	1,20,000		
Trade payables	1,15,000		
	5,55,000		5,55,000

At the Annual General Meeting, it was resolved:

1. To give existing shareholders the option to purchase one Rs. 10 shares at Rs. 15 for every four shares (held prior to the bonus distribution), this option being taken up by all shareholders.
2. To issue one bonus share for every five shares held.
3. To repay the debentures at a premium of 3%.

Give the necessary journal entries and the company's Balance Sheet after these transactions are completed.

Illustration – 7

The summarised Balance Sheet of Convertible Limited, as on 30th June, 20X1, stood as follows:

Particulars	Amount (Rs.)
Liabilities:	
Share Capital: 5,00,000 equity shares of Rs. 10 each fully paid	50,00,000
General Reserve	75,00,000
Profit And loss A/c	10,00,000
Debenture Redemption Reserve	25,00,000

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13.5% Convertible Debentures, 1,00,000 Debentures of Rs. 100 each	1,00,00,000
Other loans	65,00,000
Current Liabilities and Provisions	1,25,00,000
	4,50,00,000

The Debentures are due for redemption on 1st July, 20X1. The terms of issue of debentures provided that they were redeemable at a premium of 5% and conferred option to the debenture holders to convert 20% of their holdings into equity shares at a predetermined price of Rs.15.75 per share and the payment in cash.
Assuming that:

1. except for 100 debenture holders holding totally 25,000 debentures, the rest of them exercised the option for maximum conversion.
2. the investments were realised at par on sale; and
3. all the transactions are put through, without any lag, on 1st July, 20X1.

Redraft the balance sheet of the company as on 1st July, 20X1 after giving effect to the redemption. Show your calculations in respect of the number of equity shares to be allotted and the necessary cash payment.

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1.9 Underwriting of Shares and Debentures

Underwriting is a contract containing agreed terms wherein	Underwriting contract
one party undertakes to subscribe to shares / debentures	Underwriter
being issued by the other party	Company (making a public offer)
for a special consideration	Underwriting commission
where shares / debentures are not subscribed to by the public (whether fully or partially)	Trigger point i.e. under subscription

Problems of undersubscription

- Insufficient funds received, investment plan goes for a toss
- Brand image of company adversely affected
- High costs of making public issue
- *SEBI regulations: If company is unable to raise 90% of the issue size (minimum subscription), it must refund ALL the money collected back to public*

Primary Objective of underwriting

To have an assurance that the company will be able to raise stipulated amount of capital by issue of shares or debentures

Underwriter could be an individual, partnership or company

Considering the magnitude of their obligation, usually issue of shares or debentures are underwritten by more than one persons.

Prominent institutional underwriters

- Industrial Financial Corporation (IFC)
- Industrial Credit and Investment Corporation of India (ICICI)
- Life Insurance Corporation of India (LIC)

RELEVANT PROVISIONS OF COMPANIES ACT 2013:

D. Underwriting commission

23. Can be paid only in respect of shares and debentures which have been offered to the general public for subscription

24. Can be paid only at a rate authorized by the Articles of Association of the company

25. Cannot exceed
    - 2.5% of issue size of debentures
    - 5% of issue size of shares

E. Disclosure requirements

26. Names of underwriters must be disclosed in the Prospectus, alongwith the opinion of the directors that the resources of the underwriters are sufficient to discharge their obligations

27. Brief description of each underwritten contract to be disclosed in Statutory Report, alongwith details of any underwritten contract that not been fully carried out (extent to which not carried out and reasons for the same)

    Particulars of any commission paid or payable to any Director, Manager or their associates should also be disclosed.

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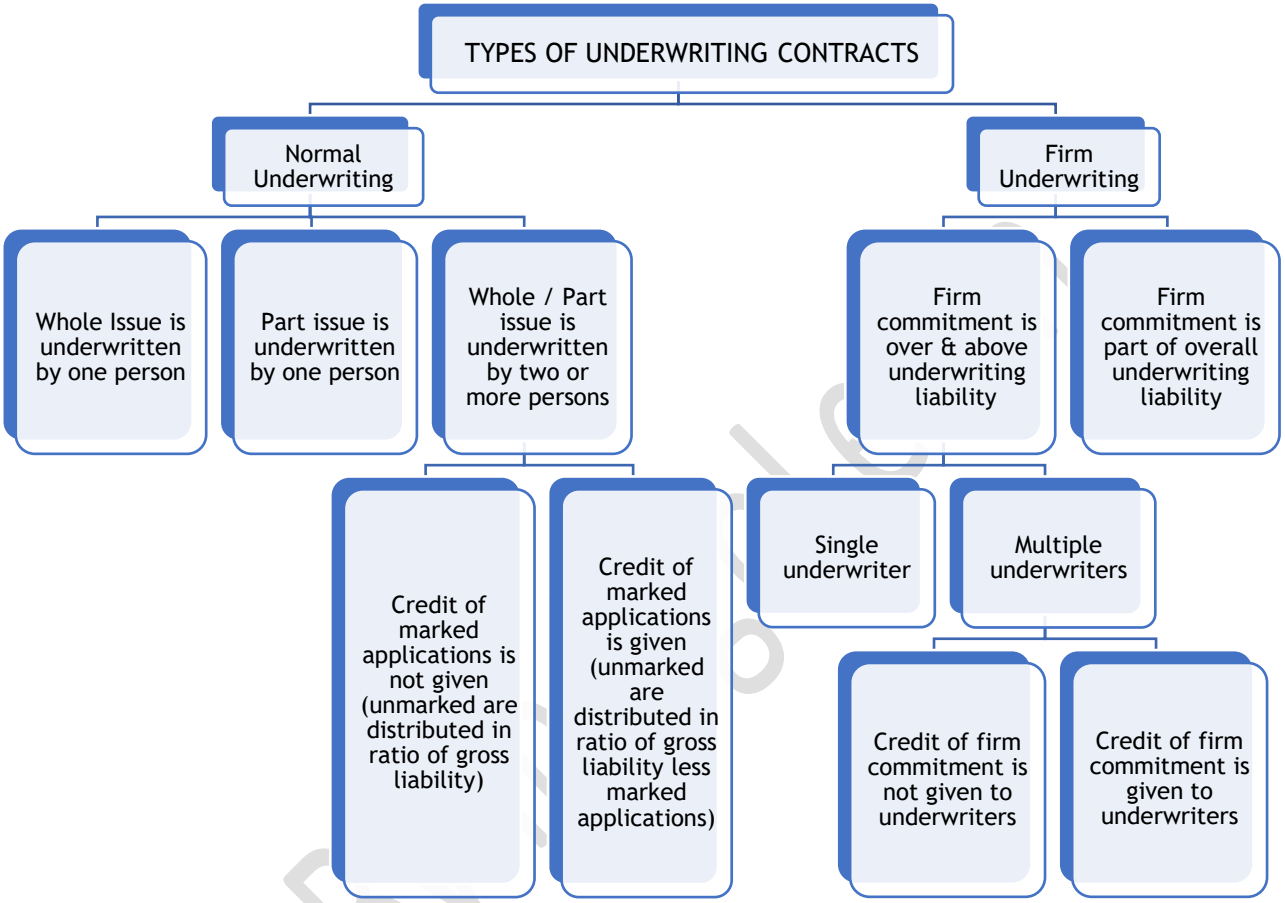
TYPES OF UNDERWRITING CONTRACTS:



DETERMINING LIABILITY UNDER VARIOUS TYPES OF UNDERWRITING CONTRACTS:

CONCEPT OF MARKED APPLICATIONS

1. Company issues share applications to offer to public for being able to subscribe to its shares.

2. Underwriters also make an effort to promote and maximize subscription.

3. Applications distributed by underwriters are marked (with a code or underwriter name or any such distinguishing feature) so that when those applications are submitted, they are clearly distinguishable.

4. The purpose of such marking of applications and thereby separating them from others (unmarked applications), will be clear below, as we understand how is the liability of underwriters determined.

DETERMINING LIABILITY OF UNDERWRITERS

A. NORMAL UNDERWRITING

To understand the concepts, let us take an example of ABC Ltd. making a public offer of 10,000 shares and X being the underwriter.

5. Whole issue is underwritten by one person

Assume X underwrites all 10,000 shares

Since whole issue is underwritten by one underwriter i.e. X, any shortfall is to be met by him. Therefore, in this case, there is no need for marking any applications.

6. Part issue is underwritten by one person

Assume X underwrites 6,000 shares

Scenario / Fact pattern	Explanation		X's liability
Issue is oversubscribed Company receives 11,000 applications 5,000 marked 6,000 unmarked	Issue size Unmarked applic Thus, Gross liab of X Marked applic Hence, shortfall	10,000 (6,000) 4,000 (5,000) Nil	Nil
Issue is undersubscribed Company receives 9,000 applications 4,000 marked 5,000 unmarked	Issue size Unmarked applic Thus, gross liab of X Marked applic Hence, shortfall X agreed for 6,000 and marked were 4,000. Thus, shortfall of 1,000 to be met by X	10,000 (5,000) 5,000 (4,000) 1,000	1,000 applications
Issue is undersubscribed	Issue size	10,000	Nil

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Company receives 9,000 applications 7,000 marked 2,000 unmarked	Unmarked applic (2,000) Thus, gross liab of X 8,000 Marked applic (7,000) Hence, shortfall 1,000 X agreed for 6,000 and marked were 7,000. Thus, X CANNOT be asked to meet the shortfall	

7. Whole / part issue is underwritten by two or more persons

To understand the concepts, let us take an example of ABC Ltd. making a public offer of 10,000 shares and X, Y and Z being the underwriter for 40%, 35% and 25% respectively.

Issue is undersubscribed - Company receives 8,000 applications
X : 2,000, Y : 1,000 , Z : 2,000 & Unmarked : 3,000

Liability will be determined as Gross Liability

Less: Marked applications

Less: Unmarked applications

Key aspect is determining allotment of unmarked applications to each underwriter. There are two methods of doing so.

Method 1: Not giving credit for marked applications to individual underwriter, i.e. unmarked applications are distributed in the ratio of gross liability

	X	Y	Z
Gross liability as underwritten	4,000	3,500	2,500
Less: Unmarked applications In the ratio 40:35:25	(1,200)	(1,050)	(750)
Adjusted gross liability	2,800	2,450	1,750
Marked applications (actuals)	(2,000)	(1,000)	(2,000)
Balance	800	1,450	(250)
Credit for Z's surplus to X and Y In the ratio 40:35	(133)	(117)	250

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Actual liability	**667**	**1,333**	**-**

Method 2: Giving credit for marked applications, i.e. unmarked applications are distributed in the ratio of gross liability less marked applications

	X	Y	Z
Gross liability as underwritten	4,000	3,500	2,500
Marked applications (actuals)	(2,000)	(1,000)	(2,000)
Liability net of marked applications	2,000	2,500	500
Less: Unmarked applications In the ratio 20:25:5	(1,200)	(1,500)	(300)
Actual liability	**800**	**1,000**	**200**

Since liability varies in both cases, underwriting contract should specify the method to be followed.

For exams: students must specify the position being adopted, in case no method is specifically prescribed

B. FIRM UNDERWRITING

It refers to a defined commitment by an underwriter to take up a specified number of shares, irrespective of number of shares prescribed by public.

Example:

- ABC Ltd. issues 10,000 shares and X underwrites 60% of the issue.
- He also applies for 1,000 shares 'firm'.
- Total applications received 8,000.
- Marked applications received in X's name are 4,800.

Now, there could be two types of arrangements:

I. 'Firm' commitment is part of overall underwriting liability

Thus, he is allowed abatement of shares applied 'firm' as per the agreed terms

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Total issue	10,000
Less: Applications received	8,000
Shortfall	2,000
Underwriting liability	6,000
Less: Marked received	4,800
Liability under underwriting agreement	1,200
Less: Shares applied for 'firm'	1,000
Shortfall to be met under underwriting agreement	200
Plus: 'Firm' application	1,000
Total Liability	1,200

II. **'Firm' commitment is over and above underwriting liability**

Thus, he is obliged to take up shares applied for 'firm' **and** shortfall basis underwriting agreement (also the case when nothing is mentioned)

SINGLE UNDERWRITER

Total issue	10,000
Less: Applications received	8,000
Shortfall	2,000
Underwriting liability	6,000
Less: Marked received	4,800
Liability under underwriting agreement	1,200
Plus: shares applied for 'firm'	1,000
Total liability to be met	2,200

MULTIPLE UNDERWRITERS

Liability will be determined as:

	A	B	C
Gross Liability	XXX	XXX	XXX
Less: Marked applications excluding firm underwriting	(XX)	(XX)	(XX)
Less: Unmarked applications (See Working Note 1)			
in ratio of gross liability	(XX)	(XX)	(XX)

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(Surplus) / Deficit	XXX	XXX	(XX)
Less: Negative applications of C			
in ratio of A & B's gross liability	(XX)	(XX)	XX
Net liability (See Working Note 2)	XXX	XXX	--
Add: Firm underwriting	XX	XX	XX
Total liability	**XXX**	**XXX**	**XXX**

1. **Where credit of firm underwriting is not given to underwriters, i.e. unmarked applications (including firm underwriting) are distributed in the ratio of gross liability**

Working Note 1: Determining total number of unmarked applications

Total subscriptions (excluding firm underwriting)	XXX
Less: Marked applications (excluding firm underwriting)	(XX)
Unmarked applications by public	XXX
Add: Applications under firm underwriting	XX
Total unmarked applications	XXX

Thus, firm underwriting is also treated as unmarked applications and distributed in the ratio of gross liability.

Working Note 2: If negative again, keep adjusting (like C's negative has been adjusted) till all liabilities becomes positive and there is no surplus in anyone's case.

2. **Where credit of firm underwriting is given to underwriters, i.e. unmarked applications (excluding firm underwriting) are distributed in the ratio of gross liability**

Working Note 1: Determining total number of unmarked applications

Total subscriptions (excluding firm underwriting)	XXX
Less: Marked applications (excluding firm underwriting)	(XX)
Unmarked applications by public	XXX

Thus, firm underwriting is NOT treated as unmarked applications and only unmarked applications by public are distributed in the ratio of gross liability.

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Working Note 2: If negative again, keep adjusting (like C's negative has been adjusted) till all liabilities becomes positive and there is no surplus in anyone's case.

ACCOUNTING ENTRIES:

1. **For shares taken up by underwriters**

   Underwriter A/c dr.
   To Share Capital A/c
   To Share Premium A/c

2. **For underwriting commission due**

   Underwriting Commission A/c dr.
   To Underwriter A/c

3. **For net amount received from underwriter (amount due on subscription less commission receivable by him)**

   Bank Dr.
   To Underwriter A/c

Illustrations

Illustration – 1

A company issued 1,50,000 shares of Rs.10 each at a premium of Rs.10.

The entire issue was underwritten as follows:

X - 90,000 shares (firm underwriting 12,000 shares)

Y - 37,500 shares (firm underwriting 4500 shares)

Z - 22,500 shares (firm underwriting 15,000 shares)

Total subscription received by the company (excluding firm underwriting and marked applications) were 22,500 shares

The marked application (excluding firm underwriting) were as follows :

X – 15,000 shares

Y – 30,000 shares

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Z – 75000 shares

Commission payable to underwriters is at 5% of the issue price.

The underwriting contract provides that credit for unmarked applications be given to the underwriters in proportion to the shares underwritten and benefit of the firm underwriting is to be given to individual underwriters.

I. Determine the liability of each underwriter (number of shares);

II. Compute the amounts payable or due from underwriters; and

Pass journal entries in the books of the company relating to underwriting.

Illustration 2

A joint stock company resolved to issue 10 lakh equity shares of Rs.10 each at a premium of Rs1 per share. One lakh of these shares were taken up by the directors of the company, their relatives, associates and friends, the entire amount being received forthwith. The remaining shares were offered to the public, the entire amount being asked for with applications.

The issue was underwritten by X, Y and Z for a commission @2% of the issue price, 65% of the issue was underwritten by X, while Y's and Z's shares were 25% and 10% respectively.

Their firm underwriting was as follows :

X 30,000 shares,

Y 20,000 shares and

Z 10,000 shares.

The underwriters were to submit unmarked applications for shares underwritten firm with full application money along with members of the general public.

Marked applications were as follows:

X 1,19,500 shares,

Y 57,500 shares and

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Z 10,500 shares.

Unmarked applications totaled 7,00,000 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 journal entries for all the transactions including cash transactions.

Illustration 3

Newton Limited incorporated on 1st January, 20X1 issued a prospectus inviting applications for 20,000 equity shares of ₹ 10 each. The whole issue was fully underwritten by A, B and C as follows:

A	B	C
10,000 shares	6,000 shares	4,000 shares

Applications were received for 16,000 shares, of which marked applications were as follows:

A	B	C
8,000 shares	2,850 shares	4,150 shares

You are required to find out the liabilities of individual underwriters.

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Illustration 4

Gemini Ltd. came up with public issue of 30,00,000 Equity shares of ₹10 each at ₹ 15 per share. A, B and C took underwriting of the issue in 3 : 2 : 1 ratio.

Applications were received for 27,00,000 shares. The marked applications were received as under:

A	B	C
8,00,000 shares	7,00,000 shares	6,00,000 shares

Commission payable to underwriters is at 5% on the face value of shares.

i. Compute the liability of each underwriter as regards the number of shares to be taken up.
ii. Pass journal entries in the books of Gemini Ltd. to record the transactions relating to underwriters.

Illustration 5

Rosy Ltd. made a public issue of 4,00,000 equity shares of ₹10 each, ₹ 2 payable on application. The entire issue was underwritten by five underwriters as follows: A: 25%, B: 25%, C: 25%, D: 10% and E: 15%. Under the underwriting terms, a commission of 2% was payable on the amount underwritten. Further, the under- writer was at liberty to apply, during the tenure of public issue, for any number of shares in which case he was entitled to a brokerage equal to 0.5% of the par value of shares so applied for.

Applications received were to be analysed on the basis of rubber stamp of the underwriter, who was to be given credit for the number of applications received bearing his rubber stamp. Applications received which did not bear any rubber stamp were considered as “direct applications” to be credited to all the underwriters in the ratio of their respective underwriting commitment. If, any such credit being given a “surplus” was to result in respect of any underwriter, as compared to his commitment,

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such surplus was to be distributed amongst the remaining underwriters in the ratio of their respective underwriting commitments.

As a result of the issue the following applications were received:

Bearing rubber stamp of	**A**	**1,02,000 shares**
Bearing rubber stamp of	B	95,000 shares
Bearing rubber stamp of	C	60,000 shares
Bearing rubber stamp of	D	32,000 shares
Bearing rubber stamp of	E	51,000 shares
Not bearing any stamp		10,000 shares
	Total	3,50,000 shares

Included in the number of applications mentioned against D in the above table was an application made by D himself for 10,000 shares. The underwriters were informed of the amounts due to or from them, the amounts were duly received or paid.

Show, with the aid of necessary workings, the entries to record the amount so received or paid.

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Illustration 6

Libra Ltd. came up with an issue of 20,00,000 equity shares of ₹10 each at par. 5,00,000 shares were issued to the promoters and the balance offered to the public. The issue was underwritten by three underwriters Anand, Vijay and Ashok - equally with firm underwriting of 50,000 shares each. The total subscription received were12,97,000 shares including the marked forms which were :

Anand	Vijay	Ashok
4,25,000	4,50,000	3,50,000

The underwriters had applied for the number of shares covered by firm underwriting. The amounts payable on application and allotment were ₹2.50 and ₹ 2.00 respectively. The agreed commission was 5%.

Pass summary journal entries for —

1. allotment of shares to the underwriters;
2. commission due to each of them; and
3. net cash paid and or received.

Note: Unmarked applications are to be credited to underwriters equally. Benefit of firm underwriting is given to individual underwriter.

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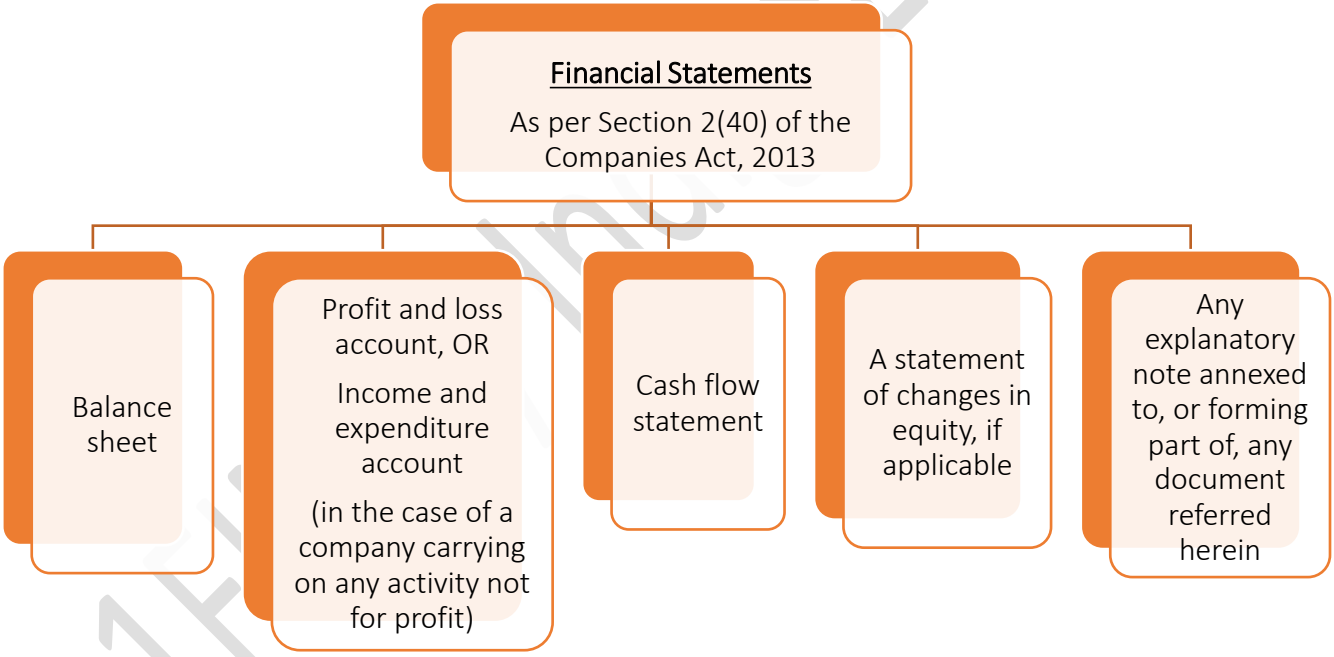
Study Note – 2 | Preparation of Financial Statements (As per Schedule III)

2.1 Introduction

FINAL ACCOUNTS

★ **Section 129 of the Companies Act, 2013** - At the AGM(Annual General Meeting) of a company, the Board of Directors of the company should lay financial statements before the company



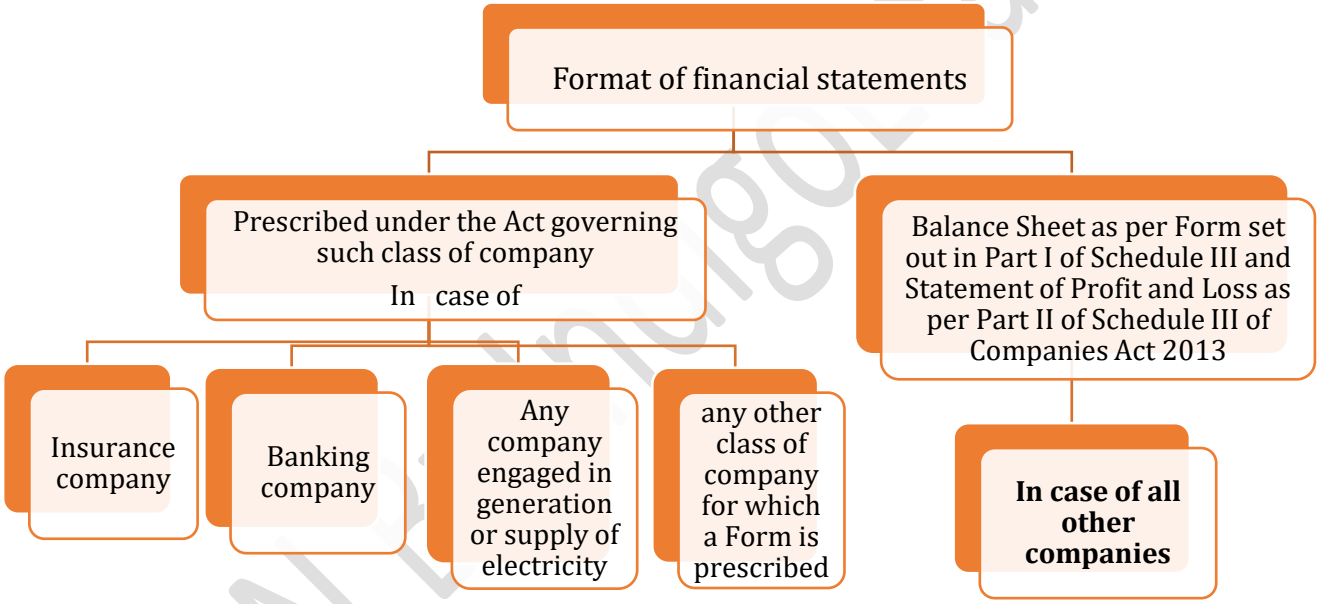
The financial statement, with respect to One Person Company, Small company and Dormant company, does not include the cash flow statement.

★ **Objective of financial statements -** It should give a true and fair view of the state of affairs of the company as at the end of the financial year.

★ **Points to be kept in mind while preparing final accounts**

- Requirements of Schedule III to the Companies Act
- Other statutory requirements;
- Accounting Standards notified by Ministry of Corporate Affairs (MCA)(AS 1 to AS 29);
- Statements and Guidance Notes issued by the Institute of Chartered Accountants of India (ICAI); which are necessary for understanding the accounting treatment/ valuation/ disclosure suggested by the ICAI

★ **Section 133 of the Companies Act -** It is mandatory to comply with accounting standards notified by the Central Government from time to time.



2.2 Balance Sheet

PART-I – FORM OF BALANCE SHEET

Name of the Company: .....
Balance Sheet as at: .....

Sr.No.	Particulars	Note no.	Figure as at the end of Current	Figures as at the end of

			reporting Period	the Previous Reporting Period
I	**Equity and Liabilities**			
1	Shareholders' Funds			
	(a) Share Capital (b) Reserves & Surplus (c) Money received against Share Warrants			
2	Share application money pending allotment			
3	Non-Current liabilities			
	(a) Long-term Borrowings (b) DTL (Net) (c) Other long-term liabilities (d) Long-term Provisions			
4	Current liabilities			
	(a) Short-term Borrowings (b) Trade Payables (c) Other Current liabilities (d) Short-term Provisions			
	TOTAL			
II	**Assets**			
1	Non-Current assets			
	(a) PPE (property, plant & Equipment) (i) Tangible assets			

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	(ii) Intangible assets (iii) Capital WIP (iv) Intangible assets under development			
	(b) Non-Current investments (c) Deferred tax assets (DTA) (Net) (d) Long-term loans & advances (e) Other Non-Current assets			
2	Current assets			
	(a) Current investments (b) Inventories (c) Trade receivables (d) Cash & Cash equivalents (e) Short-term loans & advances (f) Other Current assets			
	TOTAL			

DISCLOSURE REQUIREMENTS IN RESPECT OF BALANCE SHEET

The disclosure requirements and the points to be kept in mind with regard to each of the above items is as follows:

1. SHARE CAPITAL

(a) Authorized Capital – to be shown separately
➢ 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. ➢ Face/Par Value, as per Capital Clause in Memorandum of association should be disclosed. ➢ Separate disclosure for both Equity and Preference Shares.

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(b) Number of Shares issued, Subscribed and Fully Paid, and Subscribed but not Fully Paid

- Subscribed Share Capital" is "that portion of the issued Share Capital which has actually been subscribed by the public and subsequently allotted to the shareholders by the entity. This also includes any Bonus shares issued to the Shareholders.
- "Paid-up Share Capital" is "that part of the Subscribed Share Capital for which consideration is cash or otherwise has been received. This also includes Bonus Shares allotted and Shares issued otherwise than for cash against purchase consideration, by the corporate entity."
- If Shares are not fully called, then disclose the called up value per share.
- Separate disclosure for both Equity and Preference Shares, which should again be sub-classified and represented for each class of Shares.

(c)Rights, Preferences and restrictions attaching to shares including restrictions on the distribution of dividends and the repayment of Capital

- All such Rights, Preferences and Restrictions attached to each class of Shares, terms of redemption, etc., should be disclosed separately.
- Further, Preference Shares can be cumulative, non-cumulative, redeemable, convertible, non-convertible, etc

(d) Disclose number of Shares held by the entire chain of Subsidiaries and associates starting from the Holding Company and ending right up to the ultimate Holding Company.

- All such disclosures should be made separately representing for each class of Shares, (for both equity and Preference Shares).

(e) List of Shareholders holding more than 5% shares as on the Balance Sheet date

- 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.

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(g) 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
(h) For the period of 5 years immediately preceding the date as at which the Balance Sheet is prepared- **• Aggregate Number & Class of Shares allotted as Fully Paid and up Pursuant to Contract(s) without payment being received in Cash** **• Aggregate No. and Class of Shares allotted as fully Paid up by way of Bonus Shares** **• Aggregate Number & Class of Shares bought back**
➢ Disclose only if such event has occurred during a period of 5 years immediately preceding the Current year Balance Sheet date ➢ If the company is in operation for a period of less than 5 years, then disclosure should cover all such earlier financial years ➢ 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
(i) Terms of any Securities Convertible into Equity / Preference Shares issued along with the earliest date of conversion in descending order starting from the farthest such date.
➢ In case of Compulsorily Convertible Securities, where conversion is done in fixed tranches, all the dates of conversion have to be considered. ➢ In case of Convertible Debentures/Bonds, etc., for the purpose of simplification, reference may also be made to the terms disclosed under the note on long term Borrowings where these are required to be classified in the Balance Sheet, rather than disclosing the same against under this Clause.
(j) Calls Unpaid (showing aggregate value of Calls Unpaid by Directors and Officers)
➢ Unpaid amount towards Shares subscribed by the Subscribers of Memorandum of

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association should be considered as 'Subscribed and paid-up Capital' in the Balance Sheet and the debts due from the Subscribers should be appropriately disclosed as an asset in the B/Sheet.
(l) Forfeited Shares (amount originally paid up)

2. RESERVES & SURPLUS

Reserves & Surplus shall be classified as – (a) Capital reserves (b) Capital redemption reserve (c) Securities Premium (d) Debenture redemption reserve (e) Revaluation reserve (f) Share Options Outstanding account (g) Other reserves (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. ➢ A Reserve specifically represented by Earmarked Investments shall be termed as a 'Fund'. ➢ Debit Balance Statement of P&L shall be shown as a Negative Figure under the head 'Surplus'. Similarly, 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.
➢ **Capital Reserve -** It 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. ➢ **Capital redemption reserve (CRR)** is required to be created u/s 55 and 68 (for

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redemption of Preference Share Capital and buyback of Equity Share Capital), subject to conditions specified in the respective Sections.

- **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.
- **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.
- As per ICAI Guidance Note on ESOP, **Share Options Outstanding** should be shown as separate line item. Under Schedule III, this line item should be shown separately under reserves & Surplus.
- **Other reserves** - This includes any other Statutory reserves, e.g. tonnage tax reserve to be created under the income tax act, 1961.

3. MONEY RECEIVED AGAINST SHARE WARRANTS

This is to be shown as a separate line item on the face of Balance Sheet. Since Shares are yet to be allotted against the same, these are not reflected as a part of Share Capital, but as a separate line-item.

4. SHARE APPLICATION MONEY PENDING ALLOTMENT

- 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.

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5. NON-CURRENT LIABILITIES

(A) LONG-TERM BORROWINGS

Long-Term Borrowings shall be classified as –

a) Bonds/debentures,
b) Terms Loans – (i) from Banks, and (ii) from Other Parties,
c) Deferred Payment liabilities,
d) Deposits,
e) Loans & advances from related Parties,
f) Long-term Maturities of Finance lease Obligations,
g) Other loans & advances (specify nature)

1. Definitions and Meanings:

- 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".
- **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.
- **Deposits** classified under Borrowings would include deposits accepted from Public and inter-Corporate deposits which are in the nature of Borrowings.
- **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.

2. Security-wise Classification:

- Borrowings shall further be sub-classified as Secured and Unsecured. Nature of Security shall be specified separately in each case.
- 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

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of such borrowing as secured.

3. Guarantees:

- Where loans have been guaranteed by directors or Others, the aggregate amount of such
  loans under each head shall be disclosed.
- 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.

4. Maturity Date wise:

- Bonds / debentures (along with rate of interest & particulars of redemption or Conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or Conversion date, as the case may be.
- Current Maturities of all Long-Term Borrowings will be disclosed under "Other Current Liabilities" and not under long-term Borrowings and Short-term Borrowings.
- So, it is possible that the same Bonds/Debentures/ Term Loans may be bifurcated under both "Long-term Borrowings" as well as under "Other Current liabilities".

5. Installment redemption:

- Where Bonds/ debentures are redeemable by installments, the date of Maturity for the purpose must be reckoned as the date on which the First installment becomes due.

6. Power to reissue:

- Particulars of any redeemed Bonds/debentures which the Company has power to reissue shall be disclosed.

7. Terms of repayment:

- Repayment of term loans and Other loans shall be stated.
- Disclosure of terms of repayment should be made preferably for each loan unless the repayment terms of individual loans within a category are similar, in which case, they may be aggregated.

8. Continuing Default:

- Period and amount of continuing default as on the Balance Sheet date in

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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.
- 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.

(B) DEFERRED TAX LIABILITIES

- To be shown as a separate line item on the face of Balance Sheet.

(C) OTHER LONG-TERM LIABILITIES

It shall be classified as –

(a) Trade Payables
(b) Others

- Sundry Creditors for Goods or Services, and acceptances should be disclosed as part of trade Payables.
- Disclosure requirements under Micro, Small & Medium enterprises development (MSMED) act will also be required to be made in the annual Financial Statements.
- 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.

(D) LONG-TERM PROVISIONS

It shall be classified as –

(a) Provision for Employee Benefits

(b) Others (Specifying nature)

- This should be classified into short-term and long-term portions, and the latter amount should be included here.

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- "Others" would include items like Provisions for Warranties.

(6) CURRENT LIABILITIES

(A) SHORT-TERM BORROWINGS

Short-Term Borrowings shall be classified as –

(a) Loans Repayable on demand– (i) from Banks, & (ii)Other Parties,
(b) Loans and Advances from Related Parties,
(c) Deposits,
(d) Other Loans and Advances (specify nature)

1. Definition & meaning:

- Short-Term Borrowings will include all Loans within a period of 12 months from the date of the loan, loans payable on demand, etc., but they will not include Current Maturity of long-term Borrowings (which should be treated only as "Other Current Liabilities").
- In case of Short-Term Borrowings, all defaults (not continuing defaults as in the case of long-term Borrowings) existing as at the date of the Balance Sheet should be disclosed (item wise)
- A 3-Year Loan taken for a business with a 4-year Operating Cycle will be categorized only as Short term Borrowings, and not as long-term Borrowings.

2. Security wise Classification:

- Borrowings shall further be sub-classified as Secured and Unsecured.
- Nature of security shall be specified separately in each case.

3. Guarantees:

- Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

4. Default:

- Period & amount of default as on B/Sheet date in repayment of loans and interest shall be separately in each case.

(B) TRADE PAYABLES

It shall be classified as –

(a) Total outstanding dues of micro enterprises and small enterprises; and

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(b) Total outstanding dues of creditors other than micro enterprises and small enterprises."

- Liability for Capital goods Purchases: Amount due towards purchase disclosed under "Other Current liabilities" with a suitable description.
- Liability under Contractual Obligations: Liability towards employees, leases or other Contractual liabilities should not be included under trade Payables.
- Only "Commercial Dues" can be included under trade Payables.

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 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.

(C) OTHER CURRENT LIABILITIES

It shall be classified as –

(a) Current maturities of long-term debt,

(b) Current Maturities of Finance lease Obligations,

(c) interest accrued but not due on Borrowings,

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(d) interest accrued and due on Borrowings,

(e) income received in advance,

(f) unpaid dividends,

(g) application Money received for allotment of Securities and due for refund and interest accrued thereon

(h) unpaid Matured deposits and interest accrued thereon,

(i) unpaid Matured debentures and interest accrued thereon,

(j) Other Payables (specify nature).

- The portion of Long-Term Debts/ Lease Obligations, which is due for payments within 12 months of the reporting date is required to be classified under "Other Current Liabilities", while the balance amount should be classified under long-term Borrowings.
- Trade Deposits and Security Deposits which are not in the nature of Borrowings should be
  classified separately under Other Non-Current/ Current liabilities.
- 'Other Payables' under this head may be in the nature of statutory dues such as withholding taxes, Service tax, VAT, Excise duty, etc.
- Current/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.

(D) SHORT TERM PROVISIONS

It shall be classified as –

(a) Provision for Employee Benefits

(b) Others (Specifying nature)

- This should be classified into short-term and long-term portions, and the former amount should be included here.

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- "Others" includes Provision for dividend, Provision for taxation, Provision for Warranties, etc.

(1) NON-CURRENT ASSETS

(A) (I) TANGIBLE ASSETS

1. Classification shall be given as –

(a) Land, (b) Buildings, (c) Plant and equipment, (d) Furniture & Fixtures, (e) Vehicles, (f) Office Equipment, (g) Others (Specify Nature).

- **AS-19** excludes land leases from its scope. Leasehold land should be presented as a separate assets class under Tangible Assets. Also, Freehold land should be presented as a separate asset class.
- Assets under Lease shall be separately specified under each class of asset. The term "under lease" should mean –
  - Assets given on Operating lease in the case of lessor, and
  - Assets held under Finance lease in the case of lessee.
- Leasehold Improvements should continue to be shown as a separate asset class.
- **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.]
- **AS-26** does not permit revaluation of intangible assets.
- 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
- Similar disclosures should also be made for impairment, if any, as applicable.
- **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.

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- Asset Disposals through Demergers, etc., if any also be disclosed separately for each class of assets.
- **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 (AS11).
    - Borrowing Costs capitalized as per **AS-16**.

(A) (II) INTANGIBLE ASSETS

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, Formula, 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.

(A) (III) CAPITAL WORK IN PROGRESS

- 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.

(A) (IV) INTANGIBLE ASSETS UNDER DEVELOPMENT

- Intangible assets under development should be disclosed under this head provided they can be recognized based on the criteria laid down in AS-26.

(B) NON CURRENT INVESTMENTS

Non-Current Investments shall be classified as Trade investments and Other investments, and

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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 again 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. ➢ Under each classification, details shall be given about • The names of Bodies Corporate (indicating separately whether such bodies are – 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). ➢ "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. (itemwise) ➢ With 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. ➢ Investments in LLPs will be disclosed separately under "Other Investments". ➢ 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 Balance sheet.

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- Investments carried at other than at Cost should be separately stated specifying the basis for valuation thereof.
- Basis could be (a) Cost, or (b) Cost less Provision for other than temporary diminution, or
  (c)Lower of Cost and Fair Value.
- 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.

(1) (C) DEFERRED TAX ASSET

To be shown as a separate line-item on the face of Balance Sheet.

(1) (D) LONG TERM LOANS AND ADVANCES

1. **General Classification**: Long-term loans and advances shall be classified as –

(a) Capital advances,

(b) Security deposits,

(c) Loans and advances to related Parties (giving details thereof),

(d) Other loans and advances (specify nature)

- Capital Advances are advances given for procurement of Fixed assets which are Non-Current Assets. They are not realized back in cash, and over a period, get converted into Fixed assets.
- Other loans and Advances should include all other items in the nature of advances recoverable in cash or kind, e.g., Prepaid Expenses, Advance Tax, CENVAT Credit receivable, VAT Credit receivable and Service tax Credit receivable 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.

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3. **Bad / Doubtful**: allowance for Bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
4. **Directors, etc**.: loans and advances due by Directors or Other Officers of the Company or any of them either severally or jointly with any other persons or amounts due by Firms or Private Companies respectively in which any director is a Partner in a director of a Member should be separately stated.

(1) (E) OTHER NON-CURRENT ASSETS
1. General classification - Other Non-Current Assets shall be classified as (a) long-term trade receivables (including trade receivables on deferred Credit terms) (b) Others (specify nature)
➢ 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 according to their nature.
2. Security wise Classification: 3. Bad / Doubtful: 4. Directors, etc.: Same as above.

(2)CURRENT ASSETS

(2) (A) CURRENT INVESTMENTS
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,

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(e) investments in Mutual Funds,

(f) investments in Partnership Firms,

(g) Other investments (specify nature)

Principles given for Non-current investments will apply here also to the relevant. However, trade vs Non-Trade Classification, is not required for Current investments.

(2) (B) INVENTORIES

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)

- Goods in Transit should be included under relevant heads with suitable disclosure.
- The heading "Finished Goods" should comprise 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

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.

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2. Security wise Details: trade receivables shall be separately sub classified as –

(a) Secured, considered Good

(b) Unsecured, considered Good

(c) Doubtful.

3. Bad /Doubtful: Allowance for Bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

4. Directors, etc: debts due by directors or Other Officers of the Company or any of them either

severally or jointly with any other person or debts due by Firms or Private Companies, respectively in which any director is a Partner, or a director, or a Member should be separately stated.

- Where no due date is specifically agreed upon, normal credit period allowed 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.
- 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

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).

- 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.

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➢ Bank Deposits with more than 12 months Maturity shall be disclosed separately.

(2) (E) SHORT TERM LOANS AND ADVANCES
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. Securitywise Classification: The above shall also be subclassified as- (a) Secured, considered Good, (b) unsecured, considered Good, (c) doubtful
3. Bad / doubtful: allowance for Bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
4. Directors, etc.: loans & advances due by directors or Other Officers of the Company or any of them either severally or Jointly with any other person or amounts due by Firms or Private Companies, respectively in which any director is a Partner or a director or a Member shall be separately stated.
(2) (F) OTHER CURRENT ASSETS
➢ This is an all-inclusive heading, which incorporates Current Assets which do not fit into any other Asset Categories.
➢ Nature of each item should be specified. ➢ 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. e.g., unbilled revenue, unamortized Premium on Forward Contracts, etc.

Special note : Schedule III does not deal with any accounting treatment of special items (such as Share issue expenses, ancillary borrowing Costs and discount or Premium relating to borrowings), and the same continues to be governed by the respective AS / best practices. So, a Company can disclose the Unamortized Portion of such expenses as "Unamortized Expenses", under the head "Other Current/ Non Current assets", depending on whether the amount will be amortized in the next 12 months or thereafter.

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2.3 Statement of Profit and Loss Account

PART II-FORM OF STATEMENT OF PROFIT AND LOSS

Name of the Company :……
Profit and loss Statement for the year ended:…….. (rs. in ……..)

Sr.No.	Particulars	Note No.	Figures for the Current reporting Period	Figures for the Previous reporting period
I	Revenue from Operations			
II	Other income			
III	Total revenue (I+II)			
IV	Expenses			
	Cost of Materials Consumed Purchases of Stock-In-Trade Changes in inventories of Finished Goods / Work-in-progress and Stock-In-Trade Employee Benefits Expense Finance Costs Depreciation and amortization expense Other expenses			
	Total expenses			
V	Profit before Exceptional & Extraordinary items and tax (III – IV)			
VI	Exceptional items			

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VII	Profit before Extraordinary Items and Tax (V-VI)			
VIII	Extraordinary items			
IX	Profit before Tax (VII-VIII)			
X	Tax expenses: (1) Current tax (2) deferred tax			
XI	Profit /(Loss) for the period from Continuing Operations (IX – X)			
XII	Profit /(Loss) from Discontinuing Operations			
XIII	Tax expense of discontinuing Operations			
XIV	Profit /(Loss) from Discontinuing Operations (after tax) (XII-XIII)			
XV	Profit / (Loss) for the period (XI + XIV)			
XVI	earnings per equity Share: (1) Basic (2) Diluted			

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DISCLOSURE REQUIREMENTS IN RESPECT OF PROFIT AND LOSS ACCOUNT

1. Section 25 Companies - The provisions of this part shall apply to the income and expenditure account referred to in Sec. 129 of the act, in the same manner as they apply to a Statement of Profit and Loss.

2. Revenue from Operations

For Company other than a Finance Company:

Revenue from Operations shall disclosed separately in the Notes, revenue from –

(a) Sale of Products

(b) Sale of Services

(c) Other Operating revenues

(d) less: excise duty

For Finance Company:

Revenue from Operations shall include revenue from:

(a) interest &

(b) Other Financial Services revenue under each of the above heads shall be disclosed separately by way of Notes to accounts to the extent applicable.

3. Finance Costs

Finance Costs shall be classified as –

(a) Interest expenses,

(b) Other Borrowing Costs,

(c) Applicable Net Gain / loss on Foreign Currency transactions and translation.

4. Other Income

Other Income shall be classified as –

(a) Interest income (in case of a Company other than a Finance Company),

(b) Dividend income,

(c) Net Gain/loss on Sale of investments,

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(d) Other Non-Operating income (Net of expenses directly attributable to such income).

5. Additional Information:

(i) General breakup of income and expense

A Company shall disclose by way of Notes, additional information regarding aggregate expenditure and income on the following items referred below.

a) Employee Benefits Expense [showed 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 Rs. 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 the cost considered as Finance Cost),
j) Payments to the auditor as – (a) auditor, (b) For taxation Matters, (c) For Company law Matters, (d) For Management Services, (e) For other Services, (f) For reimbursement of expenses,
k) Item of Exceptional and Extraordinary Nature,
l) Prior Period items.

(ii)Materials, goods, Services, etc.

a) In the case of Manufacturing Companies –
- Raw Materials under broad heads.
- Goods Purchased under broad heads.

b) In the case of trading Companies, Purchases in respect of goods traded in by

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the Company under broad heads.

c) In the case of Companies rendering or supplying services, Gross income derived from Services rendered or Supplied, are shown under broad heads.
d) In the case of Companies rendering or supplying services, Gross income derived from Services rendered or Supplied, are shown under broad heads.
e) Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of Financial Statements.

(iii) Reserves – Creation & utilization:

(a) The aggregate, if material, of any amounts set aside or proposed to be set aside to reserve, without 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.

(iv) Provision – Creation & utilization:

(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.

(**v) 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 of Buildings,

(e) Repairs of Machinery,

(f) Repairs of Machinery,

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(g) Insurance,

(h) Rates and taxes, excluding taxes on income,

(i) Miscellaneous expenses.

(vi) 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

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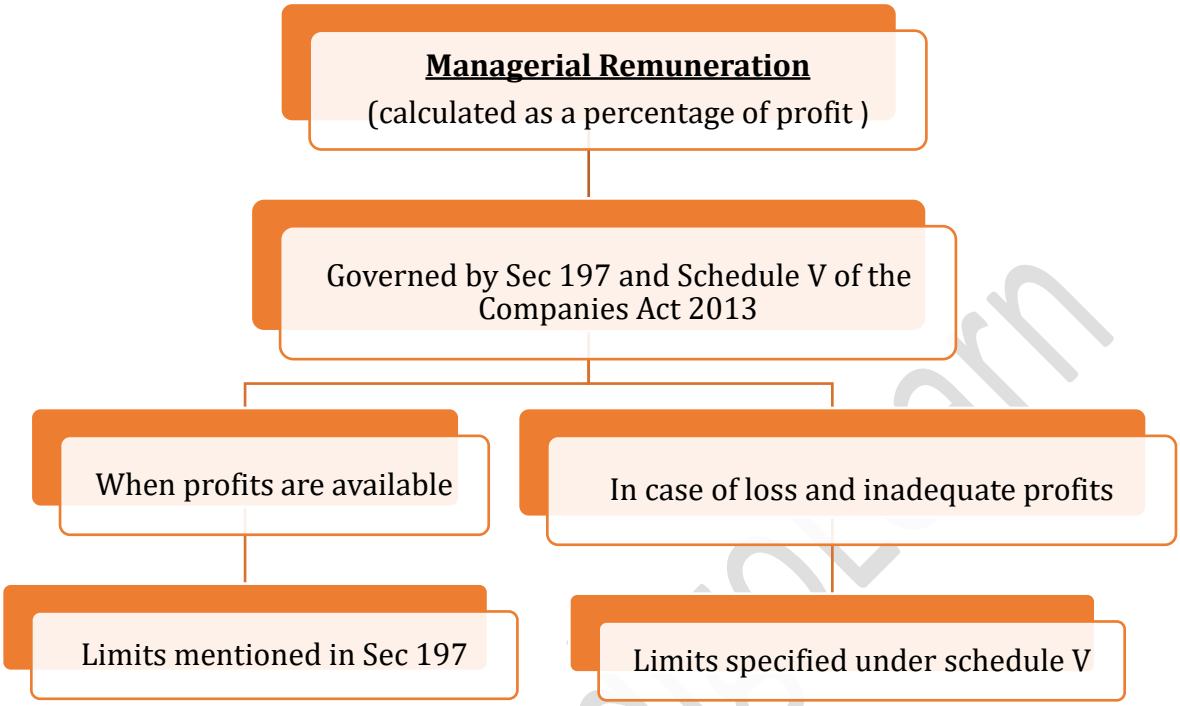
MANAGERIAL REMUNERATION



SECTION 197

★ Prescribes the overall maximum managerial remuneration payable and also managerial remuneration in case of absence or inadequacy of profits.

★ Total managerial remuneration payable
- ➢ by a public company,
- ➢ to its directors, including managing director and whole-time director, and its manager
- ➢ in respect of any financial year
- ➢ should not exceed **11%** of the net profits of that company,
- ➢ computed in the manner laid down in section 198
- ➢ except that the remuneration of the directors should not be deducted from the gross profits.

★ The company in general meeting may, authorise the payment of remuneration exceeding 11% of the net profits of the company, subject to the provisions of Schedule V.

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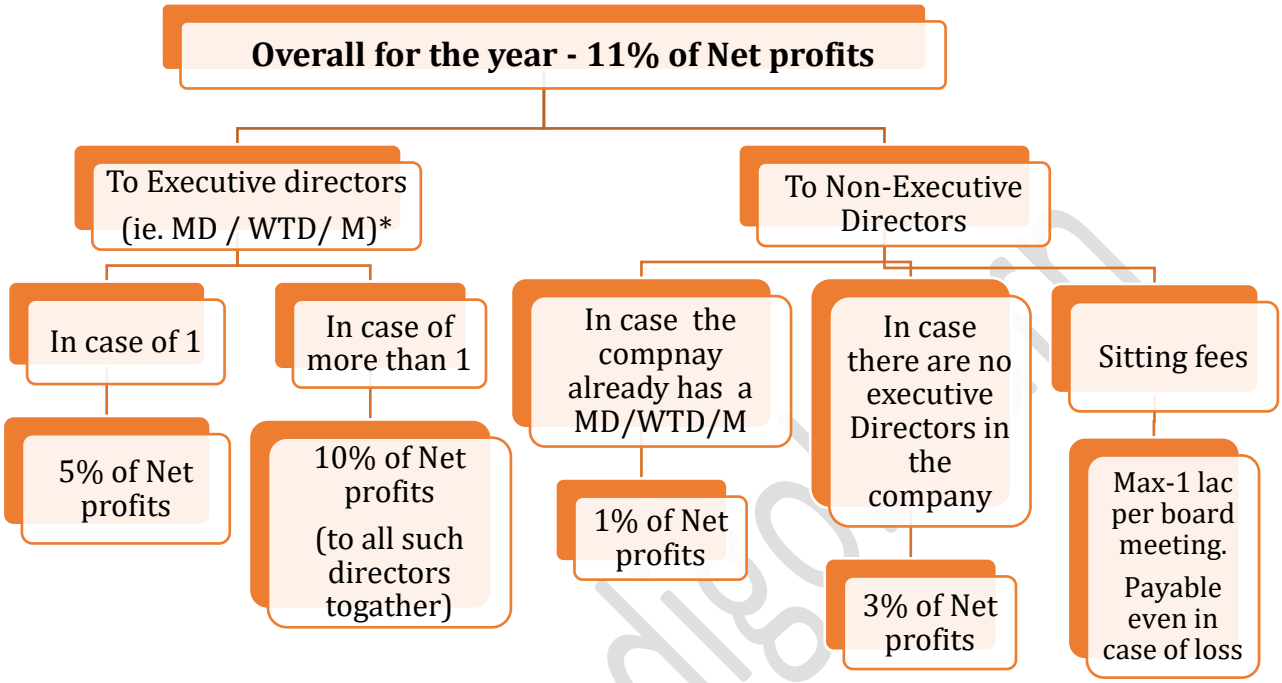
MAXIMUM MANAGERIAL REMUNERATION -PAYABLE BY A PUBLIC COMPANY IN CASE OF PROFITS



MD / WTD / M = Managing Director/ Whole time director/ Manager

Net profits is computed as specified in Sec 198

SEC 198 – COMPUTATION OF NET PROFIT FOR THE PURPOSE OF COMPUTING MANAGERIAL REMUNERATION

1. THE FOLLOWING CREDIT SHOULD BE ADDED TO GROSS PROFIT
a) Subsidies or bounties received from any Government, or any public authority, unless the Central Government otherwise directs

2. THE FOLLOWING CREDITS SHOULD NOT BE ADDED TO GROSS PROFIT
a) Profits, by way of premium on shares or debentures, which are issued or sold by the company
b) Profits on sales by the company of forfeited shares
c) Profits of a capital nature including profits from the sale of the undertaking or any of the undertakings of the company or of any part thereof
d) Profits from the sale of any immovable property or fixed assets of a capital nature

Provided that where the amount for which any fixed asset is sold exceeds the written-down value thereof, credit should be given for so much of the excess as is not higher than the difference between the original cost of that fixed asset and its written- down value.

Credit to P&L = [Sale price – WDV]-[Original cost – WDV]

e) Any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value.

3. THE FOLLOWING DEBITS SHOULD BE DEDUCTED FROM GROSS PROFIT

a) all the usual working charges

~~b) directors' remuneration~~

c) bonus or commission paid or payable

d) any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits

e) any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf

f) interest on debentures

g) interest on mortgages and loans and advances

h) interest on unsecured loans and advances

i) expenses on repairs, provided the repairs are not of a capital nature

j) outgoings inclusive of contributions made under section 181 of the Act

k) depreciation to the extent specified in section 123 of the Act

l) the excess of expenditure over income, which had arisen in computing the net profits in accordance with this section in any year which begins at or after the commencement of this Act, in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which the net profits have to be ascertained

m) any compensation or damages to be paid in virtue of any legal liability including a liability arising from a breach of contract

n) any sum paid by way of insurance against the risk of meeting any liability such as is referred to in clause (m)

o) bad debts written off

4. THE FOLLOWING DEBITS SHOULD NOT BE DEDUCTED FROM GROSS PROFIT

a) Income-tax and super-tax payable under the Income-tax Act, 1961.

b) Any compensation, damages or payments made voluntarily, (other than those mentioned above)

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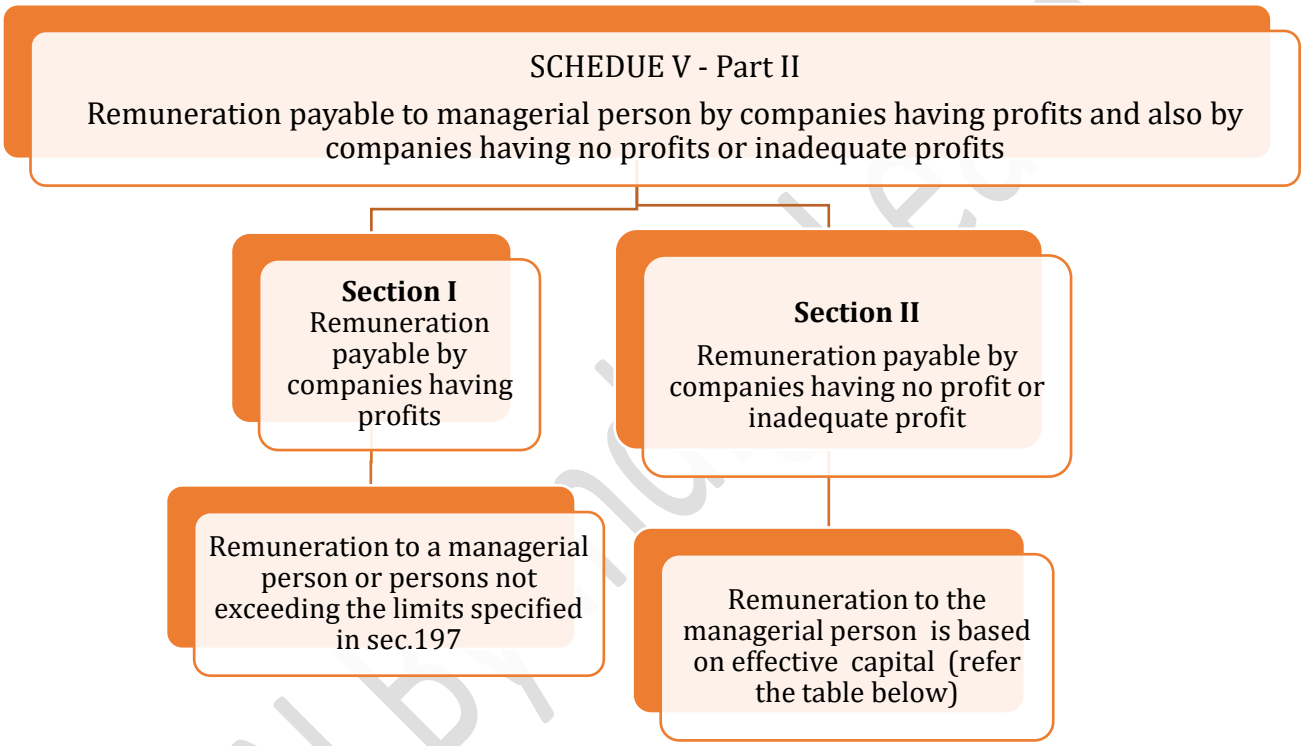
c) loss of a capital nature not including any excess of the written-down value of any asset which is sold, discarded, demolished or destroyed over its sale proceeds or its scrap value

d) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value



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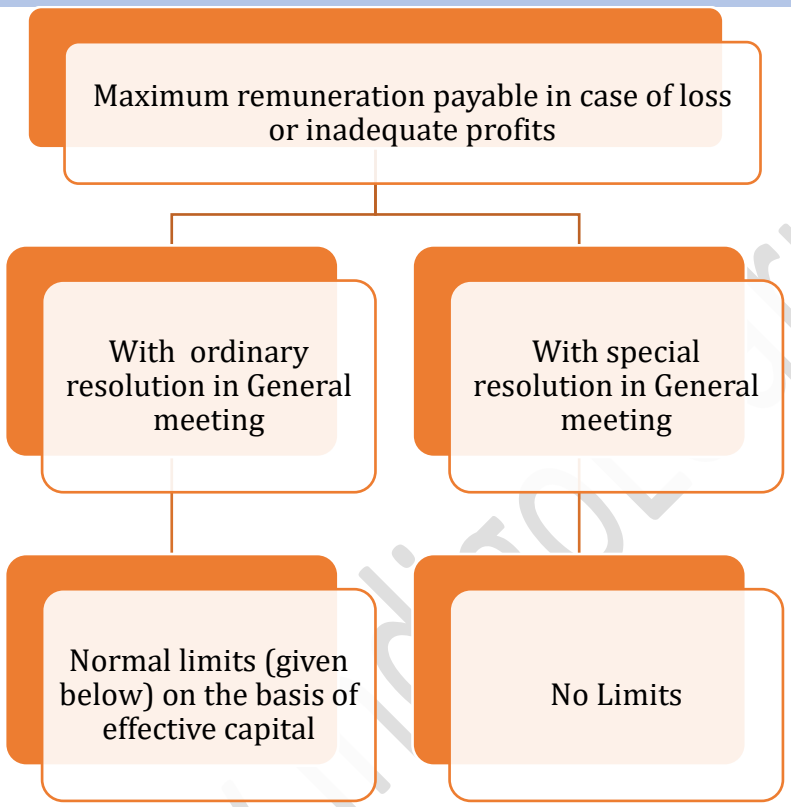
SECTION II - REMUNERATION PAYABLE BY COMPANIES HAVING NO PROFIT OR INADEQUATE PROFIT



NORMAL LIMIT BASED ON EFFECTIVE CAPITAL

Where the effective capital is	Maximum payable per year per director
Negative or less than 5 crores	60 lacs
5 crores and above but less than 100 Crores	84 lacs
100 crores and above but less than 250 Crores	120 lacs
250 crores and above	120 lakhs plus 0.01% of the effective capital in excess of Rs. 250 crores.

EFFECTIVE CAPITAL	
Aggregate of the paid-up share capital (excluding share application money or advances against shares)	xxx
(+) Securities premium account	xxx
(+) Free reserves (excluding revaluation reserve)	xxx
(+) Long- term loans, debentures and deposits repayable after one year (excluding working capital loans, over drafts, interest due on loans unless funded, bank guarantee, etc., and other short- term arrangements)	xxx
Total	**xxx**
(-)aggregate of any investments (except in case of investment by an investment company whose principal business is acquisition of shares, stock, debentures or other securities)	(xxx)
(-)preliminary expenses not written off	(xxx)
(-) accumulated losses	(xxx)
Effective capital	**xxx**

Note -

1. Where the appointment is for a period less than 1 year then limits should be pro-rated.
2. Where the appointment of the managerial person is made in the year in which company has been incorporated, the effective capital should be calculated as on the date of such appointment
3. In any other case the effective capital should be calculated as on the last date of the financial year preceding the financial year in which the appointment of the managerial person is made.
4. For the purposes of this Schedule, "negative effective capital" means the effective capital which is calculated in accordance with the provisions contained above is less

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than zero

CONDITIONS SUBJECT TO WHICH THE LIMITS APPLY

- ★ Payment of remuneration is approved by a Board resolution passed and, in the case of a company covered under Section 178(1) also by the Nomination and Remuneration Committee.
- ★ The company has not committed any default in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of 30 days in the preceding financial year before the date of appointment of such managerial person and
- ★ In case of a default, the company obtains prior approval from secured creditors for the proposed remuneration and the fact of such prior approval having been obtained is mentioned in the explanatory statement to the notice convening the general meeting
- ★ An ordinary resolution or a special resolution, as the case may be, has been passed at the general meeting of the company for a period not exceeding 3 years.
- ★ A statement along with a notice calling the general meeting referred to in the above clause is given to the shareholders containing the following information, namely:-

I. **General Information**:
   (1) Nature of industry
   (2) Date or expected date of commencement of commercial production.
   (3) In case of new companies, expected date of commencement of activities as per project approved by financial institutions appearing in the prospectus
   (4) Financial performance based on given indicators
   (5) Foreign investments or collaborations, if any.

II. **Information about the appointee:**
   (1) Background details
   (2) Past remuneration
   (3) Recognition or awards
   (4) Job profile and his suitability
   (5) Remuneration proposed
   (6) Comparative remuneration profile with respect to industry, size of the company, profile of the position and person (in case of expatriates the relevant details would be with respect to the country of his origin)
   (7) Pecuniary relationship directly or indirectly with the company, or relationship

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with the managerial personnel, if any.

III. **Other information**:

(1) Reasons of loss or inadequate profits

(2) Steps taken or proposed to be taken for improvement

(3) Expected increase in productivity and profits in measurable terms.

IV. **Disclosures:**

The following disclosures should be mentioned in the Board of Director's report under the heading "Corporate Governance", if any, attached to the financial statement:-

(1) all elements of remuneration package such as salary, benefits, bonuses, stock options, pension, etc., of all the directors;

(2) details of fixed component and performance linked incentives along with the performance criteria;

(3) service contracts, notice period, severance fees;

(4) stock option details, if any, and whether the same has been issued at a discount as well as the period over which accrued and over which exercisable.

PERQUISITES NOT INCLUDED IN MANAGERIAL REMUNERATION

1. A managerial person should be eligible for the following perquisites which should not be included in the computation of the ceiling on remuneration specified in Section II and Section III:-

(a) contribution to provident fund, superannuation fund or annuity fund to the extent these either singly or put together are not taxable under the Income-tax Act, 1961;

(b) gratuity payable at a rate not exceeding half a month's salary for each completed year of service; and

(c) encashment of leave at the end of the tenure.

2. In addition to the perquisites specified in paragraph 1 of this section, an expatriate managerial person (including a non-resident Indian) should be eligible to the following perquisites which should not be included in the computation of the ceiling on remuneration specified in Section II or Section III-

(a) Children's education allowance: In case of children studying in or outside India, an allowance limited to a maximum of Rs. 12,000 per month per child or actual expenses incurred, whichever is less. Such allowance is admissible up to a maximum of two children.

(b) Holiday passage for children studying outside India or family* staying abroad: Return holiday passage once in a year by economy class or once in two years by first class to children and to the members 'of the family* from the place oftheir study or stay abroad to India if they are not residing in India, with

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the managerial person.

(c) Leave travel concession: Return passage for self and family in accordance with the rules specified by the company where it is proposed that the leave be spent in home country instead of anywhere in India.

*For the purposes of this Schedule, "family" means the spouse, dependent children and dependent parents of the managerial person

DIVISIBLE PROFIT

- ★ A dividend is a distribution of divisible profit of a company among the members according to the number of shares held by each of them in the capital of the company and the rights attaching thereto.
- ★ Such a distribution may or may not entail a release of assets; it would be where a distribution involves payment of cash.d
- ★ Bonus shares cannot be issued in lieu of dividends.
- ★ Capital cannot be returned to the shareholders by way of dividend.
- ★ A company who has committed any default in compliance with the provisions of sec- 73 and 74 relating to the acceptance and repayment of deposits would be barred to declare dividend.
- ★ Dividend should be declared or paid only from free reserves.
- ★ Dividend shall be payable by way of
  (i) cash (ii) cheque (iii) warrant or (iv) in any electronic mode
- ★ It shall be payable to the registered shareholder of such share or to his order or to his banker
- ★ 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.
  Appropriation of a part of profit can be done in the following cases

  1. When required under a law - For example, under the Banking Regulation Act

  2. When required under any contract – For example where the company has undertaken, at the time of raising of loan, that before any part of its profit is distributed, a specified percentage of the profit every year should be credited to a reserve for the repayment of the loan and until the time for repayment arrives, the amount should remain invested in a specified manner
- ★ A company may if so authorised by its Article, pay a dividend in proportion to the amount paid on each share in case of partly paid shares.

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★ Calls paid in advance do not rank for payment of dividend.

★ Dividend on preference shares

- Holders of preference shares are entitled to receive a dividend at a fixed rate before any dividend is declared on equity shares.
- But such a right can be exercised subject to there being profits and the Directors recommending payment of the dividend.

★ As per Section 2 (35) of the Companies Act, 2013, term "Dividend" includes interim dividend also.

Final dividend	**Interim dividend**
Declared at the AGM	Declared between 2 AGMs
Paid after the finalization of accounts of the year	Paid before the finalization of accounts.
Dividend is recommended by BOD but approved by shareholders in AGM. (share holders can reduce the rate of dividend but they cannot increase it)	This dividend is declared by BOD.
Once it is declared it becomes the liability of the company and it must pay the amount.	This can be revoked with the consent of the shareholders

★ **Sec 123 (3)** - 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 should not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.

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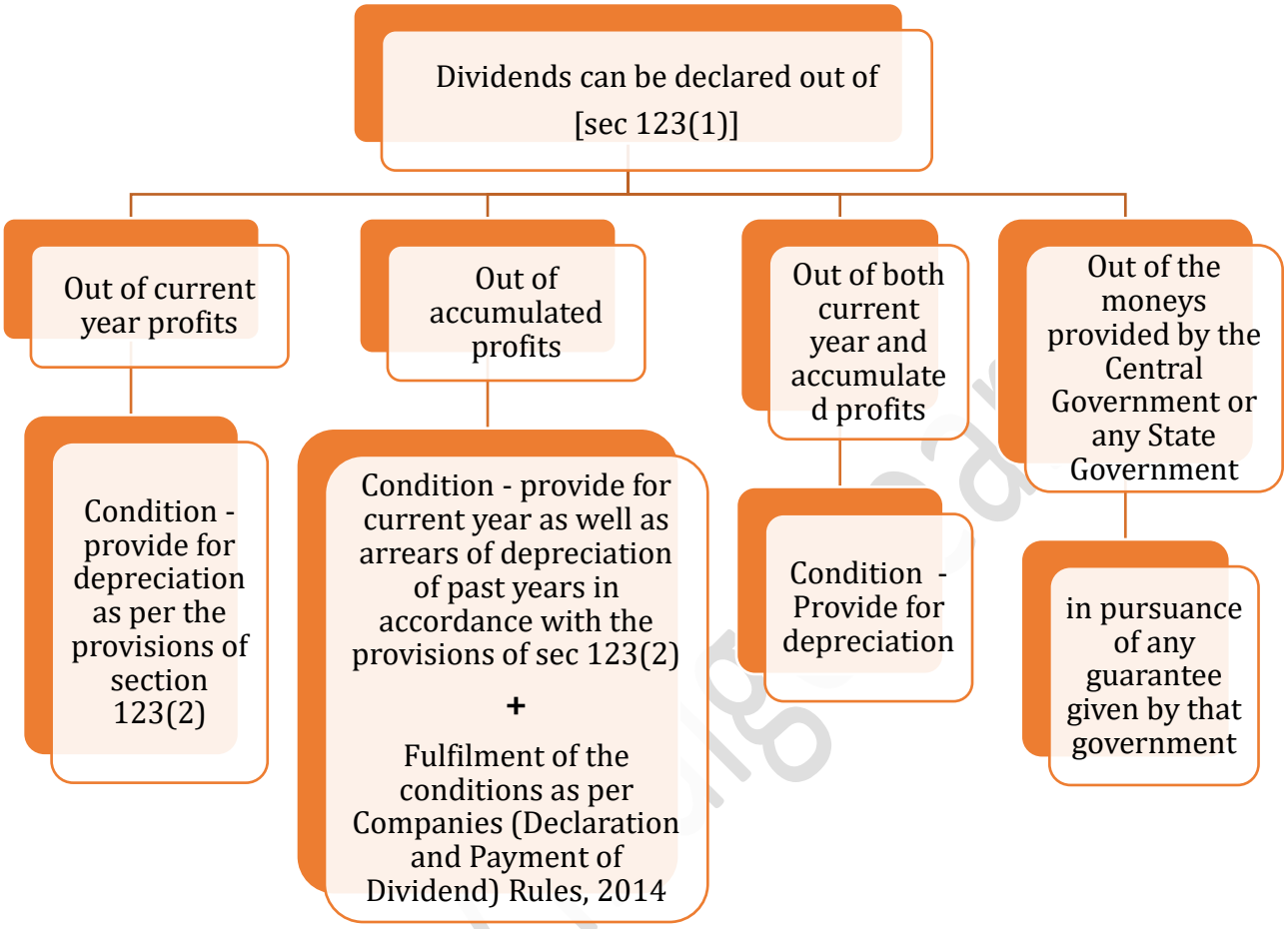

★ **Sec 123(2)** - Depreciation must be to the extent specified in Schedule II to the Companies Act, 2013.

- When the assets are sold, discarded, demolished or destroyed in any financial year, the excess of the written down value over its sale proceeds as scrap, if any should be written off in the same financial year.

★ **Conditions as per Companies (Declaration and Payment of Dividend) Rules, 2014**

(1) The **rate of dividend** declared should not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year: However this condition shall not apply to a company, which has not declared any dividend in each of the three preceding financial year.

(2) The **total amount to be drawn** from such accumulated profits should not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

(3) The **amount so drawn should 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.

(4) The **balance of reserves** after such withdrawal should not fall below 15% of its paid up share capital as appearing in the latest audited financial statement.

(5) No company should declare dividend unless **carried over previous losses** and depreciation not provided in previous year, are set off against profit of the company of the current year. The loss or depreciation, whichever is less, in previous years is set off against the profit of the company for the year for which dividend is declared or paid.

★ **Sec 124 - Payment of dividend**

(1) **Deposit in separate bank** - The amount of the dividend, including interim dividend, should be deposited in a scheduled bank in a separate account **within 5 days** from the date of declaration of such dividend.

(2) **Mandatory payment** - The dividend declared should be **paid** to the share holder **within 30 days** from the date of declaration.

(3) **Transfer to unpaid dividend account** - Where any dividend has not been paid or claimed within thirty days from the date of the declaration to any shareholder the company should, **within 7 days** from the date of expiry of the said period of 30 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.

(4) **Statement to be placed on website** - The company should, **within a period of 90 days** of making any transfer to the Unpaid Dividend Account, prepare a statement containing the names, their last known addresses and the unpaid dividend to be paid to each person and place it on the website of the company, if any, and also on any other website approved by the Central Government for this purpose, in such form, manner and other particulars as may be prescribed.

(5) **Interest of 12% in case of default -** If any default is made in transferring any amount to the Unpaid Dividend Account, the company should pay, from the date of such default, interest on such amount, at the rate of 12% per annum.

(6) **Claim to company -** Any person claiming to be entitled to any money transferred to the Unpaid Dividend Account of the company may apply to the company for payment of the money claimed.

(7) **Transfer to Investor education and protection fund** - Any money transferred to the Unpaid Dividend Account of a company which remains **unpaid or unclaimed for a period of 7 years** from the date of such transfer should be transferred by the company along with interest accrued, if any, thereon to the Fund "Investor

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Education and Protection Fund" established section 125.

(8) **Statement of such transfer -** The company should send a statement in the prescribed form of the details of such transfer to the authority which administers the said Fund and that authority should issue a receipt to the company as evidence of such transfer.

(9) **Transfer of Share -** All shares in respect of which unpaid or unclaimed dividend has been transferred to "Investor Education and Protection Fund" should also be transferred by the company in the name of Investor Education and Protection Fund along with a statement containing such details as may be prescribed:
Provided that any claimant of shares transferred above should be entitled to claim the transfer of shares from Investor Education and Protection Fund in accordance with such procedure and on submission of such documents as may be prescribed.

(10) **Punishment for failure to distribute dividend** - If a company fails to comply with any of the requirements of this section,

Liability for	Fine
Company	not be less than 5,00,000 but which may extend to Rs.25,00,000
Every officer of the company who is in default	not be less than Rs.1,00,000 but which may extend to Rs.5,00,000.

ACCOUNTING FOR TAXES

★ AS 22 Accounting for Taxes on Income prescribes the accounting treatment of taxes on income and follows the concept of matching expenses against revenue for the period.

★ The concept of matching is more peculiar in cases of income taxes since in a number of cases, the taxable income may be significantly different from the income reported in the financial statements due to the difference in treatment of certain items under taxation laws and the way it is reflected in accounts.

★ Accounting for taxes on income should be in accordance with AS 22, irrespective of whether such taxes are imposed by an Indian law or by the law of a foreign country.

★ The amount to be included in respect of income-tax in the profit and loss account should be the current tax plus or minus the deferred tax. Current tax is the tax determined in accordance with the provisions of the Income- tax Act, 1961. Deferred tax is the tax effect of timing differences.

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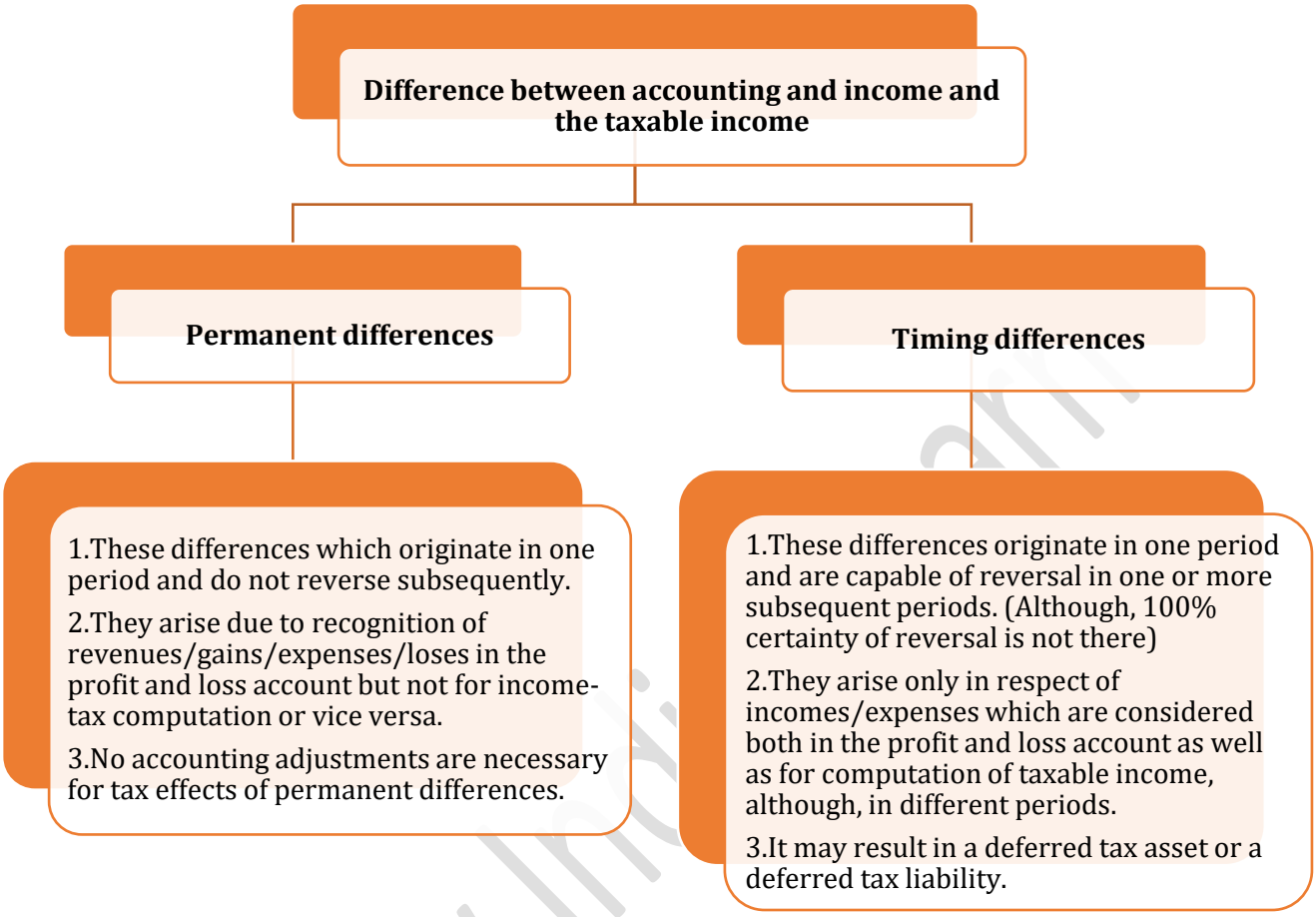

The tax effect of timing difference i.e. deferred tax should be treated in the following manner:
The deferred tax should form part of the tax expenses in the profit and loss account; and
It should be accounted as a deferred tax asset (DTA)/deferred tax liability (DTL) in the balance sheet.

DTA or DTL is created in the following cases

When book profit > taxable profit	Deferred tax liability is created
When book profit < taxable profit	Deferred tax asset is created

DTA is recognized in a case where there are unabsorbed losses/deprecation under the tax laws.
DTA should be recognized only to the extent there is virtual certainty supported by convincing evidence that adequate future taxable income will be available against

which DTAs can be realised. Mere forecasts of performance would not satisfy this criterion. virtual certainty has to be backed up by convincing evidence i.e. evidence available at the reporting date in concrete form.

Journal entries
In the year in which timing difference originates – In case of DTA DTA A/c Dr. To Profit & loss A/c Note : The amount to be debited and credited arrived at by multiplying the timing difference with the tax rate applicable for the year
In case of DTL Profit and Loss A/c Dr. To Deferred tax Liability A/c
In the subsequent year - This is the entry to be passed to account for the difference between the opening and closing balance in the DTA a/c which represents reversal of timing difference during the year Profit and loss A/c Dr. To DTA A/c **Note:** 1. The carrying amount of DTAs has to be reviewed at each balance sheet date. 2. The carrying amount of a DTA has to be written down to the extent that it is no longer reasonably certain or virtually certain, as the case may be, that adequate future taxable income would be available to realize the DTA. 3. Reversal of a previous write-down may be done to the extent it becomes reasonably certain or virtually certain, as the case may be, that adequate future taxable income would be available. 4. If the recognition criteria is not met, the entire balance should be written off.

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Illustrations

Illustration – 1

The following is the Trial Balance of Omega Limited as on 31.3.20X2:

(Figures in Rs.'000)

Particulars	Debit Rs.	Particulars	Credit Rs.
Land at cost	220	Equity Capital (Shares of Rs. 10 each)	300
Plant & Machinery at cost	770	10% Debentures	200
Trade Receivables	96	General Reserve	130
Inventories (31.3.X2)	86	Profit & Loss A/c	72
Bank	20	Securities Premium	40
Adjusted Purchases	320	Sales	700
Factory Expenses	60	Trade Payables	52
Administration Expenses	30	Provision for Depreciation	172
Selling Expenses	30	Suspense Account	4
Debenture Interest	20		
Interim Dividend Paid	18		
	1670		1670

Additional Information:

i. The authorised share capital of the company is 40,000 shares of Rs. 10 each.
ii. The company on the advice of independent valuer wish to revalue the land at Rs. 3,60,000.
iii. Declared final dividend @ 10%.
iv. Suspense account of Rs. 4,000 represents cash received for the sale of some of the machinery on 1.4.20X1. The cost of the machinery was Rs. 10,000 and the accumulated depreciation thereon being Rs. 8,000.
v. Depreciation is to be provided on plant and machinery at 10% on cost.

You are required to prepare Omega Limited's Balance Sheet as on 31.3.20X2 and Statement of Profit and Loss with notes to accounts for the year ended 31.3.20X2 as per Schedule III. Ignore previous years' figures & taxation.

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Illustration – 2

You are required to prepare a Profit and Loss Account and Balance Sheet from the following Trial Balance extracted from the books of the international Hotels Ltd., on 31st March, 20X2.

Particulars	Debit	Credit
Authorized Capital - divided into 5,000 6% Preference Shares of Rs.100 each and 10,000 equity shares of Rs.100 each		15,00,000
Subscribed Capital –		
5,000 6% Preference Shares of Rs.100 each		5,00,000
Equity Capital		8,05,000
Purchases – Wines, Cigarettes, Cigars etc	45,800	
- Foodstuffs	36,200	
Wages and Salaries	28,300	
Rent, Rates and Taxes	8,900	
Laundry	750	
Sales – Wines, Cigarettes, Cigars, etc.		68,400
- Food		57,600
Coal and Firewood	3,290	
Carriage and Cooliage	810	
Sundry Expenses	5,840	
Advertising	8,360	
Repairs	4,250	
Rent of Rooms		48,000
Billiard		5,700
Miscellaneous Receipts		2,800
Discount received		3,300
Transfer fees		700
Freehold Land and Building	8,50,000	
Furniture and Fittings	86,300	
Stock on hand, 1st April, 2011:		
Wines, Cigarettes, Cigars etc.	12,800	
Foodstuffs	5,260	
Cash in hand	2,200	
Cash with Bankers	76,380	
Preliminary and formation expenses	8,000	

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2,000 Debentures of Rs.100 each (6%)		2,00,000
Profit and Loss Account		41,500
Sundry Creditors		42,000
Sundry Debtors	19,260	
Investments	2,72,300	
Goodwill at cost	5,00,000	
General Reserve		2,00,000
	19,75,000	**19,75,000**
Wages and Salaries Outstanding	1,280	
Stock on 31st March, 2012:		
Wines Cigarettes and Cigars, etc.	22,500	
Foodstuffs	16,400	

- Depreciation : Furniture and Fittings @ 5% p.a.: Land & Buildings @ 2% p.a.
- The equity capital on 1st April 2011 stood at Rs.7,20,000 that is 6,000 shares fully paid and 2,000 shares Rs.60 paid.
- The directors made a call of Rs.40 per share on 1st October 20X1. A shareholder could not pay the call on 100 shares and his shares were then forfeited and reissued @ Rs.90 per share as fully paid.
- The directors propose a dividend of 8% on equity shares, transferring any amount that may be required from General Reserve.
- Ignore Taxation

Illustration – 3

From the following particulars furnished by Pioneer Ltd., prepare the Balance Sheet as at 31st March, 20X1 as required by Schedule III of the Companies Act. Give notes at the foot of the Balance Sheet as may be found necessary –

Equity Capital (Face value of		10,00,000
Rs.100) Calls in Arrears	1,000	
Land	2,00,000	
Building	3,50,000	
Plant and Machinery	5,25,000	
Furniture	50,000	
General Reserve		2,10,000
Loan from State Financial		1,50,000
Corporation		
Inventory:		

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Finished Goods	2,00,000		
Raw Materials	50,000	2,50,000	
Provision for Taxation			68,000
Trade receivables		2,00,000	
Advances		42,700	
Dividend Payable			60,000
Profit and Loss Account			86,700
Cash Balance		30,000	
Cash at Bank		2,47,000	
Loans (Unsecured)			1,21,000
Trade payables (For Goods and Expenses)			2,00,000
		18,95,700	18,95,700

The following additional information is also provided:

- 2,000 equity shares were issued for consideration other than cash.
- Trade receivables of Rs.52,000 are due for more than six months.
- The cost of assets:

  Building Rs.4,00,000
  Plant and Machinery Rs.7,00,000
  Furniture Rs.62,500

- The balance of Rs.1,50,000 in the loan account with State Finance Corporation is inclusive of Rs.7,500 for interest accrued but not due. The loan is secured by hypothecation of the Plant and Machinery.
- Balance at Bank includes Rs.2,000 with Perfect Bank Ltd., which is not a Scheduled Bank.
- The company had contract for the erection of machinery at Rs.1,50,000 which is still incomplete.

Illustration – 4

Due to inadequacy of profits during the year ended 31st March, 20X2, XYZ Ltd. proposes to declare 10% dividend out of general reserves. From the following particulars, ascertain the amount that can be utilised from general reserves, according to the Companies (Declaration of dividend out of Reserves) Rules, 2014:

	(Rs.)
17,500 9% Preference shares of Rs. 100 each, fully paid up	17,50,000
8,00,000 Equity shares of Rs. 10 each, fully paid up	80,00,000
General Reserves as on 1.4.20X1	25,00,000
Capital Reserves as on 1.4.20X1	3,00,000
Revaluation Reserves as on 1.4.20X1	3,50,000
Net profit for the year ended 31st March, 20X2	3,00,000

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Average rate of dividend during the last five year has been 12%.

Illustration 5

The following extract of Balance Sheet of X Ltd. was obtained:

Balance Sheet **(Extract)** as on 31st March, 20X1

Liabilities	Rs.
Authorised capital: 20,000, 14% preference shares of Rs.100	20,00,000
2,00,000 Equity shares of Rs.100 each	2,00,00,000
Issued and subscribed capital:	2,20,00,000
15,000, 14% preference shares of Rs.100 each fully paid	15,00,000
1,20,000 Equity shares of Rs.100 each, Rs.80 paid-up	96,00,000
Share suspense account	20,00,000
Reserves and surplus: Capital reserves (Rs. 1,50,000 is revaluation reserve)	1,95,000
Securities premium	50,000
Secured loans: 15% Debentures	65,00,000
Unsecured loans: Public deposits	3,70,000
Cash credit loan from SBI (short term)	4,65,000
Current Liabilities: Trade Payables	3,45,000
Assets:	**Rs.**
Investment in shares, debentures, etc.	75,00,000
Profit and Loss account (Debit balance)	15,25,000

Share suspense account represents application money received on shares, the allotment of which is not yet made.

You are required to compute effective capital as per the provisions of Schedule V. Would your answer differ if X Ltd. is an investment company?

Illustration – 6

The following is the Draft Profit & Loss A/c of Mudra Ltd., the year ended 31st March, 20X1:

	Rs.		**Rs.**

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To Administrative, Selling and distribution expenses	8,22,542	By Balance b/d	5,72,350
To Directors fees	1,34,780	By Balance from Trading A/c	40,25,365
To Interest on debentures	31,240	By Subsidies received from Govt.	2,73,925
To Managerial Remuneration	2,85,350		
To Depreciation on fixed Assets	522,543		
To Provision for Tax	12,42,500		
To General Reserve	4,00,000		
To Investment Revaluation Reserve	12,500		
To Balance c/d	14,20,185		
	48,71,640		**48,71,640**

Depreciation on fixed assets as per Schedule II of the Companies Act, 2013 was Rs.5,75,345. You are required to calculate the maximum limits of the managerial remuneration as per the Companies Act, 2013.

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Study Note – 3 | Cash Flow Statement

3.1 Introduction

INTRODUCTION

- ★ Cash flow Statement (CFS) is an ***additional information*** provided to the users of accounts in the form of an statement, which reflects the various sources from where cash was generated (inflow of cash) by an enterprise during the relevant accounting year and how these inflows were utilized (outflow of cash) by the enterprise.
- ★ Any transaction, which ***does not result in cash flow***, should not be reported.
  E.g.: Conversion of Debt into Equity, Depreciation charges, Acquisition of asset by issuing shares. Etc.
- ★ ***Movements within*** cash or cash equivalents are not cash flows.
- ★ A break-up of opening and closing cash shown as a note to cash flow statement.
- ★ ***Fundamental technique*** of cash flow preparation – It is difficult to compile a summary of cash transactions from cashbooks due to the large volume of transactions. Thus, it is possible to compile such a summary by comparing financial statements at the beginning and at the end of accounting period.

APPLICABILITY

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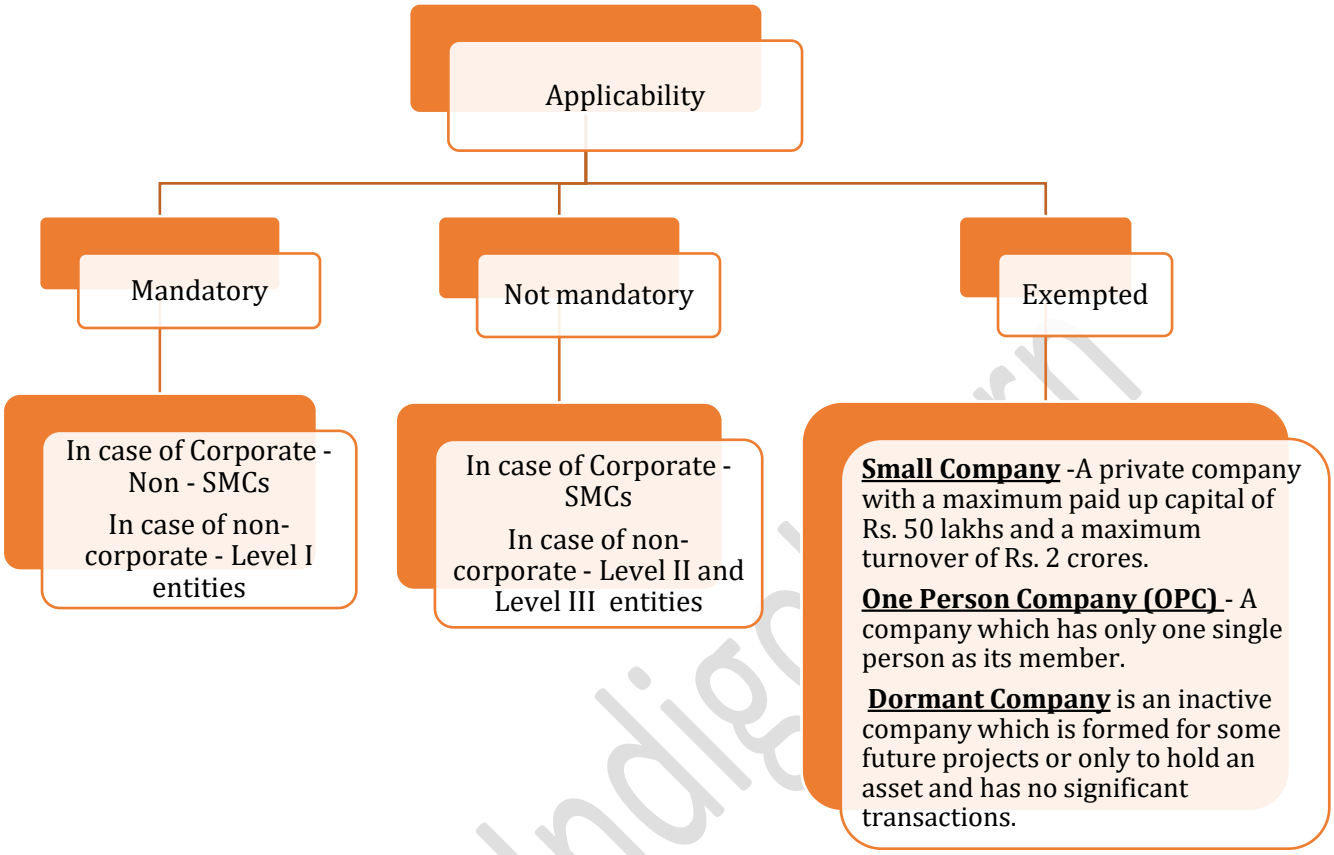

TRANSITION PROVISION

For all other enterprises though it is not compulsory, but it is encouraged to prepare such statements.

Where an enterprise was not covered by this statement during the previous year but qualifies in the current accounting year, they are not supposed to disclose the figures for the corresponding previous years. Whereas, if an enterprise qualifies under this statement to prepare the cash flow statements during the previous year but now disqualified, will continue to prepare cash flow statements for another two consecutive years.

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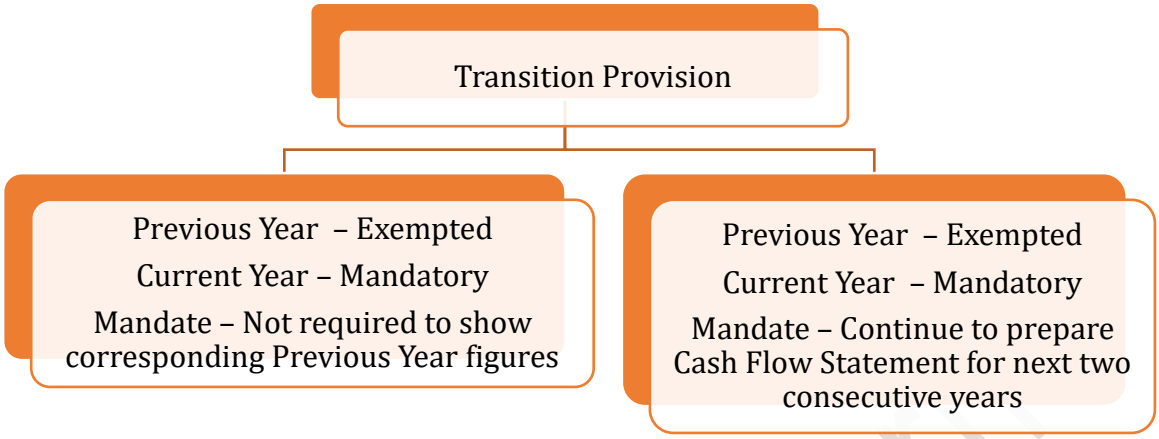

OBJECTIVE

- To identify the ***historical changes*** in the flow of cash & cash equivalents.
- To determine the ***future requirement*** of cash & cash equivalents.
- To study the ***insolvency and liquidity position*** of an enterprise.
- As an indicator of amount***, timing and certainty*** of future cash flows.
- To check the accuracy of ***past assessments*** of future cash flows
- In examining the ***relationship between profitability and net cash flow*** and the impact of changing prices.

BENEFITS

- Identifies cash generated from trading operations.
- The operating cash surplus which can be applied for investment in fixed assets.
- Portion of cash from operations is used to pay dividend and tax and the other portion is ploughed back.
- Very useful tool of planning

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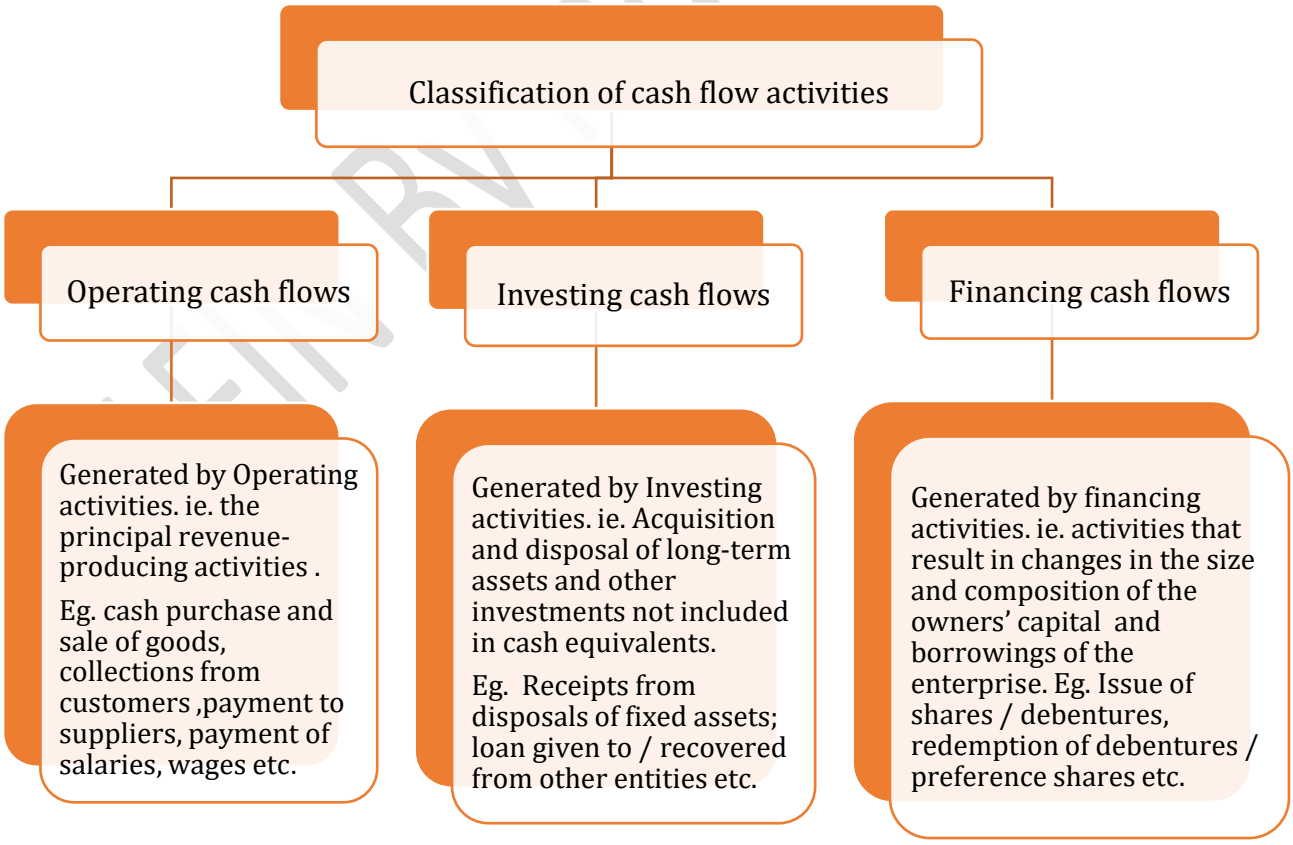
3.2 Meaning of Cash and Cash Equivalent

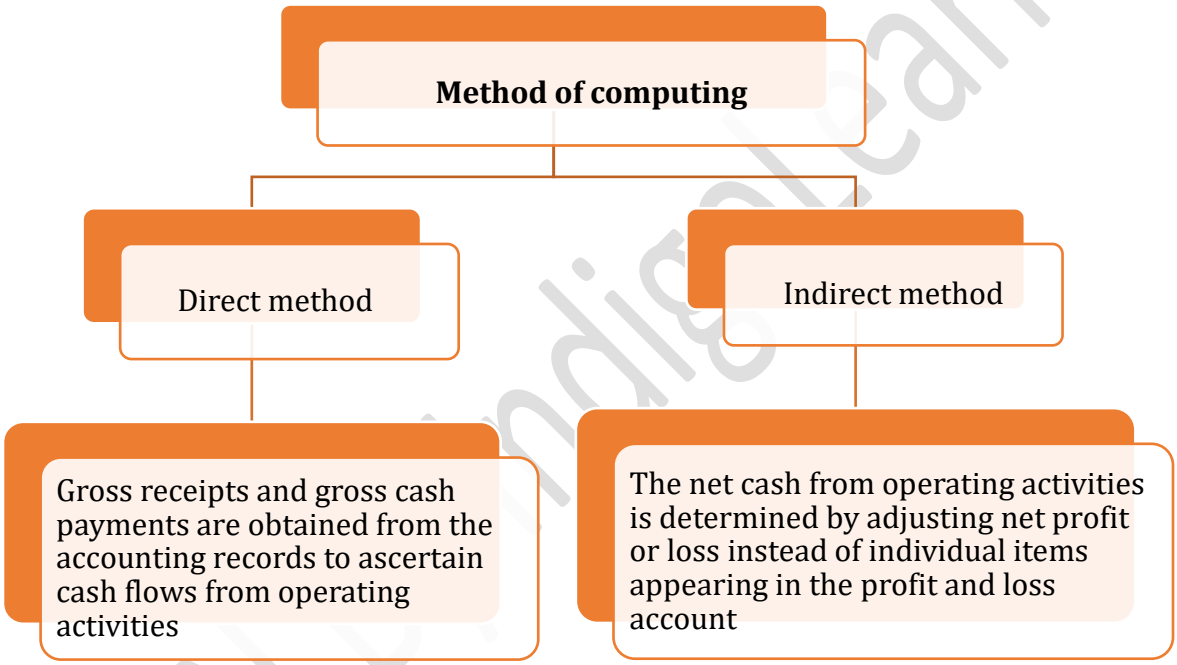
- Cash in Hand and at bank
- Demand deposits with banks and Financial Institutions
- Short term investments - highly liquid– Subject to insignificant risk of change in value.
  Eg: T-bills, Commercial papers, marketable securities
  Securities with short maturity period – Maturity within 3 months

3.3 TYPES OF CASH FLOW



Cash flow type depends on the business of the enterprise and other factors.
For example, since principal business of financial enterprises consists of borrowing, lending and investing, loans given, and interests earned are operating cash flows for financial enterprises and investing cash flows for other enterprises.

METHOD OF ACCOUNTING



1. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method.
2. Direct method adjusts individual items of profit and loss account and indirect method adjusts overall net profit (or loss) to determine cash from operation.
3. However, indirect method of determining the cash from operating activities is more popular in actual practice.
4. Cash flow from Financing activities and Investing activities are computed in the same manner under both the methods.

Format for Cash Flow from Operating activities under Direct method

Particulars	Amount	Amount
Operating Activities:		
Cash received from sale of goods	xxx	
Cash received from Trade receivables	xxx	
Cash received from sale of services	xxx	xxx
Less: Payment for Cash Purchases	xxx	
Payment to Trade payables	xxx	
Payment for Operating Expenses e.g. power, rent, electricity Payment for wages & salaries Payment for Income Tax	xxx xxx	(xxx)
Adjustment for Extraordinary Items		Xxx xxx
Net Cash Flow from Operating Activities		Xxx

Format for Cash Flow from Operating activities under Indirect method

Particulars	Amount	Amount
Net Profit for the year		Xxx
Add: Non-Cash and Non-Operating Expenses:	xxx	
Depreciation	xxx	
Loss on Sale of Assets	xxx	
Provision for taxation, etc.	xxx	
Less: Non-Cash and Non-Operating Incomes:		
Profit on Sale of Assets	xxx	
Net Profit after Adjustment for Non-Cash Items		(xxx)
Cash from operation		
Net Profit (after adjustment for Non-cash Items)	xxx	
(-) Increase in Current Assets	xxx	
(-) Decrease in Current Liability	xxx	
(+) Decrease in Current Asset	xxx	
(+) Increase in Current Liabilities	xxx	
Cash flow from Operating activities		Xxx

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CLASSIFICATION OF BUSINESS ACTIVITIES

OPERATING ACTIVITIES

Cash inflows:

1.Cash sales

2.Cash from fees, commission and other income

3.Cash received from debtors

Cash outflow:

1. Cash purchases

2.Cash paid for operating expenses like salaries, rent etc

3. Cash paid to creditors

4. Payment of Income tax

INVESTING ACTIVITIES

Cash inflows:

1. Proceeds from sale of fixed assets

2. Proceeds from sale of non-current assets

3. Interest received on debentures

4. Dividend received on shares

Cash outflow:

1. Purchase of fixed assets

2. Purchase of non-current assets

FINANCING ACTIVITIES

Cash inflows:

1. Proceeds from issue of shares / debentures

2. Loan raised (both long term and short term)

3.Increase in bank overdraft or cash credit

Cash outflow:

1.Payment for buy back of equity shares

2.Redemption of Preference shares/Debentures

3.Repayment of loans

4.Payment of dividend

5. Payment of Interest on loans

6. Payment of preliminary expenses

7. Decrease in bank overdraft or cash credit

Note: Profit or loss on sale of fixed asset is not operating cash flow. The entire proceeds of such transactions should be taken as cash inflow from **investing activity**.

Format for Cash Flow statement under Indirect method

Particulars	Amount	Amount
A. Cash flow from operating activities		
Net Profit for the year	xxx	Xxx
Add: Non-Cash and Non-Operating Expenses:	xxx	
Less: Non-Cash and Non-Operating Incomes:	xxx	
Operating profit before working capital changes		xxx
Add: Decrease in current assets & Increase in current liabilities	xxx	
Less: Increase in current assets & Decrease in current liabilities	xxx	
Cash generated from operations		
Less: Income tax paid (net of tax refund received)		xxx (xx)
Net cash from operating activities		xxx
B. Cash flows from Investing activities		
Cash inflows from investing activities (write each of them separately)	xxx	
Less: Cash outflows from investing activities (write each of them separately)	(xx)	
Net cash from Investing activities		xxx
C. Cash flow from Financing activities		
Cash inflows from investing activities (write each of them separately)	xxx	
Less: Cash outflows from investing activities (write each of them separately)	(xxx)	
Net Cash flow from Financing activities		xxx
Net increase (or decrease) in cash and cash		xxx

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equivalents (A +B+C)		
Add: Cash and cash equivalents in the beginning of the year		xxx
Cash and cash equivalents at the end of the year		**xxx**

TREATMENT OF SPECIFIC ITEMS

★Loans/Advances given, and Interests earned

Operating Cash Flow

- In case of financial enterprises – when it is earned in the ordinary course of business.
- In case of non-financial enterprises - when Interest is earned from customers for late payments
- In case of all enterprises – when,
  - Advances given to employees and interests earned on them
  - Advance payments to suppliers and interests earned on them

Investing Cash Flow

- In case of all enterprises - when given to subsidiaries and interests earned on them
- In case of non-financial enterprises – any transaction other than mentioned under operating cash flow

★Loans/Advances taken, and Interests paid

Operating Cash Flow

- In case of financial enterprises – when it is paid in the ordinary course of business.
- In case of non-financial enterprises - when advance is taken from customers and interest paid on them
- In case of all enterprises – when,
  - Interest paid to suppliers for late payment
  - Interest taken as part of inventory cost as per AS 16

Financing Cash Flow

- In case of all enterprises – when taken from subsidiaries and interests paid on them
- In case of non-financial enterprises – any transaction other than mentioned under operating cash flow

★ Extraordinary cash flows

- Separate disclosure by classifying them as cash flows from operating, investing or financing activities, as may be appropriate.
- Insurance claims received against loss of stock or loss of profits are **extraordinary operating cash inflows.**
- Insurance claims received against loss of fixed assets are **extraordinary investing cash inflows.**

★ Investments made and dividends earned

Operating Cash Flow

- In case of financial enterprises - when it is earned in the ordinary course of business

Investing Cash Flow

- In case of non-financial enterprises – Generally.
- In case of all enterprises - Investments in subsidiaries and dividends earned on them

★ Income Tax

Operating Cash Flow

- Tax paid on operating income
- Tax deducted at source on operating income and operating expense

Investing Cash Flow

- Tax deducted at source on Investing income e.g. Interest income

Financing cash flow

- Tax deducted at source on Financing expenditure e.g. Interest paid.

★ Interest and Dividends

Operating Cash Flow

- In case of financial enterprises - interest paid and interest and dividends received

Investing Cash Flow

- In case of non-financial enterprises - interest and dividends received

Financing cash flow

- In case of all enterprises – Dividends paid

★ Exchange gains and losses

- The foreign currency monetary assets (e.g. balance with bank, debtors etc.) and liabilities (e.g. creditors) are initially recognised by translating them into reporting currency by the rate of exchange on transaction date.
- On the balance sheet date, these are restated using the rate of exchange on the balance sheet date.
- The difference in values is exchange gain/loss. The exchange gains and losses are recognised in the statement of profit and loss.
- The change in cash or cash equivalents due to exchange gains and losses are however not cash flows. This being so, the net increases/decreases in cash or cash equivalents in the cash flow statements are stated exclusive of exchange gains and losses.
- The resultant difference between cash and cash equivalents as per the cash flow statement and that recognised in the balance sheet is reconciled in the note on cash flow statement.

★ Business Purchase

- The aggregate cash flows arising from acquisitions and disposals of subsidiaries or other business units should be presented separately and classified as cash flow from investing activities.
- The cash flows from disposal and acquisition should not be netted off.
- While taking the differences between closing and opening current assets and liabilities for computation of operating cash flows, the closing balances should be reduced by the values of current assets and liabilities taken over

★ Reporting Cash Flows on Net Basis

- Netting of receipts and payments from investing and financing activities is forbidden by AS3. i.e. cash paid on purchase of fixed assets should not be shown net of cash realised from sale of fixed assets.

- Exceptions to the above rule – For Financial enterprises
  - Cash flows on acceptance and repayment of fixed deposits with a fixed maturity date
  - Cash flows on placement and withdrawal deposits from other financial enterprises
  - Cash flows on advances/loans given to customers and repayments received there from.
- Exceptions to the above rule – For Investment companies
  - Cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short, e.g. purchase and sale of investments
  - Cash receipts and payments on behalf of customers.

DISCLOSURES

- AS 3 requires an enterprise to disclose the amount of **significant cash and cash equivalent balances held by it but NOT available for its use**, together with a commentary by management. This may happen for example, in case of bank balances held in other countries subject to such exchange control or other regulations that the fund is practically of no use.
- AS 3 encourages disclosure of **additional information**, relevant for understanding the **financial position and liquidity** of the enterprise together with a commentary by management. Such information may include:
  - The amount of undrawn borrowing facilities that may be available for future operating activities indicating any restrictions on the use of these facilities; and
  - The aggregate amount of cash flows required for maintaining operating capacity, e.g. additional machinery purchased to increase production.
- An enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:
  - The total purchase or disposal consideration; and
  - The portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

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Illustrations

Illustration 1

Following are the extracts of Balance Sheet of Ajay Ltd.:

Liabilities	31.3.20X1 (Rs.)	31.3.20X2 (Rs.)	Assets	31.3.20X1 (Rs.)	31.3.20X2 (Rs.)
Share Capital	5,00,000	5,00,000	Goodwill	1,15,000	90,000
15% Debentures	5,00,000	7,50,000			
Unpaid Interest	--	5,000	Discount on issue of Debentures	90,000	1,15,000
Profit & Loss A/c	50,000	90,000			

You are required to present the cashflow from financing activity, if Discount on issue of Debentures amounting to Rs. 10,000 has been written off during the year.

Illustration 2

The following summary cash account has been extracted from the company's accounting records:

Particulars	Amount (Rs. '000)	Amount (Rs. '000)
Balance at 1.3.20X1		35
Receipts from customers		2,783
Issue of shares		300
Sale of fixed assets		128
		3,246
Payments to suppliers	2,047	
Payments for fixed assets	230	
Payments for overheads	115	
Wages and salaries	69	
Taxation	243	
Dividends	80	
Repayments of bank loan	250	(3,034)
Balance at 31.3.20X2		212

Prepare Cash Flow Statement of this company Hills Ltd. for the year ended 31st March, 20X2 in accordance with AS-3 (Revised).

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The company does not have any cash equivalents.

Illustration 3

Given below is the Statement of Profit and Loss of ABC Ltd. and the relevant Balance Sheet information:

Statement of Profit and Loss of ABC Ltd. for the year ended 31st December 2013

Particulars	Rs.in lakhs
Revenue	
Sales	4150
Interest and dividend	100
Stock adjustment	20
Total Revenue(A)	**4270**
Expenditure	
Purchases	2400
Wages and salaries	800
Other expenses	200
Interest	60
Depreciation	100
Total Expenditure (B)	**3560**
Profit before tax(A-B)	**710**
Tax Provision	(200)
Profit after tax	**510**
Balance of Profit and Loss account brought forward	50
Profit available for distribution	**560**
Appropriations:	
Transfer to general reserve	200
Proposed dividend	300
Dividend Distribution Tax	30
Total Appropriations	**530**
Balance	**30**

Relevant Balance Sheet Information:

Particulars	Closing Balance Rs. in lakhs	Opening Balance Rs. in lakhs
Trade receivables	400	250
Inventories	200	180
Trade payables	250	230
Outstanding Wages	50	40
Outstanding expenses	20	10
Advance Tax	195	180

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Tax Provision-Assessed tax liability	200	180

Compute cash flow from operating activities using

1. Direct method and
2. Indirect method

Illustration 4

Prepare Cash Flow Statement of M/s MNT Ltd. for the year ended 31st March, Year 1 with the help of the following information:

1. Company sold goods for cash only
2. Gross Profit Ratio was 30% for the year, gross profit amounts to Rs.3,82,500.
3. Opening inventory was less than closing inventory by Rs.35,000
4. Wages paid during the year Rs.4,92,500
5. Office & selling expenses paid during the year Rs.75,000
6. Dividend paid during the year Rs. 30,000 (including dividend distribution tax)
7. Bank loan repaid during the year Rs.2,15,000 (including interest Rs.15,000)
8. Trade payables on 31st March, Year 0 exceed the balance on 31st March Year 1 by Rs.25,000
9. Amount paid to trade payables during the year Rs.4,60,000
10. Tax paid during the year amounts to Rs.65,000 (Provision for taxation as on 31st March of Year 1 Rs.45,000)
11. Investments of Rs.7,00,000 sold during the year at a profit of Rs.20,000
12. Depreciation on fixed assets amounts to Rs.85,000
13. Plant and Machinery purchased on 15th November of Year 0 for Rs.2,50,000
14. Cash and Cash equivalents on 31st March of Year 0 - Rs.2,00,000
15. Cash and Cash equivalents on 31st March of Year 1 – Rs.6,07,500

Illustration 5

Prepare Cash flow for Gamma Ltd., for the year ending 31.3.2014 from the following information:

(1) Sales for the year amounted to Rs.135 crores out of which 60% was cash sales.

(2) Purchases for the year amounted to Rs. 55 crores out of which credit purchase was 80%.

(3) Administrative and selling expenses amounted to Rs.18 crores and salary paid amounted to Rs. 22 crores.

(4) The Company redeemed debentures of Rs. 20 crores at a premium of 10%. Debenture holders were issued equity shares of Rs. 15 crores towards redemption and the balance was paid in cash. Debenture interest paid during the year was Rs1.5 crores.

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(5) Dividend paid during the year amounted to Rs. 11.7 crores (including Dividend distribution tax) was also paid.
(6) Investment costing Rs.12 crores were sold at a profit of Rs. 2.4 crores.
(7) Rs. 8 crores were paid towards income tax during the year.
(8) A new plant costing Rs. 21 crores were purchased in part exchange of an old plant. The book value of the old plant was Rs.12 crores but the vendor took over the old plant at a value of Rs.10 crores only. The balance was paid in cash to the vendor.
(9) The following balances are also provided:

	Rs. in crores 1.4.X0	**Rs. in crores 31.3.X1**
Debtors	45	50
Creditors	21	23
Bank	6	-

Illustration 6

From the following Balance Sheets of Mr. Zen, prepare a Cash flow statement as per AS-3 for the year ended 31.3.20X1:

Balance Sheets of Mr. Zen

Liabilities	**1.4.20X0**	**1.4.20X1**
Zen's Capital A/c	10,00,000	12,24,000
Trade payables	3,20,000	3,52,000
Mrs. Zen's loan	2,00,000	--
Loan from Bank	3,20,000	4,00,000
	18,40,000	19,76,000
Assets	**1.4.20X0**	**1.4.20X1**
Land	6,00,000	4,80,000
Plant and Machinery	6,40,000	8,80,000
Inventories	2,80,000	2,00,000
Trade receivables	2,40,000	4,00,000
Cash	80,000	56,000
	18,40,000	19,76,000

Additional information:
A machine costing Rs.80,000/- (accumulated depreciation there on 24,000/-) was sold for 40,000/-. The provision for depreciation on 1.4.20X0 was 2,00,000/- and 31.3.20X1 was 3,20,000/- The net profit for the year ended on 31.3.20X1 was 3,60,000/-.

Illustration 7

Ms. Jyoti of Star Oils Limited has collected the following information for the preparation of cash flow statement for the year ended 31st March, 20X1:

	(Rs. In lakhs)

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Net Profit	25,000
Dividend (including dividend tax) paid	8,535
Provision for Income tax	5,000
Income tax paid during the year	4,248
Loss on sale of assets (net)	40
Book value of the assets sold	185
Depreciation charged to Profit & Loss Account	20,000
Profit on sale of Investments	100
Carrying amount of Investment sold	27,765
Interest income on investments	2,506
Interest expenses of the year	10,000
Interest paid during the year	10,520
Increase in Working Capital (excluding Cash & Bank Balance)	56,081
Purchase of fixed assets	14,560
Investment in joint venture	3,850
Expenditure on construction work in progress	34,740
Proceeds from calls in arrear	2
Receipt of grant for capital projects	12
Proceeds from long-term borrowings	25,980
Proceeds from short-term borrowings	20,575
Opening cash and Bank balance	5,003
Closing cash and Bank balance	6,988

Prepare the Cash Flow Statement for the year 20X1 in accordance with AS 3.

Illustration 8

The following data were provided by the accounting records of Ryan Ltd. at year-end, March 31, 20X1:

Income Statement

	(Rs.)	(Rs.)
Sales		6,98,000
Cost of Goods Sold		(5,20,000)
Gross Margin		1,78,000
Operating Expenses		
(including Depreciation Expense of Rs.37,000/-)		(1,47,000)
		31,000
Other Income / (Expenses)		
Interest Expense paid	(23,000)	
Interest Income received	6,000	
Gain on Sale of Investments	12,000	
Loss on Sale of Plant	(3,000)	
		(8,000)

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		23,000
Income tax		(7,000)
		16,000

Comparative Balance Sheets

	31st March 20X1	31st March 20X0
Assets		
Plant Assets	7,15,000	5,05,000
Less: Accumulated Depreciation	(1,03,000)	(68,000)
	6,12,000	4,37,000
Investments (Long term)	1,15,000	1,27,000
Current Assets:		
Inventory	1,44,000	1,10,000
Accounts receivable	47,000	55,000
Cash	46,000	15,000
Prepaid expenses	1,000	5,000
	9,65,000	7,49,000
Liabilities		
Share Capital	4,65,000	3,15,000
Reserves and surplus	1,40,000	1,32,000
Bonds	2,95,000	2,45,000
Current liabilities:		
Accounts payable	50,000	43,000
Accrued liabilities	12,000	9,000
Income taxes payable	3,000	5,000
	9,65,000	7,49,000

Analysis of selected accounts and transactions during 20X0-X1

1. Purchased investments for Rs.78,000/-.
2. Sold investments for Rs.1,02,000/-. These investments cost Rs.90,000/-.
3. Purchased plant assets for Rs.1,20,000/-.
4. Sold plant assets that cost Rs.10,000/- with accumulated depreciation of Rs. 2,000/- for Rs.5,000/-.
5. Issued Rs.1,00,000/- of bonds at face value in an exchange for plant assets on 31st March, 20X1.
6. Repaid Rs.50,000/- of bonds at face value at maturity.
7. Issued 15,000 shares of Rs. 10/- each.
8. Paid cash dividends Rs. 8,000/-.

Prepare Cash Flow Statement as per AS-3 (Revised), using indirect method.

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Study Note – 4 | Accounting of Banking, Electricity and Insurance Company

4.1 Accounts of Banking Company

Meaning

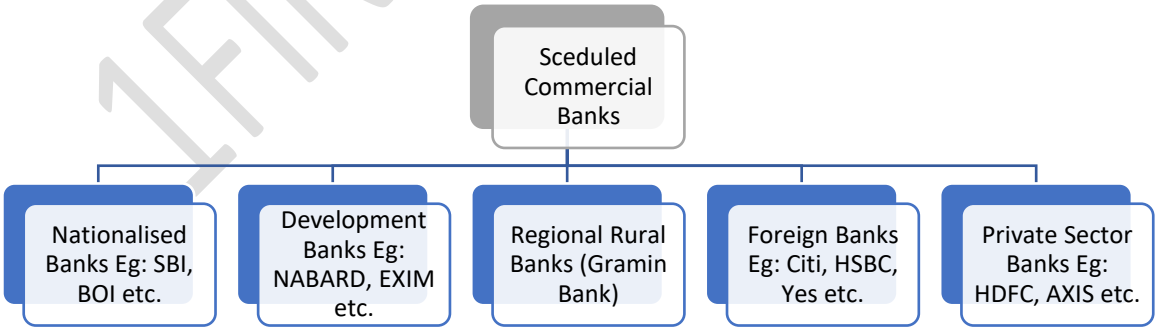
A Bank is a commercial institution which **accepts, collects, transfers, lends and exchange money both domestically and internationally** and there by circulates and manages money throughout the economy. In India banks and their activities are governed by the Banking Regulation Act, 1949.

According to section 5 of the Banking Regulation Act, 1949 a banking company means any company which transacts in

- Accepting deposits of money from public for the purpose of lending or investing
- These deposits are repayable on demand or otherwise, and can be withdrawn by cheque, draft or otherwise.

Types of Bank

Following is the broad categories of banks in India



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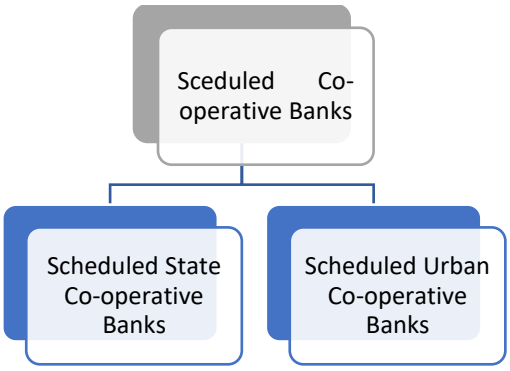

Functions of Commercial Bank

A) **Accepting Deposits:-** The most imp function of commercial bank is to accept deposits for the public. Ex Fixed deposit, saving deposit, Current deposit.

B) **Granting of Loans and Advances:-** The public deposits are used by commercial banks for the purpose of granting loans to individuals and businesses. Commercial banks grant loans in the form of overdraft, cash credit and discounting bills of exchange.

C) **Agency Functions:-** Bank functions in the form of agent and represents their customers for the following:-

   i) For collecting cheques, drafts, bills of exchange. Banks also collects dividends, pension, interests on investments etc. on behalf of their customers.

   ii) Banks arrange to send money from one place to another by the way of demand drafts, telegraphic transfers, travellers' cheques, etc.

   iii) Making payments of various obligations on behalf of their customers.

D) **Other Functions**:

   i) Issuing Letter of Credit, Guarantees.

   ii) Buying, Selling and dealing in Foreign Exchange.

   iii) Safe custody of securities and valuables.

   iv)

Statutory Provisions of Banking Regulation Act 1949

Capital and Reserve

Requirements as to minimum paid up capital and reserve (Section 11)

Cases	Paid up capital and reserve

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A) When Incorporated outside India :- **i)** Having place of business in Mumbai or Kolkata or both. **ii)** In other cities except Mumbai or Kolkata. All such companies are required to deposit with Reserve bank either in cash or in the form of unencumbered approved securities, the minimum amount of paid up capital and reserve	**i) Rs 20 lacs or more** **ii) Rs 15 lacs or more**
B) When Incorporated In India :- **i)** Having place of business in **more than one** state **and** it has a place or places of business in Mumbai or Kolkata or both. **ii)** Having place of business in **more than one state** but **not** in Mumbai or Kolkata **iii)** Having all its place of business in one state and none of which is situated in the Mumbai or Kolkata. **iv)** Having all is places of business in one state and one or more of which is situated in city of Mumbai or Kolkata. **C) When the banking company has only one place of business and it is not Mumbai or Kolkata.**	**i) Rs 10 lacs or more.** **ii) Rs 5 lacs or more** **iii) Rs 1 lakh in respect of all its principal places of business plus Rs 10,000 for its other places of business situated in the same district in which it has its principal place of business plus Rs 25000 in respect of each place of business elsewhere in the state.** **iv) Rs 5 lacs plus Rs 25,000 in respect of place of business outside Mumbai or Kolkata.** **Rs 50,000/-**

Regulation relating to authorized capital subscribed capital and paid up capital. (Section 12) - No banking company can carry on business in India unless it satisfies the following conditions:-

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1) Its subscribed capital shall not be less than half of its authorised capital and the paid up capital shall not be less than half of its subscribed capital.
2) Its capital consists of ordinary shares only or ordinary or equity shares and such preference shares as may have been issued prior to 1st April 1944
3) The voting right of any share holder cannot exceed 10% of the total voting rights.

Restriction on commission, brokerage, discount on sale of shares (Section 13)

No banking company shall pay out

- directly or indirectly,
- by way of Commission , brokerage, discount or remuneration,
- in respect of any shares issued by it,
- Any amount exceeding 2.5% of the paid up value of such shares.
-

Restriction as to payment of Dividend

No banking company shall pay any dividend on its shares until all its capitalised expenses including the following have been completely written off

- Preliminary Expenses
- Organisation Expenses
- Share Selling Commission
- Brokerage
- Amount of losses Incurred by tangible assets

Reserve Funds

Every banking company incorporated in India shall create a Reserve Fund and transfer to it at least **25%** of its annual profit before declaration of any dividend

Cash Reserve Ratio (CRR)

All the commercial banks have to maintain a certain minimum amount of deposit with Reserve Bank of India, at all the times for smoothly meeting cash payments requirements. This is called Cash Reserve Ratio (CRR).

The current Cash Reserve Ratio Rate is 4%

Statutory Liquidity Ratio (SLR)

Every bank in India has to maintain at the close of business every day a minimum portion of their net demand and time liabilities as liquid assets in the form of cash, gold and

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un-encumbered approved securities. The ratio of such liquid assets to demand and time liabilities is known as Statutory Liquidity Ratio (SLR).

Bank accounts from which you can withdraw your money at any time are called "Demand Liabilities" for bank. For Example: Savings Account, Current Deposits etc.

Bank accounts from which you can withdraw your money only after certain period of time are called "Time Liabilities" for bank. For Example: Fixed Deposits, Recurring Deposits etc.

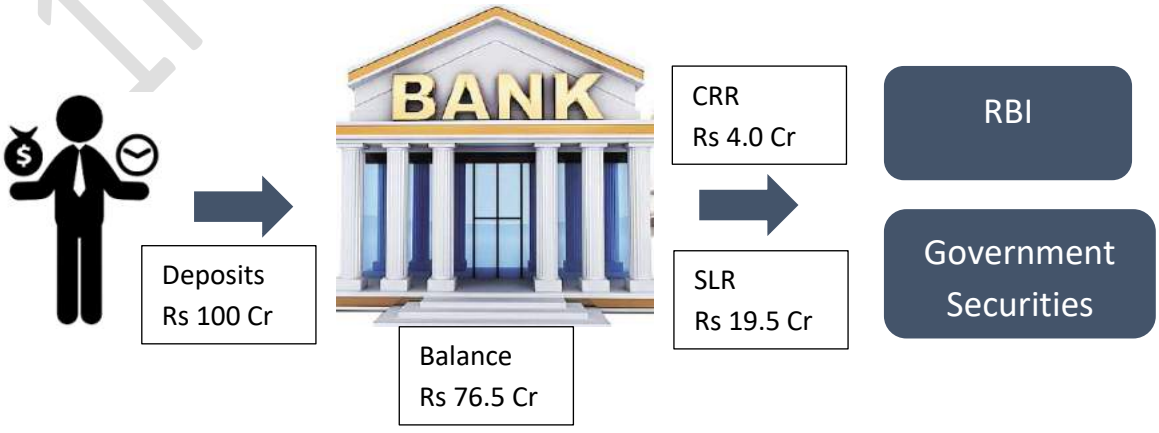
In simple words, Statutory Liquidity Ratio is percentage of total deposits that banks have to invest in government bonds and other approved securities.

The assets that are maintained as SLR Assets are as below:

- Cash
- Gold
- SLR Securities:
  - Dated Securities of Government of India
  - Treasury Bills of Government of India
  - State Development Loans of State Governments
- Deposits & Securities maintained with RBI (by a banking company incorporated outside India) under the Banking Regulation Act 1949
- Surplus balance maintained with RBI under the RBI Act 1934
- Current Account net balances in other commercial banks

Current SLR rate is 19.5% p.a.

For example, when total deposit in a bank is Rs. 100 Cr, and the current SLR rate is 19.5% and CRR is 4%, the bank will have to invest Rs. 19.5 Cr in SLR assets as mentioned above and maintain Rs. 4 Cr Cash Reserve with RBI



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In the above pictorial representation, the bank has Rs.76.5 Cr at its disposal for lending and investment purpose.

Restrictions of Loans and Advances

No Banking Company shall:

- Grant any loans or advances on the security of its own shares
- Grant any loans or advances to or on behalf of:
  - Any of its Directors
  - Any firm in which any of its Directors is interested as partner employee, manager or guarantor.
  - Any individual in respect of whom any of its Directors is a partner or guarantor.

Accounting System

A bank has a large number of customers whose accounts are to be maintained in such a way so that these should be kept up to date and can be checked regularly. Therefore it is very important that banks should have a proper system of book keeping.

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

- **Voucher posting** -Entries in the personal ledgers are made directly from vouchers
- **Voucher summary sheets**-From such entries in personal account each day summary sheets in total are prepared
- **Daily trial balance**-The general ledger's trial balance is extracted and agreed everyday
- **Control accounts**- A trial balance of detailed personal ledger is prepared periodically and gets agreed with general ledger.
- **Double voucher system**-Two vouchers are prepared for every transaction not involving cash- debit and credit voucher. This helps to increase the quality of internal check.

Slip (or Voucher) system of ledger posting

Under this system used in banking companies-

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- Entries in the personal ledger are made directly from the vouchers instead of being posted from the day book.
- Pay in slips (used by the customers at the time of making deposits) and the cheques are used as slip, which form the basis of transactions are directly recorded in the accounts of customers.
- The vouchers entered into different personal ledgers are summarized on summary sheets every day.
- Total of which are posted to the different control accounts which are maintained in general ledger.

This system helps in the division of labour and smooth flow of work.

Books of Accounts

In order to have proper track of voluminous transaction and internal check on the record of these transactions, banks are required to maintain Principal books of accounts along with its subsidiary books.

A) Principal Books of Accounts

i. **General Ledger** : It contains controls Accounts of all subsidiary ledgers and different assets and liabilities account

ii. **Profit and Loss Ledger** : Apart from one account for profit and loss in the General ledger some banks maintain separate books for detailed accounts. It provides information regarding income and operating expenses.

B) Subsidiary books

i) **Personal Ledgers** : Banks keep separate ledgers for different types of account Such as Current accounts, Savings accounts, Fixed Deposits accounts, Loans, Overdrafts etc.

ii) **Bills Registers**: These record transactions pertaining to different types of bills such as Bills purchased, Bills for Collection etc.

iii) **Other Subsidiary Registers**:
   a. Resisters For Demand Drafts, Telegraphic Transfers
   b. Letters Of Credit, Letter of Guarantee etc.

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C) Memorandum Books

i. **Departmental Journals** : Each department of the bank maintains a journal to record the entries passed by it. These are only memorandum entries and do not affect the Main Books of Account.

ii. **Cash Department** : The cash department maintains the following books-
   a) Receiving Cashiers Cash Book
   b) Paying Cashiers Cash Book
   c) Main Cash Book
   d) Cash Balance Book

iii. **Outward Clearing Department**: The following books are maintained-
   a) Clearing Cheques Received book
   b) Bank wise list of above cheques sent to the Clearing House

iv. **Loans and Overdrafts Department**
   a) Register of securities
   b) Overdraft Sanction Register etc.
   c) Storage Books, delivery order books
   d) Drawing Power books

Financial Reporting by Banking Companies

Reserve Bank of India has issued certain guidelines for preparation of profit and loss account and balance sheet by banking companies conducting affairs in India.

The financial statements are prepared in 18 schedules which are :-

- Schedules forming part of Form A- Balance sheet (Schedule 1 – Schedule 12)
- Schedules forming part of Form B- Profit and Loss Account (Schedule 13 – Schedule 16)
- Schedules forming Part of Annual Report-
  - Schedule-17 –Significant Accounting Policies.
  - Schedule-18-Notes forming part of accounts.

Notes to Accounts (Schedule - 18)

In addition to the 16 schedules to their Balance Sheet, banks are required to furnish in the 'Notes to Account' details such as:

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- Capital Adequacy Ratio; Tier I ; Tier II capital;
- Percentage of shareholding of the Government of India in the nationalised banks;
- The gross value of investments in India and outside India and the net value of investments in India and outside India;
- Provisions made towards depreciation in the value of investments and the movement of such provisions;
- Provisions of net NPAs to net advances; Provisions made towards NPAs and the movement of such provisions;
- Maturity pattern of investment securities, loans and advances, deposits, borrowings, foreign currency assets and liabilities;
- Details of 'Provisions and Contingencies'; provisions made during the year towards income tax, standard asset, floating provisions;
- Disclosures of business ratios such as interest income as a percentage to working funds; operating profit as a percentage to working funds; return in assets; business(deposits plus advances) per employee; and profit per employee
- Lending to sensitive sectors, which are sensitive to asset price fluctuation. These should include advances to sectors such as capital market, real estate,etc.
- Disclosures relating to repo transactions; non –SLR investment; forward rate agreement; and risk exposure in derivatives.

Disclosure of Accounting Policies

In order that the financial position of bank represents 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 to account in their financial statements. Such additional disclosures are regarding:-

- Concentration of Deposits, Advanced Exposures and NPAs
- Sector-wise NPAs;
- Movement of NPAs;
- Overseas assets ,NPAs and Revenue;
- Off –balance sheet SPVs sponsored by banks.

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Capital Adequacy Ratio (CAR)

Banks in the modern world face an inherent risk of insolvency. Hence if the banking system were to go bankrupt, the entire economy would collapse within no time. Therefore banks must have enough cushions to absorb such risk.

According to recommendation of Basel Committee, a banking company is required to maintain sufficient owner's fund to absorb unexpected losses which the banking company may suffer in future. To fulfill this requirement banks have to maintain Capital Adequacy Ratio based on capital funds and risk assets. It is just like bank's airbag.

Capital Adequacy Ratio mandates that a certain amount of deposits be kept aside whenever loan is being made.

For example:- Suppose CAR rate is 8% and loan given by bank is say RS 1,00,000 then the banks needs to maintain free capital for Rs 8,000 at that particular time.

Significance of Capital Adequacy Ratio

- It measures a bank's financial strength by using its capital and assets.
- It is used to protect depositors and promote the stability and efficiency of financial systems.

Currently the rate of CAR is 9%.

To calculate CAR we require two values:-

- **Capital Fund**
- **Risk Weighted Assets**

Capital fund of banking company is divided in 2 parts:-

- The primary Capital (TIER-I capital)
- Secondary Capital (TIER-II capital)

Primary Capital (Tier – I)

Tier – I capital is primary capital of banking company which is essentially the most perfect form of a bank's capital-the money the bank has stored to keep it functioning through all the risky transactions it performs, such as trading/investing and lending. It includes following elements:-

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• Ordinary Share capital • Non- Cumulative perpetual preference capital • Reserve and Surplus (Free Reserve and Statutory Reserve including share premium). • Innovative perpetual Debt Instruments. • Capital reserves which represent surplus arising out of the sale proceeds of the assets. Minus: • Equity Investment in Subsidiaries • Intangible assets. • Losses (current period + past carried forward)	XXX XXX XXX XXX XXX XXX XXX XXX
TIER –I CAPITAL	XXX

TIER-II Capital can be said to be subordinate capitals. It is not readily available to absorb unexpected losses. But on future it will be available for the same.

In calculation of CAR, Tier-II capital cannot be more than Tier-I capital.

(Tier I ≥ Tier II) i.e the quantum of tier II capital is limited to a maximum of 100% of tier I capital.

It includes:-

• Cumulative Perpetual Preference Capital • Undisclosed Reserve • 45% of Revaluation Reserve • General provisions and loss reserves, 'Floating Provisions' held by bank, Investment Reserve (subject to 1.25% of risk weighted asset) • Convertible Debentures/Hybrid Debts • Sub –ordinate debts (subject to 50% of tier-I capital)	XXX XXX XXX XXX XXX XXX
Total Tier-II Capital (subject to 100% of Tier –I capital)	XXX

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Risk Weighted Assets

Banks have various kinds of Assets on its balance sheets-Corporate loans, Personal loans, Sovereign loans etc. The riskiness also varies on the basis of type of loan. So these assets are given different weightage based on their riskiness in order to calculate Risk Weightage Assets. The riskier the asset, the higher the RWA and the greater the amount of regulatory capital required. The important weights for the purpose of Ascertainment of CAR are as follows:-

	BALANCE SHEET ITEMS	RISK WEIGHT %
1	Cash Balances with RBI	0
2	Balance with other Bank	20
3	Investment with Government Securities and loans and advances guaranteed by government	0
4	Other Investments and loans and advances	100
5	Other Assets	100
6	OFF BALANCE SHEET ITEMS	
7	Contingency Liability (Bill Guarantee / Bill Rediscounted/ Letter of Credit)	100
	Non Funded exposure to Real estate	150

Capital Adequacy Ratio = Capital Fund/Risk weighted Assets x100

Income Recognition

Bank has major source of its income from interest on loans and advances given to its customers. Income recognition form interest earned on such loans and advances is based on whether such assets are **Performing Assets or Non-Performing Assets.**

Performing Assets:- Any such assets that generates income on regular basis are called Performing Assets. Interest income generated from such assets is recognised on **Accrual Basis**.

Non-Performing Assets (NPA):- An Asset (loans & Advances) including lease assets becomes Non-Performing Assets when they cease to generate income for banks.

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In most of the cases, debt is classified as non-performing when loan payments have not been made for a period of 90 days. According to prudence norms interest income on NPA's cannot be recognised on accrual basis. It can be recognised only on **Cash Basis**.

Identification of Non Performing Asset

The Reserve Bank of India has issued guidelines to banks regarding identifying the NPA's which are:-

Type of Assets	Conditions for identifying as NPA
Bills purchased and discounted	When interest and principal remain overdue for more than 90 days from due date of bill.
Term Loans	When Interest and/or Installment of principal remain overdue for a period of more than 90 days.
Cash Credit/ Overdraft	The amount remains **out of order**** in respect of overdraft and cash credit for a period of more than 90 days.
Agricultural Advances	In case of short term crops: - If the amount is overdue for more than two crop season.
	Long term crops:- If the amount is due for more than one crop season.
Other Loans and Advances	If the amount is overdue for more than 90 days from its due date.
Derivative Transaction	Overdue receivables representing positive mark to market value of a derivative contact remaining unpaid for a period of 90 days from specified due date.

Exception:-

- Advances against term deposits, NSCs, IVPs, KVPs and life Insurance policies need not be treated as NPAs, till security cover is sufficient to cover outstanding balance.
- Income to be recognised subject to availability of margin.
- Advances against gold ornaments/ Government securities not exempt.
- Central government guaranteed advance to be classified as NPA only if Government repudiates the guarantee when invoked.

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**** Out of order**

A credit facility is considered as out of order if:-

- Such credit facility is over limit (amount withdrawn above the sanction limit) for a continuous period of more than 90 days.

  Or

  The amount deposited by borrower is not sufficient to bring the credit facility within the limit.

- If the credit facility is within the limit but there was no deposit for a continuous period of more than 90 days.

  Or

  Amount deposited is less than the interest accrues during the above period.

  Example:-

Sanctioned Limit	50 lacs
Drawing power	45 lacs
Amt outstanding from 01.01.16 to 31.03.16	30 lacs
Total Interest due	Rs 3,45,000
Total credits	Rs 1,50,000

  Since the credit in the account is not sufficient to cover the interest debited, during the period, account will be said as NPA.

Reversal of Income Credited for the Past Period

- Once any advance including bills purchased and discounted becomes NPA the entire interest **accrued and credited** to income account in the past periods should be reversed if the same is not realised.
- This will apply to government guarantee also.
-

Interest Suspense

Banking companies are allowed to recognize interest on NPA only on cash basis. So in final accounts we cannot record interest accrued on NPA in interest income account.

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To mark the advance with interest accrued we should open a dummy account named **INTEREST SUSPENSE ACCOUNT.**

Loans & Advances Dr
To Interest Suspense A/c

When the bank realises the amount from the borrower towards his outstanding balance whether in full or in part, at that time we recognise income for actual cash received in settlement

Interest Suspense A/c Dr
To Interest Income A/c (Actual Interest Received)

This income will be subsequently transferred to P/L Account

Interest Income A/c Dr
To P/L Account

Now reverse the irrecoverable portion of interest suspense with following entry:-

Interest Suspense A/c Dr
To Loans & Advances A/c

Entry for amount realised from loans and advances in final settlement

Cash A/c Dr
To Loans & Advances A/c

Balance due on loans & advances (Irrecoverable Principal amount) will be transferred to Bad debt A/c

Bad Debt's A/c Dr
To Loans & Advances A/c

Finally write off the Bad Debts against provision for NPA:-

Provision for NPA A/c Dr
To Bad Debt A/c

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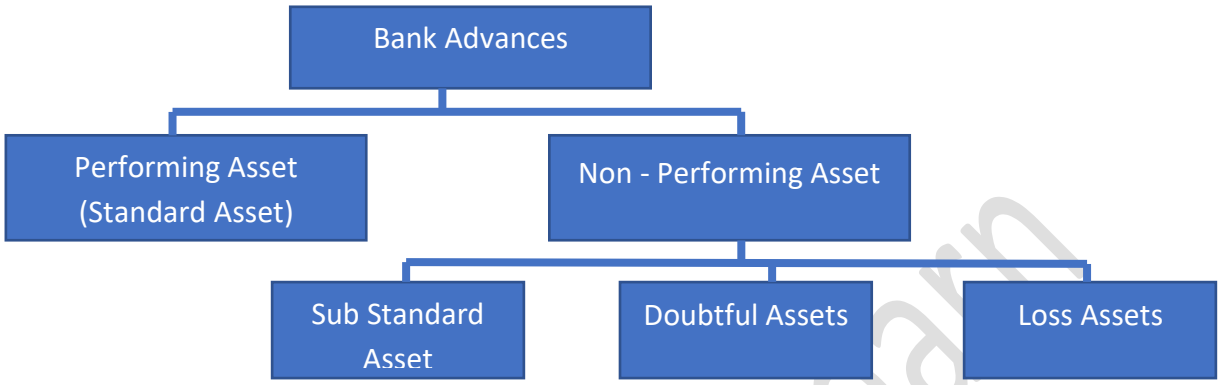
Classification of Bank Advances on basis of Performance

Banks advances can be classified as follows:-



Standard Asset:- Standard assets are those which do not carry any risk other than normal risk attached to the business.

Non – Performing Assets (NPA):

I. **Sub Standard Assets-** A Sub –standard asset is one which has been classified as NPA for a period not exceeding 12 months.
In such cases the security available to the bank is inadequate and there is a possibility that the bank may suffer some loss, if the deficiencies are not corrected.

II. **Doubtful Assets** – if an asset is a sub –standard asset for a period exceeding 12 months, it should be classified as doubtful assets.

III. **Loss Assets-** An asset may remain doubtful asset for a period of 3 years. But as soon as any of the following 3 authorities declare an advance as irrecoverable, then it will become Loss Assets.
- Officer of bank
- Auditor of bank (statutory or internal)
- Inspector of RBI during inspection.

In other words such an asset is considered uncollectible. However, only those advances are classified as loss assets where no security is available. In accounts where some security/ECGC/DICGC cover is available, these accounts are not reported under loss asset.

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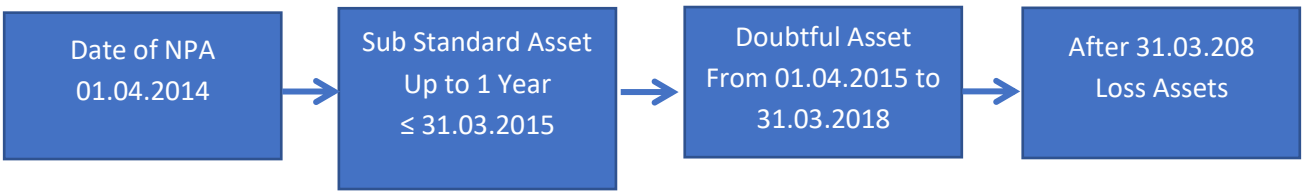
Illustration:



The classification of advances should be done taking into account:-

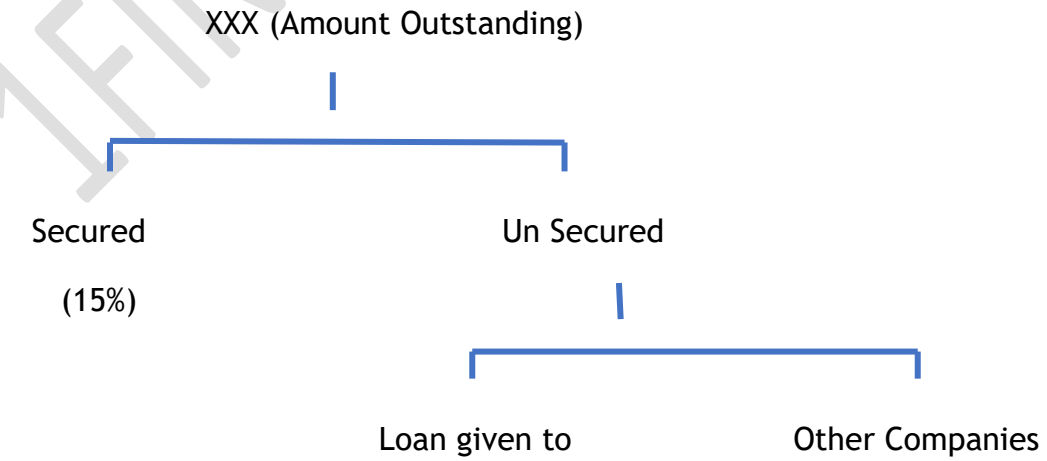
- Degree of well-defined credit weakness.
- Extent of dependence on collateral security for the recovery of dues.

Provisions: Rates of Provision on Loans & Advances

STANDARD ASSETS:

- Agricultural Loan and Small & Medium Enterprises 0.25%
- Non Funded Commercial Real Estate Advance 1.00%
- Other Loans and Advances 0.40%

SUB STANDARD ASSETS:



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Infrastructure companies And	(25%)
bank had sufficient safety measure	(20%)
DOUBTFUL ASSETS:	
XXX (Amount Outstanding)	
Secured	Un Secured
Years Rate	(100%)
≤ 1 : 25%	
1 - 3 : 40%	
>3 : 100%	
LOSS ASSETS:	
Written Off 100%	

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Provision for Advances covered by ECGC/DICGC Guarantee

- If a loan is classified as doubtful and guaranteed by ECGC (Export Credit Guarantee Corporation) or DICGC, then for such guaranteed part, bank is not required to create any provision for bad debts.
- In case the bank also holds a security in respect of advance guaranteed, the realisable value of security should be deducted from the outstanding balance before the guarantee is off set.

For example - ABC had taken loan of Rs 50 lakh from BOI. The loan is guaranteed by ECGC @ 40%. The loan has remained doubtful for more than 3 years. Bank also holds security in respect of advance having realisable value of 20 lakhs.

Here the provision will be calculated as:- Rs 50 Lakh less Rs 20 lakh (value of security). From Balance of 30 lakhs ECGC cover will be deducted @40% = 18 lakh(30 lakh-30 lakh x 40%). On 18 lakh 100% provision will be made. And on secured portion i.e 20 lakh also 100% provision will be made as it is doubtful for more than 3 years i.e, Total Provision =(18+20= 38 lakh).

Classification of Advances:

The entire Investment Portfolio of the banks (including SLR securities and non-SLR Securities are classified under three categories: -

- Held to Maturity
- Available for Sale
- Held for Trading

Held to Maturity (HTM) :-

- Held to Maturity investments are investments made by bank, which it intends to hold till maturity.
- Only debt securities can be classified as held to maturity because they have a definite maturity.
- Investments under this category should not exceed 25 per cent of the total investment.

VALUATION: - They appear on the balance sheet at the Amortized Cost (Meaning the Initial acquisition Cost plus any additional cost incurred to date.)

Held- For-Trading (HFT): - These are financial assets that are held with the sole intent of generating short term profits. Such investments are held for a short period of time. These securities are to be sold within 90 days.

VALUATION: - A held for trading investment is reported at its fair value on the balance sheet and any change in the fair value during a period and any dividend or interest income over the period is recognised in the profit or loss for the period.

Available -For -Sale (AFS):-

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- Securities which do not fall within the above two categories should be classified as 'Available for Sale'.
- The banks can decide the extent of holding under HFT and AFS based on the various aspects.

VALUATION: - Available for sales are also valued at the fair value. Any resulting gain or loss is recorded to an unrealised gain and loss account.

Illustrations

Illustration 1

A commercial bank has the following capital funds and assets. Segregate the capital funds into Tier I and Tier II capitals. Find out the risk-adjusted asset and risk weighted assets ratio –

Capital Funds:	Rs. Lakh
Equity Share Capital	4,80,00
Statutory Reserve	2,80,00
Capital Reserve (of which ₹ 280 lakhs were due to revaluation of assets and the balance due to sale)	12,10
Assets:	
Cash Balance with RBI	4,80
Balances with other Bank	12,50
Claims on Banks	28,50
Other Investments	782,50
Loans and Advances:	
i. Guaranteed by government	128,20
ii. Guaranteed by public sector undertakings of Government of India	702,10
iii. Others	52,02,50
Premises, furniture and fixtures	182,00
Other Assets	201,20
Off-Balance Sheet Items:	

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Acceptances, endorsements and letters of credit	37,02,50

Illustration 2

Following facts have been taken out from the records of Adarsha Bank in respect of the year ending March 31, 2012:

a. On 1-4-2011 Bills for collection were Rs.7, 00,000. During 2011-2012 bills received for collection amounted to Rs.64, 50,000, bills collected were Rs.47, 00,000 and bills dishonoured and returned were Rs.5, 50,500. Prepare Bills for Collection (Assets) A/c and bills for Collection (Liability) A/C.

b. On 1-4-2011, Acceptance, Endorsement, etc. not yet satisfied amounted to Rs.14, 50,000. During the year under question, Acceptances, Endorsements, Guarantees etc., amounted to Rs.44, 00,000. Bank honoured acceptances to the extent of Rs.25, 00,000 and client paid off Rs.10, 00,000 against the guaranteed liability. Clients failed to pay Rs.1, 00,000 which the Bank had to pay. Prepare the "Acceptances, Endorsements and other Obligations A/c" as it would appear in the General ledger.

c. It is found from the books, that a loan of Rs. 6, 00,000 was advanced on 30-9-2011 @ 10 per cent p.a. interest payable half yearly; but the loan was outstanding as on 31-3-2012 without any payment recorded in the meantime, either towards principal or towards interest. The security for the loan was 10,000 fully paid shares of Rs. 100 each (the market value was Rs. 98 as per the Stock Exchange information as on 30th Sept., 2011). But due to fluctuations, the price fell to Rs.40 per share in January, 2012. On 31-3-2012, the price as per Stock Exchange rate was Rs.82 per share. State how you would classify the loan as secured/unsecured in the Balance Sheet of the Company.

Illustration 3

The outstanding amount (funded as well as unfunded) as on 31st March 2011 was ₹10,000. The realizable value of security of the same was ₹8,000. Period for which the advance has remained in 'doubtful' category as on 31st March 2011 was: 2.5 years.

Compute the total provision required for year ended 31st March 2011 and 31st March 2012 as per relevant banking provisions.

Illustration 4

From the following information, find out the amount of provisions to be shown in the Profit and Loss Account of AG bank.

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Assets		**₹In lakhs**
Standard		5,000
Sub-standard		4,000
Doubtful	: for one year	800
	: for three years	600
	: for more than three years	200
Loss Assets		1,000

Illustration 5

From the following information of AY Limited, compute the provisions to be made in the Profit and Loss account:

	₹ In lakhs
Assets	
Standard	20,000
Substandard	16,000
Doubtful	
For one year (secured)	6,000
For two years and three years (secured)	4,000
For more than three years (secured by mortgage of plant and machinery ₹600 lakhs)	2,000
Loss Assets	1,500

Illustration 6

From the following information, compute the amount of provision as per applicable banking provisions.

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Outstanding Balance	₹ 4 lakhs
ECGC Cover	50%
Period for which the advance has remained doubtful	More than 3 years remained doubtful (as on March 31, 2011)
Value of security held	₹1.50 lakhs

Illustration 7

In KR Bank, the doubtful assets (more than 3 years) as on 31.3.2011 is ₹ 1,000 lakhs. The value of security (including DICGC 100% cover of ₹100 lakhs) is ascertained at ₹500 lakhs. How much provision must be made in the books of the Bank towards doubtful assets?

Illustration 8

A loan outstanding of ₹50, 00, and 000 has DICGC cover. The loan guaranteed by DICGC is assigned a risk weight of 50%. What is the value of Risk-adjusted asset?

Illustration 9

The following is an extract from Trial Balance of overseas Bank as at 31st March, 2011

	₹	₹
Bills discounted	12,64,000	
Rebate on bills discounted not due on March 31st, 20X0		22,160
Discount received		1,05,708

An analysis of the bills discounted is as follows:

	Amount	Due Date 2011	Rate of Discount
	₹		(%)
(i)	1, 40,000	June 5	14

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(ii)	4, 36,000	June 12	14
(iii)	2, 82,000	June 25	14
(iv)	4, 06,000	July 6	16

Calculate Rebate on Bills Discounted as on 31-3-2011 and show necessary journal entries.

Illustration 10

On 31st March, 2011, Uncertain Bank had a balance of ₹ 9 crores in "rebate on bills discounted" account. During the year ended 31st March, 2012, Uncertain Bank discounted bills of exchange of ₹4,000 crores charging interest at 18% per annum the average period of discount being for 73 days.

Of these, bills of exchange of ₹600 crores were due for realisation from the acceptors/customers after 31st March, 2012, the average period outstanding after 31st March, 2012 being 36.5 days.

Uncertain Bank asks you to pass journal entries and show the ledger accounts pertaining to:

(i) discounting of bills of exchange and
(ii) rebate on bills discounted.

Illustration 11

The following information is available in the books of X Bank Limited as on 31st March, 2012:

	₹
Bills discounted	1,37,05,000
Rebate on Bills discounted (as on 1.4.2011)	2,21,600
Discount received	10,56,650

Details of bills discounted are as follows:

Value of bill (₹)	Due date	Rate of Discount

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18,25,000	5.6.2012	12%
50,00,000	12.6.2012	12%
28,20,000	25.6.2012	14%
40,60,000	6.7.2012	16%

Calculate the rebate on bills discounted as on 31.3.2012 and give necessary journal entries.

Illustration 12

From the following information, prepare a Balance Sheet of ADT International Bank as on 31st March, 2011 giving the relevant schedules and also specify at least four important Principal Accounting Polices:

Rs in Lakhs

Particulars	Dr	Cr
Share Capital		198.00
19,80,000 Shares of Rs. 10 each		
Statutory Reserve		231.00
Net Profit before Appropriation		150.00
Profit and Loss Account		412.00
Fixed Deposit Account		517.00
Savings Deposit Account		450.00
Current Accounts	28.00	520.12
Bills Payable		0.10
Cash credits	812.10	
Borrowings from other Banks		110.00
Cash in Hand	160.15	
Cash with RBI	37.88	
Cash with other Banks	155.87	
Money at Call	210.12	
Gold	55.23	
Government Securities	110.17	
Premises	155.70	
Furniture	70.12	
Term Loan	792.88	
Total	**2,588.22**	**2,588.2**

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		2

Additional Information:

Bills for collection	18,10,000
Acceptances and endorsements	14,12,000
Claims against the Bank not acknowledged as debt	55,000
Depreciation charges—Premises	1,10,000
Furniture	78,000

50% of the Term Loans are secured by Government guarantees. 10% of cash credit is unsecured

Illustration 13

From the following information, prepare Profit and Loss A/c of Dimple Bank as on 31-3-2013:

Item	**Rs. in '000**
	2012-13
Interest and Discount	20,45
Income from investment	1,12
Interest on Balances with RBI	1,77
Commission, Exchange and Brokerage	7,12
Profit on sale of investments	1,22
Interest on Deposits	8,22
Interest to RBI	1,47
Payment to and provision for employees	8,55
Rent, taxes and lighting	1,79
Printing and stationery	2,12
Advertisement and publicity	98
Depreciation	98
Director's fees	2,12
Auditor's fees	1,10
Law charges	1,52
Postage, telegrams and tel. Ph	62

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Insurance	52
Repair & maintenance	66

Also give necessary Schedules

Other Information:

(i) The following items are already adjusted with Interest and Discount (Cr.):

Particulars	**Rs. In `000**
Tax Provision	1,48
Provision for Doubtful Debts	92
Loss on sale of investments	12
Rebate on Bills discounted	55

(ii) Appropriations:

- 25% of profit is transferred to Statutory Reserves.
- 5% of profit is transferred to Revenue Reserve.

Illustration 14

From the following information, prepare Profit and Loss A/c of KC Bank for the year ended 31st March, 2011

Items	**Rs in '000**
Interest on cash credit	18,20
Interest on overdraft	7,50
Interest on term loans	15,40
Income on investments	8,40
Interest on balance with RBI	1,50
Commission on remittances and transfer	75
Commission on letters of credit	1,18
Commission on government business	82
Profit on sale of land and building	27
Loss on exchange transactions	52
Interest paid on deposit	27,20

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Auditors' fees and allowances	1,20
Directors' fees and allowances	2,50
Advertisements	1,80
Salaries, allowances and bonus to employees	12,40
Payment to Provident Fund	2,80
Printing and stationery	1,40
Repairs and maintenance	50
Postage, telegrams, telephones	80

Other Information

i. Interest on NPA's is as follows

Rs. in '000s

	Earned	**Collected**
Cash Credit	8,20	4,00
Over Draft	4,50	1,00
Term Loans	7,50	2,50

ii. Classification of NPA's

	Rs. in '000s
Standard	30,00
Sub-Standard	11,20
Doubtful assets not covered by security	2,00
Doubtful assets covered by security for 1 year	50

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Loss Assets	2,00

iii. Investments Rs 27, 50,000. Bank should not keep more than 25% of its investment as 'held-for-maturity' investment. The market value of its rest 75% investment is Rs. 19,75,000 as on 31-3-2011

4.2 Accounts for Insurance Companies

UNDERSTANDING INSURANCE:

A. Overview of the concept:

Insurance is a contract containing agreed terms wherein	Insurance policy
one party undertakes to indemnify	Insurer (Insurance company)
specified losses	Claim
suffered by the other party	Insured
for a special consideration	Premium

Two major types (references in definitions below) are:

- ✓ Life insurance
- ✓ General insurance (fire, marine, other miscellaneous)

B. Key terms used in insurance business:

1. Insurance policy

- ✓ The document issued by the insurance company containing terms of insurance contract.
- ✓ Specifies the losses that are covered and also the maximum amount payable (known as the policy amount).

2. **Premium**
   - ✓ Payment made by the insured to the insurance company as a consideration for undertaking to indemnify specified losses suffered by the insured
   - ✓ Is generally paid annually (maybe at shorter intervals too)
   - ✓ Is to be paid front end i.e. before commencement of the insurance policy

3. **Claim**
   - ✓ Liability that occurs when a policy falls due for payment i.e. on death or maturity of policy in case of life insurance, and on incurring of loss in case of general insurance
   - ✓ A separate claims account is prepared by insurance company. At year end, the insurance company must provide for both claims intimated but not accepted, as well as claims accepted but not paid (since a year end provision, it is reversed on 1st day of next year)

4. **Surrender value**
   - ✓ Amount becoming due when the policy holder surrenders his right under the policy (in order to realize the amount of policy) before expiry of full term of the policy
   - ✓ Calculated basis a fixed formula

5. **Commission**
   - ✓ Represents amount paid to agents who generate business for the insurance company
   - ✓ Is usually paid on the basis of insurance premium generated by the agent

6. **Bonus**
   - ✓ Applicable to life insurance only
   - ✓ Life insurance policy may be "without profits" or "with profits"

On maturity, holder is entitled to receive ONLY the amount specified in the policy	On maturity, in addition to specified amounts, holder is entitled to receive bonuses declared on each valuation

   - ✓ Primarily represents excess of credit balance in Life Fund over net liability.
   - ✓ Is determined by actuary on each valuation, and distributed as bonus on maturity or alternatively, in cash on declaration or as reduction of future premiums
   - ✓ Reversionary bonus – when paid at the time of claim
   - ✓ Interim bonus – when paid intermittently to a policyholder, before completion of valuation, without exact profit/bonus having being determined

7. **Reinsurance**
   - ✓ Insurance taken by an insurance company to reinsure a part/whole of risk assumed by it
   - ✓ Such insurance company giving up its business / risk - Ceding company
   - ✓ Second insurance company assuming the risk - Reinsurer
   - ✓ Ceding company shares premium it has received to cover the risk, with Reinsurer

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- ✓ Reinsurer pays commission to Ceding company for providing business (income for Ceding company and expense for Reinsurer)
- ✓ Where claim arises, it is shared in pre-agreed proportions

> *Reinsurance business transaction is an agreement between Ceding Company and Reinsurer wherein former agrees to give up and latter agrees to take up certain specified share of risk in return for a share of premium*

8. Co-insurance

- ✓ Sharing of business in case of large risks
- ✓ Shared between more than one insurers under co-insurance arrangements at agreed percentages
- ✓ Leading insurer issues documents, collects premium and settles claims, and shares Statement of Accounts with this information with other co-insurers

9. Paid up policy

- ✓ Applicable only to life insurance
- ✓ Where holder is unable to pay future premiums, he may request for conversion into paid up policy
- ✓ Insured amount is then reduced proportionately basis the premiums paid, i.e.

$$\text{Paid up value} = \frac{\text{Sum assured}}{\text{Total Number of premium payable}} \times \text{Number of Premium paid}$$

10. Annuity

- ✓ A contract that provides for an income for a specific period of time (X number of years or life)
- ✓ Such annuity payments could be monthly, quarterly, half yearly or yearly
- ✓ Person receiving the payment is called annuitant

11. Catastrophic loss

- ✓ Loss which is unbearable i.e. causes severe consequences like bankruptcy to family, organization or insured

12. Bonus in reduction of premium

- ✓ Applicable to general insurance
- ✓ General insurance policies are usually taken for one year, after which they expire and need to be renewed
- ✓ In case of renewal, insurance company usually grants certain reduction in premium if no claim was made by the insured in the preceding year
- ✓ Such reduction is called bonus in reduction of premium
- ✓ The rate of reduction increases if no claim is made year after year
- ✓ For an insurance company, it is an expense and is accounted as:

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Bonus in reduction of premium account Dr.
To Premium account

KEY INSURANCE PRINCIPLES:

Insurable Interest

Having a vested interest in the contract

- Insurance contracts cannot be entered into by anyone
- Every policy insists upon insurable interest
- E.g. A can insure life of B if B is his spouse, debtor, business manager etc., and NOT if B is a total stranger
- A contract without insurable interest = wagering contract

Principle of Indemnity

To compensate for losses suffered

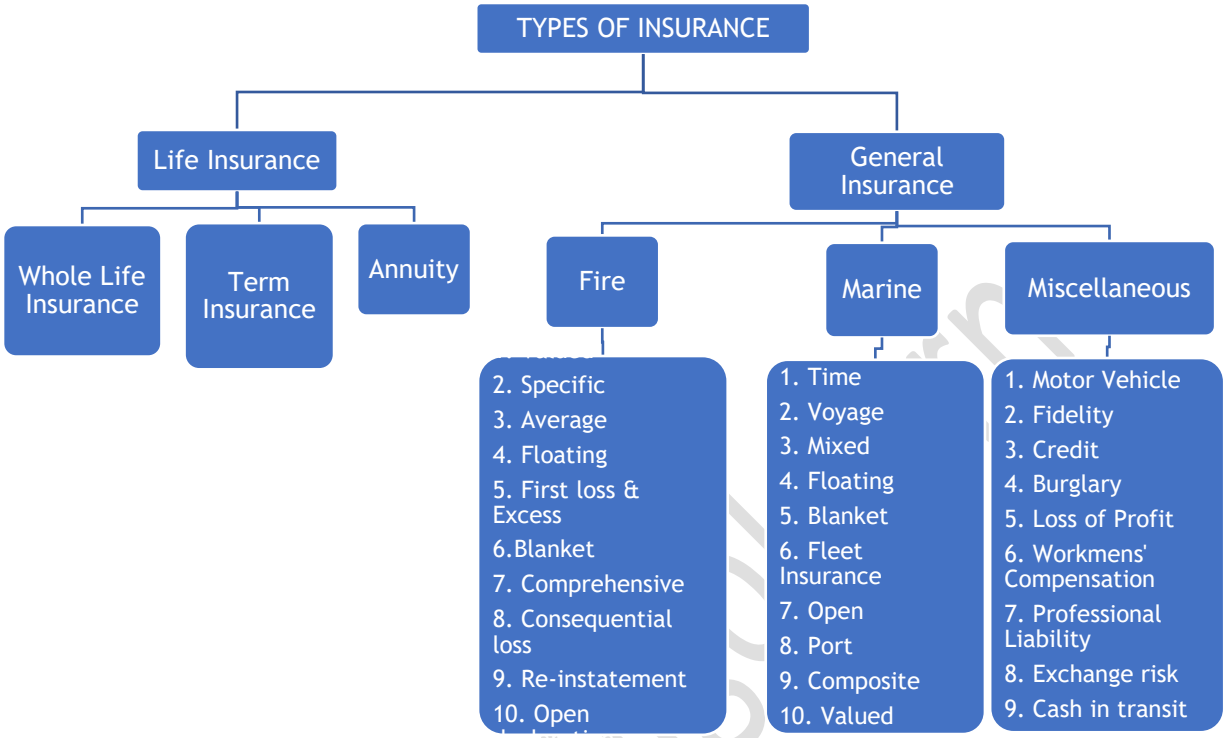
- Insurance contract is a contract of indemnity
- Insurer indemnifies the insured for loss incurred
- One cannot make profit by insuring his risks

Principle of *uberrimae fidei*

Uberrimae Fidei means utmost good faith

- Under ordinary law, there is no positive duty to tell whole truth. Only a negative obligation to tell nothing but the truth
- Insurance contract is however a contract of uberrima fidei - contract of utmost good faith
- There must be full and frank disclosure of all material facts. Assessment of risk and determination of premium depends upon the same

TYPES OF INSURANCE:



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A. LIFE INSURANCE

28. Covers 'life-risk' of the person insured

29. In the event of death, nominee gets policy amount

30. Since the event (death) is bound to occur, it is also called life **assurance**

31. Types of Life Assurance (based on when policy amount is paid):

    a) Whole Life Assurance: Policy amount is paid only on death of the insured
    b) Tem Assurance: Policy amount is paid in lumpsum on maturity of the term of the policy (say 20 years or so)
    c) Annuity: On maturity, policy amount is paid in instalments (say monthly)

B. GENERAL INSURANCE

1. Covers insurance other than life insurance

2. Insurance Act definition of 'General Insurance business': Fire, marine or miscellaneous insurance business whether carried on singly or in combination with one or more of them

3. Usually policy is taken for one year and renewed yearly

4. **Insured gets compensation only when he suffers losses due to reasons specified in the policy**

5. Types:

   a) Fire Insurance:

   ✓ Covers risk of loss of property by accidental and non-intentional fire

   ✓ Contract usually specifies the agreed amount upto which Insurer agrees to indemnify the insured

   ✓ Types (based on what is being insured and to what level/quantum):

(i)	Valued policy	– Value of property is ascertained, which the insurer undertakes to pay in event of destruction by fire – Not very common these days
(ii)	Specific policy	– Insures as risk for specific amount – Insurer pays whole loss provided it is not more than sum specified in the policy – Thus, value of goods/property is not considered
(iii)	Average policy	– Contains 'average clause', i.e. if property is under-insured and loss happens, insurer will bear actual loss only in that proportion as sum assured bears to value of property at the time of loss
(iv)	Floating policy	– Covers several types of goods lying at different locations under one amount and one premium – Premium is normally average of premium that would have been paid if each lot of goods had been insured specifically and separately
(v)	First loss policy & Excess policy	– Taken when stocks of the insured fluctuate – Policy taken for minimum amount below which his stocks do no normally fall: First loss policy – And another policy for maximum amount of stocks: Excess Policy
(vi)	Blanket policy	– Covers all assets (fixed and current) under one policy

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(vii)	Comprehensive policy	– Covers risks such as fire, flood, riots, strikes, burglary etc. upto a certain specified amount
(viii)	Consequential loss policy	– Indemnifies the insured against loss caused by interruption of business due to fire – Also known as loss of profit policy
(ix)	Re-instatement policy	– Insurer pays amount which is sufficient to re-instate assets or property damaged
(x)	Open declaration policy	– Insured makes a deposit with the insurer and declares the value of subject matter in respect of which risk is covered – Usually taken when value of stocks etc. fluctuates considerably

b) Marine Insurance

✓ Oldest type of insurance

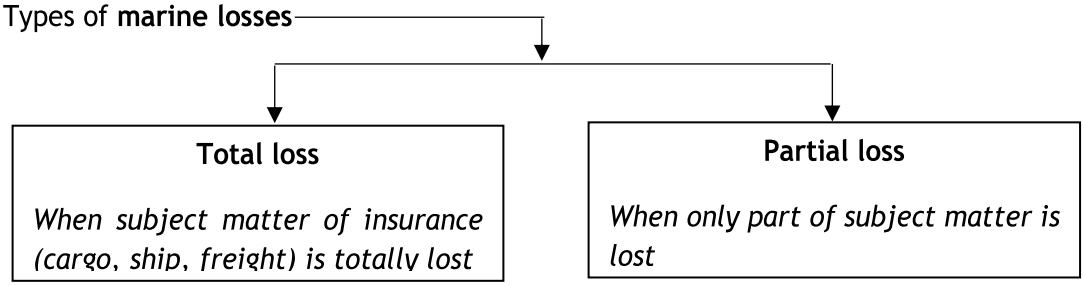
✓ Insurer agrees to indemnify the owner of ship / cargo against risks incidental to a marine adventure viz. sinking / burning of the ship / its contents, stranding of the ship, collision, jettison (throwing cargo into the sea to save the ship) etc.

✓ Types of **marine insurance** (based on what is being insured):

(i)	Cargo insurance	Covers risks arising act of God, enemies, fire etc. to **the cargo** of the ship
(ii)	Hull insurance	Covers risks arising act of God, enemies, fire etc. to **the ship**
(iii)	Freight insurance	Covers loss of **freight** to shipping company in the event cargo gets destroyed on the way and freight charges had to be paid by the owner of goods after cargo was safely delivered

✓ Underwriters: Persons who insure cargo, hull or freight (since they sign and write their name at the foot of the policy)

✓ Types of **marine losses**



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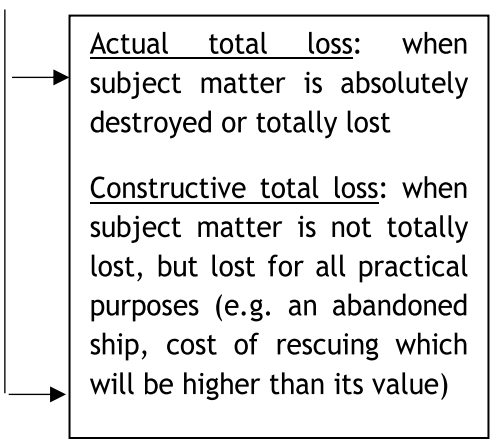

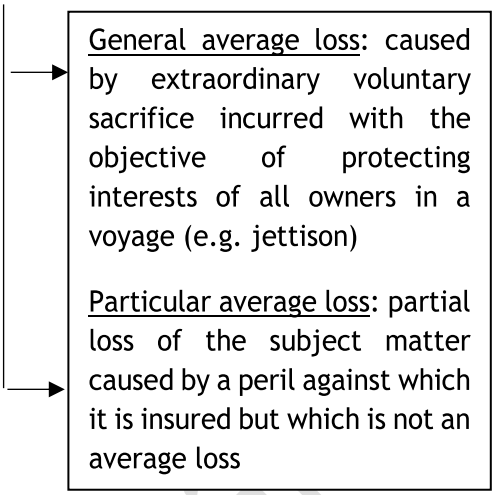

- ✓ Types of main **marine insurance policies**

Time policy	– Covers risk of subject matter for a specified period of time – Generally used for hull insurance, but sometimes for cargo too
Voyage policy	– Insures subject matter in transit from one place to another – Usually used for cargo
Mixed policy	– Also known as time and voyage policy – Subject matter on a particular voyage is insured for a specified period of time
Floating policy	– Taken out by cargo owners who make regular shipments – Insures shipments expected to be shipped for a certain time by one policy – At the time cargo is shipped, insured declares value of shipment and total value of policy is reduced by that amount
Blanket policy	– Is taken for a specified amount – Premium is paid for the entire policy in beginning itself, and is adjusted at the end of specified period for value of risks covered during this period
Fleet insurance policy	– Covers whole fleet of ships
Open policy	– Taken without specifying value of subject matter as the insured is not aware – Value is declared later, subject to the limit of sum assured
Port policy	– Covers the ship when it is docked / at the port
Composite policy	– Underwritten by more than one underwriter – Liability of each underwriter is distinct and separate
Valued policy	– Value of subject matter is pre-agreed between underwriters and insured at the time of taking the policy and is specified therein

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✓ Some of the **important clauses in marine policy** include:

Lost or Not Lost Clause	– Insertion of this clause covers loss of goods occurring between shipment of goods and issuance of policy
Waiver clause	– Inserting this clause implies that if a ship is abandoned, notice of abandonment is given to insurer, and thereafter any steps are taken by either insured or insurer in saving, maintaining and preserving the cargo or the hull, such steps would not be considered as waiver of notice of abandonment
Permission to touch and stay clause	– Ship is permitted to touch and stay at the ports mentioned in the policy in the order specified – Exception would be in emergency to save ship and / or lives of the passengers
Running down clause	– This clause enables the insured to claim the loss caused by collision with another ships
Free of capture and seizure clause	– This clause clarifies that the underwriters will not be liable for any loss caused by ship being captured or seized in a war or war-like situation
Continuation clause	– Included in time policy to cover ship until the end of the voyage or for not more than 30 days thereafter, if the ship is still at sea at the time of expiry of policy – A monthly pro rata premium is required to be deposited in this case
Excepted perils clause	– Specifies the risks not covered by the insurance policy
Free of particular average & free of all averages clauses	– Exempts underwriter from particular average and all averages (particular and general) liabilities
Insurance clause	– Covers inter-alia, the losses covered by the negligence of master, crew etc. or by explosives or by other defects in machinery of the ship
Jettison clause	– Covers loss caused by jettisoning of goods, i.e. throwing goods overboard to reduce weight of the ship and prevent capture
Barratry	– Covers all losses caused by willful misconduct or defaults of the master and crew of the ship

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c) Miscellaneous insurance

✓ Very wide scope, covers almost all commercial activity

✓ Some important ones are:

Motor Vehicle Insurance	– Normally taken out for two types of risks (a) Risk of damage by an accident or loss by theft (b) Risk of liability arising from injury or death of any person in an accident caused by a vehicle – third party insurance – Under the Indian Vehicles Act, it is compulsory for owner of vehicle to get third party insurance. Other types are voluntary
Fidelity insurance	– Taken by an employer for protection against frauds, defalcations etc. by employees – Usually taken in cases where employees handle cash, goods or other valuables of the employer
Credit insurance	– Protects the insured against losses caused by bad debts, whether due to insolvency of debtors or otherwise
Burglary insurance	– Protects the insured against losses from theft or burglary
Loss of profit insurance	– Usually accompanies fire insurance – Covers the risk of loss of profits due to disruption of business caused by fire, until business resumes at normal level – Includes fixed costs incurred during that period as well
Workmen's compensation insurance	– Covers risk of liability to pay compensation where worker is injured or dies in an accident in the course of employment
Professional liability insurance	– Protects professionals such as doctors, lawyers, accountants etc. against the risk of liabilities arising from lawsuits filed by clients / third parties – May cover legal expenses incurred in defending such lawsuits as well

C. DIFFERENCE BETWEEN LIFE AND GENERAL INSURANCE

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		Life Insurance	General Insurance
1.	Nature	Insures risk to life arising out of death	Insures other risks
2.	Insurance vs. Assurance	Since death is a certain event, this type of insurance is also known as assurance Insured gets an assured sum	Known as insurance only
3.	Timing of payment of claim	On death or on maturity of policy	On incurring of loss at the happening of event specified in the policy
4.	Contract duration	Usually long term, runs over number of years	Usually one year, and is renewed annually
5.	Policy value	Can be done for any value depending upon premium that the insured is willing to pay	Usually specifies maximum limit Claim is paid in respect of loss actually incurred, subject to the maximum amount so specified
6.	Carrying liability in books of insurer	Actuarial valuation is done periodically to estimate the liability under existing policies Accordingly, valuation balance sheet is prepared to determine profit	A portion of premium (income) is carried forward as a provision for unexpired liability Balance premium, after netting off claims and expenses, is taken as profit or loss

LEGISLATION RELATING TO INSURANCE:

A. HISTORY OF LEGISLATION RELATING TO INSURANCE:

3. General insurance business is governed by Insurance Act, 1938 **('1938 Act')**.

   It is mostly based on British Insurance Act.

4. General insurance industry was nationalized vide General Insurance Business (Nationalization) Act, 1972 **('1972 GI Act')**. Management of all general insurance companies operating at that time (63 domestic and 44 foreign) was taken over by the government.

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General Insurance Corporation (GIC) was formed to superintend, control and carry on general insurance business in India.

It has 4 subsidiaries in four zones of the country, which undertake all classes of general insurance (except aviation)

(i) Oriental Insurance Co. Ltd.
(ii) National insurance Company Ltd.
(iii) New India Assurance Company Ltd.
(iv) United India Insurances Company

Aviation is undertaken by GIC directly.

5. Life insurance business was nationalized vide Life Insurance Corporation Act, 1956 **('1956 LIC Act')**. Management of all life insurance companies operating at that time (16 non-Indian and 75 Provident Societies) was taken over by the government.

   LIC was formed as a corporate and its working is governed by the 1956 LIC Act.

6. Another act was passed in 1999, namely The Insurance Regulatory and Development Authority Act, 1999 **('IRDA 1999')** to provide for establishment of an Authority:
   - To protect the interest of policyholders
   - To regulate, promote and ensure orderly growth of the insurance industry
   - To amend 1938 Act, 1956 LIC Act, 1972 GI Act so as to end monopoly of GIC and LIC in insurance and general insurance businesses respectively

7. More recently, Insurance (Amendment) Act, 2015 **('2015 Act')** was passed to bring about long awaited amendments in these legislations, including increase in permitted FDI (Foreign Direct Investment) limit from 26% to 49%.

B. KEY PROVISIONS FROM 1938 ACT (amended suitably by IRDA 1999 and 2015 Act):

1. Final accounts
   - Every insurance company to prepare a Balance sheet, P&L, Receipts & Payments account, Revenue account in accordance with the regulations
   - To be prepared in respect of insurance business transacted and shareholders' funds
   - To be prepared at every financial year end (April – March)

2. Audit
   - Afore-mentioned Balance Sheet and all Accounts to be audited annually
   - Auditors to have powers, duties, liabilities and restrictions as per Company Act 2013

3. Register of Policies & Claims
   - Every insurer to maintain:

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(i) A record of policies – should capture following details of every policy issued by the insurer:
    - Name and address of policyholder,
    - Date when policy was effected,
    - Any transfer, assignment or nomination notified to the insurance company

(ii) A record of claims – should capture details of every claim made:
    - Date of claim
    - Name and address of claimant
    - Date on which claim was discharged or rejected as the case may be
    - If rejected, reasons therefor

– Above records to be maintained in any form, including electronic mode, as may be specified in the regulations

4. Approved investments
   – General insurance company to invest its funds only in approved securities as specified
   – Insurers not to invest their funds either directly or indirectly outside India
   – IRDA to have powers to direct insurers to invest funds in infrastructure and social sectors subject to conditions

5. Commission payments to authorized agents
   – Remuneration or reward (as commission or otherwise) for soliciting / procuring insurance business in India to be paid to no one except insurance agent / intermediary / insurance intermediary in manner specified in regulations
   – IRDA to regulate their eligibility, qualifications and other aspects
   – Insurance intermediary to include insurance brokers, re-insurance brokers, insurance consultants, corporate agents, third party administrators, surveyors and loss assessors
   – Commission on fire and marine policies raised from 10% to 15%

6. Limit of expenditure
   – Management expenses of an insurer in any financial year not to exceed amount specified in the regulations
   – Details of management expenses to be furnished in such manner and form as specified in the regulations

7. Sufficiency of assets / Solvency margin
   – Excess of value of assets over liabilities to be maintained upto prescribed levels (such excess cannot be less than 50% of minimum capital calculated in the manner specified in the regulations)
   – If such margin is not maintained, a financial plan needs to be submitted to IRDA indicating the step plan for correcting the deficiency
   – If these requirements are not met, insurer may be deemed insolvent and wound up by the court

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– Prescribed return to be submitted to show required solvency margin has been maintained. In case of life insurance business, return o be certified by an actuary. In case of general insurance, return to be certified by an auditor

C. <u>Key Provisions from IRDA Act 1999:</u>

	Life Insurance Business	General Insurance Business
Applicability of AS	All accounts to be in conformity with AS issued by ICAI to the extent applicable except: (a) AS 3: Cash flow statement – to be prepared only under the Direct Method (b) AS 17: Segment Reporting – to apply to all irrespective of listing / turnover requirements	All accounts to be in conformity with AS issued by ICAI to the extent applicable except: (a) AS 3: Cash flow statement – to be prepared only under the Direct Method (b) AS 13: Accounting for investments – not applicable (c) AS 17: Segment Reporting – to apply to all irrespective of listing / turnover requirements
Recognition of premium	When due	Over contract period Premium received in advance = current liability, to be disclosed separately Unearned Premium (premium attributable to succeeding accounting periods) = current liability. Create Reserve for unexpired risks
Premium deficiency	-	Recognize if sum of expected claim costs, related expenses and maintenance costs > related reserve for unexpired risks
Acquisition costs	Expense off in the year in which they are incurred	

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	Life Insurance Business	General Insurance Business
	(Acquisition costs represent expenses related to acquisition of new and renewal insurance contracts)	
Amount of Claims to be accounted for	Policy benefit amount + claim settlement cost	Claim made + claim settlement cost + claims incurred but not reported + claims incurred but not enough reported Adjust salvage value if there is sufficient degree of certainty of its realization
Actuarial valuation	Required for estimation of liability against life policies Actuarial assumptions to be disclosed in notes to accounts Liability to be calculated such that, together with future premium payments and investment income, it is sufficient to meet all future claims and expenses	Required for estimation of liability against contracts for more than 4 years Actuarial assumptions to be disclosed in notes to accounts
Valuing investments **(a) Real estate investment properties**	Value at historical cost Revalue in 3 years. Any change in carrying amount to be transferred to revaluation a/c Assess for impairment at each balance sheet date. Any impairment loss to go to P/L	Value at historical cost *Less* accumulated depreciation *Less* impairment loss Revaluation is not permitted Assess for impairment at each balance sheet date. Any impairment loss to go to Revenue or P/L

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	Life Insurance Business	General Insurance Business
	Impairment loss on revalued asset to be set off from revaluation a/c. if impairment loss exceeds revaluation reserve balance, excess to be charged to Revenue or P/L	Additional disclosure: Fair value at balance sheet date and basis of its determination
(b) Debt security	Measure at historical cost, subject to amortization (considered as held to maturity) (Debt security to include govt. securities & redeemable preference shares)	
(c) Equity security & derivative instruments traded actively (actively traded implies trading volume i.e. units sold/purchased per annum are more than 10,000 units)	Measured at FMV FMV = lowest of last quoted closing price on stock exchange Assess for impairment on each balance sheet date. Any impairment loss to go to Revenue or P/L. any subsequent reversal to be recognized in Revenue or P/L too. Unrealized gain/losses due to change in FMV to go to Fair Value Change A/c (FVC A/c) which goes to equity Actual profit / loss on sale of investment and related changes in fair value previously recognized in FVC A/c, to be transferred to P/L. Till then, FVC A/c is not available to shareholders for dividend	
(d) Unlisted & other non-actively traded equity shares and derivative instruments	Recorded at historical cost Provision to be made for any diminution in value of investment Such provision can be reversed in case of increase. However, carrying amount cannot be more than historical cost (Non-actively traded are one with trading volume < 10,000 units)	
Loans	Recorded at historical cost, subject to impairment provision	

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	Life Insurance Business	General Insurance Business
Linked business	Separate set of financial statements for each segregated fund of business to be annexed	-
Funds for future appropriation	To be presented separately (Funds for future appropriation represent all funds whose allocation - to policyholders or shareholders - has not been determined by year end)	-
Catastrophe Reserve	-	To be created by general insurance company to meet future potential liability against the insurance policies in force, in accordance with regulations specified (no regulations specified till date) Not created for any specific or known purpose Investment out of funds out of this reserve to be made in accordance with prescription of IRDA

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WHO DOES WHAT IN A GENERAL INSURANCE COMPANY:

An Insurance company usually has following offices:

- ✓ Divisional offices or divisions
- ✓ Branches attached to these divisions

- ✓ Head office (HO)

Further, an insurance company will have following types of business:

- ✓ Direct business, including co-insurance
- ✓ Re-insurance

For both types of businesses, two key business activities are:

- ✓ Collecting premiums
- ✓ Paying claims

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BUSINESS ACTIVITIES

Receipt / recording of Premium

- Essentially confined to divisions/ branches. Accounting also done there
- Branches communicate their transactions to divisions
- Outstanding premium to be reported separately in some cases. See Note 1
- Separate bank accounts are maintained for collecting premium and paying claims
- Commissions to agents, earned towards earning premium, are paid by following law-prescribed basis and rates

Claims

- Essentially confined to divisions/ branches. Accounting also done there
- Branches communicate their transactions to divisions - every division prepares separate claim statement
- Outstanding Liability / Claims provision is determined at divisions/branches
- Basis consolidated figure of all divisions, HO may further provide for outs. claims
- Claims paid also disclosed separately. Divisions acertain genuineness, complete formalities, obtain relevant sanctions, and then pay claim. All evidence is maintained in files
- Similar information to be submitted regarding re-insurance and co-insurance. See Note 2 and 3

Loans & Investments

- Housing and other loans to staff - recorded at Divisonal/regional level
- Other loans dealt with at HO
- Various types of loans & investments to be reported in Balance Sheet. See Note 4 & 5
- Guidelines for investing investible funds to be adhered to. See Note 6.
- Investment department of HO to maintain certain books and records. See Note 7.

Others

- Unexpired risks reserve to be recorded at HO. See Note 8
- Management expenses - ledger and Analysis Register maintained at divisions. Expenses to be apportioned to fire, marine and miscellaneous revenue a/cs, basis of apportionment to be disclosed
- Provision for outstaning expenses
- List of books / records normally maintained at adivisional office are listed in Note 9.

Notes:
[From list of accounts/records/registers, students are advised to remember any 6 from exam point of view]

1. **Outstanding Premium**

   - ✓ Insurance company is allowed relaxation in some cases where premium is uncollected.
   - ✓ However, such balances are expected to be temporarily outstanding, and should be recovered within stipulated period after year end.
   - ✓ Other cases would be where premium is otherwise receivable & due, but remains uncollected.
   - ✓ Further, as regards premium received against bank guarantee and cash deposit, outstanding premium in excess of bank guarantee and cash deposit is to be reported.

2. Divisional offices need to submit statements for **re-insurance adjustments** to HO – claims paid and provided for

   Liability for outstanding claims (in relation to unreported claims) regarding re-insurance business needs to reported too.

3. Accounting for premiums, claims etc. for **co-insurance** is similar to that of direct business, with following peculiar features:

   (i) Incoming Co-insurance
   - ✓ Premium is booked basis statements / advice received from leading insurer
   - ✓ All premium must be booked in relevant year. Any further extensions/endorsements by leading insurer should be accounted for as well, basis subsequent advices
   - ✓ Entry for recording above:
     Leading Insurer Company's Account dr.
     To Premium (income) account
   - ✓ Similarly, for claims paid by leading insurer, Claims Paid Register is updated basis advice from leading insurer.
   - ✓ General practice is to treat all claims paid advices received upto 31 January subsequent to the accounting year, as claims paid for that accounting year.
   - ✓ Entry for recording above:
     Claims Paid Account dr.
     To Leading Insurer Company's Account

   (ii) Outgoing Co-insurance

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- ✓ Only own share of premium and claims to be accounted for
- ✓ Share of other co-insurers debited to their personal accounts, and not routed through revenue accounts

4. Various types of **loans** usually reported in Balance Sheet include:
   (i) Loan on mortgage of property in India
   (ii) Loan on mortgage of property outside India
   (iii) Loans on stocks and shares
   (iv) Loans on insurer's policies within their surrender value
   (v) Loans on personal security
   (vi) Loans to subsidiary companies (other than reversionary)
   (vii) Loans to Subsidiary Reversionary companies
   (viii) Debenture / debenture stocks ordinary stocks of Subsidiary Reversionary companies
   (ix) Reversions and Life Interests purchased
   (x) Loans on Reversions and Life Interests
   (xi) Loans to industrial undertakings in India on consortium basis

5. Various types of **investments** usually reported in Balance Sheet include:
   (i) Deposit with RBI
   (ii) Central government / state government / Foreign government securities
   (iii) Bonds / debentures / stocks / other securities where interest is backed by central government/ state government / foreign government
   (iv) Indian Municipal securities
   (v) Debentures / preference or guaranteed shares / ordinary stock of Indian Railways
   (vi) Debentures / preference or guaranteed shares / ordinary stock of Railways out of India
   (vii) Debentures / preference or guaranteed shares / ordinary stock of companies incorporated in India
   (viii) Debentures / preference or guaranteed shares / ordinary stock of companies incorporated out of India
   (ix) Holdings in subsidiary companies

6. Presently applicable guidelines for **investing investible funds**:

(i)	Central government securities	Minimum 20%
(ii)	Central government securities, state government securities, and other approved securities	Minimum 30% (including (i) above)
(iii)	Other investments as specified, subject to Exposure / Prudential Norms	Maximum 25%
(iv)	Approved and Other investments as specified, subject to Exposure / Prudential Norms	Maximum 70% (including (iii) above)

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(v)	Housing and Loans to state government for housing and firefighting equipment. These could be by way of: (a) Investment in housing (bonds & debenture issued by HUDCO, National Housing Bank etc.; asset backed securities with underlying housing loans; etc.) (b) Investment in Infrastructure (bonds, debentures, asset backed securities with underlying infrastructure assets)	Total investment in (i) to (iv) above taken together: (a) In housing: minimum 5% of investment assets (b) In infrastructure: minimum 10% of investment assets

Investments are made basis the estimates made in the beginning of the year.
They may be periodically reviewed and revised, as necessary.

7. Following **books and records** are normally **maintained in the Investment Department of HO** of a general insurance company:
   (i) Contracts
   (ii) Copies of Delivery Instructions
   (iii) Purchase Registers
   (iv) Application Money Registers
   (v) Allotment and Call Money Registers
   (vi) Rights Issue / Bonus Issue Registers
   (vii) Sales Redemption Registers
   (viii) Term Loan Registers
   (ix) Fixed Deposits / Participation Certificates / Bills Register
   (x) Underwriting Registers
   (xi) Dividend Reconciliation Register
   (xii) Interest Reconciliation Register
   (xiii) Safe-Custody Receipts issued by Banks
   (xiv) Cash / Bank Book
   (xv) Investment Sub-Ledgers
   (xvi) General Ledgers
   (xvii) Investment Schedules classifying nature of investments

8. **Unexpired risks reserve**
   - ✓ Not all risks under various insurance policies expire by year end date (31 March)
   - ✓ For policies which extend into following year, a provision for unexpired risks is made for the unexpired liability under the remaining term of these policies
   - ✓ The effort involved in calculating this can be very time consuming. Hence, it is usually calculated on the basis of Net Premium income earned during the year
   - ✓ **Provision is made for unexpired risks at:**
     - **50%* of Net Premium in case of Fire, Marine Cargo and Miscellaneous business**
     - **100% of Net Premium in case of Marine Hull business**

     These rates are based on the deductibility allowed in the Income Tax law.

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* Alternatively, percentage or 1/365th on premium methods may be followed. Method once followed is to be followed consistently. Any change can be made only with prior approval of IRDA.

- ✓ If the management feels above is not sufficient, it may create additional reserve
- ✓ Amounts are debited / credited to Revenue Account, basis the provision brought forward (opening balance). Two approaches:
  - o Reverse opening in full and create fresh reserve for full amount required to be carried forward as opening balance
  - o Compute difference between opening and closing and accordingly pass entry for differential amount
- ✓ Accounting entry:
  - o Where fresh provision needs to be created
    Marine Revenue / Fire Revenue / Miscellaneous Revenue dr.
    To Revenue Account
  - o When opening provision needs to be reversed (whether in full or amount that is in excess of what needs to be carried forward)
    Revenue Account dr.
    To Marine Revenue / Fire Revenue / Miscellaneous Revenue

9. Following **books of accounts / records** are normally **maintained at Divisional office**:
   (i) Cash Receipt Book
   (ii) Cash Disbursement Book
   (iii) Daily Cash Balance Book
   (iv) Dishonored Cheque Register
   (v) Stale Cheque Register
   (vi) Claim Disbursement Book
   (vii) Premium Register
   (viii) Bank Transfer Journal
   (ix) Journal
   (x) Summary books for incorporation of Branch Returns
   (xi) General Ledger
   (xii) Sub-Ledgers
   (xiii) Register for Analysis of Management Expenses
   (xiv) Cash Receipts, Cash Disbursement Vouchers and Journal Vouchers
   (xv) Remittances Received Register
   (xvi) Salvage Register
   (xvii) Claims Recovery Register
   (xviii) Stationary Register
   (xix) Trunk Call Register
   (xx) Assets Register
   (xxi) Policy Stamp Register
   (xxii) Excess/Shortage Register
   (xxiii) Co-insurers Register

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ACCOUNTING ENTRIES FOR RE-INSURANCE:

13. To recapitulate:
    - ✓ Re-insurance is insurance taken by an insurance company to reinsure a part/whole of risk assumed by it
    - ✓ Such insurance company giving up its business / risk - Ceding company
    - ✓ Second insurance company assuming the risk – Re-insurer

14. Entries in books of Ceding company

    - ✓ For premium on re-insurance business ceded i.e. sharing the premium with re-insurer

Reinsurance premium dr. To Re-insurer Account

    - ✓ For Commission earned from Re-insurer for providing reinsurance business

Re-insurer Account dr. To Commission (income)

    - ✓ For claims receivable in respect of insurance business ceded

Re-insurer Account dr. To Claims (on re-insurance ceded)

15. Entries in books of Re-insurer

    - ✓ For premium received on assuming risk in re-insurance business

Ceding Company Account dr. To Premium (income)

    - ✓ For commission payable to ceding insurance company

Commission (expense) dr. To Ceding Company Account

    - ✓ For claims accepted in proportion to agreed share

Claims (on re-insurance accepted) dr. To Ceding Company Account

16. Types of re-insurance contracts

(i) Facultative reinsurance

- ✓ Contract relates to one particular risk which is specified in policy
- ✓ Each transaction is negotiated individually
- ✓ Each party (ceding company and re-insurer) are free to accept or reject
- ✓ Main drawback – extensive work involved and time consuming to cover a risk

(ii) Treaty reinsurance

- ✓ Treaty agreement is entered into between ceding company and re-insurer
- ✓ All reinsurances are within Treaty limits (limits relate to monetary, geography, section of business etc.)
- ✓ Obligatory for re-insurer to accept all risks within the scope of this Treaty
- ✓ Obligatory for ceding company to cede all risks within the scope of this Treaty
- ✓ Two further types – proportional treaties, non-proportional treaties

FINANCIAL STATEMENTS OF AN INSURANCE COMPANY:

IRDA Regulations 2002 provide forms in which financial statements of an insurance company need to be prepared:

- ✓ Schedule A of Regulations prescribes formats for Life Insurance Company
- ✓ Schedule B of Regulations prescribes formats for General Insurance Company

Both Schedules provide formats for:

- ✓ Revenue Account / Policyholders' Account / Technical Account
- ✓ Profit and Loss Account / Shareholders' account / Non-technical Account
- ✓ Balance Sheet

Format for cash flow statement is not prescribed. Receipts and Payments Account to be prepared in accordance with AS 3.

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Revenue Account of Insurance co ~ Trading Account of any co

- ✓ Captures incomes and expenses directly relatable to insurance business viz. premium income, commission expenses, claims paid etc.
- ✓ Balance is transferred to P/L A/c and other requisite reserves, if any (e.g. catastrophe reserve in case of general insurance company)

Profit and Loss Account of Insurance co ~ P/L Account of any co

- ✓ Further adjusts other incomes and expenses to profit/loss determined in Revenue Account, to arrive at PBT
- ✓ Provision for tax is created
- ✓ PAT so determined, is appropriated towards dividend and other requisite reserves, if any
- ✓ Remaining balance, together with opening balance, is carried forward to Balance Sheet

Balance Sheet of Insurance co ~ Balance sheet of any co

- ✓ Like in any other balance sheet, it captures sources of funds (liabilities side) and application of funds (assets side)
- ✓ Schedules thereto capture appropriate disclosures in accordance with the regulations

Further, formats for both life insurance and general insurance are broadly similar, except some peculiarities of each business that may have to be captured additionally viz. linked business disclosures in life insurance, catastrophe reserve in general insurance.

APPROACH TO PROBLEM SOLVING IN EXAMS:

1. Questions usually provide a host of information around expenses like commission or claims paid/payable, incomes like premium or reinsurance claims received / receivable and may ask to:
   a. Compute charge towards Reserve for Unexpired risk (general insurance business)
   b. Compute premium income as will appear in Revenue Account
   c. Compute the commission expense that will be charged to Revenue account
   d. Prepare claims statement or compute claims' amount that will appear in Revenue account

Following tables should be useful in this regard:

Computing Net change in Reserve for Unexpired risk	Amount in Rs.
Closing balance of Reserve for Unexpired risk computed at prescribed rates on Net Premium	XXX
Less: Opening balance of Reserve for Unexpired risk	(XXX)
Charge / (income)	XXX

Computing Net Premium income to be credited to Revenue Account	Amount in Rs.
Premium on new policies	XXX
Add: Renewal premium	XXX
Add: Premium on Reinsurance accepted	XXX
Less: Premium on Reinsurance ceded	(XXX)
Net Premium	XXX
Less: Charge for change in Reserve for Unexpired risk **Or** Add: Income for change in Reserve for Unexpired risk	(XXX)
Net Premium earned	XXX

Computing Net Commission to be charged to Revenue Account	Amount in Rs.
Commission on new policies	XXX
Add: Commission on renewals, if any	XXX
Add: Commission paid on reinsurance accepted	XXX
Less: Commission received on Reinsurance ceded	(XXX)
TOTAL	XXX

Net Claims incurred to be charged to Revenue Account	Amount in Rs.	
Charge relating to Direct business (expense / liability)		
Closing balance of claims payable	XXX	
Add: Claims paid during the year	XXX	

Add: Expenses in connection with settlement of claims		
Less: Opening balance of claims payables	(XXX)	XXX
Add: Charge relating to Reinsurance business accepted (expense / liability)		
Closing balance of claims payable	XXX	
Add: Claims paid during the year	XXX	
Less: Opening balance of claims payables	(XXX)	XXX
Less: Related to Reinsurance business ceded (income / asset)		
Closing balance of claims receivables	(XXX)	
Add: Claims received during the year	(XXX)	
Less: Opening balance of claims receivables	XXX	(XXX)
TOTAL		**XXX**

Formulae in this table are arrived at using the below basic principles:
(a) Op. Bal. of payables + Charge during the year – Claims paid = Cl. Bal. of payables
Thus, Charge = Cl. Bal. + Claims paid – Op. Bal. (same is exhibited above in the table)
(b) Op. Bal. of receivables + Income for the year – Claims received = Cl. Bal. of receivables
Thus, Income = Cl. Bal. + Claims received – Op. Bal. (same is exhibited above in the table)

2. Questions may ask to prepare Revenue Account/ Policyholders' Account / Technical Account

   a. Apart from workings in #1 above, some other workings may also be required like:
      - ✓ Transferring prescribed percentages to other funds / reserves viz. Catastrophe Reserve in case of general insurance, life fund in case of life insurance etc.
      - ✓ Declaring dividend
      - ✓ Making other adjustments as specified

   b. Appropriate working notes, including ledgers if required, should be prepared for all the adjustments specified in the question, before preparing Revenue Account.

   c. Following pointers may be useful in this regard:
      - ✓ Any expenses towards claim settlement (viz. legal, survey etc.) would be added to amount of net claims charged to Revenue Account.
      - ✓ If such expenses are included in management expenses or any other head, exclude from there.

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3. Questions may also ask to prepare P/L and B/S too. Pls see key formats (statutory formats prescribed by IRDA). Appropriate schedules to financial statements would also need to be prepared (schedule numbers are also prescribed and need to be followed as it is).

   a. Following pointers may be useful in this regard:
      - ✓ Incomes / expenses in excess of 1% of total premium (less reinsurance) or Rs 5,00,000 whichever is higher, should be shown as separate line item
      - ✓ Rental income to include realized rent only, and not any notional rent

Illustrations

Illustration – 1

Indian insurance company limited furnishes you with the following information:

(i) On 31.12.20X1 it had reserve for unexpired risk to the tune of Rs. 40 crores.
(ii) It comprised of Rs 15 crores in respect of marine insurance business: Rs 20 crores in respect of fire insurance business and Rs 5 crores in respect of miscellaneous insurance business.
(iii) It is the practice of Indian Insurance Co. Ltd. to create reserves at 100% of net premium income in respect of marine insurance policies and at 50% of net premium income in respect of fire and miscellaneous income policies.
(iv) During 20X2, the following business was conducted:

(Rs. Crores)

	Marine	Fire	Miscellaneous
Premia collected from:			
(a) Insureds in respect of policies issued	18	43	12
(b) Other insurance companies in respect of risks undertaken	7	5	4
Premia paid/payable to other insurance companies on business ceded	6.7	4.3	7

Indian Insurance Co. Ltd. asks you to:

(a) Pass journal entries relating to "Unexpired risks reserve".

(b) Show in columnar form "Unexpired risks reserve" a/c for 20X2.

Illustration 2

Janani Assurance Co. Ltd. received ₹5,90,000 as premium on new policies and ₹ 1,20,000 as renewal premium. The company received ₹90,000 towards reinsurance accepted and paid ₹70,000 towards reinsurance ceded. How much will be credited to Revenue Account towards premium?

Illustration 3

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, 20X2:

	Direct business	**Re-insurance**
Claim paid during the year	46,70,000	7,00,000
Claim Payable — 1st April, 2012 31st March 2012	7,63,000 8,12,000	87,000 53,000
Claims received		2,30,000
Claims Receivable — 1st April 2012 31st March 2012	_ _	65,000 1,13,000
Expenses of Management (includes Rs.35,000 Surveyor's fee and Rs.45,000 Legal expenses for settlement of claims)	2,30,000	_

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Illustration 4

From the following information of Reliable Marine Insurance Ltd. for the year ending 31st March 2012 find out the

i. Net premium earned

ii. Net claims incurred

(Rs)

	Direct business	Re-insurance
Premium:		
Received	88,00,000	7,52,000
Receivable -1.04.2011	4,39,000	36,000
Receivable -31.03.2012	3,77,000	32,000
Paid:		
Payable- 1.04.2011		27,000
Payable – 31.03.2012		18,000
Claims:		
Paid	69,00,000	5,54,000
Payable – 1.04.2011	89,000	15,000
Payable - 31.03.2012	95,000	12,000
Received		2,01,000
Receivable –1.04.2011		
Receivable - 31.03.2012		40,000
		38,000

Illustration 5

Prepare Revenue Account in proper form for the year ended 31st March 2011 from the following particulars related to Goma General Insurance Co. for the year 2011-2012

	Direct Business	Re-Insurance
Premiums: Amount received	30,00,000	2,40,000
Receivable at the beginning	1,80,000	24,000
Receivable at the end	2,40,000	36,000

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Amount paid Payable at the beginning Payable at the end	_	3,60,000 30,000 42,000
Claims: Amount paid Payable at the beginning Payable at the end	18,00,000 60,000 1,20,000	 1,80,000 12,000 18,000
Amount recovered Receivable at the beginning Receivable at the end	_ _ _	1,20,000 18,000 12,000
Commission: Amount paid Amount received	72,000 _	10,800 14,400

Additional information:

i. Interest, dividend and rent received *30,000*

Income-tax in respect of above *6,000*

Management expenses including Rs.12,000 related to

Legal expenses regarding claims *132,000*

(ii)Provision for income tax existing at the beginning of the year was Rs. 1,95,000 the income – tax actually paid during the year Rs.1,68,000 and the provision necessary at the yearend Rs. 2,07,000

The net premium income of the company during the year 2010-2011 was Rs. 24,00,000 on which reserves for unexpired risk @ 50% and additional reserve @7 ½ % was created. This year the balance to be created forward to be carried forward is 50% of net premium on reserves for unexpired risk and 5% on additional reserves.

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Study Note – 5 | Accounting Standards

5.1 AS 11: Accounting for the Changes in Foreign Exchange Rates

1.0 : The Scope of the Standard:

AS 11 (Revised 2003) is to be mandatorily applied by an enterprise:

i. In accounting for transactions in foreign currencies;

ii. In translating the financial statements of foreign operations;

iii. In accounting for foreign currency transactions in the nature of forward exchange contracts (except the ones that are entered into hedge the foreign currency risk of a 'firm commitment' or 'highly probable forecast transaction')

However, the standard is not applicable to:

i. The restatement of the enterprise's financial statements from its reporting currency into another currency for the users accustomed to that currency or for similar purpose.

ii. The presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flow of a foreign operation.

iii. Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (covered by AS-16)

iv. Exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a 'firm commitment' or 'a highly probable forecast transaction' (A 'firm commitment' as a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates whereas a 'forecast transaction' is an uncommitted but anticipated future transaction.)

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2.0 : Terms that have been defined in the standard:

Exchange Rate: Exchange rate is the ratio for exchange of two currencies (e.g. if $ = Rs. 50, it means that one US dollar can be exchanged for 50 Indian rupees) as applicable to the realization of a specific asset or the payment of a specific liability or the recording of a specific transaction or a group of inter-related transactions.

Average Rate: Average rate is the mean of exchange rates in force during a period,

Forward Rate: Forward rate is the specified exchange rate for exchange of two currencies at a specified future date.

Closing Rate: Closing rate is the exchange rate at the balance sheet date.

Spot exchange rate is the exchange rate for immediate delivery

Monetary Items: Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money, e.g., cash, receivables, payables.

Long term monetary items are monetary items having a maturity of 12 months or more from the date of initial recognition of asset or liability.

Non-monetary Items: Non-monetary items are assets and Liabilities other than monetary items e. g., fixed assets, inventories, investments in equity shares.

Reporting Currency: Reporting currency is the currency used in presenting the financial statements, e.g., Rupee will be the reporting currency to be used in presenting the financial statements in India.

Foreign Currency: Foreign currency is a currency other than the reporting currency of an enterprise, e.g., if a branch of an Indian Company is located in US then dollar will be the foreign currency.

Exchange Difference: Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rate.

Fair Value: Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

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Foreign Operation: Foreign operation is a subsidiary, associate, joint venture or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.

Forward Exchange Contract: Forward exchange contract means an agreement to exchange different currencies at a forward rate.

Integral Foreign Operation: Integral foreign operation is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.

Non-integral foreign operations is a foreign operation that is not an integral foreign operation

Net Investment in a Non-integral Operation: Net investment in a non-integral foreign operation is the reporting enterprise's share in the net assets of that operation.

Foreign Currency Transactions: Transactions denominated in a foreign currency or those that require settlement in a foreign currency are called foreign currency transactions.

3.0 : Foreign Currency Transactions:

a) **Initial Recognition:** Transactions involving foreign currencies can be brought under four groups, namely,

   (a) Buying or selling of goods and services,
   (b) Borrowing or lending money,
   (c) Acquiring or disposing of assets, or incurring and settling liabilities, or
   (d) By being a party to a forward exchange contract.

   For initial recognition, the Accounting Standard prescribes ***that a foreign currency transaction should be recorded by applying the exchange rate at the date of the transaction***.

   Note: For practical reasons, an average rate for day/ a week/ month may be used, if the fluctuations are not high

b) **Reporting at subsequent Balance sheet date:** For the purpose of showing the effect of change in foreign exchange rates, the transactions are classified into monetary items and non-monetary items. At each balance sheet date:

Type	***Reporting Rate***

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Monetary Item	Closing Rate
Non-Monetary Item carried at historical cost (e.g. Fixed Assets)	Exchange Rate on date of transaction
Non-Monetary items carried at fair value	Exchange Rates that existed when the fair values were determined.

C.**Recognizing exchange difference:** Exchange differences can arise on three counts:

- A transaction – either a monetary item, or a non-monetary item – being ***settled at a rate different from the rate at which it was initially recorded (Settlement in the same accounting period)***.

- A transaction ***being reported at a rate different from the rate at which it was either initially recorded (balance sheet reporting)***.

- A transaction being ***settled as a rate different from the one taken for reporting in the last financial statement (settlement in different accounting period)***.

Accounting for Exchange Differences

Option I: Exchange differences shall be recognized as income or expense in the period in which they arise.

Option II - Long Term Foreign Currency Monetary Items

Exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements,

- ***If they relate to the acquisition of a depreciable capital asset,***
    - ***can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and***
- ***in other cases,***
    - ***can be accumulated in the Foreign Currency Monetary Item Translation Difference (FCMITD) Account and should be written off over the useful life of the assets (amortized over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods)***

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The treatment availed at the option of the company shall be irrevocable and shall be exercised till 31st March, 2020. In other words, if an entity chooses to capitalize exchange differences, it should continue the same policy till 31st March 2020.

An asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of 12 months or more at the date of origination of the asset or liability.

4.0 : Financial Statement of Foreign Operations:

1. **Integral:** A foreign operation is said to be integral operations as if were an extended arm of the reporting entity. Any change in the foreign exchange rate will have all immediate impact on the cash flows of the reporting entity. Such an impact will arise from and will be relatable to all monetary items - except of course, the net investment of reporting entity.

   Example - A foreign operation might only sell goods imported from the reporting entity and remits back the proceeds to the reporting entity. Certain other situations that would be an integral operation are:

   - Acts as a selling agency: receiving stocks of goods from and remitting proceeds back to the investing company.

   - Produces a raw material or component, and transfers the goods for inclusion in the ultimate product being manufactured by investing company (end-products of foreign operations are captivity consumed by reporting entity)

   - Foreign operation has been set up to raise finance to help investing entity or for tax reasons.

2. **Non-integral:** An operation which is not an integral operation is called Non-Integral operation. A non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in the local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency".

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A question to be asked is -

Will such operations have an impact on the cash flows from operations of reporting entity?
If answer is negative it is non-integral operations.

An analysis will show that in cases of the nature cited above, a change in the exchange rate between reporting currency, and the currency in which foreign operations are conducted — will not have any direct effect on the cash flows for reporting entity. The effect, if any, would be traceable to a change in the 'net investment in foreign operations" of reporting entity.

The focus is on whether there are any regular movement of cash or cash equivalents, or whether it is only occasional, i.e. remittance of dividends. Mere "control" is not a determinant factor. Impact on cash flows from operations is relevant.

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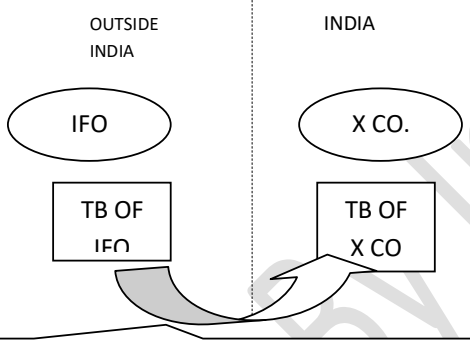
SUMMARY OF ACCOUNTING FOR INTEGRAL AND NON INTEGRAL FOREIGN OPERATIONS

INTEGRAL FOREIGN OPERATIONS – (IFO)

Accounting treatment of integral Foreign Operations: The financial statements of an integral foreign operation should be translated using the principles and procedures in paragraphs 8 to16 as if the transactions of the foreign operation had been those of the reporting enterprise itself.



Convert the TB of IFO by using following rates:

ITEM	CONVERSION RATE
Fixed assets (including depreciation)	rate on date of acquisition
All monetary items	at closing rate
All incomes/ expenses (other than depreciation)	Actual rate Or Average rate if fluctuation is not high
HO Account	Actual amount as per books

NOTE - After conversion of TB of IFO from Foreign Currency to domestic currency, it may/ may not tally, as different exchange rates are used.
Such difference is foreign currency fluctuation on account of integral foreign operations and is charged off to P&L

NON INTEGRAL FOREIGN OPERATIONS – (NIFO)

ITEM	CONVERSION RATE
All Balance Sheet items	At closing rate
All Revenue items	Rate on date of transaction
Any goodwill/ Cap reserve/ Contingent liability	Closing rate

The translation of the financial statements of a non-integral foreign operation results in the recognition of exchange differences arising from:

a. translating income and expense items at the exchange rates at the dates of transactions and assets and liabilities at the closing rate;

b. translating the opening net investment in the non-integral foreign operation at an exchange rate different from that at which it was previously reported; and

c. other changes to equity in the non-integral foreign operation.

The exchange fluctuations on account of conversion should be transferred to Foreign Currency Translation Reserve A/c (FCTR). FCTR cant be used for dividend distribution purpose. The same will be transferred to P&L when the NIFO is disposed off or discontinued.

These exchange differences are not recognized as income or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. When a non-integral foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority

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OTHER KEY ASPECTS IN ACCOUNTING FOR NIFO –

1. **Consolidation** as per AS 21, 23, 27:

The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary (see AS 21, Consolidated Financial Statements, and AS 27, Financial Reporting of interests in Joint Ventures). However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting enterprise, such an exchange difference continues to be recognized as income or an expense or, if it arises from the circumstances described in paragraph 15, it is accumulated in a foreign currency translation reserve until the disposal of the net investment.

2. **DIFFERENT REPORTING DATES**

When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares, for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise. When it is impracticable to do this, AS 21, Consolidated Financial Statements, allows the use of financial statements drawn up to a different reporting date provided that the difference is no greater than six months and adjustments are made for the effects of any significant transactions or other events that occur between the different reporting dates. In such a case, the assets and liabilities of the non-integral foreign operation are translated at the exchange rate at the balance sheet date of the non-integral foreign operation and adjustments are made when appropriate for significant movements in exchange rates up to the balance sheet date of the reporting enterprises in accordance with AS 21. The same approach is used in applying the equity method to associates and in applying proportionate consolidation to joint ventures in accordance with AS 23, Accounting for Investments in Associates in Consolidated Financial Statements and AS 27, Financial Reporting of Interests in Joint Ventures.

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3. CLASSIFICATION AND RECLASSIFICATION

The classification of a Foreign Operation as IFO / NIFO is the responsibility of the management.

The accounting treatment to be followed on reclassification from IFO to NIFO and NIFO to IFO is summarised below:

IFO to NIFO

- Till the date of reclassification, exchange differences are transferred to P&L
- The exchange differences subsequent to date of reclassification are accumulated in Foreign Currency Translation Reserve (FCTR)

NIFO to IFO

- The accumulated balance in FCTR will be carried in the Balance Sheet. The balance will be transferred to P&L when the foreign operation is disposed.
- The exchange differences subsequent to date of reclassification is transferred to P&L.
- The translated amount of non-monetary items as on the date of change is treated as historical cost.

4. DISPOSAL OF NIFO

On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognized as income or as expenses in the same period in which the gain or loss on disposal is recognized.

5. FORWARD EXCHANGE CONTRACTS

Category I: An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date or a transaction.

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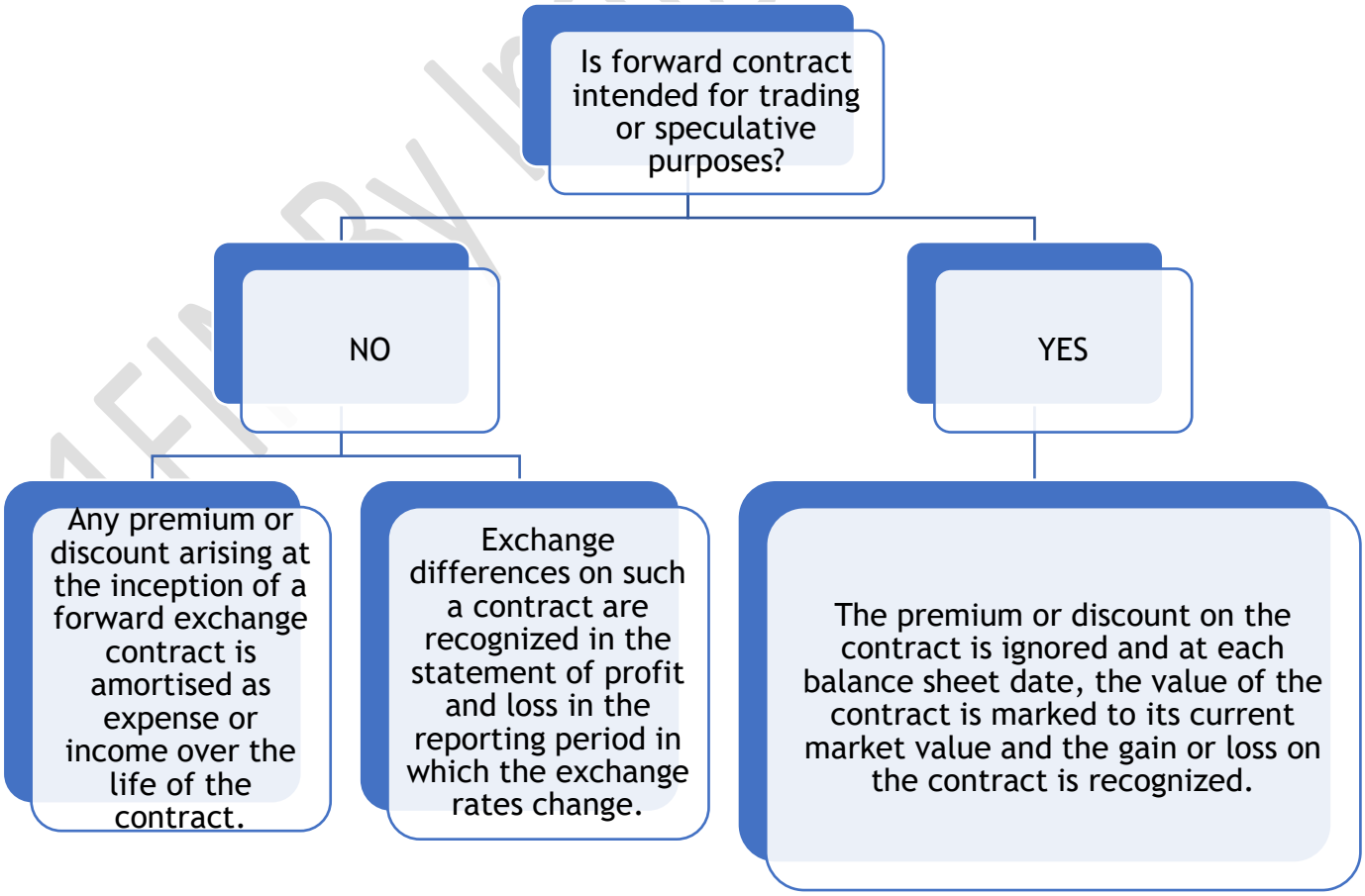
The premium or discount arising at the inception of such a forward exchange contract should be amortized as expense or income over the life of the contract. Exchange differences on such a contract should be recognized in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit of loss arising on cancellation or renewal of such a forward exchange contract should be recognized as income or as expense for the period.

Category II: In respect of a forward contract entered into as a speculative activity, Accounting Standard prescribes that the contract should he recognized on the reporting date. A gain or loss on a such forward exchange contract should be computed by multiplying the foreign currency amount of the forward exchange contract by the difference between the forward rate available at the reporting date for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period).

The gain or loss- so computed should be recognized in the statement of profit and loss for the period. The premium or discount on the forward exchange contract is not recognized separately.



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5.0: Disclosure requirements: An enterprise should disclose:

a. the amount of exchange differences included in the net profit or loss for the period; and

b. net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

a. the nature of the change in classification;

b. the reason for the change;

c. the impact of the change in classification on shareholders' funds; and

d. the impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.

Matters to be disclosed	**Place of disclosure**
Amount of exchange differences included in the net profit or loss for the period.	Profit & Loss
Net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders funds and a recognisation of such exchange differences at the beginning and end of the period.	Balance sheet notes
Reason for using a different currency, when the reporting currency is different from the currency of the country in which the enterprises is domiciled.	Notes
Reason for any change, if any, in the reporting currency.	Notes

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When there is a change in the classification of a significant foreign operation, (a) - the nature of the change in classification, (b) - the reason for the change (c) - the impact of the change in classification on presented had the change in classification occurred at the beginning of the earliest period presented.	Notes
Effect on foreign currency monetary items or on the financial statements of a foreign operation of a change in exchange rates occurring after the balance sheet date, as per AS – 4.	Notes
Enterprise's foreign currency risk management policy (optional disclosure).	Notes

PRESENTATION OF FOREIGN CURRENCY MONETARY ITEM TRANSLATION DIFFERENCE ACCOUNT

In the format of Schedule III to the Companies Act, 2013, no line item has been specified for the presentation of FCMITDA. Since the balance in FCMITDA represents the foreign currency translation loss, it does not meet the above definition of asset, as it is neither a resource nor any future economic benefit would flow to the entity there from. Therefore, such balance cannot be reflected as an asset. Therefore, Dr/ Cr balance in FCMITDA should be shown on the EQUITY and LIABILITIES side of the balance sheet under the head RESERVES AND SURPLUS as a separate line item

Question 1:

Explain Monetary Item as per AS 11. How are Foreign Currency Monetary items to be recognized at each balance sheet date?

Classify the following as monetary or non-monetary items.

Share Capital, Trade Receivables, Investments, Fixed Assets

Solution1:

Monetary Items are money held and Assets & Liabilities to be received or paid in fixed or determinable amounts of money. Eg: Debtors, Creditors, Loans etc.

Foreign Currency monetary items are recognized at closing rate at each balance sheet date.

- Share Capital - Non Monetary Item
- Trade Receivables - Monetary Item
- Investments - Non Monetary Item
- Fixed Assets - Non Monetary Item

Question 2:

BK Limited purchased fixed asset costing Rs. 5,000 lacs on 1.4.2012 payable in foreign currency (USD) on 5.4.2013. Exchange rate of 1 USD is Rs.50 and Rs.54.98 as on 1.4.2012 and 31.3.2013 respectively. The Company also obtained a soft loan of USD 100,000 on 1.4.12 payable in 3 equal annual installments. First installment was due on 1.5.13. You are required to state how these transactions are to be accounted for in the books of accounts for the year ended 31.3.13

Solution2:

Part 1

Date of acquisition of Fixed Asset 1.4.2012

Cost of acquisition: Rs.5000 lacs = USD 100 lacs X Rs. 50/USD

Creditor Reinstatement Date: 31.03.2013; Exchange rate 1 USD = Rs.54.98

Rupee Depreciation over the year 2012-13: Rs.4.98 per USD

Increase in creditor payables consequent to reinstatement following rupee depreciation:

Rs.4.98 /USD x USD 100 lacs = Rs.498 Lacs

Option 1: Rs.498 lacs of forex fluctuation can be debited to P&L in FY13

Option 2: The Company may also choose to capitalize this loss to the cost of the fixed asset so acquired.

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Part 2:

Assume USD 100,000 of loan was used to acquire a Fixed asset / a non-monetary item

Loss on the reinstatement of the loan for FY2013 is

USD 100,000 x Rs.4.98 / USD = Rs. 4.98 lacs

Option 1: The loss may be entire charged off to P&L

Option 2:

a) If the asset so acquired from the loan is a fixed asset then the loss can be transferred to the fixed asset account.
b) If the asset so acquired is not a depreciable fixed asset or is for working capital purposes, the loss can be transferred to Foreign Currency Monetary Item Translation Difference Account (FCMITD) and written off in 3 years starting FY13. That will be well before 31.03.2020, the date before which all FCMITDA balances are to be written off as mandated by AS11.

Question 3:

Sterling Ltd. purchased a plant for US $ 20,000 on 31st December, 2011 payable after 4 months. The company entered into a forward contract for 4 months @ Rs. 48.85 per dollar. On 31st December, 2011, the exchange rate was Rs. 47.50 per dollar.

How will you recognize the profit or loss on forward contract in the books of Sterling Limited for the year ended 31st March, 2012?

Solution3:

Forward premium Paid by the Company per USD = Rs.48.85 - 47.50 = Rs1.35

The forward premium of Rs.1.35 is for a period of 4 months

Total forward premium = Rs. 1.35 X 20,000 = Rs. 27,000

Amount to be amortised per month = Rs 27,000/4 = Rs. 6750

Amount to be amortised for year ending 31.03.2012 = Rs. 6,750 X 3 months = Rs. 20,250

Rs.20,250 will be recognized in the books of sterling limited as forward premium expense for year ended 31st March 2012.

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Question 4:

Goods purchased on 1.1.11 of USD 10,000 when USD 1 – Rs.45. Exchange rate on 31.3.11 is Rs.44 and exchange rate on date of actual payment (07.07.11) was Rs.43 . Ascertain the gain or loss for FY10-11 and FY11-12. Also give treatment as per AS 11.

Solution 4:

Technical context:

As per AS 11, Monetary items have to be restated at the end of an accounting period at the closing rate prevailing on such date

Analysis & Conclusion

Part 1

Liability towards Creditors for Cost of goods purchased on 1.1.11 – Rs.45 X 10,000 = Rs.4,50,000

On 31.3.11 such creditor balance (monetary item) needs to be reinstated at closing rate. Closing rate on 31.3.11 is Rs.44 / USD

Rupee appreciated from Rs.45/ USD to Rs.44 USD – there is gain of Re 1.

For FY11 gain of Rs.10,000 (USD 10,000 x Re.1/ USD of gain) will be recognized in P&L

Part 2

Rupee appreciated by additional Re.1 between 31.3.11 and 7.7.11 and the payment was made at Rs.43/ USD on 7.7.11

Additional gain of Rs.10,000 (USD 10,000 x Re.1/ USD of gain) will be recognized in P&L in FY12

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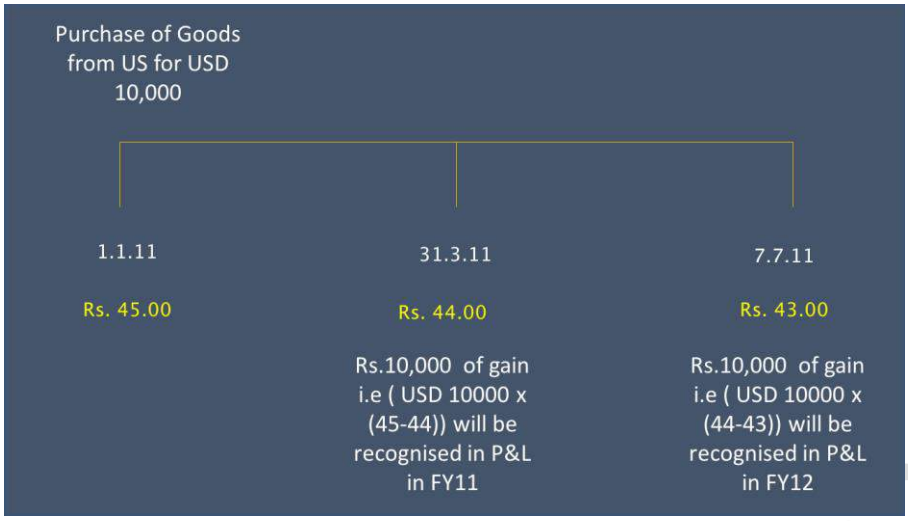

Question 5:

Sunshine Company Limited imported raw materials worth US Dollars 9,000 on 25th February, 2011, when the exchange rate was Rs. 44 per US Dollar. The transaction was recorded in the books at the above mentioned rate. The payment for the transaction was made on 10th April, 2011, when the exchange rate was Rs. 48 per US Dollar. At the year end 31st March, 2011, the rate of exchange was Rs. 49 per US Dollar.

The Chief Accountant of the company passed an entry on 31st March, 2011 adjusting the cost of raw material consumed for the difference between Rs. 48 and Rs. 44 per US Dollar. Discuss whether this treatment is justified as per the provisions of AS-11.

Solution 5:

Technical context:

As per AS 11, Monetary items have to be restated at the end of an accounting period at the closing rate prevailing on such date

Analysis:

In the current case, creditor in respect of raw materials is a monetary item and has to be restated at the closing rate on 31.3.11 in the books of Sunshine Limited. The creditor has to be reinstated on 31.3.11 at the exchange rate prevailing on 31.3.11 i.e. at Rs. 49 per USD

Exchange loss of Rs.45,000 i.e USD 9000 x (Rs.49 –Rs.44 = Rs.5) is recognized in FY11.

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There is an exchange gain from the balance sheet date (31.03.2011) to the date of actual payment. Exchange gain of Rs.9000 i.e USD 9000 x (Rs.49/ USD –Rs.48/ USD = Rs.1/USD) is recognized in FY12.

Conclusion

The amount payable to creditor (which is a monetary item) must be reinstated. Any loss or gain arising due to such reinstatement must be transferred to profit and loss account as "Foreign Exchange Fluctuation Gain/(Loss). Treatment of recognizing exchange gain of Rs.36000 by reducing the cost of raw material in FY11 as proposed by the chief accountant is is not justified

Question 6:

Explain briefly the accounting treatment needed in the following cases as per AS 11 as on 31.3.15:

1. **Sundry debtors include amount receivable from Umesh Rs.5 lacs recorded at the prevailing Exchange rate on the date of sale. Transaction recorded at USD 1 = Rs. 58.50**
2. **Long term loan taken from a US company amounting to Rs.60 lacs recorded at USD 1 = 55.6; exchange rate taken at rate prevailing on date of transaction.**

On 31st March 2015 USD 1 = Rs.61.20

Solution 6:

Sundry Debtors: Amount receivable from Umesh in USD = Rs. 5,00,000 / (Rs.58.5 per USD) = USD 8547

Accounting as on 31.3.15:

Rupee depreciation from date of transaction to 31.3.15 :

Rs. 61.20 / USD– Rs. 58.5/ USD = Rs. 2.70/ USD of gain

Total gain on monetary item i.e receivable from Umesh = USD 8547 x Rs.2.70 / USD = Rs.23,077

This gain will be recognized in P&L with corresponding increase in the receivable account.

Treatment of long term loan:

Loan in USD = Rs.60 lacs / Rs.55.60 per USD = USD 107913.67

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For a monetary payable, rupee depreciation will result in a loss.

Loss is Rs.61.20/ USD – Rs.55.60 / USD = Rs.5.60/ USD

Total loss = Rs.5.60 / USD x USD 107913.67 = Rs.604317

This loss on long term loan can be

1) transferred to P&L or
2) If it is for a depreciable asset capitalised it along with the cost of the fixed asset, If not it can be accumulated in FCMITD account and written off

5.2 AS 12: Accounting for Government Grants

WHY IS THIS STANDARD REQUIRED?

The receipt of Government assistance by an entity may be significant for the preparation of financial statements for two reasons. Firstly, if resources have been transferred, an appropriate method of accounting for transfer must be found. Secondly, it is desirable to give an indication of the extent to which the entity has benefitted from such assistance during the reporting period.

AS-12 Accounting for Government Grants
Scope: AS – 12 deals with this important topic of grants or assistance in the from both capital and revenue, from various government agencies. These grants are also referred to as subsidies, cash incentives, duty drawbacks etc. These can also be non-monetary, e.g. land or other resources, the standard provides accounting method that can be followed, to suit specific situations. The standard does not deal with

1. Accounting for grants, in FS that reflect the effect of changing price
2. Other indirect forms of assistance, or
3. Government participation in the ownership of enterprises.

Definitions:

Government Grants – Defined: Government grants are assistance by Government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with

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government which cannot be distinguished from the normal trading transactions of the enterprise.

Illustration 1: Company A deals in a product which attracts 5% Sales Tax. However, under some package scheme of incentive, the Company is exempt from Sales Tax upto a certain limit. Is this a Govt. Grant?

Answer – NO. As, Government grant is "Assistance by government in cash or in kind"

Government refers to state and Central Government, Government agencies and similar bodies, whether local, national or international.

Recognition of Government Grants

Government grants should be recognized only if there is a certainty that

(i) the enterprise will comply with the conditions attached to them; and

(ii) the grants will be received

Government grant may be awarded for the purpose of giving immediate financial support to an enterprise rather than as incentive to undertake specific expenditure. In this case, the grant may be taken to income in the period in which the enterprise qualifies to receive it, as an extraordinary item.

Method Of Accounting:

AS 12 lays down two possible methods for accounting treatments of government grants, viz:

a)Capital Approach: In capital approach, grant is treated as part of shareholders' funds.

b)Income Approach: In income approach, a grant is treated as income (of one or more periods depending upon circumstances of each case).

In other words, government grants are recognised in the profit and loss statement on a systematic and rational basis over the periods necessary to match them with the related costs.

Government grants should not be recognised on a receipt basis. If these are recognised on a receipt basis then that will not be in accordance with the fundamental accounting assumption of 'Accrual' as envisaged in AS 1 on

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'Disclosure of Accounting Policies.'

Which method should be adopted:

Accounting for government grants should be based on the nature of the grants. Grants which have the characteristics similar to those of promoters' contribution (i.e, which are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected) should be accounted for on the basis of 'Capital Approach', whereas other grants (ie, grants related to revenue) should be accounted for on the basis of 'Income Approach'.

Following paragraphs explain Accounting Treatment of Government Grants:

A. Accounting Treatment of Grants in the nature of capital receipts (Capital Approach):

1. Grant received is not for acquiring specific fixed asset. (i.e. in the nature of promoter‘s contribution):

Government grants can be in the nature of promoter‘s contribution, examples include a capital subsidy for a project. Such grants should be ***credited to capital reserve*** and treated as part of shareholders’ fund, in as much as no repayment is ordinarily expected in respect of such grants.

Entry required:

Cash/ Bank Account…….Dr.

To Capital Reserve A/c.

2. Grant received for acquiring specific fixed assets:

Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

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The grants relating to specific fixed assets could relate to depreciable as well as non-depreciable fixed assets. We shall now discuss the treatment of grants in each of these cases:

Option – 1 : Deduct the value of grant from the cost of Fixed Asset

- Deduct grant from gross value of asset.
- Depreciate the asset on net value (ie, gross value less the amount of grant).
- If grant equals the whole or virtually the whole of the cost of the asset then the asset should be recorded at a nominal value.

Entries required:

1. Cash/ Bank Account……Dr.

   To Government Grant A/c

2. Fixed Asset Account……Dr.

   To Cash/Bank A/c.

3. Government Grant A/c ……Dr.

   To Fixed asset account

(Note: depreciation is charged on the adjusted balance of fixed asset.)

- **Example**

Gross value of asset	Rs.1 crore
Government grant	
(i)	Rs.20 lakhs
(ii)	Rs. 1 crore

In situation (i), the asset will be recorded at Rs 80 lakhs in the balance sheet and depreciation will also be charged on this amount of Rs 80 lakhs.

In situation (ii), the asset should be recorded at a nominal value, say, Rs 100, in the balance sheet, so that the existence of the asset, is reflected. No

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depreciation is to be charged in this case.

Option – 2:

Situation1: Fixed Asset is non-depreciable asset.

The grant is credited to capital reserve, However, if the grant requires the fulfillment of certain obligations then the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income and the deferred income balance should be separately disclosed in the financial statements.

Entry required:

Cash/Bank Account…… Dr.

To Capital reserve A/c

Situation 2: Fixed Asset is depreciable asset – Grant is treated as a deferred income

- Treat the grant as deferred income and recognise it in the profit and loss account in the proportions in which depreciation on such asset is charged.
- Depreciate the asset on the basis of its gross value.

Entries required:

1. Cash/Bank Account……...Dr.

To Government Grant A/c

2. Fixed Asset Account……..Dr.

To Cash/Bank A/c

3. Depreciation A/c……Dr. Entry No 3 & 4 are passed each year

To fixed Asset A/c. during the useful life of the asset

4. Government Grant A/c……..Dr

To P& L Account

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- **Example**

  In the example that has been discussed, if it is desired that Option 2 is followed, then in both the situations, the asset will be recorded at the full value of Rs 1 crore in the balance sheet.

  In the first situation, every year an amount of Rs 2 lakhs (assuming useful life is 10 years and straight line method of depreciation is followed) and in the next case, an amount of Rs 10 lakhs will be credited to the profit and loss account for a period of 10 years.

B. Grant in the nature of revenue receipts (Revenue Approach)

Government grant related to revenue should be recognized on a systematic basis in the profit and loss statement. Such recognition should be spread over the periods necessary to match them with the related costs, which the grant is intended to compensate.

Hence, two alternatives are possible:

Alternative I

Credit the grant to the profit and loss account, either separately or as a part of 'other income'.

Alternative II

Deduct the grant so received from the related expenses (which they intend to compensate).

Refund of Government Grants.

A government grant may have to be refunded if certain conditions attached to it have not been fulfilled. In such a case, the following treatment should be adopted:

Government grants that become refundable should be accounted for as an extraordinary item.

Nature of Grant	***Treatment at the time of receipt of Grant***	***Treatment required at the time of refund***
Revenue	Credited to Profit & Loss	Debit to Profit & Loss

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Revenue/Capital	Credited to Deferred Income	Debit to Deferred Income. *In case of insufficient balance in Deferred Income account, debit Profit & Loss*
Capital	Reduced from value of fixed asset	Increase the value of fixed asset. *Depreciation to be charged on revised asset value prospectively over the remaining useful life of asset.*
Capital	Credited to Capital Reserve	Debit to Capital Reserve

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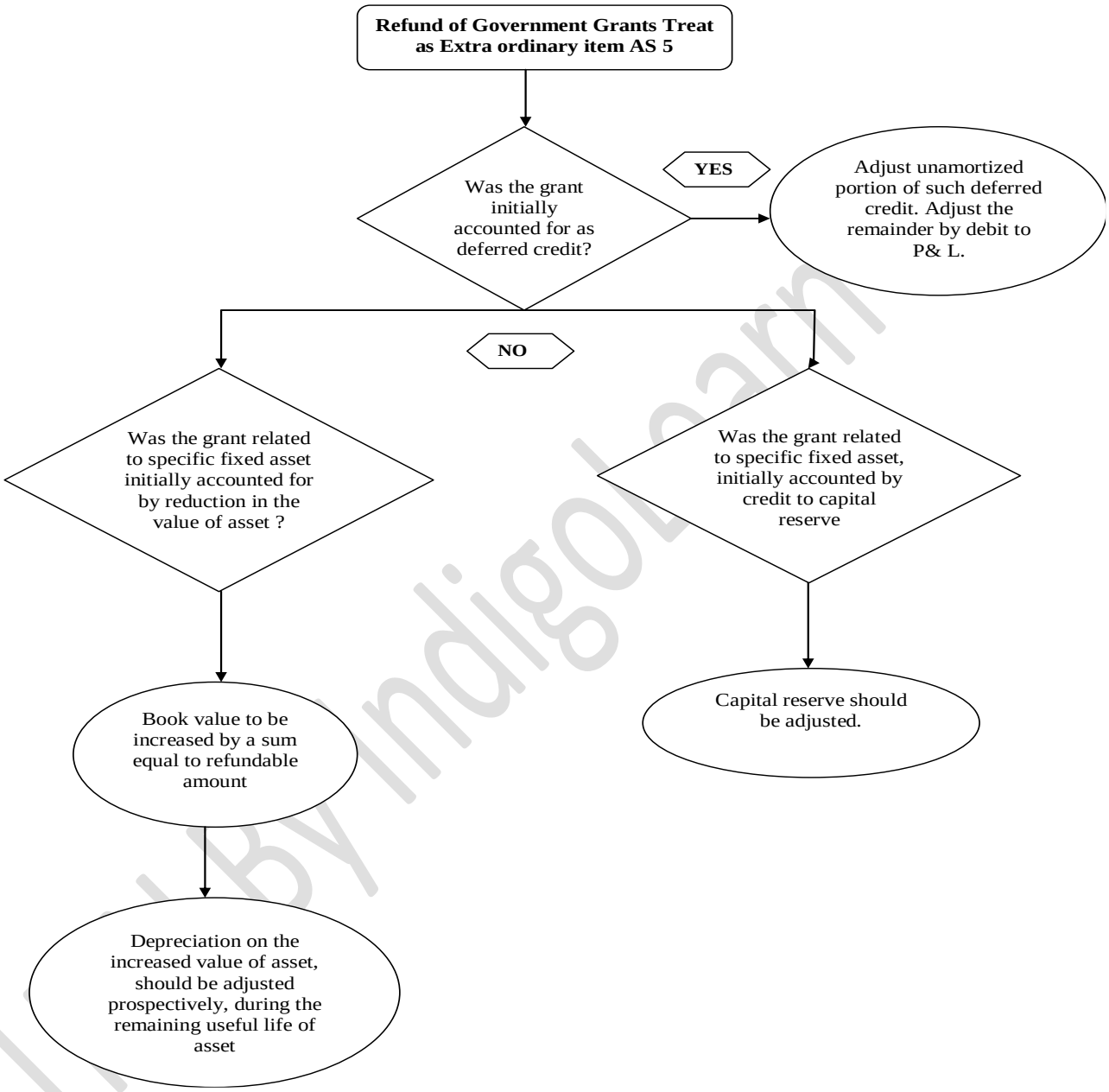

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- **Example**

X Ltd. received a government grant for purchase of plant and machinery. The grant amount was Rs 10 lakhs and the gross value of plant and machinery was Rs 40 lakhs. The grant was received on 1-4-2005 and certain conditions regarding production were attached to it. The plant and machinery, having a useful life of 10 years, was acquired on the same date and put to use. In the year 2008-09, an amount of Rs 4 lakh became refundable as the desired

level of production could not be achieved. Suggest how should this be recorded in the accounts assuming that the company follows straight line method of depreciation?

AS 12 provide several alternatives in which the refund of government grant be treated in accounts. These are as under:

1. An amount of Rs 4 lakhs could be reduced set off against the deferred income balance (in the present case which will be Rs 7 lakhs as the total grant of Rs 10 lakhs will be recognised over a period of 10 years).

2. Alternatively, the book value of the plant and machinery can be increased by Rs 4 lakhs and depreciation calculated accordingly. The relevant calculations are shown below:

	Rs.
Gross Book Value on 1-4-2005	40 lakhs
Net Book value on 1-4-2005	30 lakhs
Annual depreciation (assuming no scrap value)	3 lakhs
Book value on 1-4-2008 (Rs. 30 lakhs – Rs, 9 lakhs)	21 lakhs
Amount of grant refundable	4 lakhs
Revised book value	25 lakhs
Remaining useful life	7 years

Revised annual depreciation

$$= \frac{\text{Revised book value}}{\text{Remaining useful life}}$$

= Rs. 2500000 / 7

= Rs. 3,57,143 (approx)

12.1. Disclosure Requirements: The following are the disclosure requirements of standard.

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- The accounting policy adopted for government grants, including the methods of presentation in the financial statements;

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

12.2. Some Noteworthy points:

1) Grant may be Non-Monetary

Case 1: Grant may be in the form of Assets acquired at concessional rate. e.g. Land allotted in industrial park at concessional rate. in such case it shall be recorded at its. acquisition cost

Case 2: Grant may be in the form of Assets, received free of cost. In such case it is recorded at a Nominal value (say Rs.100) for the purpose of identification and control.

Grant may be receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period. Such grant is recognized in Income statement of the period in which it becomes receivable, as extra-Ordinary items (if considered appropriate) as per AS-5

2) How should a contingency relating to government grants be treated

A contingency related to a government grant, arising after the grant has been recognised, should be treated in accordance with AS 4 on "Contingencies and Events Occurring after the Balance Sheet Date".

3) When can a government grant be treated as an extraordinary item

In the following circumstances a government grant may be treated as an extraordinary item:

a) when the grant is awarded for the purpose of giving immediate financial support to an enterprise rather than as an incentive to undertake specific expenditure;

b) when the grant is awarded as compensation for expenses or losses incurred in a previous accounting period.

In such a case, AS 5 on 'Net Profit or Loss for the period, prior period items and changes in accounting policies' should be followed.

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SAMPLE DISCLOURES IN BALANCE SHEET

Government grants The Group recognizes government grants only when there is reasonable assurance that the conditions attached to them shall be complied with, and the grants will be received. Government grants related to depreciable assets are treated as deferred income and are recognized in the consolidated statement of profit and loss on a systematic and rational basis over the useful life of the asset. Government grants related to revenue are recognized on a systematic basis in the consolidated statement of profit and loss over the periods necessary to match them with the related costs which they are intended to compensate.

OTHER LONG TERM LIABILITIES

Particulars	**March 2015**	**March 2014** ***INR CRORES***
Deferred income - government grant on land use rights*	**—**	**—**

***** During the year ended March 31, 2014, XYZ Co received a grant of approximately `___ crore from Government towards construction of campus which is yet to be completed.

ILLUSTRATIONS

Question 1

Supriya Ltd. received a grant of Rs. 2,500 lakhs during the accounting year 2010-11 from

Government for welfare activities to be carried on by the company for its employees. The grant prescribed conditions for its utilization. However, during the year 2011-12, it was found that the conditions of grants were not complied with and the grant had to be refunded to the government in full.

Elucidate the correct accounting treatment, with reference to the provisions of AS-12.

Solution 1

The Government grant was received for carrying out welfare activities for its employees. The Grant received was of revenue in nature and hence would have been credited to profit and loss account at the time of receipt (or in proportion of expenses over the years in which expenses for employee welfare was incurred).

The amount refundable in respect of a government grant related to revenue is applied first
Against any unamortised deferred credit remaining in respect of the grant. To the extent that
the amount refundable exceeds any such deferred credit, or where no deferred credit exists,
The amount is charged immediately to profit and loss statement. In the present case, the amount of refund of government grant should be shown in the profit & loss account of the company as an extraordinary item during the year 2011-12

A government grant that becomes refundable is treated as an extraordinary item as per AS 5.

Question 2:

A Ltd. purchased a machinery for Rs. 40 lakhs. (Useful life 4 years and residual value

Rs. 8 lakhs). Government grant received is Rs. 16 lakhs.

Show the Journal Entry to be passed at the time of refund of grant and the value of the fixed assets, if:

i. the grant is credited to Fixed Assets A/c.

ii. The grant is credited to Deferred Grant A/c.

Solution 2:

i. **If the grant is credited to Fixed Asset Account,**

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Fixed Asset A/c .... Dr. ... Rs. 16 lacs

To Cash/Bank Rs. 16 lacs

Original Cost	Rs. 40 lacs
Less: Grant Received	Rs. 16 lacs
Carrying Amount	Rs. 24 lacs
Less: Residual Value	Rs. 8 lacs
Depreciable Value	Rs. 16 lacs
Useful Life	4 years
Depreciation Per Year	Rs. 16 lacs/4 = Rs. 4 lacs
WDV at the end of Second Year	= Rs. 24 lacs – Rs. 4 lacs X 2 = Rs. 16 lacs
Add: Amount of Refund	Rs. 16 lacs
Value of Asset after Refund	= Rs. 32 lacs

ii. **If the grant was credited to Deferred Grant Account.**

Depreciation per year = Rs. (40 lacs – Rs. 8 lacs) /4 = Rs. 8 lacs per annum.

The grant will be credited to Profit and Loss Account equally (because depreciation is charged on SLM basis and hence ratio of depreciation is 1:1:1:1).

Amount credited to Profit & Loss Account for 2 years = Rs. 16 lacs/4 X 2 = Rs. 8 lacs.

Balance left in Deferred Grant Account after 2 years = Rs. 16 lacs – Rs. 8 lacs = Rs. 8 lacs.

The refund of grant in this case should be debited to Deferred Grant Account to the extent of balance available. Since the amount of refund is more than the balance in Deferred Grant Account, the shortfall will be debited to profit and loss account.

The journal entry will be:

Deferred Government Grant Dr ... Rs. 8 lacs

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Profit & Loss Account	Dr....	Rs. 8 lacs
To Cash/Bank		Rs. 16 lacs

The refund of grant will not impact the fixed asset account.
Balance in fixed asset account at the time of refund = Rs. 40 lacs – Rs. 8 lacs X 2 = Rs. 24 lacs.

Question 3:

Santosh Ltd. has received a grant of Rs. 8 crores from the Government for setting up a factory in a backward area. Out of this grant, the company distributed Rs. 2 crores as dividend. Also, Santosh Ltd received land free of cost from State Government but it has not recorded it at all in its books as no money has been spent. In the light of AS 12 examine, whether the treatment of both the grants is correct.

Solution 3:

Grant received for setting up a factory is in the nature of promoter's contribution and should be credited to Capital Reserve. Such amount is not available for distribution as dividend. Hence, the company is not permitted to distribute dividend out of such grant. The accounting treatment given by the company is not in accordance with AS-12.

According to AS-12, if assets are received free of cost from Government as a grant, such assets should be recorded at nominal value. Hence, in the given case, the company must record the land received free of cost at a nominal value (say Rs. 1 or Rs. 10). The accounting treatment given by the company is not correct.

Question 4:

Viva Limited received a specific grant of Rs. 30 lacs for acquiring a plant of Rs. 150 lacs during 2007-08 having useful life of 10 years. The grant received was credited to deferred income in the balance sheet.

During 2010-11, due to non-compliance of conditions laid down for the grant, the company had to refund the whole grant to the government. Balance in the deferred income account on that date was Rs. 21 lacs and written down value of the plant was Rs. 105 lacs.

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i. What should be the treatment of refund of grant and the effect on cost of the fixed asset and amount of depreciation charged during the year 2010-11 in profit and loss account?

ii. What should be the treatment of refund, if grant was deducted from the cost of plant during 2007-08 assuming plant account showed a balance of Rs. 84 lacs as on 1.4.2010?

Solution 4:

i. If the amount was initially recorded to deferred income initially, the amount of refund must be debited to the deferred account to the extent of balance available. Any shortfall in deferred income account should be debited to profit and loss account. The total amount of refund is Rs. 30 lacs and the balance available in deferred income account is only Rs. 21 lacs. The shortfall of Rs. 9 lacs must be debited to profit and loss account.

Deferred Income A/c Dr.... Rs. 21 lacs

Profit & Loss A/c Dr. Rs. 9 lacs
To Cash/Bank Rs. 30 lacs

ii. If the grant was deducted from cost of fixed asset account, the amount of refund must be debited to fixed asset account. The value of fixed asset account in this case would be increased by Rs. 21 lacs and the revised value of fixed asset would be depreciated over the balance useful life.

Fixed Asset A/c Dr. ... Rs. 30 lacs
To Cash/Bank Rs. 30 lacs

Balance in Fixed Asset account = Rs. 84 lacs + Rs. 30 lacs = Rs. 114 lacs.
Revised depreciation = Rs. 114/7 = Rs. 16.286 lacs per year.

5.3 AS 15: Accounting for Employee Benefits

REFERENCES:

INDIAN GAAP	AS 15 – EMPLOYEE BENEFITS

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IND AS	IND AS 19 - EMPLOYEE BENEFITS IND AS 19 - APPENDIX B - THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION.

Employee benefits, as the name suggests, comprises of benefits that are payable to the employee as a result of an employer-employee relationship. Employee benefits will also include benefits provided to the dependents of employees. Employment may be part-time, full-time, permanent, temporary or on casual basis. For this standard, employee includes directors and other managerial personnel.

EMPLOYEE BENEFITS

This Statement should be applied by an employer in accounting for all employee benefits, except employee share-based payments. (ESOP).

The standard prescribes accounting and recognition of employee benefits**, the two basic principles being:**

i. Employer should recognize a liability when employees render services in exchange for benefits be paid to them later.

ii. Employer should recognize an expense when the services provided by the employees are consumed by him.

Employee benefits are all forms of consideration given by an enterprise in exchange for service rendered by employees.

FORMS OF EMPLOYEE BENEFIT:

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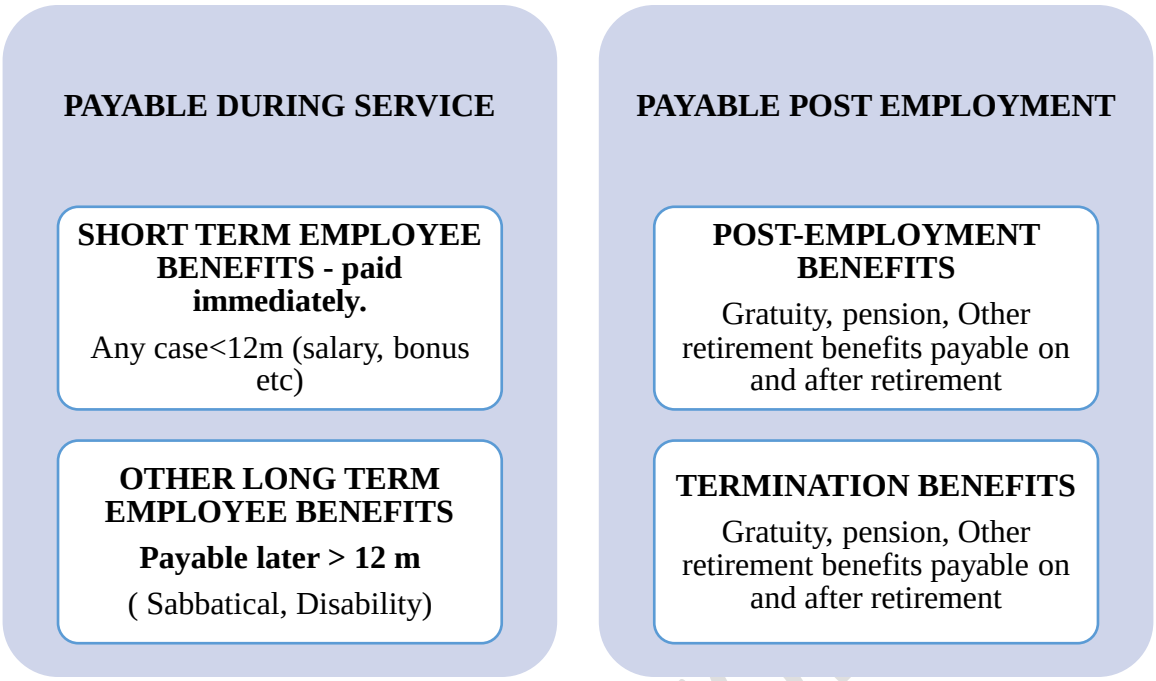

Note: Dictionary meaning of sabbatical Leave: A Leave for a year or half to School / College / University teacher for study / rest

a. **Short-term employee benefits**

Short-term employee benefits are employee benefits (other than termination benefits) which fall due wholly within 12 months after the end of the period in which the employees render the related service.

b. **Post-employment benefits**

Post-employment benefits are employee benefits (other than termination benefits) which are payable after the completion of employment.

c. **Other long-term employee benefits**

Other long-term employee benefits are employee benefits (other than post-employment benefits and termination benefits) which do not fall due wholly within twelve months after the end of the period in which the employees render the related service.

d. **Termination benefits**

Termination benefits are employee benefits payable as a result of either:

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- an enterprise's decision to terminate an employee's employment before the normal retirement date (dismissal); or

- an employee's decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement).

DEFINITIONS

Post-employment benefit plans are formal or informal arrangements under which an enterprise provides post-employment benefits for one or more employees.

Defined contribution plans (DCP) are post-employment benefit plans under which an enterprise pays fixed contributions into a separate entity (a fund) and will have no obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Defined benefit plans (DBP) are post-employment benefit plans other than defined contribution plans.

Multi-employer plans are defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:

- pool the assets contributed by various enterprises that are not under common control; and

- use those assets to provide benefits to employees of more than one enterprise, on the basis that contribution and benefit levels are determined without regard to the identity of the enterprise that employs the employees concerned.

Net defined benefit liability (asset)

It is the deficit or surplus adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

Deficit or Surplus is

a. the present value of the defined benefit obligation LESS
b. the fair value of the plan assets if any

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Asset Ceiling

It is the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

Interest cost is the increase during a period in the present value of a defined benefit obligation which arises because the benefits are one period closer to settlement.

Plan assets comprise:

- assets held by a long-term employee benefit fund; and
- qualifying insurance policies.

Assets held by a long-term employee benefit fund are assets (other than non-transferable financial instruments issued by the reporting enterprise) that:

- are held by an entity (a fund) that is legally separate from the reporting enterprise and exists solely to pay or fund employee benefits; and
- are available to be used only to pay or fund employee benefits, are not available to the reporting enterprise's own creditors (even in bankruptcy), and cannot be returned to the reporting enterprise, unless either:
  - the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting enterprise; or
  - the assets are returned to the reporting enterprise to reimburse it for employee benefits already paid.

A qualifying insurance policy is an insurance policy issued by an insurer that is not a related party (as defined in AS 18 Related Party Disclosures) of the reporting enterprise, if the proceeds of the policy:

- are not available to the reporting enterprise's own creditors (even in bankruptcy) and cannot be paid to the reporting enterprise, unless either:

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- the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or

- the proceeds are returned to the reporting enterprise to reimburse it for employee benefits already paid.

Fair Value

It 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

Service Cost

It comprises of

a. ***Current service cost*** which is the increase in the present value of the defined benefit obligation resulting from employee service in the current period.

b. ***Past service cost*** which is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting in the current period from the introduction of, or changes to, post-employment benefits or other long-term employee benefits.

Past service cost may be either positive (where benefits are introduced or improved) or negative (where existing benefits are reduced).

c. Any gains and losses on settlement

Net interest on the net defined benefit liability (asset)

It is the change during the period in the net defined benefit liability (asset) that arises from the passage of time.

Re-measurements of the net defined benefit liability (asset)

It comprises of:

a. Actuarial gains and losses
b. Return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and
c. any change in the effect of the asset ceiling, excluding amounts

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included in net interest on the net defined benefit liability (asset).

Actuarial gains and losses

Actuarial gains and losses comprise:

- experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and
- the effects of changes in actuarial assumptions.

Settlement

It is a transaction that eliminates all further legal or constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.

Vested employee benefits are employee benefits that are not conditional on future employment.

The ***present value of a defined benefit obligation*** is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

BASIC PRINCIPLES

Though the standard prescribes 4 different methods, the recognition can be narrowed down to 2 principles:

a. Accrual basis of accounting
b. Applying present value concept and recognizing a future liability at present value as on the balance sheet date

Therefore, recognize the expenses of benefit to employees during their service Period, which may be paid.

a. Currently;
b. On Retirement; or
c. Post Retirement

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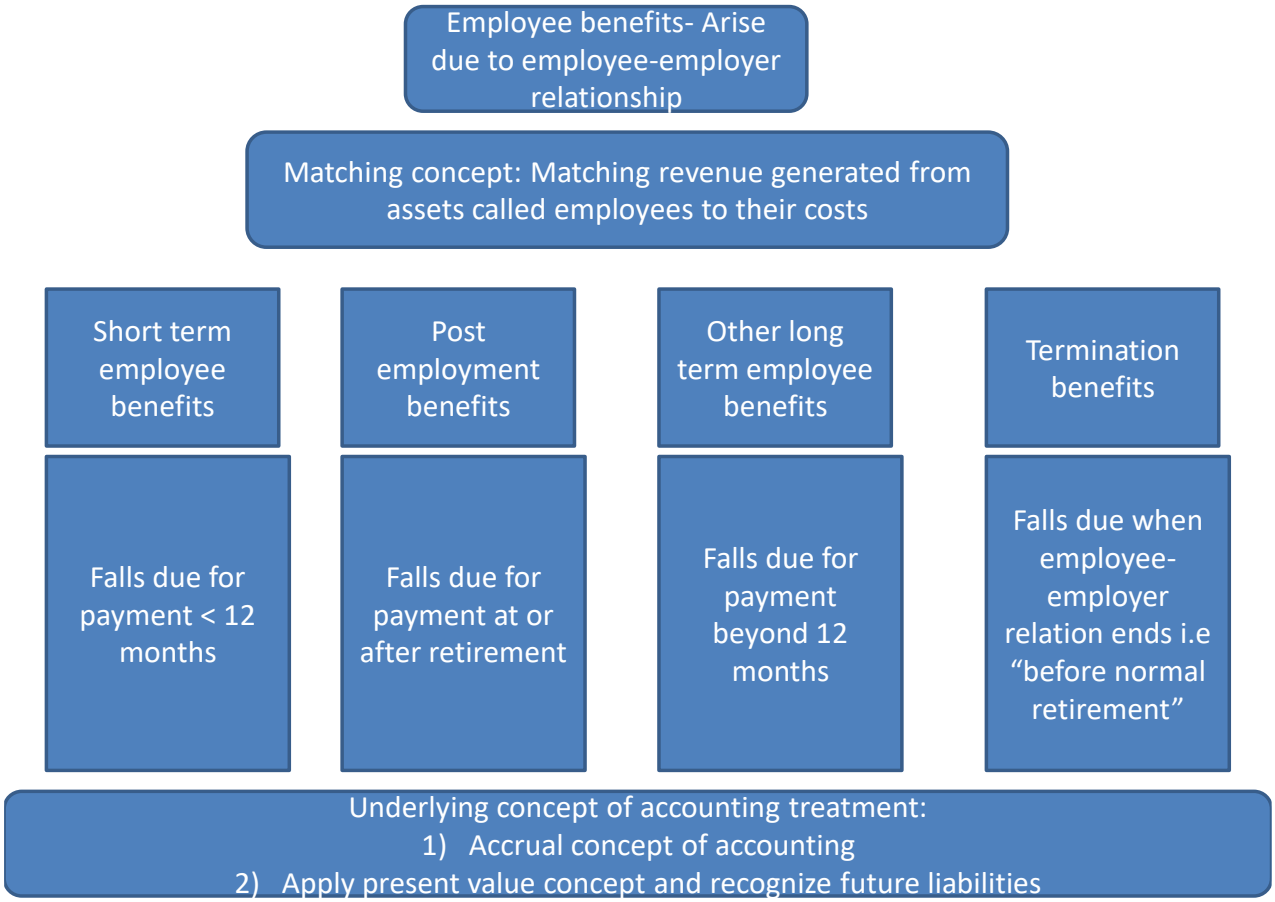


SCOPE

It Covers all employee Benefits as per

- Formal agreement;
- Legislative requirement; and
- Informal practice

It does not cover

- Employee benefit Plans e.g., ESOP

SHORT TERM EMPLOYEE BENEFITS

All short-term employee benefits are to be recognised on an undiscounted basis (actual cost). The expenses in relation to the revenue derived from the employees are to be accrued. If the amount paid already exceeds the amount expected to be payable then the excess is to be recognised as an asset. In case of capitalization of self-constructed fixed asset, a part of cost can be included

as cost of an asset. The following generally fall under short term employee benefits-

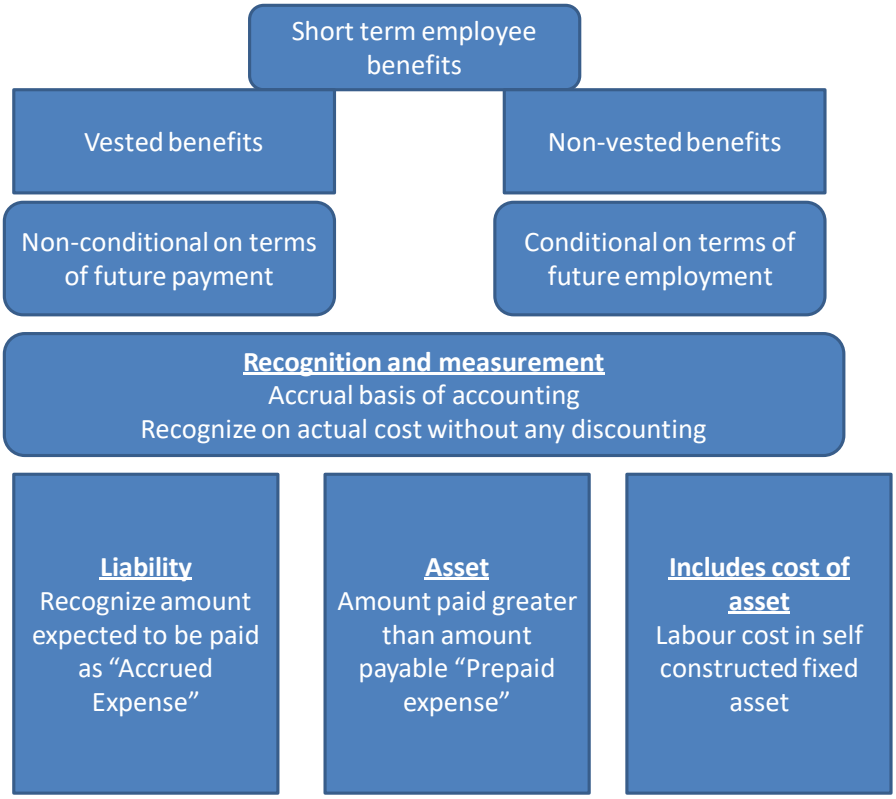
1. Wages, Salaries
2. Leave Compensation
3. Bonus
4. Non-Monetary Benefits

Vested benefits

- They are not conditional on terms of future employment. The benefit would be payable without any terms attached to the scheme of benefit

Non-vested benefits

- They are conditional on terms of future employment. The benefit would be payable on satisfaction of the terms attached to the scheme of benefits



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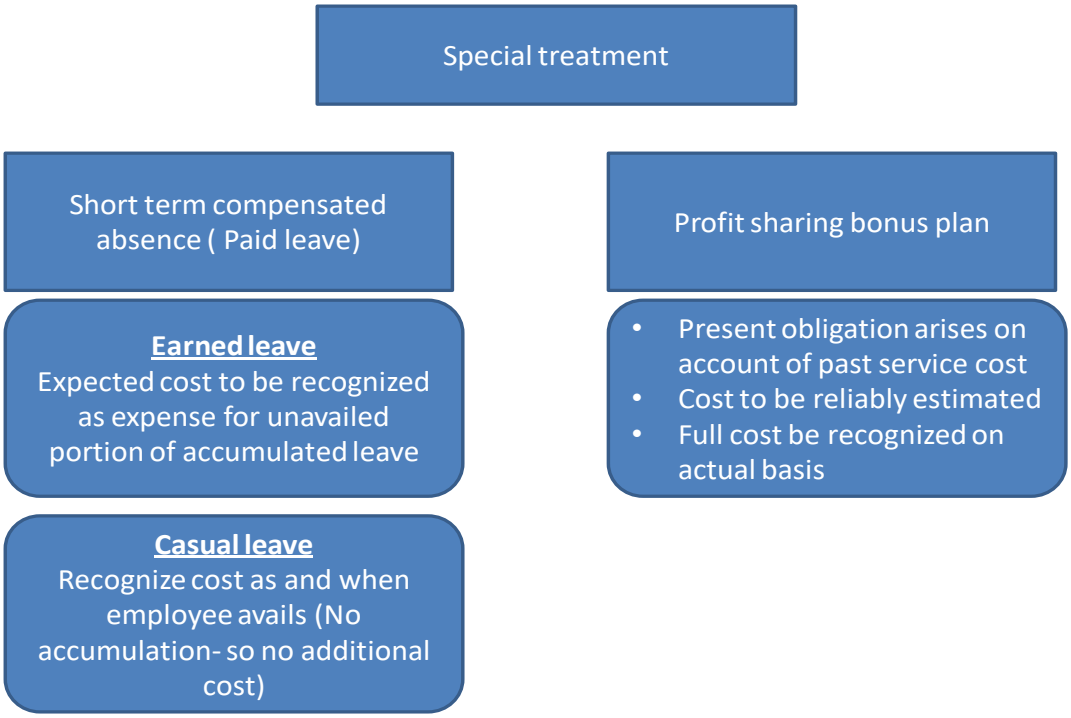
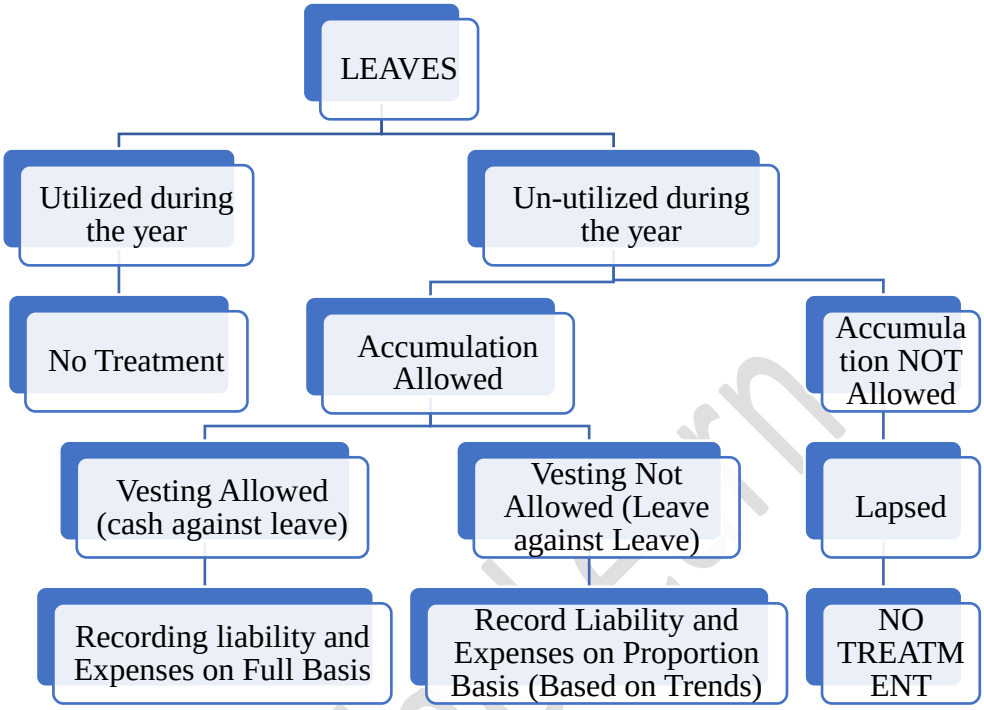
The standard provides additional guidance on recognition and measurement of short-term compensated absences and profit sharing bonus plans. These forms of short term benefits require an element of estimation. The estimation of short term benefits does not require actuarial valuation of these estimates as these are not complex estimations and the entity can make a reliable estimate on its own.





POST EMPLOYMENT BENEFITS

- Gratuity

- Pension/Superannuation

- Provident Fund

- Medical Facilities

The recognition and measurement is based on the classification of the benefits. They are classified as under:

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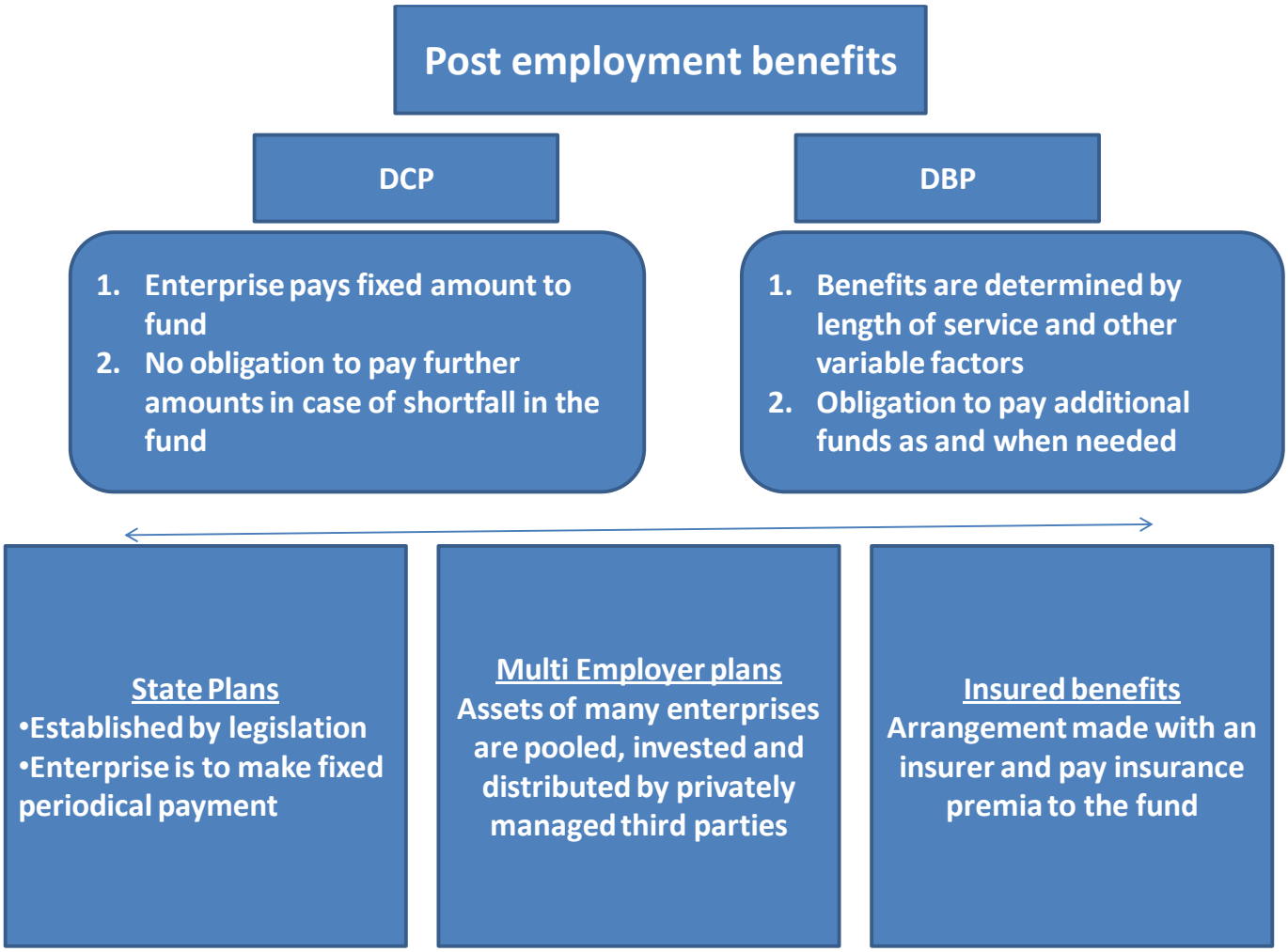
Post employment benefits
DCP
DBP
1. Enterprise pays fixed amount to fund
2. No obligation to pay further amounts in case of shortfall in the fund
1. Benefits are determined by length of service and other variable factors
2. Obligation to pay additional funds as and when needed
State Plans
•Established by legislation
•Enterprise is to make fixed periodical payment
Multi Employer plans
Assets of many enterprises are pooled, invested and distributed by privately managed third parties
Insured benefits
Arrangement made with an insurer and pay insurance premia to the fund

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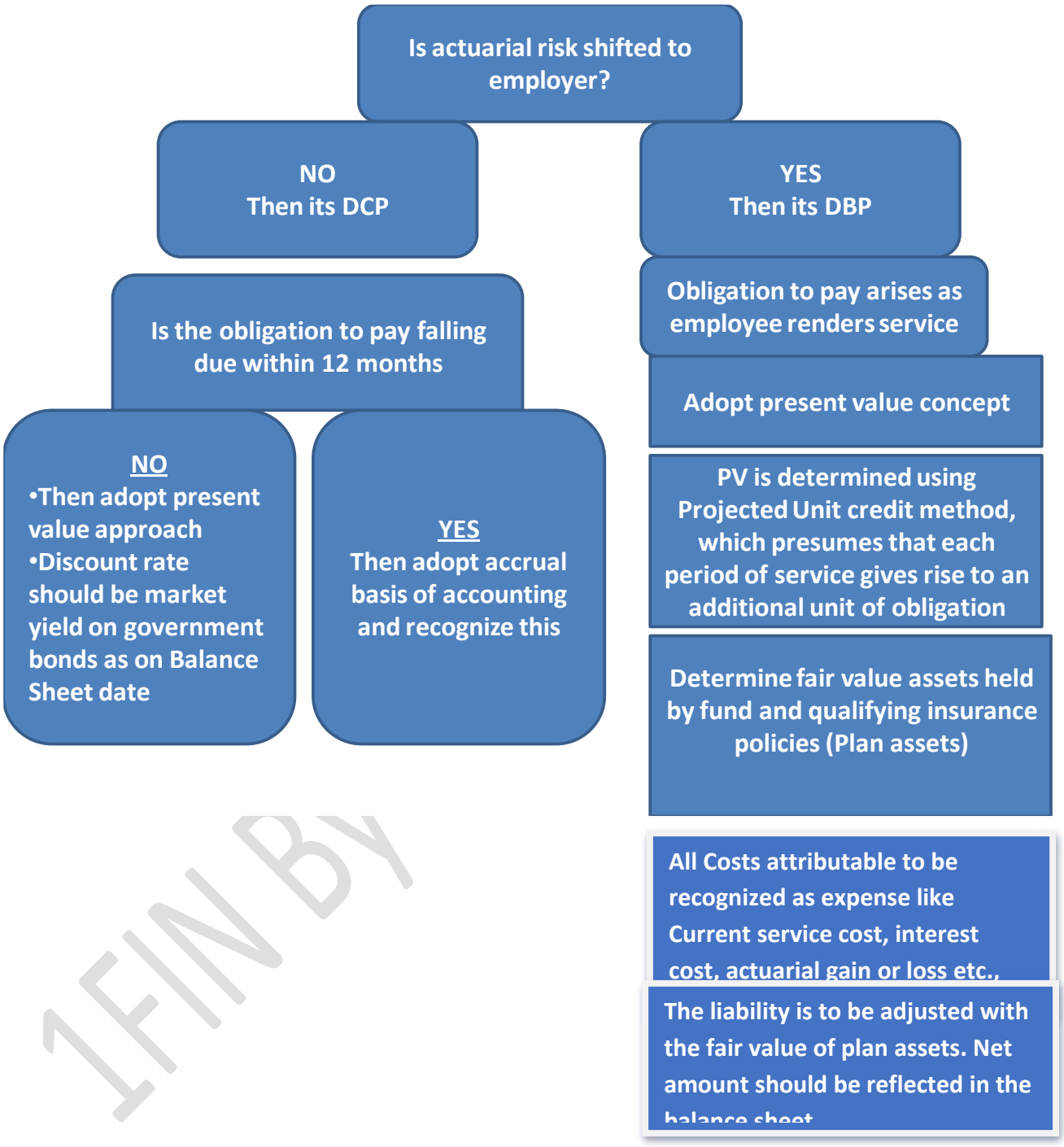
Is actuarial risk shifted to employer?
NO
Then its DCP
YES
Then its DBP
Is the obligation to pay falling due within 12 months
Obligation to pay arises as employee renders service
Adopt present value concept
NO
•Then adopt present value approach
•Discount rate should be market yield on government bonds as on Balance Sheet date
YES
Then adopt accrual basis of accounting and recognize this
PV is determined using Projected Unit credit method, which presumes that each period of service gives rise to an additional unit of obligation
Determine fair value assets held by fund and qualifying insurance policies (Plan assets)
All Costs attributable to be recognized as expense like Current service cost, interest cost, actuarial gain or loss etc.,
The liability is to be adjusted with the fair value of plan assets. Net amount should be reflected in the balance sheet

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Summary of Accounting Principles for Defined Contribution Plan

Situation (1)	Situation (2)
When obligation of an enterprise fall due for payment within 12 months	When obligations of an enterprise do not wholly fall due for payment within 12 months (i.e., > 12 months)
Recognise the liability (and expense) on accrual basis of accounting	Recognise the liability (and expense) at its Present Value.
	Discount rate should be the market yield on Government Bonds as on balance Sheet date. Adopt the yield for that tenor which equals the term of obligations. E.g., if the term of obligations of an employer entity is estimated at 8 years, discount rate should be the yield-to-maturity rate for Government Bond with a remaining maturity of 8 years.

Disclosures for Defined Contribution Plans: The Standard provided disclosure in two area

i. **In Profit & Loss:** An enterprise should disclose the amount recognised as an expense for defined contribution plans.

ii. **As a part of Notes on Accounts:** Where required by AS 18 (Related Party Disclosures), an enterprise disclose information about contributions to defined contribution plans for key management personnel.

Accounting by an enterprise for defined benefit plans involves the following steps:

Step 1: Reliable estimate of Employee Benefits: using actuarial techniques to make a reliable estimate of the amount of benefit that employees have earned in return for their service in the current and prior periods. This requires an enterprise to determine how much benefit is attributable to the current and prior periods and to make estimates (actuarial assumptions) about demographic variables (such as employee turnover and mortality) and financial variables (such

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as future increases in salaries and medical costs) that will influence the cost of the benefit

Step 2: discounting that benefit using the Projected Unit Credit Method in order to determine the present value of the defined benefit obligation and the current service cost;

Step 3: determining the fair value of any plan assets;

Following Adjustments are often required:

(a) determining the total amount of actuarial gains and losses ;

(b) where a plan has been introduced or changed, determining the resulting past service cost ; and

(c) where a plan has been curtailed or settled, determining the resulting gain or loss.

In Profit and Loss Account following expenses are to be provided:

1. Current Service Cost
2. Interest Cost
3. Expected return on Plan Asset
4. Actuarial gain or losses
5. Past Service Cost
6. Effect of any curtailment or settlement

Noteworthy Points in relation to Defined Benefit Plan:

1. Where an enterprise has more than one defined benefit plan, the enterprise applies these procedures for each material plan separately.
2. For measuring the amounts, in some cases, estimates, averages and simplified computations may provide a reliable approximation of the detailed computations. An enterprise should account not only for its legal

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obligation under the formal terms of a defined benefit plan, but also for any other obligation that arises from the enterprise's informal practices.

Informal practices give rise to an obligation where the enterprise has no realistic alternative but to pay employee benefits. An example of such an obligation is where a change in the enterprise's informal practices would cause unacceptable damage to its relationship with employees. Simplified computations may provide a reliable approximation of the detailed computations.

3. **Actuarial Valuation Method:** An enterprise should use the Projected Unit Credit Method to determine the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost.

The Projected Unit Credit Method (sometimes known as the accrued benefit method pro-rated on service or as the benefit/years of service method) considers each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation. An enterprise discounts the whole of a post-employment benefit obligation, even if part of the obligation falls due within twelve months of the balance sheet date.

4) Attributing Benefit: In determining the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost, an enterprise should attribute benefit to periods of service under the plan's benefit formula. However, if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an enterprise should attribute benefit on a straight-line basis from:

(a) the date when service by the employee first leads to benefits under the plan (whether or not the benefits are conditional on further service); until

(b) the date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.

5) Actuarial Assumptions: Actuarial assumptions are needed to estimate the size of the future (post-employment) benefits that will be payable under a defined benefits scheme. The main categories of actuarial assumptions are as follows:

Demographic assumptions	**Financial assumptions**

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• Mortality rates before and after retirement	• Discount rates to apply
• Rate of employee turnover	• Expected return on Plan assets
• Early retirement	• Future salary levels (allowing for seniority and promotion as well as inflation)
• Claim rates under medical plans for former employees	• Future rate of increase in medical costs (not just inflationary cost rises, but also cost rises specific to medical treatments and to medical treatments required given the expectations of longer average life expectancy)

The standard requires actuarial assumptions to be neither too cautious nor too imprudent : they should be 'unbiased'. They should also be based on market expectations' at the reporting date, over the period during which the obligations will be settled.

Assumption about Discount Rate: The rate used to discount post-employment benefit obligations (both funded and unfunded) should be determined by reference to market yields at the balance sheet date on government bonds. The currency and term of the government bonds should be consistent with the currency and estimated term of the post-employment benefit obligations.

Actuarial Gains and Losses: Actuarial gains and losses should be recognised immediately in the statement of profit and loss as income or expense.

6) Past Service Costs: In measuring its defined benefit liability, an enterprise should recognise past service cost as an expense on a straight-line basis over the average period until the benefits become vested. To the extent that the benefits are already vested immediately following the introduction of, or changes to, a defined benefit plan, an enterprise should recognise past service cost immediately.

Past service cost arises when an enterprise introduces a defined benefit plan or changes the benefits payable under an existing defined benefit plan. Such changes are in return for employee service over the

period until the benefits concerned are vested. Therefore, past service cost is recognised over that period, regardless of the fact that the cost refers to employee service in previous periods. Past service cost is measured as the change in the liability resulting from the amendment.

7) Curtailments & Settlements: A curtailment occurs when an enterprise either:

(a) has a present obligation, arising from the requirement of a statute/regulator or otherwise, to make a material reduction in the number of employees covered by a plan; or

(b) amends the terms of a defined benefit plan such that a material element of future service by current employees will no longer qualify for benefits, or will qualify only for reduced benefits.

A curtailment may arise from an isolated event, such as the closing of a plant, discontinuance of an operation or termination or suspension of a plan. An event is material enough to qualify as a curtailment if the recognition of a curtailment gain or loss would have a material effect on the financial statements. Curtailments are often linked with a restructuring. Therefore, an enterprise accounts for a curtailment at the same time as for a related restructuring.

A settlement occurs when an enterprise enters into a transaction that eliminates all further obligations for part or all of the benefits provided under a defined benefit plan, for example, when a lump-sum cash payment is made to, or on behalf of, plan participants in exchange for their rights to receive specified post-employment benefits.

An enterprise should recognise gain or losses on the curtailment or settlement of a defined benefit plan when the curtailment or settlement occurs. The gain or loss on a curtailment or settlement should comprise:

a) any resulting change in the present value of the defined benefit obligation;

b) any resulting change in the fair value of the plan assets;

c) any related past service cost that, had not previously been recognised.

Before determining the effect of a curtailment or settlement, an enterprise should remeasure the obligation (and the related plan assets, if any) using current actuarial assumptions (including current market interest rates and other

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current market prices).

8) Defined Benefit Plan Assets:

a) Meaning: Defined Benefit Plan assets mean those assets created for sole purpose of meeting the cash flows relating to payment of benefits to employees and not for any other purpose. These are not held by employer entity. Third party entity holds these assets. Fair value of these assets represents the amount that is available to settle the benefit payments.

b) Recognition of Defined Benefit Asset: Plan asset shall be recognised at it's fair value. When no market price is available, the fair value of plan assets is estimated. e.g. by discounting expected future cash flows using a discount rate that reflects both risk associated with plan assets and the maturity or expected disposal rate of these assets (if they have no maturity, the expected period until the settlement of the related obligation).

Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations, as described in paragraph 55 (subject to any reduction required if the amounts receivable under the insurance policies are not recoverable in full)

Plan assets exclude unpaid contributions due front the reporting enterprise to the fund, as well as any non-transferable financial instruments issued by the enterprise and held by the fund. Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, for example, trade and other payables and liabilities resulting from derivative financial instruments.

c) Return on Plan Assets: Difference between the expected return on plan assets and the actual return on plan assets is an actuarial gain or Loss.

The expected return on plan assets is based on market expectations, at the beginning of the period, for returns over the entire life of the related obligation. The expected return on plan assets reflects changes in the fair value of plan assets held during the period as a result of actual contributions paid into the fund and actual benefits paid out of the fund.

In determining the expected and actual return on plan assets, an enterprise deducts expected administration costs, other than those included in the actuarial assumptions used to measure the obligation.

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d) **Reimbursements:** When, and only when, it is virtually certain that another party will reimburse some or all of the expenditure required to settle a defined benefit obligation, an enterprise should recognise its right to reimbursement as a separate asset. The enterprise should measure the asset at fair value. In all other respects, an enterprise should treat that asset in the same way as plan assets. In the statement of profit and loss, the expense relating to a defined benefit plan may be presented net of the amount recognised for a reimbursement.

Sometimes, an enterprise is able to look to another party, such as an insurer, to pay part or all of the expenditure required to settle a defined benefit obligation. Qualifying insurance policies are plan assets. An enterprise accounts for qualifying insurance policies in the same way as for all other plan assets. When an insurance policy is not a qualifying insurance policy, the enterprise recognises its right to reimbursement under the insurance policy as a separate asset, rather than as a deduction in determining the defined benefit liability.

e) **Offset:** An enterprise should offset an asset relating to one plan against a liability relating to another plan when, and only when, the enterprise:

   i. has a legally enforceable right to use a surplus in one plan to settle obligations under the other plan; and

   ii. intends either to settle the obligations on a net basis, or to realise the surplus in one plan and settle its obligation under the other plan simultaneously.

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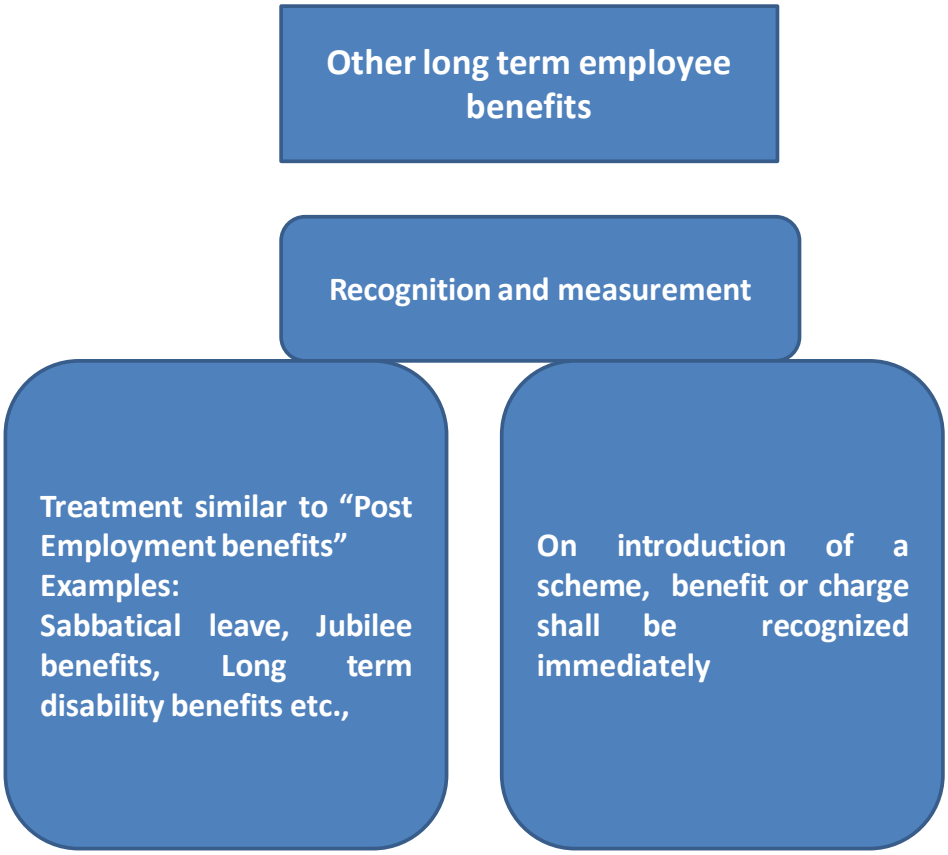
OTHER LONG-TERM EMPLOYEE BENEFITS



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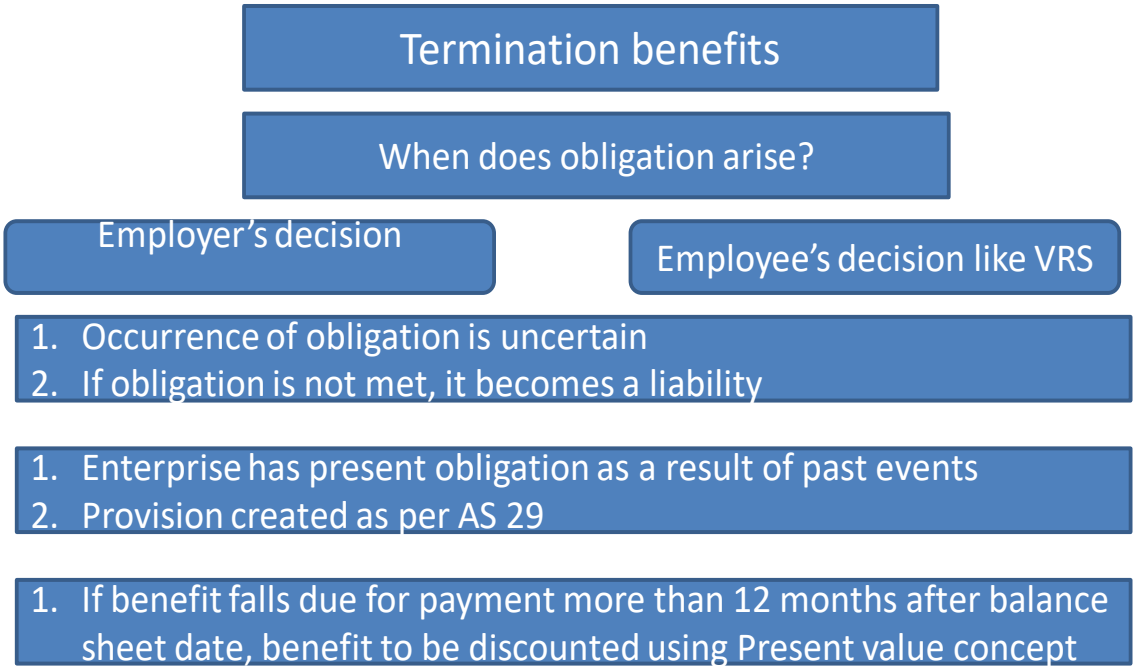
TERMINATION BENEFITS



Actuarial Assumptions

a. Demographic
   - Mortality
   - Employee Turnover

b. Financial
   - Future Salary increase
   - Discount rate
   - Return on plan asset
   - Medical Treatment Cost
   - Change in cost of Medical Services

Discount rate to be as per return on Government Bonds

Special Features of Revised AS-15

- Disclosure of Different Components of cost to be charged to P& L Account.
- Disclosure and break up of actuarial assumptions.
- Discounting Rates as per yield on Government Bonds.
- Actuarial Assumptions may be reviewed by Management/ Auditors.
- Benefit Obligations and plan asset to be separately disclosed.
- Management of plan assets is separately reflected.

Disclosures

- Nature of Defined Benefit plans and effect of changes if any.
- Break up and reconciliation of different components of defined benefit obligation.
- Break up and reconciliation of different components or plan assets and return on assets.
- Expenses recognized in P& L Account in different components.
- Main Actuarial assumptions used.

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AS 15 VIS-À-VIS IND AS 19

Employee Benefits - Primary literature	AS 15 (Revised 2005) - Employee Benefits	Ind AS 19 - Employee Benefits Ind AS 19 - Appendix B - The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction.
Short - term and other long-term employee benefits	The distinction between short-term and other long-term employee benefits depends on whether they fall wholly due within 12 months after the end of the period in which the employees render the related service. There is an inconsistency in the definition of short-term employee benefits and the current / non-current classification in Schedule III. While the definition of short-term employee benefits as per AS 15 refers to benefits "which fall due wholly within 12 months after the end of the period in which the employees render the related service", as per Schedule III requirements, for classification as current liabilities, the benefits should be "due to be settled within 12 months after the reporting date".	The distinction between short-term and other long-term employee benefits depends on whether those benefits are expected to be settled wholly before twelve months after the end of the annual reporting period. Short-term employee benefits are recognised as an expense in the period in which the Employee renders the related service. Unpaid short-term benefit liability is measured at an undiscounted amount.

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	However, the Guidance Note to the Revised Schedule VI to the Companies Act, 1956 (Schedule VI has been superseded by Schedule III under the companies Act, 2013), issued by ICAI, has clarified that while AS 15 governs the measurement requirements, Schedule VI (now Schedule III) governs the presentation requirements. Therefore, each company will need to apply these criteria to its facts and circumstances and decide an appropriate classification of its employee benefit obligations.	
Short-term compensated absences	Short-term employee benefits include short-term compensated absences where the absences are expected to occur within 12 months after the end of the period in which the employees render the related service. There is an inconsistency in the description of short-term compensated absences and the current / non-current classification in Schedule III. While the description of short-term employees compensated absence as per AS 15 refers to absences that "are expected to occur within 12 months after the end of the period in which the	Short-term employee benefits include paid annual leave and paid sick leave if it is expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services.

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	employees render the related service", as per Schedule III requirements, for classification as current liabilities, the absences should be "due to be settled within 12 months after the reporting date". However, the Guidance Note to the Revised Schedule VI to the Companies Act, 1956 (Schedule VI has been superseded by Schedule-III under the Companies Act, 2013), issued by ICAI, has clarified that while AS 15 governs the measurement requirements, Schedule VI (now Schedule III) governs the presentation requirements. Therefore, to the extent the employees has an unconditional right to avail the leave, the same needs to be classified as current even though a portion of the same may have to be measured as other long term employee benefits as per AS 15	
Actuarial valuation	Similar to Ind AS, except that detailed actuarial valuation to determine present value of the benefit obligation is carried out at least once every three years and fair value of plan assets are determined at each balance other date.	Detailed actuarial valuation to determine the present value of the net defined benefit liability (asset) is performed with sufficient regularly so that the amounts recognised in the financial statements do not differ materially from the amounts that would have been

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		determined at the end of the reporting period IAS 19 does not specify sufficient regularity.
Actuarial gains and losses	All actuarial gains and losses should be recognised immediately in the statement of profit and loss	Actuarial gains and losses representing changes in the present value of the defined benefit obligation resulting from experience adjustment and effects of changes in actuarial assumptions are recognised in other comprehensive income and not reclassified to profit or loss in a subsequent period.
Discount rate	Market yields at the balance sheet date on government bonds are used as discount rates. The currency and term of the government bonds should be consistent with the currency and estimated term of the post-employment benefit obligations.	Post-employment benefit obligations (both funded and unfunded) should be discounted using a discount rate determined by reference to market yields at the end of the reporting period on government bonds. However, subsidiaries, associates, joint ventures and branches domiciled outside India should use a rate determined by reference to market yields on high quality corporate bonds at the end of the reporting period. 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 should be used. The currency and term

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		of the government bonds or corporate bonds should be consistent with the currency and estimated term of the post-employment benefit obligations.
Defined benefit plans	The changes in defined benefit liability (surplus) has the following components : a) Service cost - recognised in profit or loss; b) Interest cost - recognised in profit or loss; c) The expected return on any plan assets - recognised in profit or loss; d) Net actuarial gains and losses - recognised in profit or loss.	The change in the defined benefit liability (asset) has the following components: a) Service cost - recognised in profit or loss; b) Net interest cost (i.e. time value) on the net defined benefit deficit / (asset) - recognised in profit or loss; c) Remeasurement including i) changes in fair value of plan assets that arise from factors other than time value and ii) Actuarial gains and losses on obligations - recognised in other comprehensive income.
Termination benefits	Termination benefits are recognised as a liability and an expense when, and only when: * the enterprise has a present obligation as a result of a past event; * it is probable that an outflow of resources embodying economic benefits will be required to	A termination benefit liability is recognised as the earlier of the following date : * When the entity can no longer withdraw the offer of those benefits - additional guidance is provided on when this occurs in relation to an employee's decision to accept an offer of benefits on termination and as a result of an entity's decision to

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	settle the obligation; and * a reliable estimate can be made of the amount of the obligation.	terminate an employee's employment. * When the entity recognizes costs for a restructuring under IND AS 37 provisions, Contingent Liabilities and Contingent Assets which involves the payment of termination benefits.
Past service cost and curtailments	Past service cost is recognised as under: * As an expense on a straight-line basis over the average period until the benefits become vested. * If benefits already vested, recognised as an expense immediately. Entitles recognize a curtailment when it occurs. However when a curtailment is linked with a restructuring, it is accounted for at the same time as the related restructuring.	Past service cost (includes curtailments) is recognised as an expense at the earlier of the following dates: * When the plan amendment or curtailment occurs; and * When the entity recognizes related restructuring costs or termination benefits.
Actuarial assumptions - administration costs	The expected and actual return on plan assets is arrived at after deducting expected administrative costs, other than those included in the actuarial assumptions used to measure the defined benefit obligation. But AS 15 does not specify which costs	In determining the return on plan assets, an entity deducts the costs of managing the plan assets and any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the defined benefit obligation. Other administration costs are not deducted from the return on plan assets

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	should be included in those actuarial assumptions.	
Contributions from employees or third parties to defined benefit plans	No specific guidance	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.
The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their interaction	No specific guidance	Addresses when refunds or reductions in future contributions are regarded as available for recognition of an asset; how minimum funding requirements may affect the availability of reductions in future contributions and when minimum funding requirement may give rise to a liability. It also deals with prepayments of a minimum funding requirement.

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OTHER KEY ASPECTS OF IND AS 19

1. DISCLOSURES

SHORT TERM; OTHER LONG TERM AND TERMINATION BENEFITS

- NO SPECIFIC DISCLOSURE REQUIREMENTS

DEFINED CONTRIBUTION PLANS

- Amound recognized as expense for DCP in P&L
- DCP for Key Managerial Personnel as per Ind AS 24

DEFINED BENEFIT PLAN

- General description of the type of plan
- Net defined benefit liability/ (asset) - showing separate reconciliation between opening and closing balances of PV of obligation and FV of plan assets. Reconcicliation should comprise
  - Current service cost
  - Interest income or expense
  - Return on plan assets
  - Actuarial gains and losses arising from demographic assumptions
  - Actuarial gains and losses arising from changes in financial assumptions
  - Past service costs
  - Gains and losses from settlements
  - effects of changes in forex rates
  - contribution to the plan
  - payments from the plan
  - effects of business combinations and disposals
- Principal actuarial assumptions
- A sensitivity analysis for each significant actuarial assumptions, showing how defined benefit obligation would have been affected
- methods and assumptions used in sensitivity analysis and changes from previous period

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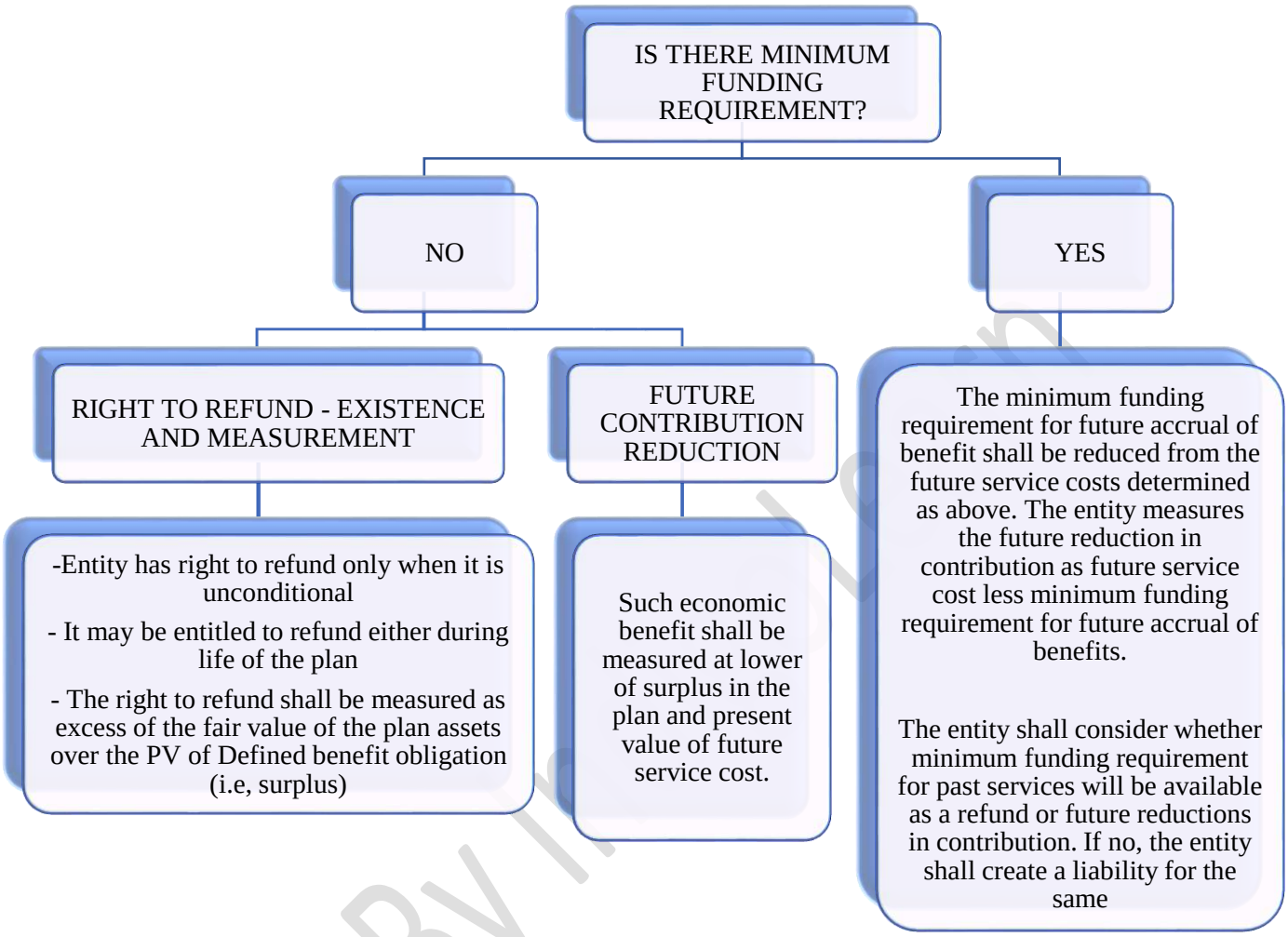
2. APPENDIX A TO IND AS 19 - THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION.



3. COMPARISION WITH IFRS

For determining discount rates, corporate bond rates can be taken in case of IFRS, whereas only government bond rates are allowed in IND AS.

Illustrations

Illustration -1

A Company has a scheme for settlement allowance to retiring employees. Under the scheme retiring employees are allowed to reimbursement of certain travel expenses for a class they are entitled to as per company rules and to a lumpsum payment to cover expenses of food and stay during the travel. Alternatively, employees can

claim a lumpsum amount equal to one month pay last drawn.

The company's contention in this matter are

(i) Settlement allowance does not depend upon length of service of employee, it is restricted to employees eligibility under travel rules of the company or where option for lumpsum payment is exercised, equal to last pay drawn.

(ii) Since it is not related to length of service of employee it is accounted on claim basis.

State whether contentions of the company are correct as per relevant accounting standards. Give reasons in support of your answer

Solution

Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15 (Revised). A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation. Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company's obligation under the scheme is uncertain and requires estimation.

Illustration - 2

As on 1st April 2008, the fair value of Plan assets is Rs 1 lac in respect of pension plan of Zealius Ltd. On 30th September 2008 the plan laid out benefits of Rs.19,000 and received inward contributions of Rs.49,000.

Plan Assets on 1/4/08	Rs. 1 lac
As on 30/9/08	
Paid out benefits (A)	Rs.19,000
Contribution from company(B)	Rs.49,000
Net difference(B-A)	Rs 30,000

On 31st March 2009 the fair value of plan assets was Rs.1,50,000 and present value of defined benefits obligation was Rs.1,47,920. Actuarial losses on obligations for the year 2008-09 was Rs.600.

On 1st April 2008 the company made the following estimates based on its market studies understanding prevailing prices.

- Interest and dividend incomes after tax payable by the fund 9.25%

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- Realised & Unrealised gain on plan assets after tax 2%
- Fund administrative costs 1%
- Expected rate of return 10.25%

Find the expected and actual return on plan assets.

Solution

	Amount	Interest Rate	Period	Workings	Amount (Rs)
Opening balance	1,00,000	10.25%	12m	1,00,000 X 12/12 X 10.25%	10,250
Net Amount	30,000	10.25%	6m	30,000 X 6/12 X 10.25 = 30,000 X 5%	1,500
Total Expected return on plan assets					11,750

Plan Assets A/c (Rs)

To Bal b/d	1,00,000	By Benefits Paid	19,000
To Contributions	49,000		
To Return on Plan Assets (Bal figure)	20,000		
		By Bal c/d	1,50,000
	1,69,000		1,69,000

Illustration 3

The following data applies to X Ltd. Define benefit pension plan for the year ended 31 March 2009. Calculate the actual return on plan assets

Benefits paid	Rs. 2.00 lacs
Employer contribution	Rs. 2.80 lacs
Fair market value of plan assets on 31 March 2009	Rs.11.40 lacs
Fair market value of plan assets on 31 March 2008	Rs. 8.00 lacs

Solution

Plan Assets A/c (Rs)

To Bal b/d	8,00,000	By Benefits Paid	2,00,000
To Contributions	2,80,000		

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To Return on Plan Assets (Bal Figure)	2,60,000		
		By Bal c/d	11,40,000
	13,40,000		13,40,000

Illustration - 4

Kumar Ltd. is in engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of Rs. 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to Rs. 2 lakhs instead of Rs. 5 lakhs. The average remaining life of the employee is estimated to be 6 years.

You are required to advise the company.

Solution

According to AS 15 (Revised) "Employee Benefits", actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus of Rs. 6 lakhs in the pension scheme on its actuarial valuation is required to be credited to the profit and loss statement of the current year.

Hence, Kumar Ltd. cannot spread the actuarial gain of Rs. 6 lakhs over the next 2 years by reducing the annual contributions to Rs. 2 lakhs instead of Rs. 5 lakhs. It has to contribute Rs. 5 lakhs annually for its pension schemes and provide for the same as an expense.

Illustration 5

Z Ltd changed its employee remuneration policy from 1 April 2012 to provide for 12% contribution to Provident fund on leave encashment also. As per the leave encashment policy the employees can either utilise or encash it. As at 31 March 2013 the company opted an actuarial valuation for leave encashment liability. However, it did not provide for 12% provident fund contribution on it.

The auditor of the company wants it to be provided but the management replied that as and when employees availed leave encashment provident fund contribution was made. The company

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further contends that this is correct treatment as it is not sure whether the employees will avail leave encashment or utilise it. Comment

Solution

As per AS-15 Employee Benefits, compensated absences are part of employee benefits. An enterprise must recognise the cost of compensated absences when the employees render services which increase the entitlement to future compensated absences. An enterprise should measure the expected cost of compensated absences using actuarial valuation techniques.

In the given case, the company must provide for compensated absences including the 12% provident fund contribution. The contention of Auditor is valid.

Illustration 6

P Ltd has 3 business segments which are FMCG, batteries and sports equipment. The batteries segment has been consistently under performing and P Ltd after several discussions with labour unions have finally decided on closure of this segment.

Under the agreement with the labour union, the employees of the battery segment will earn no further benefit as the arrangement is a curtailment without settlement where in the employees of the discontinued segment will continue to receive benefits of services rendered when the segment was functioning.

As a result of curtailment the company's obligation that were arrived on the basis of actuarial valuation before the curtailment have come down.

The following information is also furnished :

Value of gross obligation before curtailment calculated on actuarial basis	Rs 4,000 lacs
Value of unamortised past service costs	Rs 100 lacs

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Curtailment will bring down gross obligations by	Rs 500 lacs
Fair Value of Plan assets on date is estimated	Rs 3,250 lacs

And, P Ltd anticipates a proportional decline in the value of unamortized past service costs also.

You are required to calculate the gain from curtailment and also show the liability to be recognized in the P&L a/c and Balance Sheet of P Ltd after curtailment.

Solution

	Before curtailment	After Curtailment	Impact fro m Curtailment
Gross obligation	4,000 lacs	3,500 lacs	500 lacs
Fair Value of Plan	3,250 lacs	3,250 lacs	
Unamortized Past Service Costs	100 lacs	87.5 lacs	12.5 lacs

Illustration - 7

An employee Darshan joined a company PQR Ltd in the year 2014. The annual emoluments of Darshan as decided is Rs 15,52,303. The company also has a policy of giving a lumpsum payment of 25% of the last drawn salary of the employee for the each of the completed years of service, if the employee retires after completing minimum 5yrs of service. Salary of Darshan is expected to grow at 10% per annum. The company has inducted Darshan at the beginning of the year and it is expected that he will complete minimum 5yr term before retiring.

What is the amount the company should charge in its Profit & Loss a/c every year as cost for defined benefit obligation? Also calculate service cost and the interest costs to be charged per year assuming a discount rate of 8%.

Solution

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(a) Calculation of Defined Benefit Obligation

If Darshan will complete minimum 5 year term, then it is assumed that he will retire in the 6th year.

Accordingly, Expected last drawn salary in the 6th year

= Rs. 15,52,303 x 110% x 110% x 110% x 110% x 110% = Rs. 25,00,000 Defined Benefit

Obligation (DBO) = Rs. 25,00,000 x 25% x 5 = Rs. 31,25,000

Amount of Rs. 6,25,000 will be charged to Profit and Loss Account of the company every year as cost for Defined Benefit Obligation.

Calculation of Current Service Cost & Interest Cost to be charged per year

Year	Opening Balance	Current Service Cost	Interest = Op Bal * 8%	Closing Balance
2014	-	6,25,000*0.735= 4,59,375	Nil	4,59,375
2015	4,59,375	6,25,000*0.794= 4,96,250	4,59,375*8%=36750	9,92,375
2016	9,92,375	6,25,000*0.857= 5,35,625	9,92,375*8%=79,390	16,07,390
2017	16,07,390	6,25,000*0.926= 5,78,750	16,07,390*8%=1,28,591	23,14,731
2018	23,14,731	6,25,000*1.000= 6,25,000	23,14,731*8%=1,85,269	31,25,000

5.4 AS 16: Borrowing Costs

Objective and Scope

The interest and other costs incurred before the asset is effectively used, is known as borrowing cost. AS-16 aims to provide accounting for borrowing costs. However, it does not deal with the actual or imputed cost of capital, both equity and preference.

Coverage Under AS-16 Excluded

The Standard does not apply to the following:

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- Actual cost of owners' equity- including preference share capital, or
- Imputed cost of such equity,
- And such other items forming part of equity and not classified as a liability.

The substance of AS-16 is that, by applying the matching and accrual concepts, borrowing costs can be capitalized as a part of the cost of a qualifying asset, within certain limits.

KEY TERMS USED

Borrowing costs

Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds, e.g.

a) Interest and commitment charges on bank borrowings and other short term and long-term borrowings;

b) amortization of discounts or premiums relating to borrowings;

c) amortization of ancillary costs incurred in connection with the arrangement of borrowings;

d) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and

e) Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Qualifying asset

It is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale, **Examples of qualifying assets are:**

- Manufacturing plants,
- Power generation facilities,
- Inventories that require a substantial period of time to bring them to a saleable condition, and

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- Investment properties.

However, if an asset is ready for its intended use or sale at the time of its acquisition then it is not treated as a qualifying asset for the purposes of AS 16, eg, if a ready building is acquired and put to use immediately, it is not a qualifying asset.

What is substantial period of time

Ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get ready for its intended use or sale should be considered.

The following assets ordinarily take twelve months or more to get ready for intended use or sale unless the contrary can be proved by the enterprise:

i. assets that are constructed or otherwise produced for an enterprise's own use, eg, assets constructed under major capital expansions;

ii. assets intended for sale or lease that are constructed or otherwise produced as discrete projects, eg, ships or real estate developments.

Further, in case of inventories, substantial period of time is considered to be involved where time is the major factor in bringing about a change in the condition of inventories, eg, liquor is often kept in store for more than twelve months for maturing.

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1. When should the borrowing costs be capitalized?

Borrowing costs should be capitalized as part of the cost of qualifying asset when:

a) it is probable that they will result in future economic benefits;
b) they can be measured reliably.

If these conditions are not satisfied, then the borrowing costs should be treated as an expense in the period in which they are incurred.

2. How to determine the amount to be capitalized when the funds

have been borrowed specifically

When the funds have been borrowed specifically then the amount of borrowing costs to be capitalized is to be calculated as under:

- Ascertain actual borrowing costs [say (a)]
- Ascertain any income on the temporary investment of these borrowings [say (b)]
- Ascertain the borrowing costs to be capitalized by deducting (b) from (a), -

➢ **Example**

	Rs.
Amount borrowed	*10 crores*
Borrowing costs incurred (a)	*1.5 crores*
Income from temporary investment of funds During the period they were in surplus (b)	*0.2 crores*
Amount to be capitalized (a) - (b)	*1.3 crores*

3. How to determine the amount to be capitalized when the funds have been borrowed generally

- When the funds have been borrowed generally then the amount of borrowing costs to be capitalized is to be calculated by applying a capitalization rate to the expenditure on that asset.
- The capitalization rate, here, means the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for obtaining a qualifying asset.
- However, the amount of borrowing costs capitalized during a period should not exceed the amount of borrowing costs incurred during that period.

4. How to treat the excess of carrying amount of the qualifying asset over its recoverable amount

The carrying amount or the expected ultimate cost of a qualifying asset should not exceed its recoverable amount or net realizable value. In case

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it so exceeds, the carrying amount should be written down or written off as per AS 2 or AS 10, as the case may be. In certain circumstances, the amount so written down or written off can also be written back as per AS 2 or AS 10, as the case may be.

- **Example**

	2007-08
	Rs.
Carrying Amount	*1,00,000*
Recoverable amount	*84,000*
Written down to	*84,000*
Amount written off	*16,000*

If in the year 2008-09, the recoverable amount becomes Rs. 96,000 then the carrying amount can be written back to Rs. 96,000. However, if the recoverable amount exceeds Rs. 1,00,000 (say Rs. 1,10,000) then the carrying amount cannot be increased beyond Rs. 1,00,000.

5. When should capitalization commence

There are certain conditions that need to be satisfied for capitalization to commence. These conditions are:

a) Expenditure for the acquisition, construction or production of a qualifying asset is being incurred.

(For this purpose, only such expenditure as has resulted in payments of cash, transfers of other assets or the assumption of interest bearing liabilities will be included. Further, it will be reduced by progress payments, if any, received as well as grants received in connection with the asset in question.)

b) borrowing costs is being incurred; and
c) Activities which are necessary to prepare the asset for its intended use or sale are in progress.

Following '**Acid Test**' shall be applied to capitalize bon-owing costs:

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1) There is borrowing.

2) Borrowing is directly attributable to Acquisition / production / construction of Asset.

3) That asset is qualifying Asset i.e., Asset requires substantial period of Time to get ready for its intended use or sale. Thus Qualifying Asset may be Fixed Asset or Stock for sale. Generally a period of 12 months is considered as a substantial period of time

- ✓ If all above 3 conditions are fulfilled capitalize Borrowing cost i.e., add to acquisition cost of asset.

- ✓ Otherwise Borrowing Cost shall be treated as expense of the period and charged to Profit & Loss A/c.

Borrowing costs incurred while land is under development are capitalized during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while Land acquired for building purposes is held without any associated development activity do not qualify for capitalization.

6. **Suspension of Capitalization: Capitalization of borrowing costs should be suspended during extended periods in which active development is interrupted.** Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalization.

   Exceptions:

   1) Capitalization of borrowing costs is not normally suspended 'during a period when substantial technical and administrative work is being carried out.

   2) Capitalization of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalization continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

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7. **Cessation of Capitalization: Capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.** An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as Ike decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

8. **When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalization of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part its intended use or sale are complete.**

   A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant with in the same site, such as a steel mill.

9. **Which exchange difference can be included in borrowing costs (Para 4(e) of AS 16)**

   - Exchange differences arising from foreign currency borrowings and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings.

   - Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowings costs to be accounted for under this Standard and the remaining exchange difference, if any, is accounted for under AS 11 – The Effects of Changes in Foreign Exchange Rates.

   - For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings.

   ➢ **Example**

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RGS Ltd. has raised a loan of $ 1,00,000 on 1-4-2008 for a specific project @ 6% p.a. payable annually. On 1-4-2008, the exchange rate is Rs. 48 per $. On 31-3-2009, the exchange rate is Rs. 50 per $. The corresponding amount could have been borrowed by RGS Ltd. in local currency @ 10% p.a. as on 1-4-2008.

In this case, the amount that can be included in the borrowing costs will be computed as under:

1) Interest for the period

   = $ 1,00,000 x 6% x 50 = Rs. 3,00,000

2) Increase in liability towards the principal amount

   = $ 1,00,000 x 2 = Rs. 2,00,000

3) Interest that would have resulted if the loan was taken in local currency

   = $ 1,00,000 x 48 x 10% = Rs. 4,80,000

4) Difference between interest on local currency and foreign currency borrowing

= Rs. 1,80,000 (Rs. 4,80,000 – Rs. 3,00,000)

Thus, out of Rs. 2,00,000 increase in the liability towards principal amount, only Rs. 1,80,000 will be considered as the borrowing cost. Thus, the total borrowing costs would be Rs. 4,80,000 (Rs. 3,00,000 + Rs. 1,80,000). The remaining amount of Rs. 20,000 would be considered as the exchange difference to be accounted for as per AS 11 (Revised 2003).

Ministry of Corporate Affairs has clarified vide circular no. 25/ 2012 dated 09th August, 2012 that Para 49e) of AS 16 should not apply to a company which is applying Para 46A of AS 11 (refer chapter 11: AS on 'Effects of Changes in Foreign Exchange Rates', i.e., the entire foreign exchange arising on subsequent reporting of a long-term foreign currency monetary item will be either capitalized or transferred to FCMITDA, as the case may be.

- **Example**

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XYZ Ltd. has taken a long-term loan of USD 10,000 on April 1, 2011 at an interest rate of 5% p.a., payable annually. On April 1, 2011, the exchange rate between the currencies was Rs. 45 per USD. The exchange rate, as at march 31, 2012, is Rs. 48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 percent per annum as on April 1, 2011.

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16-

a) Interest for the period = USD 10,000 x 5% X Rs. 48 / USD = Rs. 24,000

b) Increase in the liability towards the principal amount = USD 10,000 x (48-45) = Rs. 30,000

c) Interest that would have resulted if the loan was taken in Indian currency = USD 10000 x 45 x 11% = Rs. 49,500

d) Difference between interest on local currency borrowing and foreign currency borrowing = Rs. 49,500 – Rs. 24,000 = Rs. 25,500

Therefore, out of Rs. 30,000 increase in the liability towards principal amount, only Rs. 25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be Rs. 49,500 being the aggregate of interest of Rs. 24,000 on foreign currency borrowings (covered by paragraph 4(a) of AS 16) plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of Rs. 25,500. Thus, Rs. 49,500 would be considered as the borrowing cost would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining Rs. 4,500 would be considered as the exchange difference to be accounted for as per AS 11. ***It may be noted here that this accounting treatment is valid if the company does not opt for Para 46A of AS 11.***

Borrowing costs of Rs. 49,500	
Capitalize if in relation to a qualifying asset	Otherwise, charge to profit and loss account as on 'interest expense' under the head 'finance costs'
Foreign exchange loss of Rs. 4,500:	

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Recognize as an expense in profit and loss account:

In case the company opts for Para 46A of AS 11:

Entire exchange difference of Rs. 30,000 will be accounted for under Para 46A of AS 11.

Foreign exchange loss of Rs. 30,000:	
If in relation to acquisition of a depreciable capital asset:	In any other case:
Add to the cost of the asset and depreciate over the balance life of the asset	Accumulate in FCMITDA and amortize over the balance period of such borrowings

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Exchange Difference treated as borrowing cost: As per paragraph 4(e) of AS 16, exchange differences to the extent of adjustments to interest costs, are treated as borrowing costs. Since interests on foreign currency borrowing are recognized and paid on the same day and hence translated at same rate, no exchange difference can arise on account of interest payments, unless the payments are delayed. It therefore appears that the term 'exchange difference' for the purpose of paragraph 4(e) does not mean the exchange difference on interest payments. It has now been interpreted that a part of exchange difference arising on the principal amount of foreign currency borrowed should be regarded as borrowing cost. The part of exchange difference treated as borrowing cost should be dealt in accordance with AS 16. The remaining exchange difference if any, can be treated as per AS 11. As explanation to paragraph 4(e) of notified AS 16, the exchange difference to be treated as borrowing cost is the difference between interest on local currency borrowings and interest on foreign currency borrowings. If this difference is equal to or more than the exchange difference on the principal, the entire exchange difference is treated as borrowing cost.

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10. Disclosure: AS –16 requires that the Financial statement should disclose:

a) The accounting policy adopted by the firm for borrowing costs; and

b) The amount of borrowing costs capitalized during the period.

11. ICAI Interpretations: ASI 1, 10

ASI 1: Substantial period of time: Ordinarily, **a period of twelve months** is considered as substantial period of time, unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. Thus, a rebuttable presumption of a period of twelve months, is considered a "substantial" period of time. Para 4 (e) of AS-16 i.e. "Borrowing costs may include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs."

Land not Qualifying Asset: Interest on loan taken for the purpose of constructing building / cannot be capitalized as borrowing cost since land is not a Qualifying Asset, The fact that acquisition of land is an integral part of development of a property, would not make it a Qualifying Asset since each of the asset necessary for the project should be considered separately for the purpose of deciding whether it constitutes a 'Qualifying Asset' for AS-16 purposes. 'Land and Building' in a case are considered separate asset.	**Nov 2005 CA Journal**

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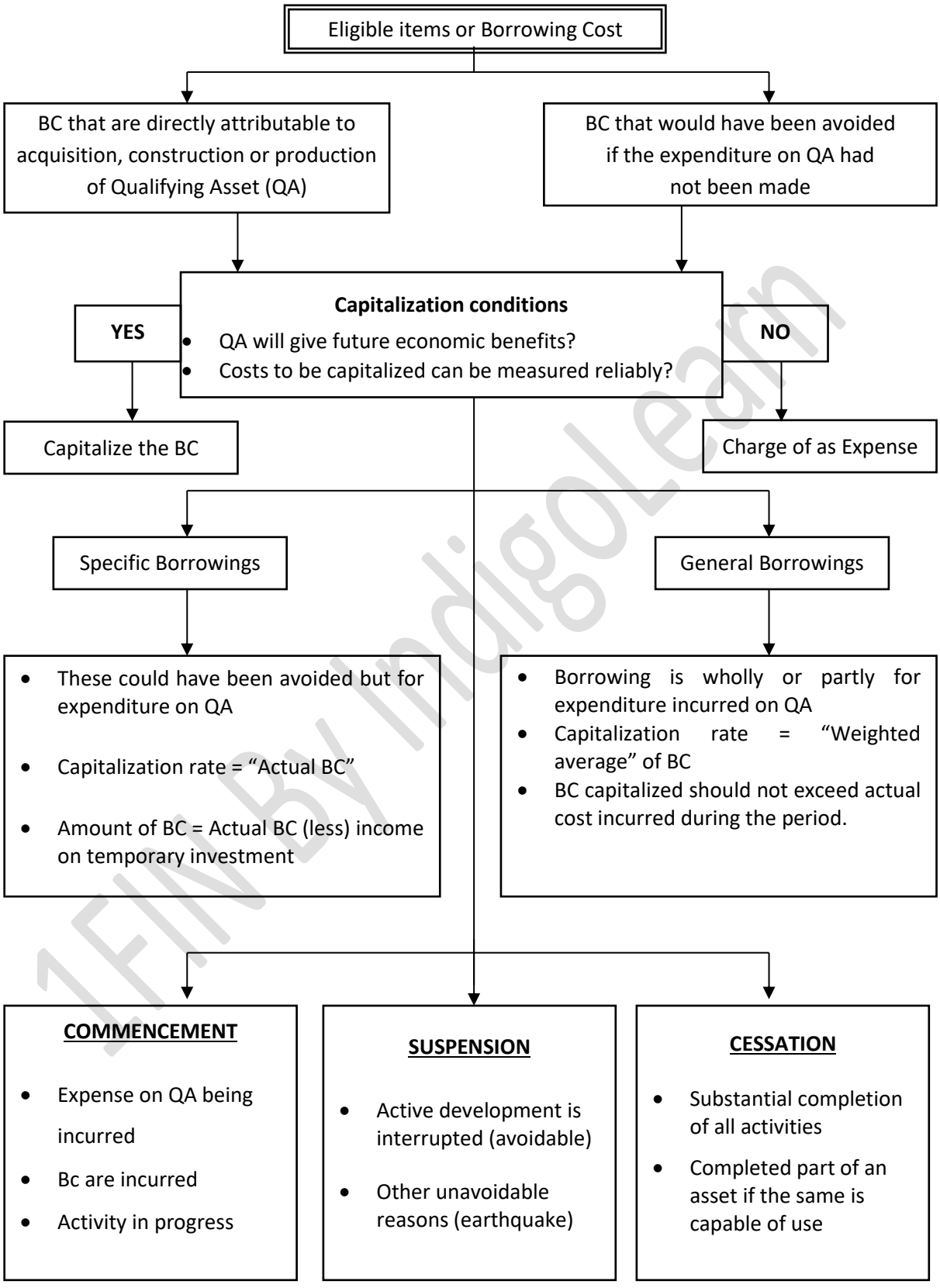

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Question and Answers

Question 1:
GHI Limited obtained a loan for Rs.70 lacs on 15.4.2010 from JKL Bank to be utilized as under:

Construction of factory shed	Rs.25 lacs
Purchase of machinery	Rs.20 lacs
Working capital	Rs.15 lacs
Advance for purchase of truck	Rs.10 lacs
Total	**Rs.70 lacs**

On March 31st construction of factory shed was completed and machinery which was ready for its intended use was installed. Delivery of Truck was received in the next financial year.

Total interest of Rs.9.1 lacs was charged by the bank for FY11. Show the treatment of interest under AS 16 and explain the nature of asset

Solution:

Treatment of Interest (Borrowing cost) as per AS 16 'Borrowing Costs'

Construction of Factory Shed:

If the period April 2010 to March 2011 is substantial period as per the Company's policy, then interest incurred on borrowings taken for such construction can be capitalized, if not such interest cost should be charged off to the P&L Interest

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attributable to Factory shed:

Rs.9.1lacs x Rs.25 lacs /Rs. 70 lacs = Rs.3.25 lacs

Purchase of Machinery:

It is not a qualifying asset as it is ready for intended use on its purchase itself. The interest cost on same should be charged off to P&L: Rs. 9.1 lacs X 20/70 = Rs. 2.6 lacs

Working Capital:

Interest cost on inventory can be capitalised if it takes substantial period of time. Working capital is generally a non-qualifying asset and interest cost on such working capital should be charged off: Rs. 9.1 lacs X 15/70 = Rs. 1.95 lacs

Advance for purchase of truck:

Even after delivery is made, if an asset takes substantial period of time to be ready for intended use only then will it be considered as a qualifying asset.

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Hence, truck is a non-qualifying asset and the interest pertaining to the loan will be debited to profit and loss account: Rs. 9.1 X 10/70 = Rs. 1.3 lacs.

Question 2:

Axe Ltd began construction of a new plant on 1.4.2011 and obtained a special loan of Rs.4 lacs to finance construction of the plant. Interest rate is 10%. Expenditure that was made on the project of plant was as follows:

1.4.2011	Rs. 5 lacs
1.8.2011	Rs. 12 lacs
1.1.2012	Rs. 2 lacs

The Company's other outstanding non-specific loan was Rs.23 lacs at interest rate of 12%. Construction of the plant completed on 31.3.2012. You are required to:

(a) Calculate the amount of interest to be capitalized as per the provisions of AS 16 "Borrowing Cost".

(b) Pass a journal entry for capitalizing the cost and the borrowing cost in respect of the plant.

Solution:

Total expenses to be capitalized for borrowings as per AS 16 "Borrowing Costs":

	Rs.
Cost of Plant (5,00,000 + 12,00,000 + 2,00,000) *Add*: Amount of interest to be capitalised (W.N.1)	19,00,000 1,54,000
	20,54,000

Journal Entry

		Rs.	Rs.

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31st March, 2012	Plant A/c Dr. To Bank A/c [Being amount of cost of plant and borrowing cost thereon capitalised]	20,54,000	20,54,000

Working Notes:
1. Computation of Interest

Date	Amount	Months	Rate	Interest
01.04.2011	4,00,000	12	10%	4,00,000 X 10% X12/12 =40,000
01.04.2011	1,00,000	12	12%	1,00,000 X 12% X 12/12 =12,000
01.08.2011	12,00,000	8	12%	12,00,000 X 12% X 8/12 =96,000
01.01.2012	2,00,000	3	12%	2,00,000 X 12% X 3/12 =6,000
	Total			Rs. 1,54,000

Question 3:

On 18th April, 2011, Amazing Construction Ltd. obtained a loan of Rs. 32 crores to be utilized as under:

(i) Construction of sea link across two cities (work was held up totally for a month during the year due to high water levels)	Rs. 25 crores
(ii) Purchase of equipment and machineries	Rs. 3 crores
(iii) Working capital	Rs. 2 crores
(iv) Purchase of vehicles	Rs.50,00,000
(v) Advance for tools/cranes etc	Rs.50,00,000
(vi) Purchase of technical know-how	Rs.1 crores

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(vii) Total interest charged by the bank for the year ending 31st March 2012	Rs. 80,00,000

Show the treatment of interest by Amazing Construction Ltd.

Solution:

According AS 16 'Borrowing costs', a qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use or sale. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

In the given case, construction of sea-link is a qualifying asset. The capitalisation is continued for periods in which active development is stopped due to high water levels (which is common in construction of bridges).

Purchase of equipment and vehicles are not qualifying asset as they are generally ready for use at the time of purchase. Similarly, technical know-how are not qualifying assets.

Working capital for day to day operations of business is not qualifying asset

The treatment of interest by Amazing Construction Ltd. can be shown as:

	Qualifying Asset	Interest to be Capitalized Rs.	Interest to be charged to Profit & Loss A/c Rs.	

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Construction of sea-link	Yes	62,50,000		[80,00,000*(25/32)]
Purchase of equipment and machinery	No		7,50,000	[80,00,000*(3/32)]
Working capital	No		5,00,000	
Purchase of vehicles	No		1,25,000	[80,00,000*(2/32)]
Advance for tools, cranes etc.	No		1,25,000	[80,00,000*(.5/32)]
Purchase of technical knowhow	No		2,50,000	[80,00,000*(.5/32)]
Total		**62,50,000**	**17,50,000**	[80,00,000*(1/32)]

Question 4:

Suhana limited issued 12% secured debentures of Rs.100 lacs on 1.5.2013 to be utilised as under:

- Construction of factory building – Rs.40 lacs
- Purchase of Machinery – Rs.35 lacs
- Working Capital Rs.25 lacs

In March 2014 construction of factory building was completed and Machinery was installed and is ready for its intended use.

Total interest on debentures for FY14 was 11 lacs. During the year 13-14, the company had invested idle funds out the money raised from debentures in Bank FDs and earned interest of Rs.2 lacs. Show the treatment of interest under AS 16 and explain the nature of asset.

Solution:

According to AS 16 "Borrowing Costs", borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset.Other borrowing costs should be recognised as an expense in the period in which they are incurred.

Also para 10 of AS 16 "Borrowing Costs" states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Thus, eligible borrowing cost = Rs. 11,00,000 - Rs. 2,00,000 = Rs. 9,00,000

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S.No.	Particulars	Nature of assets	Interest to be Capitalized (Rs.)	Interest to be charged to Profit & Loss Account (Rs.)
1	Construction of factory building	Qualifying Asset*	9,00,000x40/100 = Rs. 3,60,000	NIL
2	Purchase of Machinery	Not a Qualifying Asset	NIL	9,00,000x 35/100 = Rs.3,15,000
3	Working Capital	Not a Qualifying Asset	NIL	9,00,000x 25/100 = Rs. 2,25,000
	Total		**Rs. 3,60,000**	**Rs. 5,40,000**

* A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Question.5

Shan Builders Limited has borrowed a sum of US $ 10,00,000 at the beginning of Financial Year 2014-15 for its residential project at LIBOR + 3 %. The interest is payable at the end of the Financial Year. At the time of availing the loan, exchange rate was Rs. 56 per US $ and the rate as on 31st March,2015 was Rs. 62 per US $. If Shan Builders Limited had borrowed the loan in India in Indian Rupee equivalent, the pricing of loan would have been 10.50%. Compute Borrowing Cost and exchange difference for the year ending 31st March, 2015 as per applicable Accounting Standards. (Applicable LIBOR is 1%).

Solution:

(i) Applicable interest rate : 1% +3% = 4%

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Interest for the period 2014-15 = US $10,00,000 x 4% × Rs. 62 per US $ = Rs. 24.80 lakhs

(ii) Increase in the liability towards the principal amount = US $ 10,00,000 × Rs. (62 - 56) = Rs. 60,00,000

(iii) Interest that would have resulted if the loan was taken in Indian currency = US $ 10,00,000 × Rs. 56 x 10.5% = Rs. 58,80,000

(iv) Difference between interest on local currency borrowing and foreign currency borrowing = Rs. 58,80,000– Rs. 24,80,000 = Rs.34,00,000.

Borrowing Costs include exchange differences arising from foreign currency borrowings
To the extent that they are regarded as an adjustment to interest costs.
Therefore, out of exchange fluctuation loss of Rs.60 lakhs towards principal amount, only Rs. 34 lakhs will be considered as the borrowing cost.
Total Borrowing Cost = Rs. 24,80,000 + Rs. 34,00,000 = Rs. 58,80,000

Hence, Rs. 58.80 lakhs would be considered as the borrowing cost to be accounted for as per AS 16 "Borrowing Costs" and the remaining Rs. 26 lakhs (60 - 34) would be considered as the exchange difference to be accounted for as per AS 11 "The Effects of Changes in Foreign Exchange Rates".

5.5 AS 17 Segment Reporting

INDIAN GAAP	AS 17 – SEGMENT REPORTING
IND AS	IND AS 108 – OPERATING SEGMENTS

AS17 SEGMENT REPORTING

Applicability

Mandatory for

1. Enterprises whose equity or debt securities are listed whether in India or outside India.

OR

2. Enterprises which are in the process of listing their equity or debt securities as evidenced by the Board's resolution in this regard.

Scope

a) Applied in presenting general purpose financial statements.

b) The requirements of this Statement are also applicable in case of consolidated financial statements.

c) If a single financial report contains both consolidated statements and the separate financial statements of the parent, segment information need be presented only on the basis of the consolidated financial statements, the references in this Statement to any financial statement items should constructed to be the relevant item as appearing in the consolidated financial statements.

Definitions of the terms used in this standard:

A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments.

Aggregation Criteria: Two or more business segments may be aggregated in to a single business Segment if the segments have similar economic characteristics on following aspects

a) The nature of the products and services;

b) The nature of the production processes;

c) The type or class of customer for their products and services;

d) The methods used to distribute their products or provide their services; and

e) If applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

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A geographical segment is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include:

a) similarity of economic and political conditions;

b) relationships between operations in different geographical areas;

c) proximity of operations;

d) special risks associated with operations in a particular area;

e) exchange control regulations; and

f) the underlying currency risks.

A reportable segment is a business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by this Statement.

Ind AS 108 uses the term "OPERATING SEGMENT" which is defined later in this chapter

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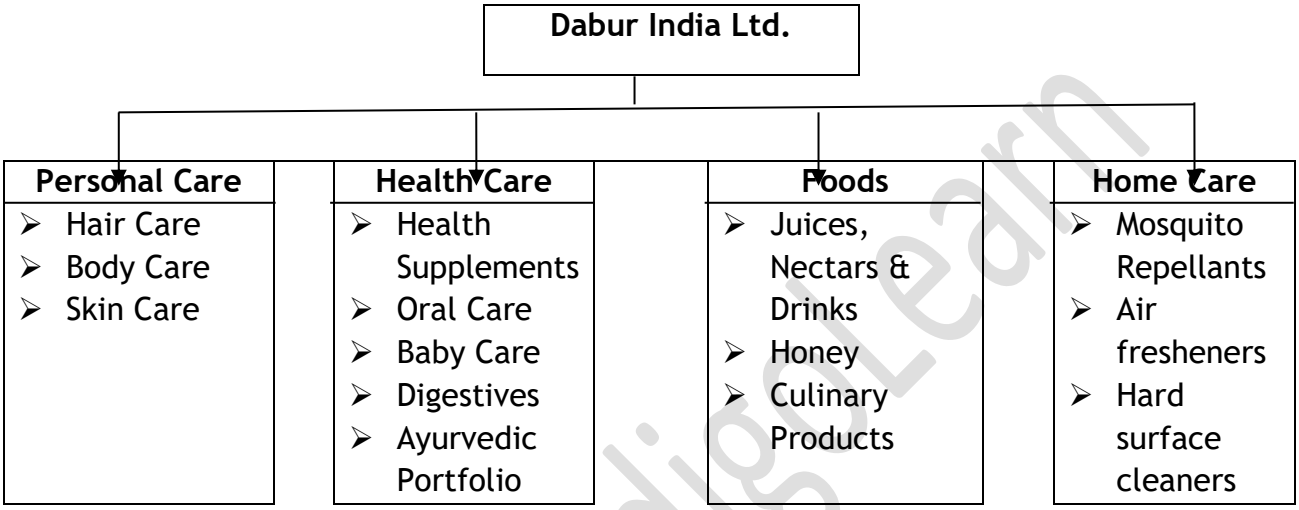
How do you identify Business Segments?

a) **Nature of Products and Services (risk and returns associated):** Dabur has identified following segments based on risk and returns.



b) **Production Processes**

Example: Shroff Furniture Manufactures and sells furniture. The main products are chairs, tables and sofas. The production process is similar for chairs and tables. Hence the aggregation criteria can be applied and the product chairs and tables can be reported as on operating segment.

c) **Customer**

Example: IDBI Bank provides the following services: corporate banking, retail banking, personal banking, commercial banking and cash management services. Its major customers for corporate banking and cash management services are corporate bodies. Therefore the entity can merge corporate banking services and commercial banking services and treat them as one reporting segment using the aggregation criteria.

d) **Distribution Methods**

Example: Sultanchand Publications carry out the following two major activities: Publishing of books, both academic and educational and story / novel. The distribution methods for the academic & educational books action are quite similar. Therefore, applying the aggregation criteria, the publishing activities of the both types of books can be merged and reported as a single reporting segment.

e) **Regulatory environments**

Example: Reliance Capital is involved in various business activities which include insurance underwriting and share Broking. Under insurance, it provides insurance of life and property. Its insurance activities are -regulated by the Insurance Act. So all the services under the

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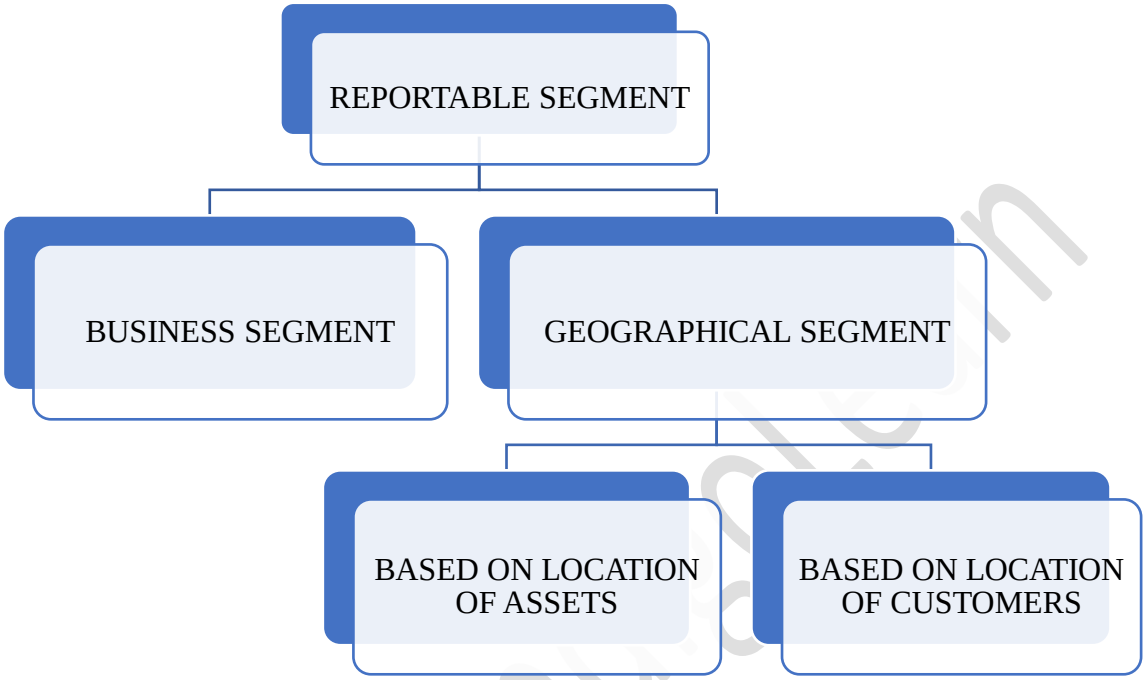
insurance business may be aggregated and the merged segment may be reported as a single segment.



Segment revenue is the aggregate of

a) the portion of enterprise revenue that is directly attributable to a segment,

b) the relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, and

c) revenue from transactions with other segments of the enterprise.

Segment revenue does not include:

a) extraordinary items as defined in AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies;

b) interest or dividend income, including interest earned on advances or loans to other segments, unless the operations of the **segment are primarily of a financial nature; and**

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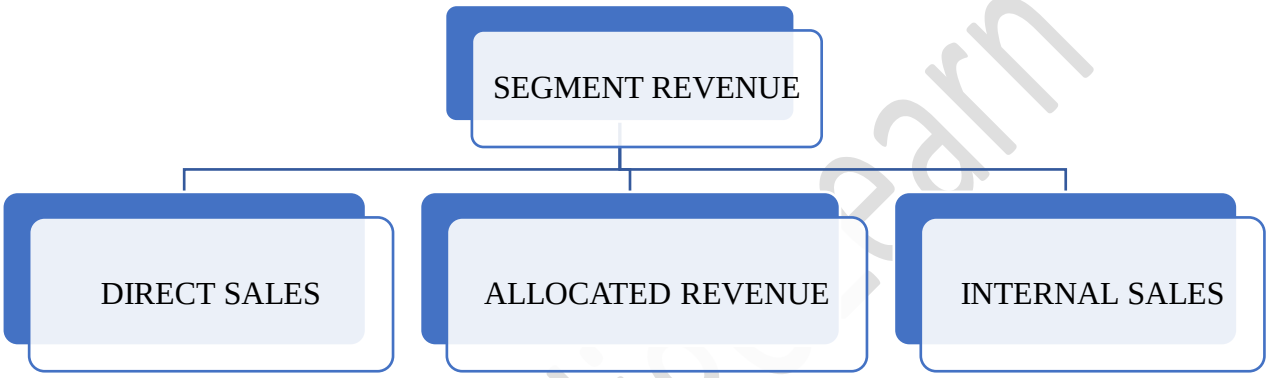
c) gains on sales of investments or on extinguishment of debt unless the operations of the segment are primarily of a financial nature.

Meaning of revenue is explained by following chart:



NOTE - Do not include extra-ordinary items, Interest or dividend income, gain on sale of investment

Segment expense is the aggregate of:

a) the expense resulting from the operating activities of a segment that is directly attributable to the segment, and

b) the relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment, including expense relating to transactions with other segments of the enterprise.

Segment expense does not include:

a) extraordinary items are defined in AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

b) interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature;

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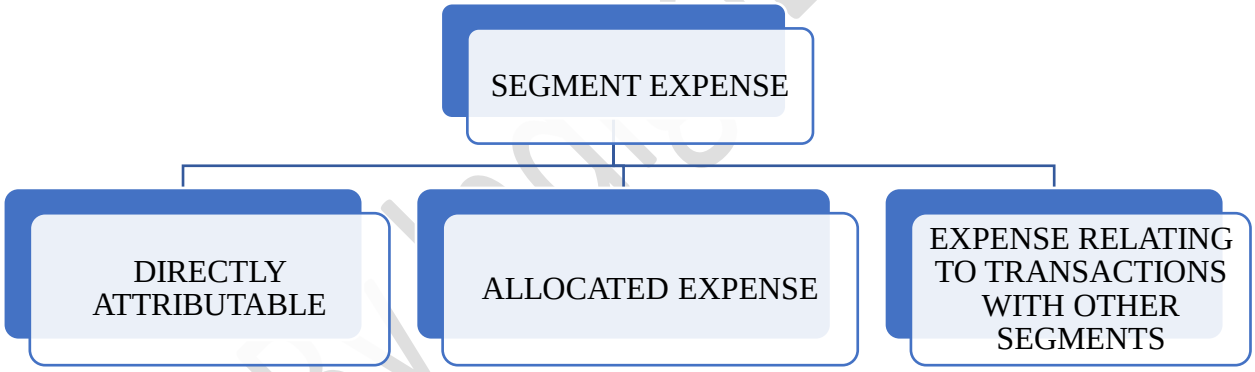
c) losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature;

d) income tax expense; and

e) general administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis

Segment expense can be summarized as under:



NOTE - Do not include extra-ordinary items, Interest Expenses, loss on sale of investment, Income tax expenses and Head Office Expenses.

Segment result is segment revenue less segment expense.

Segment assets are those operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. **If the segment result of a segment includes interest or dividend income, its segment assets include the related** receivables, loans, investments, or other interest or dividend generating assets. orient assets do not include income tax assets.

Segment assets are determined after deducting related allowances/provisions

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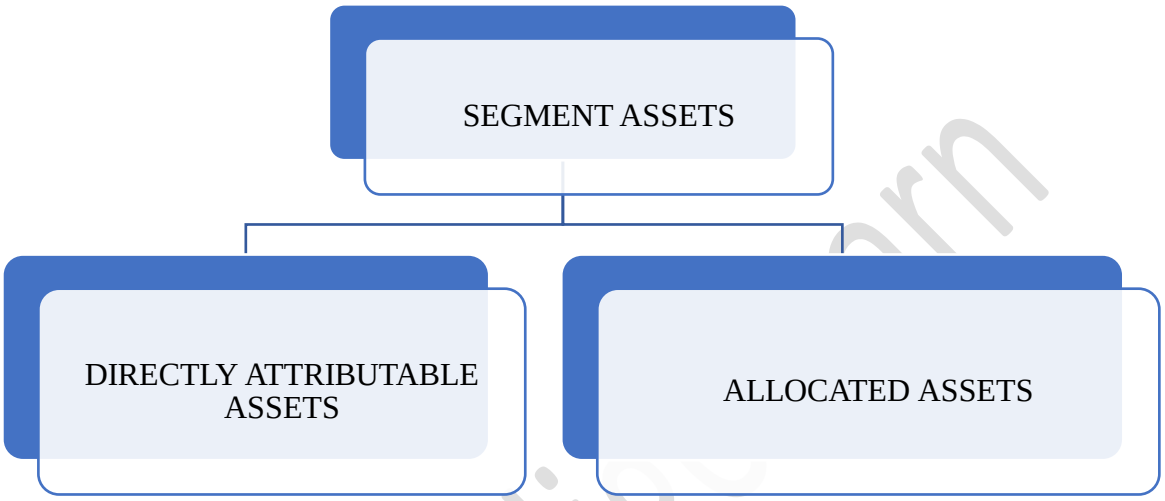
that are reported as direct offsets in the balance sheet of the enterprise.

Meaning of Segment asset can be summarized as under:



NOTE - Include

- ***Receivable loans, investments etc., if segment results includes Interest, dividend income.***
- ***Do not include income tax assets.***

Segment liabilities are those operating liabilities that result from the **operating activities of a segment** and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities.

NOTE - Segment liabilities do not include income tax liabilities.

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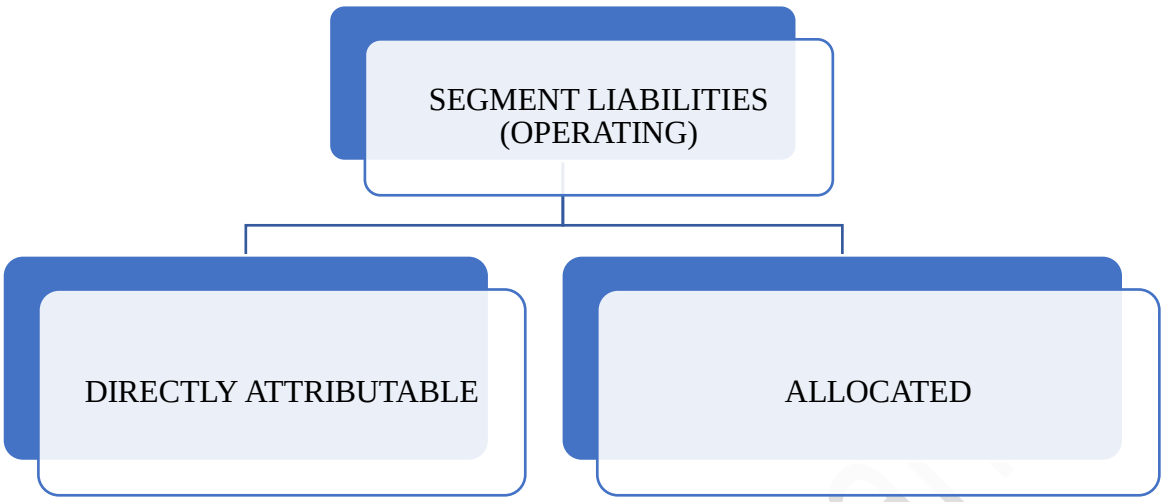

Segment accounting policies are the accounting policies adopted for preparing and presenting the financial statements of the enterprise as well as those accounting policies that relate specifically to segment reporting

Deciding Primary and Secondary Segments format

Deciding Primary and Secondary Segments format:

1. Some businesses have business as well as geographical segment e.g. a multiproduct company like HUL having operations in several countries, segmentation by either the line of activity (business segments) or by geographical areas of operation (geographical segments) is taken as primary.

    a. If the risks and returns are affected predominantly by difference in products and services it process it's primary format for reporting segment information should be business segments with secondary information reported geographically.

    b. Similarly if the risks and returns of the enterprise are affected predominantly by the fact it operates in different countries or other geographical areas, it's primary format for reporting segment information should be geographical segments with secondary information reported for group of related products or services.

2. Normally organizational and management structure of an enterprise and it's internal financial reporting system provides best evidence of predominant source of risks and returns of the enterprise for the purpose

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of segment reporting.

a. Except in rare circumstances, an enterprise will report segment information in its financial statements on the same basis as it reports internally to top management.

b. Its predominant source of risks and returns becomes its primary segment-reporting format.

c. Its' secondary source of risks and returns becomes its secondary segment reporting format.

3. **'Matrix presentation'** –

a. for some businesses, both business segments and geographical segments as primary segment reporting formats with full segment disclosures on each basis

b. will often provide useful information if risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates.

c. This Statement does not require, but does not prohibit, a 'matrix presentation'.

The objective is to achieve a reasonable degree of comparability with other enterprises, enhance understandability of the resulting information, and meet the needs of investors, creditors, and others for information about product/service-related and geographically related risks and returns.

Deciding Reportable Segments:

1. **Apply Quantitative threshold Test:** A business segment or geographical segment should be identified as a reportable segment if:

a) its revenue from sales to external customers and from transactions with other segments is 10 per cent or more (>=10%) of the total revenue, external and internal, of all segments;

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b) its segment result, whether profit or loss, is 10 per cent or more (>=10%) of –

i. the combined result of all segments in profit, or

ii. the combined result of all segments in loss, whichever is greater in absolute amount;

OR

c) its segment assets are 10 per cent or more (>=10%) of the total assets of all segments.

For Insightful Learning…..
The10 per cent thresholds in this Statement are not intended to be a guide for determining materiality for any aspect of financial reporting other than identifying reportable business and geographical segments.

2. **Management discretion:** A business segment or a geographical segment which is not a reportable segment may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item.

3. 75% Revenue coverage: If total external revenue attributable to reportable segments constitutes less than 75 per cent of the total enterprise revenue, additional segments should be identified as reportable segments, even if they do not meet the 10 per cent thresholds, until at least 75 per cent of total enterprise revenue is included in reportable segments.

For Insightful Learning...!
1. A segment identified as a reportable segment in the immediately preceding period because it satisfied the relevant 10 per cent thresholds should continue to be a reportable segment for the current period notwithstanding that its revenue, result, and assets all no longer meet

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the 10 per cent thresholds.

2. If a segment is identified as a reportable segment in the current period because it satisfies the relevant 10 per cent thresholds, preceding-period segment data that is presented for comparative purposes should, unless it is impracticable to do so. be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the 10 per cent thresholds in the preceding period.

Accounting Policies followed in Segment Reporting

Uniform Accounting Policies:

a) Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole.

b) It is not indicated whether the accounting policies are to be applied to reportable segments as if these segments were separate reporting entities.

c) A detailed calculation done in applying a particular accounting policy at the enterprise wide level may be allocated to segments if there is a reasonable basis for doing so. Eg. Pension calculations are done for an enterprise as a whole, but the enterprise wide figures may be allocated to segments based on salary and demographic data.

1. **Different Accounting Policies:** Additional Segment Information on the basis of policies other than the enterprise's Accounting Policies may be disclosed provided that-

a) The information is reported internally to the Board of Directors and the CEO for making decisions about allocating resources to the segment and assessing its performance, and

b) The basis of measurement for this additional information is clearly described

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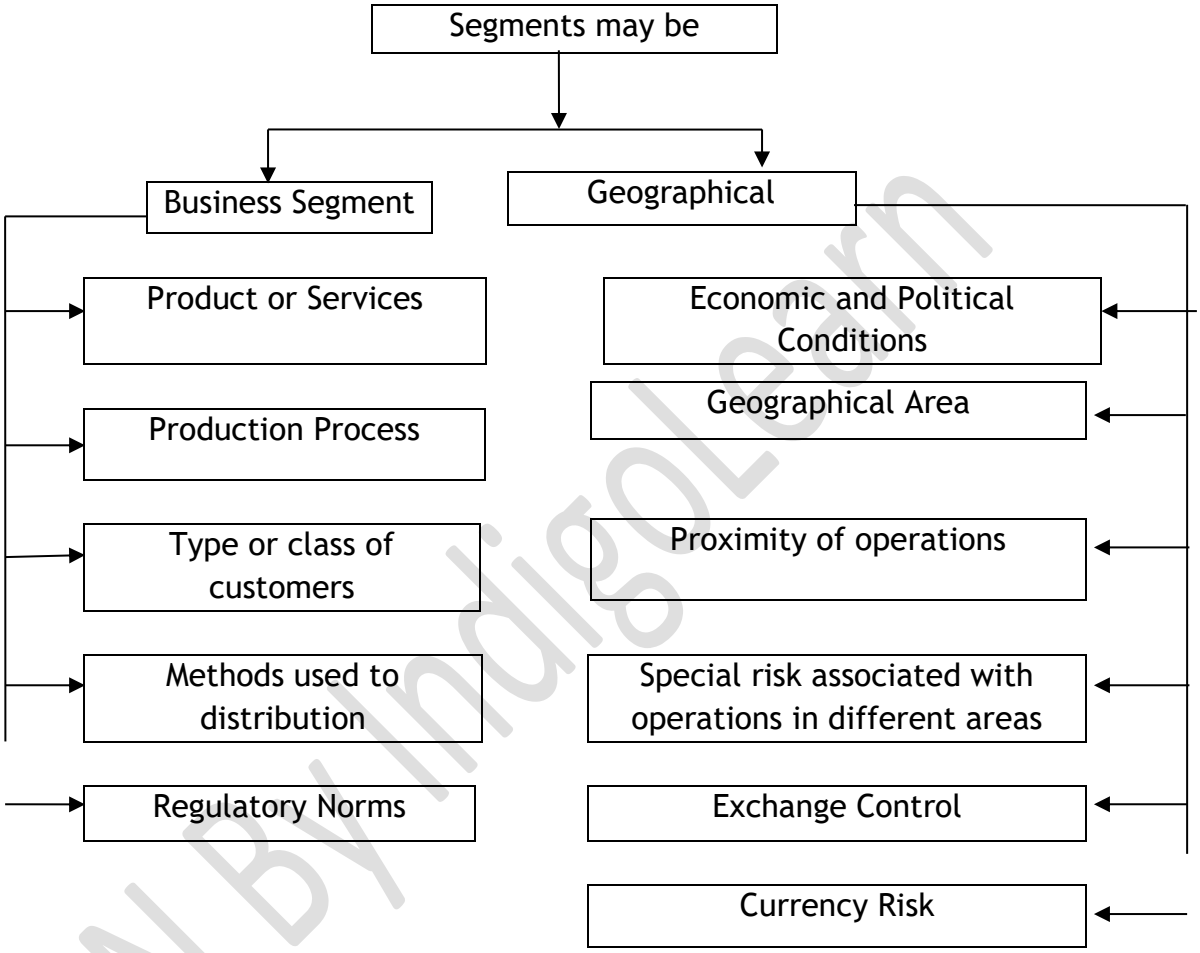
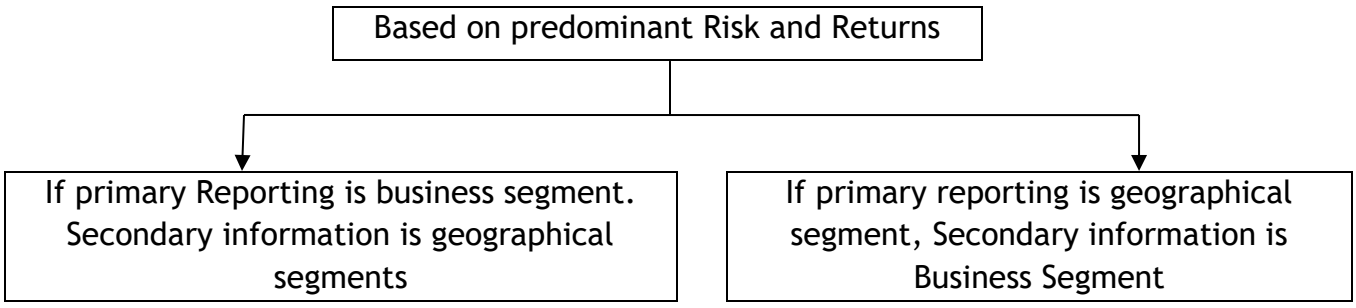
AS-17 Summary:

Step 1: Identify segments: Segments may be Business segments or geographical segments



Step2: Decide basis for Primary Segments Report and Secondary Segment Report



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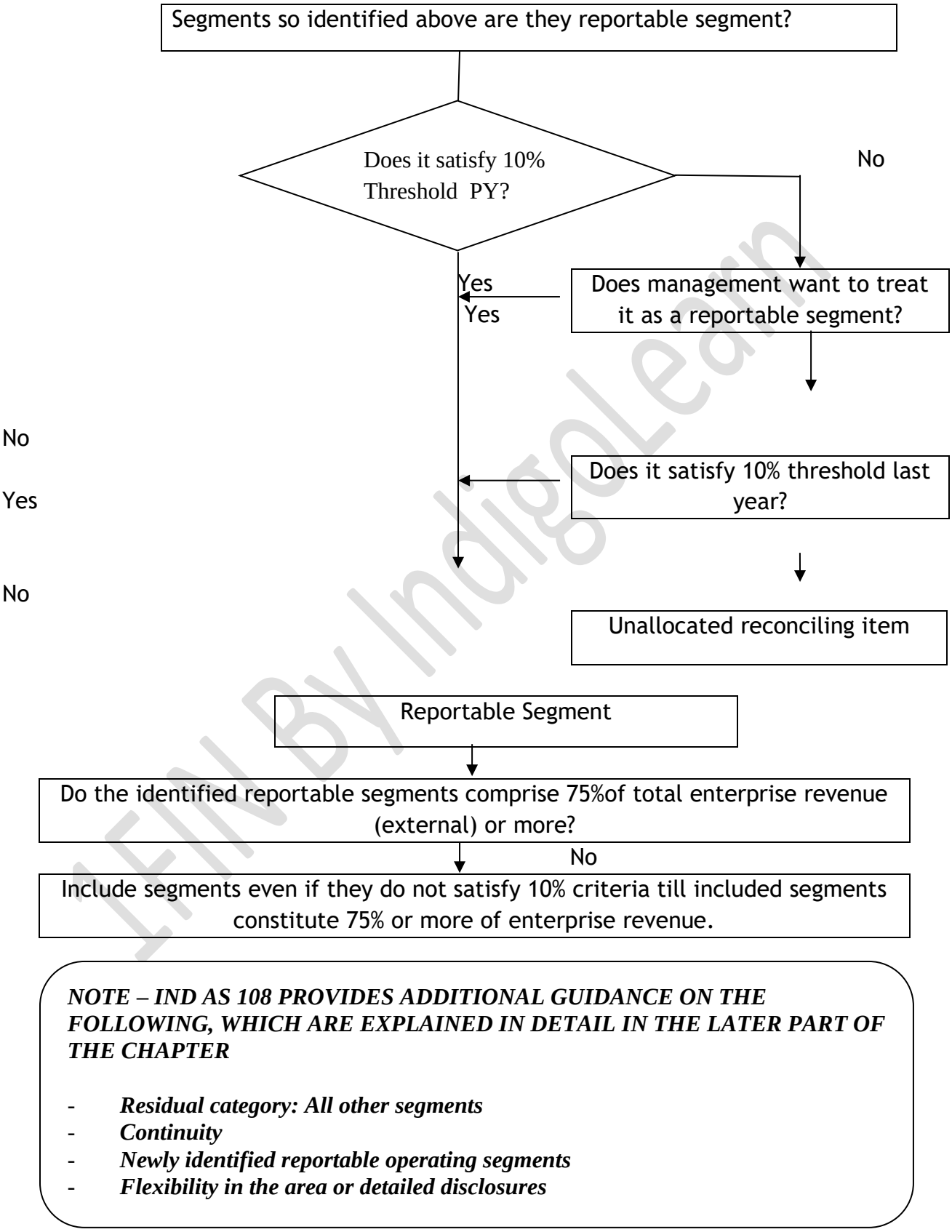
Step3: Identifying reportable segments.



NOTE – IND AS 108 PROVIDES ADDITIONAL GUIDANCE ON THE FOLLOWING, WHICH ARE EXPLAINED IN DETAIL IN THE LATER PART OF THE CHAPTER

- ***Residual category: All other segments***
- ***Continuity***
- ***Newly identified reportable operating segments***
- ***Flexibility in the area or detailed disclosures***

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Disclosure Requirements

A. Disclosure requirements for primary reporting Format

1. **Applicability:** The disclosure requirements of AS 17 should be applied to each Reportable Segment based on primary Reporting Format of an enterprise.

2. **Disclosure:** An enterprise should disclose the following, for each reportable segment-

- Revenue from external customers
- Inter-Segment Revenue
- Segment Result
- Carrying amount of Segment Assets
- Segment Liability
- Capital Expenditure
- Depreciation & amortization Expense
- Non-Cash Expense
- Share of Profit / Loss in associate / Joint Venture
- Investment in associate / Joint Venture (equity method)
- Reconciliation of revenue, result, assets & liabilities by business segment

3. **Extra Ordinary items warranting disclosure:**

a) As required by AS-5 disclosure is required in respect of the nature and mount of any items of Segment revenue and Segment Expense that are of such size, nature or incidence that their disclosure is relevant to explain the performance of the segment for the period.

b) Examples:

1. Write downs of inventories

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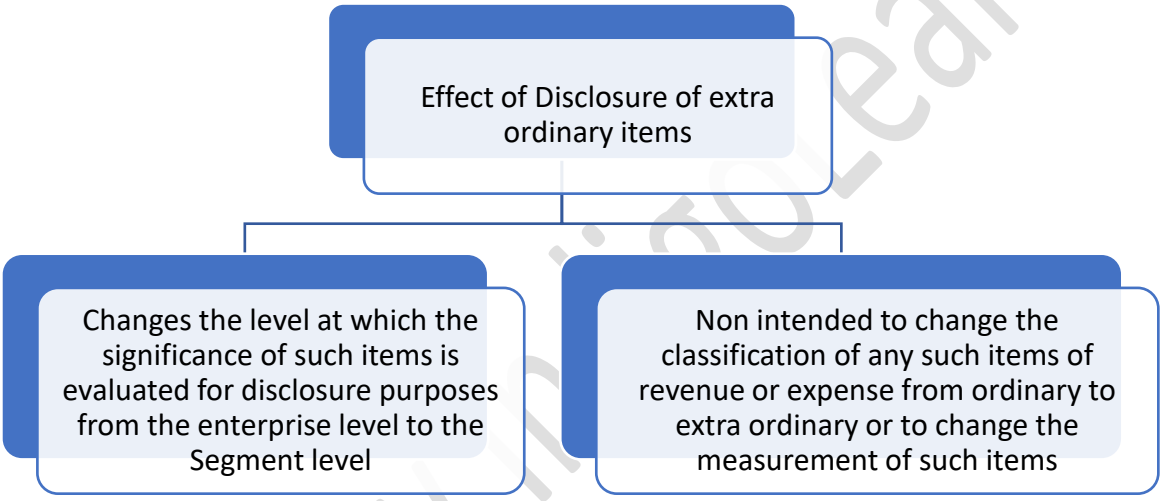
2. Provisions for restructuring

3. Disposals for fixed assets and long term investments,

4. Legislative changes having retrospective application

5. Litigation settlements

6. reversal of provisions etc.



NOTE – AS PER IND AS 1 - PRESENTATION OF ANY ITEM OF INCOME OR EXPENSE AS EXTRAORDINARY IS PROHIBITED

4. **Cash flow Statements:** When an enterprise presents a Cash flow statement and reports Cash flows from operating, investing and Financing Activities of each reportable segment, depreciation and amortization expense and non cash expenses of such segment as required above need not be disclosed.

5. **Reconciliation:** A Reconciliation between the information disclosed for reportable segments and the aggregated information in the enterprise financial statements should be presented. The reconciliation should be for the following-

   a. Segment revenue reconciled with enterprise revenue,

b. Segment result reconciled with enterprise net profit or loss,

c. Segment assets reconciled with enterprise assets, and

d. Segment liabilities to enterprise liabilities,



NOTE – IND AS 108 ALSO PRESCRIBES 'RESIDUAL SEGMENT' CATEGORY. HENCE IT HAS TO BE CONSIDERED IN RECONCILIATION ALSO.

Disclosure requirement for Secondary Segments

Applicability: The disclosure requirements of AS-17 should be applied to each Reportable Segment based a Secondary Reporting Format of an enterprise

Primary Format	Secondary Disclosure requirements
Business Segments	• The Secondary Format report the following information- Segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10% or more of enterprise revenue • Total Carrying amount of Segment assets by geographical location of assets, for each geographical segment whose segment assets are 10% or more of the total assets of all

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	geographical segments, and • Total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by geographical location of assets, for each geographical segment whose segment assets are 10% or more of the total assets of all geographical segments	
Geographical segments based on the location of assets	For each business segment whose revenue from sales to external customers is 10% or more of enterprise revenue, or whose segment assets are 10% or more of the total assets of all business segments the following information: - a. Segment revenue from external customers, b. Total Carrying amount of segment assets, and c. Total cost incurred during the period acquires segment	Where the location of its customers is different from the location of its assets, then the enterprise should also report Revenue from sales to external customers for each customer based geographical segment whose revenue from sales to external customers in 10% or more of enterprise revenue.

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	assets that are expected to be used during more than one period (tangible and Intangible fixed assets).	
Geographical segments based on the location of its customers	For each business segment whose revenue from sales to external customers is 10% or more of enterprise revenue or whose segment assets of all business segments, the following information- a. Segment revenue from external customers, b. Total carrying amount of segment assets, and c. Total cost incurred during the period to acquire segment	Where the assets of the enterprise are located in different geographical areas from its customers, then, for each asset based geographical segment whose revenue from sales to external customers or segment assets are 10% or more of total enterprise amounts, the following information- a. Total carrying amount of segment assets by geographical location of the assets and b. Total cost incurred during the period to acquire segment assets that are expected to be used during more than one period

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	assets that are expected to be used during more than one period (Tangible and intangible fixed assets)	(tangible and intangible fixed assets) by location of the assets.

Disclosure requirements

C. Other disclosure requirements of AS-17

Particulars	Matter to be disclosed
Inter Segment transfers	• Basis of pricing inter segment transfers, and • Any changes therein Note: Inter segment transfer should be measured on the basis that enterprise actually used to price those transfers.
Change in Accounting Policies	• Changes in accounting policies adopted for segment reporting (e.g. changes in identification of segments basis of allocating revenues and expenses) having a material effect on segment information indicating (a) nature of the change and (b) financial impact over financial statements of the period of such change. • Where the effect of such change is not ascertainable, wholly or in parts an indication of the fact of change. • Even if a change in accounting policies has no material effect on the financial statements for the current period but is reasonably expected to have a material effect in later periods, the fact of such change in the period in which the change is adopted. • Nature of the change and the financial effect of the change in accounting policies which are specifically related to Segments.

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Types of products/ services (Composition)	• **Business segments:** The types of products and services included in each reported business segment so as to assess the impact of shifts in demand. changes in prices of inputs or other factors of production, development of alternative products and processes on a business segment. • **Geographical segments:** the composition of each reported geographical segment, both primary and secondary to assess the impact of changes in economic and political environment on risks and returns of a geographical segment.
ASI-20	Disclose in the Note of Accounts, the fact that there is only one business segment and/ or geographical segment and therefore the requirements of AS-17 is not complied with.

NOTE – IND AS 108 PROVIDES ADDITIONAL GUIDANCE ON DISCLOSURE REQUIREMENTS. THE SAME ARE ELABORATED IN THE LATER PART OF THE CHAPTER

ICAI Interpretations: ASI 20, 22

ASI 20: Single Segment: - No reporting

In cases where on applying the definitions in the Standard, it is conducted that there if there is neither more than one Business Segment, nor more than one Geographical

NOTE – IND AS 108 MENTIONS THAT CERTAIN DISCLOSURES SHOULD BE MADE EVEN FOR SINGLE REPORTING SEGMENT

Segment, segment information as per AS 17 is not acquired to be disclosed.

ASI 22: Interest on Bank Overdraft: Interest expenses relating to overdrafts and other operating liabilities identified to a particular segment, should not be included as a part of the segment expenses unless the operations of the segment are primarily of a financial nature, or unless the interest is included as part of the cost of inventories in compliance with AS 16. In all situations where, interest forming a part of cost of inventories is included as segment expense, a separate disclosure should be made to that effect.

NOTE – IND AS 108 REQUIRES SPECIFIC DISCLOSURES ABOUT INTEREST REVENUE AND INTEREST EXPENSE OF EACH REPORTABLE SEGMENT. HENCE NOT SPECIFICALLY DEALT WITH.

separate disclosures have to be made for different products of the Finance Company as required by prudential norms, the Risk and Returns of the different products of a Financial Company have to be evaluated for the purpose of identification of different Business Segments under AS -17. A test of this would be the evaluation of the internal reporting and the organizational structure of the Finance Company.	***Website***
Segment Reporting for Sale of Power to State Grid: For applying 10% threshold limit test With reference to Revenue, both Revenues from Sales to External Customers and from transactions with other Segments is to be taken into account. Other tests like Segment Result and Assets should also be considered.	**Aug 2006 - CA Journal Page 228**

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AS 17 VIS-À-VIS IND AS 108

IND AS 108 is different from existing provision of AS 17 for identifying segments, but threshold for reportable segments remain the same.

Segments – Primary Literature	**AS 17 – Segment Reporting**	**Ind AS 108 – Operating Segments**
Scope	Applicability of the standard is not linked to the listing status of an entity.	Ind AS 108 is applicable to companies to which Ind AS notified under the Companies Act apply.
Operating segment	Not defined	Ind AS 108 defines the term **"OPERATING SEGMENT"** which is defined as a component of an entity: - That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity); - Whose operating results are regularly reviewed by the entity's chief operating decision maker (CODM) to make decisions about resources to be allocated to the segment and assess its performance; and - for which discrete financial information is available
Determination of segments	AS 17 requires an enterprise to identify two sets of segments (business and geographical), using a risks and rewards approach, with	Identification of segments is based on management approach. Operating segments are identified based on the financial information that is regularly reviewed by the

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	the enterprise's system of internal financial reporting to key management personnel serving only as the starting point for the identification of such segments.	chief operating decision maker in deciding how to allocate resources and in assessing performance.
Measurement	Segment information is prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. Segment revenue, segment expense, segment result, segment asset and segment liability have been defined. A reconciliation is presented between the information disclosed for reportable segments and the aggregated information in the enterprise's financial statements	Segment profit or loss is reported on the same measurement basis as that used by the chief operating decision maker. There is no definition of segment revenue, segment expense, segment result, and segment asset or segment liability nor does it require segment information to be prepared in conformity with the accounting policies adopted for the entity's financial statement. Requires reconciliation of segment performance measures with the corresponding amounts reported in the financial statements. A reconciliation of the total of the segments' assets and total of the segments' liabilities to the entity's assets and the entity's liabilities respectively should only be provided if the segment assets and segment liabilities are regularly provided to the chief operating decision-maker.
Aggregation criteria	No specific guidance in AS 17	Two or more operating segments may be aggregated into a single operating segment if the aggregation is consistent with the principles laid down in the standard. Management need to disclose the judgments made in

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		applying the aggregation criteria for operating segments
Single reporting segment	When there is not more than one geographic segment or business segment, segment information need not be disclosed. It should be mentioned in a footnote.	Certain disclosures should be made even for single reporting segment
Interest Revenue and Interest expense	Interest expense identified with overdrafts or other operating liabilities identified to a particular segment should not be included as segment expense	Requires specific disclosures about interest revenue and interest expense of each reportable segment. Hence not specifically dealt with.
Entity wide disclosures	Disclosures are required based on the classification of segments as primary or secondary. Disclosure requirements for secondary reporting format are less detailed than those required for primary reporting formats.	Requires disclosure of a) external revenues from each product or service; b) Revenues from customers in the country of domicile and from foreign countries; c) Geographical information on non-current assets located in the country of domicile and foreign countries. Information on major customers including total revenues from each major customer is disclosed if revenue from each customer is 10% or more of total segment revenues. The entity need not disclose the identity of such customers.

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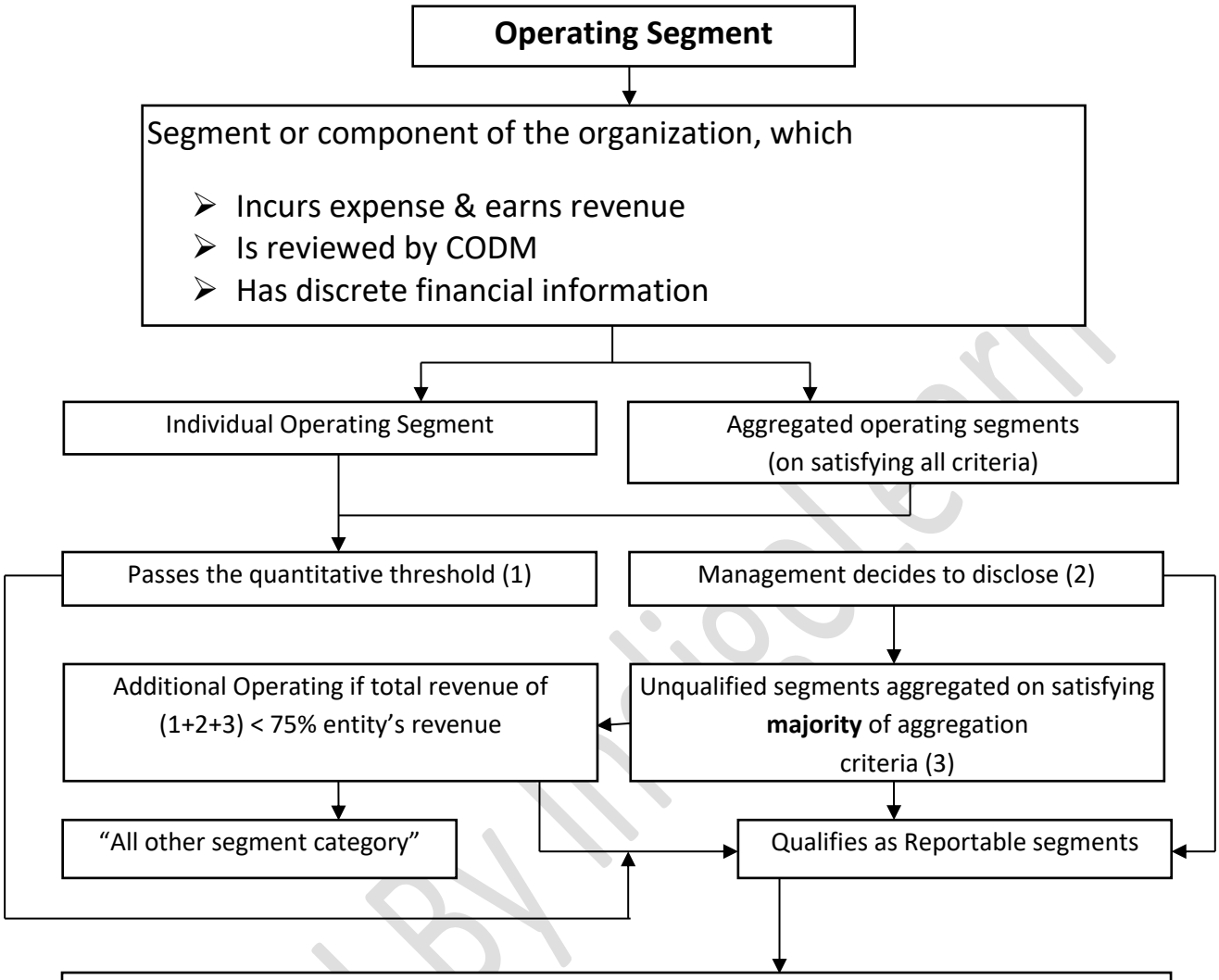
SUMMARY OF IND AS 108



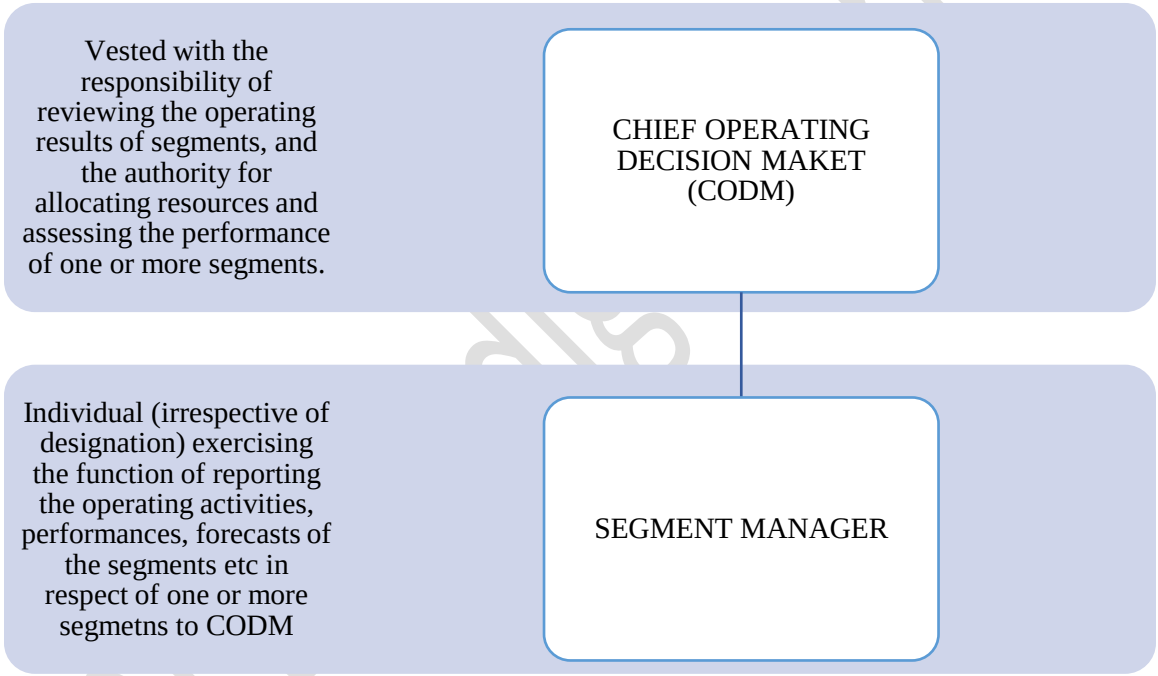
DISCLOSURES

- Basic of Selection
- Required line items for all reportable segments
- Reconciliation between
  - Segment revenue, result, assets, liabilities & others &
  - Entity's revenue, result, assets, liabilities & others
- Entity Revenue based on
  - Products & Services
  - Geographical Areas
- Customer accounting for > 10% revenue

OTHER KEY POINTS IN IND AS 108

IND AS 108 sets out requirements for disclosure of information about an entity's operating segments and also about the entity's products and services, the geographical areas in which it operates, and its major customers. The standard requires the whole entity's financial information to be segmented and reported on the basis of principles laid down for identification of Operation segments, and for measurement of items to be reported.

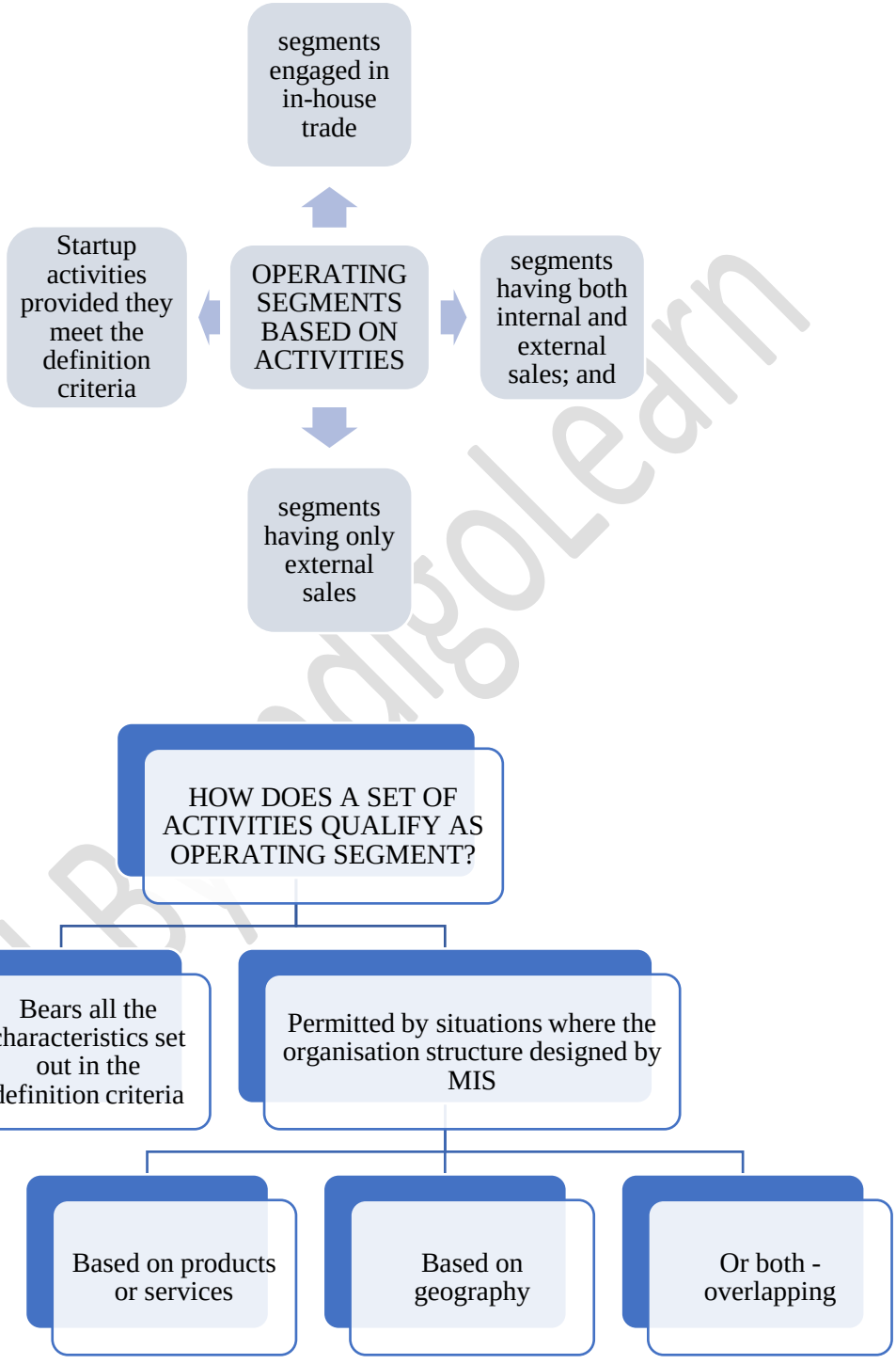
1. ORGANIZATION HIERARCHY



2. OPERATING SEGMENTS

Operating segments are components involved in the business activities capable of generating income (including internal sales) for which discrete financial information is available and whose performance is reviewed regularly by CODM.

Operating segments include:



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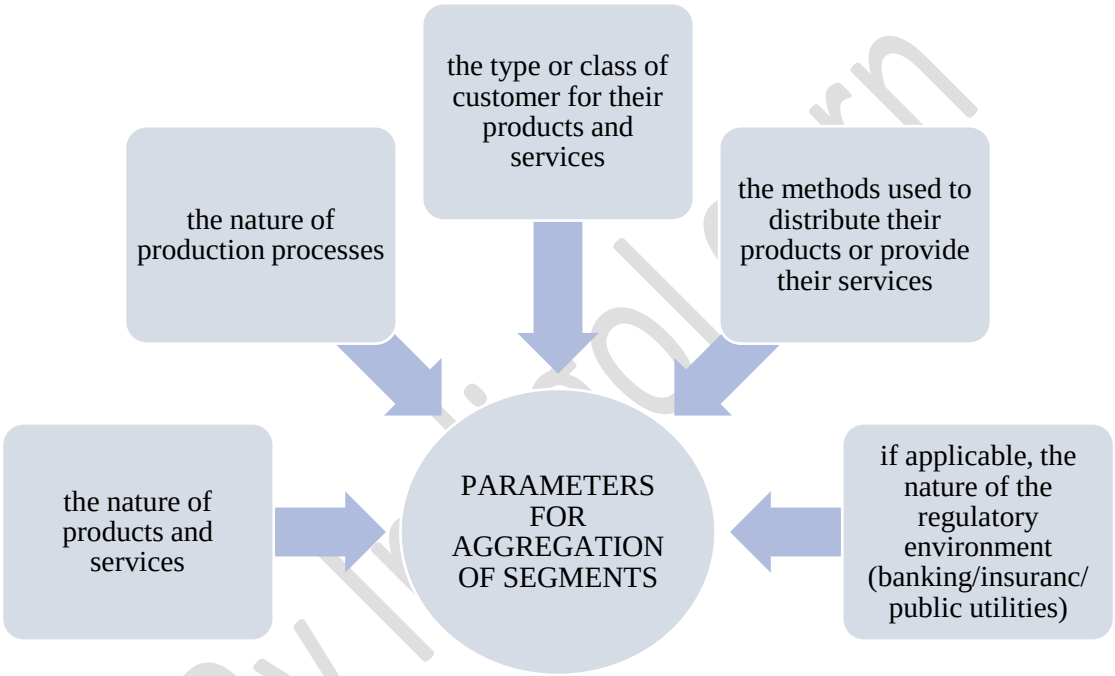
3. AGGREGATION OF OPERATING SEGMENTS

Two or more operating segments may be aggregated into a single segment if they have similar characteristics and are similar in each of the following parameters:



4. REPORTABLE SEGMENTS

IND AS prescribes a step by step process for the identification of an operating segment.

The operating segments so identified (either single or two or more segments aggregated) are subjected to the test of quantitative thresholds to determine the reportable segments. The thresholds are same as mentioned above in AS 17.

Residual category: All other segments

Information about other business activities and operating segments that are not reportable shall be combined and disclosed in 'all other segments' category

separately from other reconciling items.

Continuity

If management concludes that an operating segment identified as a reportable segment in the immediately preceding period is of continuing significance, information about that segment shall continue to be reported separately in the current period even if no longer meets the criteria for reportability

Newly identified reportable operating segments

If the business activities which did not qualify either as an operating segment or a reporting segment in the prior periods qualify as a reportable segment through the quantitative threshold tests in the current period, the comparative figures for the prior periods of such reportable segment shall be disclosed.

Flexibility in the area or detailed disclosures

Considering the cost-benefit aspect of gathering and reporting segment data, the standard requires the entities to review whether a practical limit is reached, if the number of reportable segments exceeds ten in number (rebuttable).

DISCLOSURE

In addition to the disclosure requirements in AS 17, the following additional disclosure requirements are needed by IND AS 108.

a. THE ENTITY SHALL DISCLOSE

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the basis of factors considered for identifying the reportable segment

types of products and services from which each reportable segment derives its revenues

information of the following lines about each reportable segment if these are regularly reviewed by CODM

- (all the disclosure items mentioned above in AS 17)
- interest revenue
- interest expense
- material items of income and expense disclosed in accordance with Ind AS 1
- income tax expense or income

b. MEASUREMENT FOR THE PURPOSES FOR DISCLOSURES:

- all the items of reportable segments shall be stated at the measure reported to the CODM irrespective of the measure used in entity's financial statements.
- the accounting policies used to measure the line items of reportable segments maybe different from that of entity's accounting policies
- this standard requires that an entity shall provide an explanation of the measurements of segment profit or loss, segment assets and liabilities for each reportable segment.

c. MINIMUM DISCLOSURES

- **DESCRIPTIVE DISCLOSURES**
- The basis of accounting for transactions between reportable segments
- The nature of any difference between the measure adopted for reporting the profit or loss, assets, liabilities, etc and the measure adopted for reporting them in the entity's financial statements
- The nature of any changes relative to prior periods in the measurement methods including its effect on determining profit or loss
- The nature and effect of any asymmetrical allocations to reportable segments

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d. QUANTITATIVE RECONCILIATION

- SAME AS AS 17

e. *RESTATEMENT OF PREVIOUSLY REPORTED INFORMATION*

- When there is a change in the entity's internal organization resulting in the change of composition of reportable segments, the entity shall restate the earlier period amounts or disclose the fact whether restatement has been done or not if information is not available or cost to develop that information is excessive
- If restatement is not done due to the above said reasons, the entity shall disclose amounts for the current period on both old basis and new basis unless if information is not available or cost to develop that information is excessive.

f. ENTITY WIDE DISCLOSURES

The standard requires disclosure of revenues attributable to external customers. The disclosure of amounts in this area shall be based on financial information used to produce the entity's financial statements.

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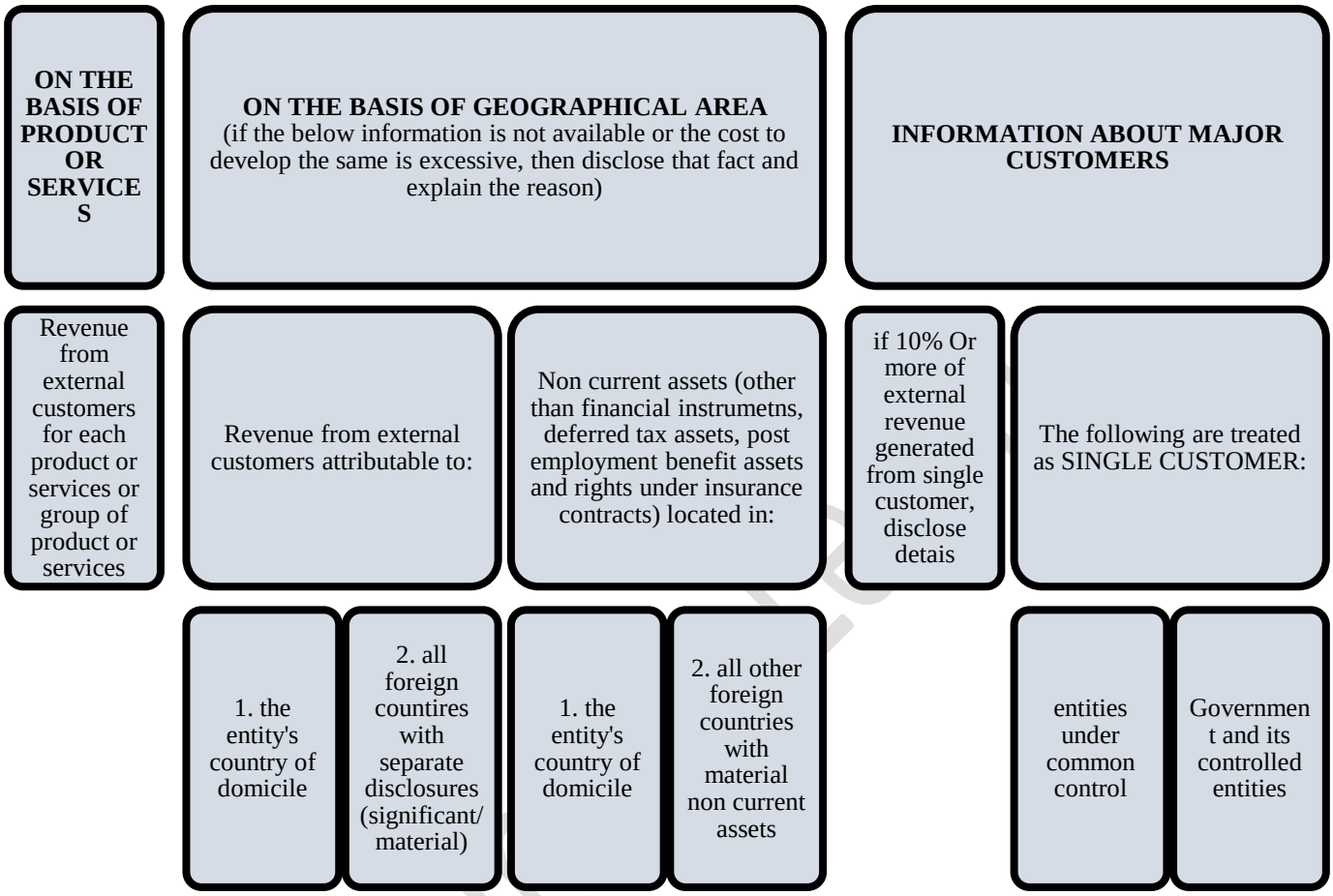

Question and Answers

Illustration 1

Tirumala Limited has the following business or geographical segments. Examine which of these are reportable segments under AS 17.

Rs.' Lacs

Segments	Revenue	Profit (+)/Loss(-)	Assets
A	9,600	1,750	4,100
B	300	180	450
C	100	70	450

Solution:

Test 1 : Revenue Test

Segments	Revenue (Rs.)
A	9,600
B	300
C	100
Total	10,000
10% of Revenue	1,000

Since only Segment A has revenue >= 1,000, Segment A is reportable.

Test 2 : Segment Result Test

Segments	Profit (+)/Loss(-)
A	1,750
B	180
C	70
Total	2,000
10% of Segment Results	200

Since only Segment A has results >= 200 Segment A is reportable.

Test 3 : Segment Assets Test

Segments	Assets
A	4,100
B	450
C	450
Total	5,000
10% of Segment Assets	500

Since only Segment A has assets >= 500, Segment A is reportable

External revenue is not given in question and hence, 75% test is not recognised. As per the three tests, only Segment A is reportable.

Illustration 2

Chief Accountant of Sports Limited gives the following data on its six segments

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Segments	Assets	Results	Revenue
M	40	50	300
N	80	-190	620
O	30	10	80
P	20	10	60
Q	20	-10	80
R	10	30	60
Total	200	-100	1200

Chief Accountant is of the opinion that M & N alone should be reported. Is he justified in his view? Discuss.

Solution:

Segments	Assets	Absolute Profits	Absolute Loss	Revenue
M	40	50		300
N	80		190	620
O	30	10		80
P	20	10		60
Q	20		10	80

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R	10	30		60
Total	200	100	200	1200
10%	20	20 (higher)		120

As per Revenue Test, Segment A&B are reportable

As per Asset Test, Segments M, N, O, P & Q are reportable

As per Segment Result test, M, N & R are reportable

Hence all segments are reportable, and the contention of the Chief Accountant is not correct.

Illustration 3

M/s XYZ Ltd has three segments namely X,Y and Z.

The total of the assets of the company are Rs.10 crores. The details of segment wise assets are given below.

X: Rs. 2 Crores

Y: Rs. 3 Crores

Z: Rs. 5 Crores.

Deferred tax assets included in the assets of each segment are

Segment X – 0.5 cr

Segment Y – 0.4 cr

Segment Z – 0.3 cr

The accountant contends that all three segments are reportable segments. Comment

Solution:

As per AS-17, Deferred Tax Assets do not form a part of Segment Assets.

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Segment	Total Assets	Deferred Assets	Segment Assets
X	2	0.5	1.5
Y	3	0.4	2.6
Z	5	0.3	4.7
Total			8.8
10% of Assets			0.88

Since all segments have assets more than 10% of total segment assets, all segments are reportable. The contentions of Accountant is correct.

5.6 AS 18 Related Party Disclosures

Scope

AS- 18 is mandatory in nature and primarily a disclosure based standard. It is concerned to improve the quality of information provided by Financial Statements. It focuses on need of "users" to receive information for financial decisions rather than merely information on the stewardship of management.

Applicability

The standard is applicable to both:

i. Independent Financial Statements of reporting enterprise.

ii. Consolidated Financial Statements (except for intra group transactions)

Objective:

The objective of this standard is to establish requirements for disclosure of

a. Related Party relationships and

b. Transactions between a reporting enterprise and its related party.

1. **Related Party Relationships (RPR):**

At any time during the reporting period, one party has the ability to **control** the other party or exercise **significant influence** over other party, in making financial or/ and operating decisions.

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Related Party Relationships (RPR), can be grouped into relationships that lead to either

(a) Control, or

(b) Significant Influence.

A variety of situations can be envisaged, which lead to either Control or significant influence. However, Only the following related party relationships are covered by this Standard: -

i. enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under the common control with, the reporting enterprises. This includes a company, its subsdiaries and fellow subsidiaries.
ii. associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;
iii. individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise and relatives of any such individual;
iv. key management personnel and relatives of such personnel; and
v. enterprises over which any person described in (iii) or (iv) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

The related party relationships covered by AS 18 are illustrated in the diagram below:

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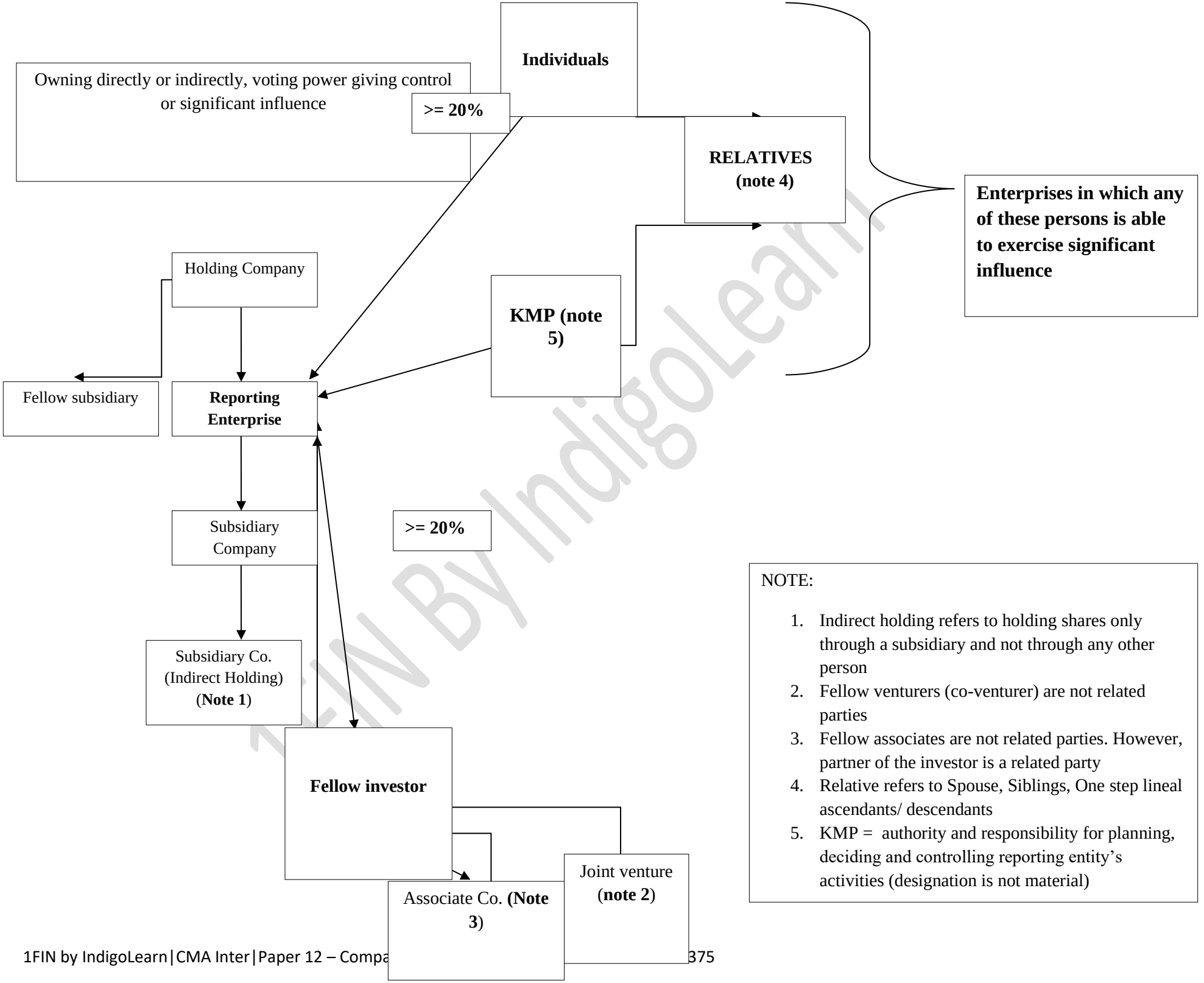

NOTE:

1. Indirect holding refers to holding shares only through a subsidiary and not through any other person
2. Fellow venturers (co-venturer) are not related parties
3. Fellow associates are not related parties. However, partner of the investor is a related party
4. Relative refers to Spouse, Siblings, One step lineal ascendants/ descendants
5. KMP = authority and responsibility for planning, deciding and controlling reporting entity's activities (designation is not material)

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Parties Not Deemed to be Related Party:

i. **Common Directors:** Two Companies, simply because they have a Director in common, unless the Director is able to affect the policies of both Companies in their mutual dealings.

ii. **Economic Dependence:** A single Customer, Supplier, Franchiser, Distributor, or General Agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence.

iii. **Participation in decision-making:** The parties listed below, **in the course of their normal dealings** with an enterprise by virtue only those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process)-
- Providers of finance,
- Trade Unions
- Public Utilities
- Government Departments and Government Agencies including Government Sponsored Bodies.

iv. **Co-Ventures** who share joint control over a joint venture.

RELATED PARTY TRANSACTIONS

A transfer of resources or obligations between related parties regardless of whether or not a price is charged, DURING THE PERIOD OF EXISTENCE OF SUCH RELATION

Definitions:

- **Related Party:** Parties are considered to be related if at any time during the reporting period, one party has ability to **control** the other party or exercise **significant influence** over other party, in making financial or/ and operating decisions.

- **An Associate:** an enterprise in which an investing reporting party has significant influence, and which is neither a subsidiary nor a joint venture of that party.

- **A Joint venture:** a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control.

- **Holding company:** a company having one or more subsidiaries

- **Subsidiary:** a company:

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a. in which another company (the holding company) holds, either by itself and/or through one or more subsidiaries, more than one-half in nominal value of its equity share capital; or

b. of which another company (the holding company) controls, either by itself and/or through one or more subsidiaries, the composition of its board of directors.

- **Fellow subsidiary:** a company is considered to be a fellow subsidiary of another company if both are subsidiaries of the same holding company.

- **State-controlled enterprise:** an enterprise which is under the control of the Central Government and/or any State Government(s).

- **Control means**

i. Ownership, directly or indirectly of more than one-half of the voting power of an enterprise.

ii. Control of the composition of the Board of Directors in the case of a company or Governing Body in the case of any other enterprise.

iii. **A substantial interest in voting power AND** the power to **direct**, by statute or agreement, the financial and / or operating policies of the enterprise

- **Significant influence means** participation in the financial and/ or operating policy decisions of an enterprise, but not in the control of those policies.

- **Joint control** means the contractually agreed sharing of power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

- **Relatives** in relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence or be influenced by that individual in his or her dealings with the reporting enterprise.

- **Key Management Personnel:** are those persons who have the authority and responsibility for planning, directing and controlling the activities or reporting enterprise. E.g. Managing Director, Whole-time director and Manager under Companies Act.

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The control of composition of Board of Directors of a Company or Governing Body of other enterprises arises out of power that can be exercised without consent or concurrence of any other person to appoint or remove all or a majority of directors and, such a power is said to be vested in an enterprise (say, X) when.

- A person cannot be appointed as director without X casting a favorable vote for the purpose
- A person's appointment as director necessarily follows his appointment to a position in X.
- Nomination by X, or by Subsidiary of X.

Is the term Control bearing same meaning as in AS 21?

It has different meaning. The Term Control has broader meaning in AS 18 as compared to AS 21. It includes same scenario as in AS 21, but additionally it includes **Control through Substantial Interest.**

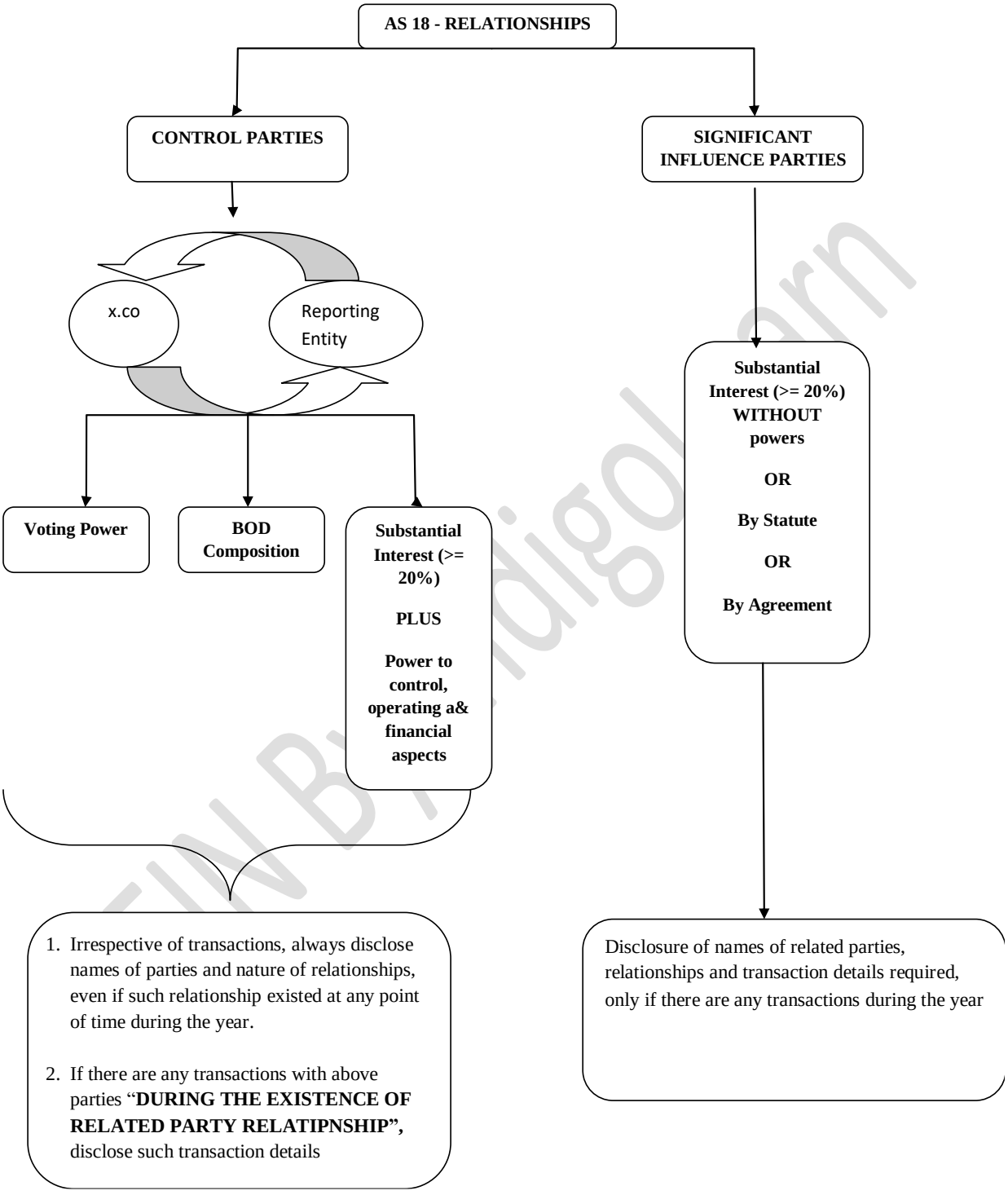
An enterprise is considered to have a substantial interest in another enterprise if that enterprise owns, directly or indirectly, 20 per cent or more interest in the voting power of the other enterprise. Similarly, an individual is considered to have a substantial interest in an enterprise, if that individual owns, directly or indirectly, 20 per cent or more interest in the voting power of the enterprise. In addition to two parameters as that of AS 21, the term control in AS 18 stands for substantial interest + power to direct financial and / or operating policies of the enterprise. Such power may be obtained by virtue of statute or agreement.

Significant influence (as per AS 23) implies right to participate in policy making process and includes ability to influence intercompany transactions that are material or an ability to change managerial personnel. The ability to exercise significant influence may flow from:

- Ownership (e.g. Azim Premji in Wipro — holding 20% or more of voting power)
- Statue (e.g. SBI in its associate bank like SBT), or
- Agreement (e.g. Managing Director of a company)

Significant influence has a direct linkage with shareholding or voting power in an enterprise. The standard clarifies this aspect further.
i. When there is ownership of shares with direct or **indirect** control of 20**% or greater than 20% of voting power,** (referred as substantial interest) it is presumed that significant influence exists unless proved otherwise.
ii. Conversely, when there is ownership of shares with direct or indirect control of less than 20% of voting power, it is presumed that no significant influence exists unless proved otherwise.
iii. Consider the situation of two parties A and B. A holds 63% voting power, while B holds 27%. A's position is majority ownership. The standard clarifies that this position of substantial or majority ownership by A. does not preclude B from having significant influence on the reporting

Disclosure Requirements:



1. Related Party Relationships: Name of the Related Party and nature of the Related Party Relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.

2. Related Party Transactions: If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following

a. the name of the transacting related party.

b. a description of the relationship between the parties,

c. a description of the nature of transactions,

d. volume of the transactions either as an amount or as an appropriate proportion,

e. any other elements of the related party transactions necessary for an understanding of the Financial Statements, e.g. disclosure making and indication that the transfer of a major asset had taken place at an amount materially different from that obtainable on normal commercial terms.

f. the amounts or appropriate proportions of outstanding items pertaining to related parties at the Balance Sheet date and provisions for doubtful debts due from such parties at that date, and

g. amounts written off or written back in the period in respect of debts due from or to related parties.

3. Grouping: Items of a similar nature may be disclosed in aggregate according to type of related party. However, when separate disclosure is necessary for an understanding of the effects of related party transactions on the Financial Statements of the reporting enterprise, it should be separately disclosed and not grouped. Therefore,

a. Items of a similar nature may be disclosed in aggregate by type of related party, since **voluminous information does not mean effective disclosure.** However, the following points are to be considered in this regard:

- Separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the reporting enterprise. In other words, though items of a similar nature may be disclosed in aggregate by type of related party, this is not done in such a way as to obscure the importance of significant transactions. For example, purchases or sales of

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goods are not aggregated with purchases or sales of fixed assets nor a material related party transaction with an individual party is clubbed in an aggregated disclosure.

- Materiality primarily depends on the facts and circumstances of each case. In deciding whether an item or an aggregate of items is material, the nature and the size of the item(s) are evaluated together.
- As regards size, for the purpose of applying the test of materiality, ordinarily a related party transaction, the amount of which is in excess of 10% of the total related party transactions of the same type (such as purchase of goods), is considered material, unless on the basis of facts and circumstances of the case it can be concluded that even a transaction of less than 10% is material.
- As regards nature, ordinarily the related party transactions which are not entered into in the normal course of the business of the reporting enterprise are considered material.
- Importance of significant transactions should not be diminished/ obscured by aggregation. Material Related Party Transaction should not be clubbed in the course of aggregation.

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1. Should the relationship persist on the date of balance sheet to be a related party for this accounting standard? No. Relationship at any time during the reporting period is sufficient to place a party as related party.

2. What are the important factors to decide as whether a party is related or not? Ability of one party to control the other party or exercising significant influence over the other party in making financial or operating decisions.

3. Should the relationship and transactions co-exist to be covered under AS 18? Yes, Relationship and transactions should co-exist to be disclosed.

4. Is it necessary to make disclosure where there is no transaction between related parties? Yes. When the relationship is on account of control. No. When the relationship is on account of significant influence.

5. Is the term 'Control' bearing the same meaning as in AS 21 or is it different in this AS? It has a different meaning. The term Control is broader in AS 18. It includes the same scenarios as in AS 21, but additionally includes control through 'Substantial Interest'.

6. Arms Length transaction — Need not be disclosed

Ans : Wrong, All transactions between Related parties shall be disclosed.
7. In separate financial statements of a parent company, presented on a "stand-alone" basis as permitted under AS 18, transactions with its subsidiaries would be disclosed as related-party transactions. However, in "consolidated financial statements" of the parent company, there will be no related-party transactions or balances reported between members of the consolidated group, as all such items will have been eliminated upon consolidation by applying the procedures outlined in AS 21, Consolidated and Separate Financial Statements.

8. The pricing of related-party transactions is often a sensitive subject, particularly if pricing is not at arm's length. This area can be a difficult one that is open to judgment. For example, an entity may sell 60% of its production to a related party at unit prices substantially lower than what it charges to other third parties for the balance 40% production. None of the third parties accounted for more than 5% of the sales. It may be very difficult to determine whether the volume discount was at a market rate. It can be even more difficult to determine arm's length if there are no sales to third parties. In such cases, the Standard states that a transaction can be described as at arm's length only if it can be substantiated. Thus it is the responsibility of the management to prove the market value of transactions if it wishes to describe transactions as "at market value."

2. **Disclosure specifically exempt under AS-18: No disclosure is required in the following cases:**

a. Intra group transactions need not be disclosed in Consolidated Financial Statements.

b. Related party relationships (RPR) and transactions between two or more state controlled entities.

c. Where disclosure of RPR and transactions with such enterprises would come in conflict with the duties of confidentiality, of the reporting enterprises e.g. Banks.

ICAI Interpretations: ASI 13,19,21,23 ASI 13: Reporting Format

ICAI have provided a specimen format in which aggregated information on transactions with related parties be presented. This is reproduced below:

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DISCLOSURE FORMAT – AS 18

Name of the Company
Notes forming part of the financial statements

GN 6.13 **Note 30 Disclosures under Accounting Standards (contd.)**

Ref. No.	Particulars

AS 18
GN 6.15

Related party transactions

Details of related parties:

AS 18.21

Description of relationship	Names of related parties
AS 18.23 Ultimate Holding Company	AA Ltd.
Holding Company	A Ltd.
Ultimate Holding Company	AA Ltd.
Subsidiaries	B Ltd. and C (P) Ltd.
Fellow Subsidiaries (to be given only if there are transactions)	D Ltd. and Q Ltd.
Associates	X Ltd. and Y Ltd.
Key Management Personnel (KMP)	Mr. Y and Mr. Z
Relatives of KMP	Mrs. Y (wife of Mr. Y), Mr. F (father of Mr. Z)
Company in which KMP / Relatives of KMP can exercise	D Ltd in which MD(KMP) and his wife hold 50%

Note: Related parties have been identified by the Management.

Details of related party transactions during the year ended 31 March, 20X2 and balances outstanding as at 31 March,

AS 18.23

	Ultimate Holding Company	Holding Company	Subsidiaries	Fellow Subsidiaries	Associates	KMP	Relatives of KMP	Entities in which KMP / relatives of KMP have significant influence	Total
AS 18.24 AS 18.26 ✍ Party-wise details - aggregation to be done only if the related party is < 10 % of the total amount of that particular type of transaction - e.g. purchases. Also note that in some cases even less than 10% will be required to be disclosed and such importance depends on circumstances of the respective companies.									
Purchase of goods									
Sale of goods									
Purchase of fixed assets									
Sale of fixed assets									
Rendering of services									
Receiving of services									
Agency arrangements									
Leasing or hire purchase arrangements									
Transfer of research and development									
License agreements									
Finance (including loans and equity contributions in cash or in									
Guarantees and collaterals									
Management contracts including for deputation of employees									
Provision for doubtful receivables, loans and advances									
Write off / write back made during the year									
Balances outstanding at the end of the year									
Trade receivables									
Loans and advances									
Trade payables									
Borrowings									
Provision for doubtful receivables, loans and advances									

Note: Figures in bracket relates to the previous year

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ASI 19: Intermediary: The term "intermediary" used in Paragraphs 3 and 13 of AS-18, means enterprises which are "subsidiaries" as defined in AS 21.

ASI 21: Non Executive Director – KMP? A non-executive Director, merely by virtue of his being a Director will not be covered within the meaning of related party and hence AS 18 is not

applicable to such a non executive director. However a non —executive director would be covered by a related party relationship in case, any other requirement of AS 18 is met.

ASI 23: Remuneration to KMP: Key Management Personnel being related parties under AS 18, remuneration paid to KMP will be a related party transaction requiring disclosure under AS 18, except that remuneration paid to a non-executive Director merely by virtue of being a Director, need not be reported in less any other provisions of AS 18 are attracted.

Question and Answers

Question 1

As a statutory auditor, how would you deal with the following?

A husband and wife are controlling 34% of voting power in XY Co. Ltd. They are having a separate partnership firm which supplies mainly the raw material to the company. The management says that the above transaction need not be disclosed.

Solution

The husband and wife hold more than 20% of voting power and hence exercise significant influence over XY Co. Ltd. Hence, they are related parties as per AS-18. If the persons having significant influence over the reporting entity control or have significant influence over another entity, the other entity is also considered as a related party.

Hence, the partnership firm which is controlled by them is also a related party under AS-18.

If there is any transaction with related party,

• Name and nature of relationship needs to be disclosed.

• Transactions which occur during the existence of relationship party relationship needs to be disclosed.

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Conclusion : The contention of management is not correct.

The treatment given by the company is not in accordance with AS-18 on Related Parties. The auditor (I) would issue a suitable modified report.

Question 2

Narmada Ltd. sold goods for Rs. 90 lakhs to Ganga Ltd. during financial year ended 31st March 2006. The managing director of Narmada Ltd owns 100% Ganga Ltd. The sales were made to Ganga Ltd. at normal selling prices followed by Narmada Ltd.

The Chief Accountant of Narmada Ltd contends that these sales need not require a different treatment form the other sales made by the company and hence no disclosure is necessary as per Accounting Standard. Is the Chief Accountant correct?

Solution:

As per AS-18, Key Management Personnel [KMP], Managing Director in this case, are considered to be related party. The enterprises controlled by KMP are also considered to be related parties. Since Ganga Ltd. is controlled by Managing Director, Narmada Ltd and Ganga Ltd are considered to be related parties. Disclosure of related parties transaction is required irrespective of the fact that the transactions are at market/normal prices.

Transactions of 90 lakhs happened between Narmada Ltd. and Ganga Ltd. The transaction is a related party transaction which requires disclosure.

Conclusion: The view of the chief accountant is not in line with AS-18. The transactions must be disclosed even if the transactions are at normal market prices.

Question 3

P Ltd. has 60% voting right in Q Ltd. Q Ltd. has 20% voting right in R Ltd. [22325] Also, P Ltd. directly enjoys voting right of 14% in R Ltd. R Ltd. is a listed company and regularly supplies goods to P Ltd. The management of R Ltd. has not disclosed its relationship with P Ltd.

How would you assess the situation from the viewpoint of AS 18 on Related Party Disclosures?

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Solution

A company has significant influence over another company if it enjoys at least 20% of voting rights. Since P Ltd enjoys voting right of 34% [14% directly and 20% thorough Q Ltd] in R Ltd, it exercises significant influence over R Ltd. As per AS-18 two parties are considered to be related if one exercises significant influence over the other. Hence a related party relationship exists between P & R

According to the disclosure requirements of AS-18, R Ltd. should disclose the relationship with P Ltd in its financial statements. The transactions with P Ltd. should also be disclosed.

5.7 AS 19 Accounting for Leases

Status and Applicability

AS — 19 is mandatory in nature and is applicable to all enterprises in respect of assets leased during the period commencing on or after 1.4.2001. Consequently, the Guidance Note e d by the Institute of Chartered Accountants of India on 'Accounting for lease' is not applicable.

Objective and Scope

Lease arrangement is a specific type of a transaction in which one party, ailed lessor, allows the use of an asset to another party, called lessee, in return for a rental. It is not a sale or base transaction. Lease allows the user to use the asset for a limited period or for almost the full economic life without owning the asset. The objective of AS — 19 is to provide for accounting treatment of lease transaction in the books of both the parties. It covers lease arrangements for asset except the following:

1. Lease agreements to explore for or use of natural resources, such as oil, gas, timber, metals and other mineral rights; and

2. Licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and

3. Lease agreements to use lands.

4. It does not apply to services which do not transfer the right to use the

asset.

Definitions

The following terms have been used in the Standard:

A **lease** is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time. A lease agreement also includes a Hire Purchase agreement.

A financial lease is a lease that transfers substantially all **the risks and rewards incident to ownership of an asset.**

An operating lease is a lease other than a finance lease.

A NON-CANCELLABLE LEASE is a lease that is cancellable only:

a. upon the occurrence of some remote contingency; or
b. with the permission of the lessor; or
c. if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or
d. upon payment by the lessee of an additional amount such that at inception, continuation of the lease is reasonably certain.

The inception of the lease is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease.

Lease term is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee with exercise.

Minimum lease payments are the payments over the lease term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be reimbursed to the lessor, together with:

a) in the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or

b) in the case of the lessor, any residual value guaranteed to the lessor:

   i. by or on behalf of Lessee or

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ii. by an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option

Fair value is the amount for which an asset could be exchanged between willing parties in an arm's length transaction.

Economic life is either (a) the period over which an asset is expected to be economically usable by one or more users; or,(b) the number of units expected to be produced from the asset by one or more users.

Useful life of a leased asset is the period over which the leased asset is expected to be used by the lessee: or the number of units expected to produced from the use of the asset by the lessee.

Residual value of a leased asset is estimated fair value of the asset at the end of the lease term.

Guaranteed residual value in the case of the lessee, is that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee; and in case of lessor, is that part of the residual value which is guaranteed by or on behalf of the lessee to the lessor.

Unguaranteed residual value of a leased asset is the difference between the expected residual value of the asset and its guaranteed residual value.

Gross investment in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor plus any unguaranteed residual value accruing to the lessor.

Net investment in the lease is the gross investment in the lease less unearned finance income.

The interest rate implicit in the lease is the discount rate at which the aggregate present value of

a) the minimum lease payments under a finance lease from the standpoint of the lessor plus.

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b) the present value of any unguaranteed residual value is equal to the fair value of the leased asset.

The lessee's incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or if that is not determinable, the rate that, at the inception f the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g, percentage of sales, amount of usage, price indices, market rates of interest).

Classification of Leases

At the inception of Lease itself, a lease is required to be "classified" either as finance or an operating lease. The term "at the inception of lease" means, date of the lease agreement or the date of commitment by the parties to the principal provisions of the lease. whichever is earlier. Such a classification is linked to the "substance" of the agreement rather than its "form". Determination is based on the extent to which the risks and rewards attributable to ownership of the asset lie with lessor or lessee. If the arrangement transfers to lessee "substantially all the risks and rewards incidental to ownership", the transaction is classified as a Finance Lease. Else, it is an operating lease. It should, however, be noted that at the inception of lease, the final transfer of title in favour of lessee may or may not take place.

A lease is classified as finance lease in any of the following situations:

1. Transfer of ownership of the asset to the Lessee by the end of the lease term.

2. Option to purchase the asset, to the lessee, at a price which is sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised.

3. Lease Term is for the major part of the economic life of the asset even if title is not transferred,

4. Present Value of the minimum lease payments at the inception of the lease amounts to at least substantially all of the Fair Value of the leased asset, (i.e. PV of MLP = Fair Value approximately) and

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5. The leased **Asset is of a specialized nature** such that only the lessee can use it without major modifications being made.

Note: Classification of lease are to be made at the inception of the lease. The inception of a lease is the earlier of the agreement date and the date of the commitment by the parties to the principle provisions of the lease.

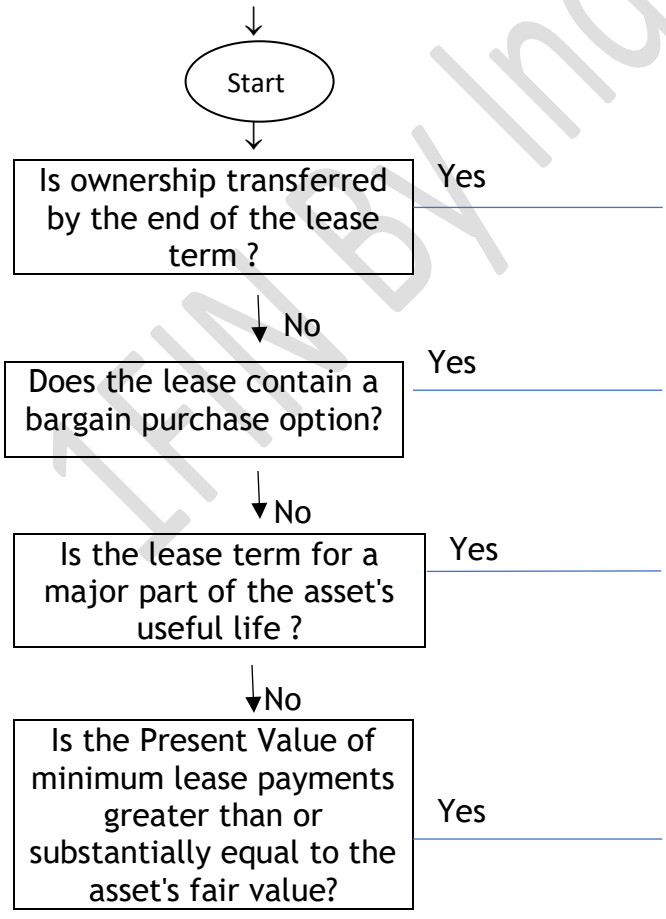
Indicative Factors: In following cases a lease **may be** classified as a Finance Lease:

a. If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.

b. Gains or losses from the **fluctuation in the Fair Value** of the residual fall to the lessee, (e.g. in the form of a rent rebate equaling most of the sales proceeds at the end of the lease), and

c. The lessee can **continue** the lease for a secondary period at a rent, which is substantially lower than Market Rent.

Classification of Leases



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↓ No

Operating Lease	**Finance Lease**

It may be noted that first five criteria, 1 to 5 are determination, and if any of these is met, the lease would ie classified as a finance lease. In these five situations, economic reality (substance) is that risk and •maw& associated with ownership are transferred to lessee. However. the other three criteria, a to b, are suggestive only and may indicate that the lease may be classified as finance lease. A lease which is not financing lease is classified as an operating lease.

Accounting Treatment for Leases in the Books of Lessee.

A: Finance Leases:

1. **Initial Recognition:** This is to be done at the inception of finance lease. The lessee should recognize the lease as an asset and a liability. Accordingly, (I) the value of asset and (11) amount of liability has to be quantified. The amount will be LOWER of

   a. Fair value of leased asset

   b. Present value of minimum lease payments (for lessee). This PV is computed at the interest rate implicit in the lease. Where this is found impracticable, PV is computed at lessee's incremental borrowing, rate.

   In considering PV of MLP, contingent rent is excluded. Contingent rent means that portion of the lease payments that is not fixed in amount but is based on a factor other than .just the passage of time (e.g. % of sales, amount of usage, price indices, market rates of interest).

   Incremental borrowing rate- on the other hand- has a linkage with lessee's position. If lessee does not know lessor's IRR, lessee will adopt his incremental borrowing rate for accounting for "finance charges". This connotes lessee's borrowing cost from an alternative source, and not his ‘veif.-1,1ited average cost of capital i.e. the rate that the lessee would incur at the inception of the lease to borrow a similar term, and with a similar security, for the funds necessary to purchase the asset should be used.

2. **Lease Payments-** Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance

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charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period. (The Standard permits some approximations being made, for convenience).

3. **Depreciation Charge:-** The finance lease give rise to (i) finance expense and (ii) depreciation, in each accounting period. The depreciation policy for a leased asset should be consistent with that for other, owned, depreciable assets. Consistent Amount of depreciation recognized should be calculated on the basis set out in AS-6 Depreciation Accounting.

Three elements in computation of depreciation	
Amount of asset	Lower of Present value of MIT or fair value, adjusted for finance charge.
Rate of depreciation	Consistent with depreciation policy in compliance with statute and with AS-6.
Tenor or period during which the asset will be depreciated	(i) Economic life of asset if lessee were to obtain ownership at the end of lease term.
	(ii) lease term or economic life whichever is shorter — if lessee were not to obtain such ownership.

B: Operating Leases: Lease payments: In an operating lease the risks and rewards incidental to ownership rest with the lessor- and not with the lessee. The critical aspect relevant for accounting treatment for operating leases, is "lease payments". Lease payments should be recognized as an expense in the statement of profit and loss on a straight- line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

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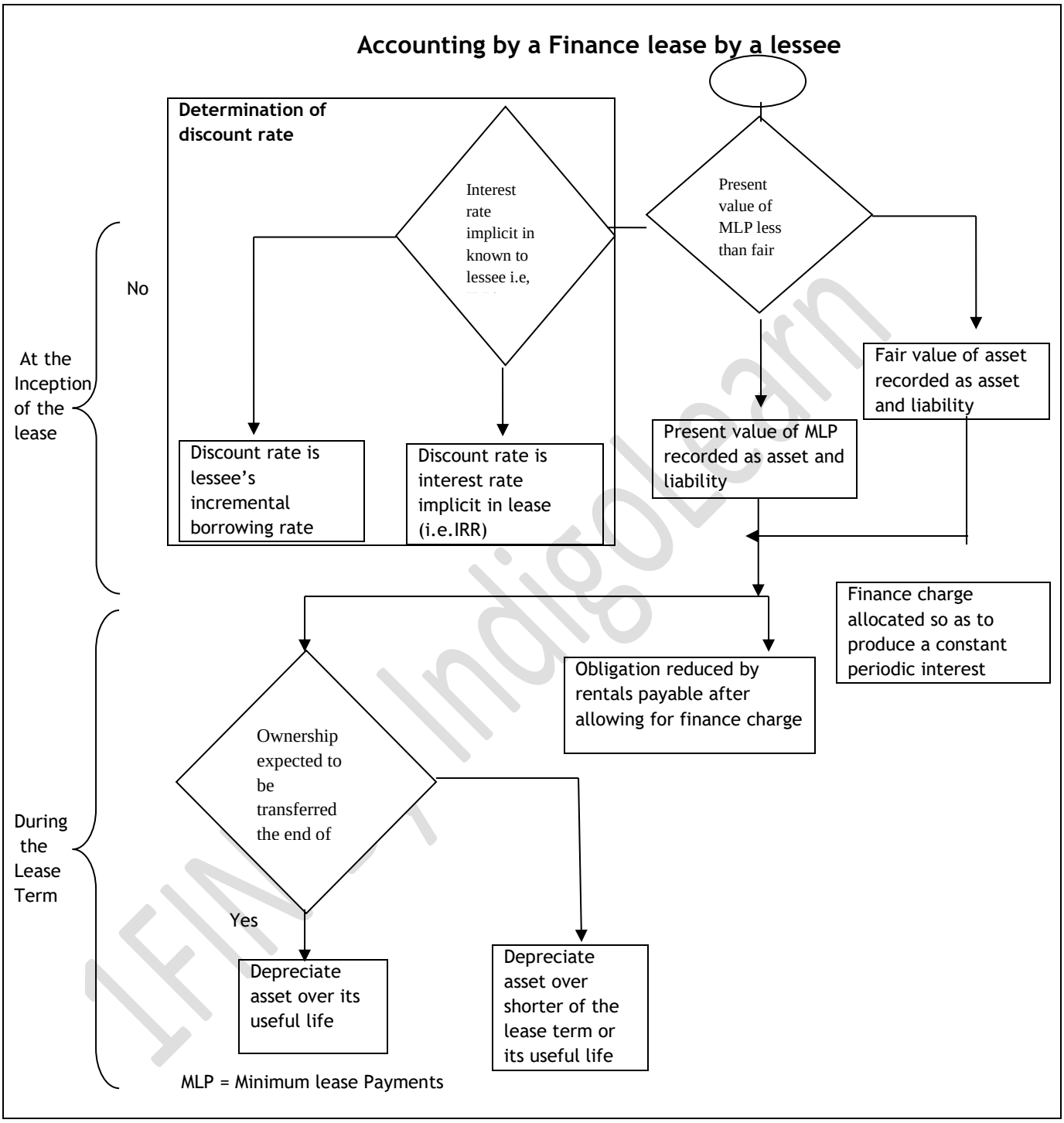

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Accounting Treatment for Leases in the Books of Lessor —

A. Finance Leases — The finance Lease transaction stands recognized as an "asset and liability" in the books of lessee. It follows; therefore, the lessor cannot account for the same items as an asset. What is a liability (dues to) for lessee, will get reflected in the books of lessor as "receivables" (due from). Accounting treatment is explained as under

1. **Asset Recognition:** The Lessor should recognise Assets given under a Finance Lease in its Balance Sheet as a receivable at an amount equal to the Net Investment in the Lease. Since risks and rewards incidental to the legal ownership are transferred by the Lessor, the Lease Payments Receivable is treated by the Lessor as repayment of principal i.e. Net Investment in the Lease.

2. **Income Recognition:** The recognition of Finance Income should he based on a pattern reflecting a constant periodic rate of return on the Net Investment of the Lessor outstanding in the respect of the Finance Lease. The Finance Income constitutes the reward to the Lessor for its investment and services. The Lessor aims to allocate finance income over the lease tern on a systematic and rational basis.

3. **Lease Payments received:** Lease Payments relating to the accounting period, excluding costs for services, are reduced from both the Principle (i.e. Not Investment in the Lease) and the Unearned Finance Income.

4. **Review of Unguaranteed Residual Value (URV):** The Estimated URV used in computing the Lessor's Gross Investment in the lease are review regularly. When there is a reduction in the estimated URV, the income allocation over the remaining lease term is revised and a reduction in respect of amounts already accrued is recognised immediately. However, an upward adjustment of the Estimated URV is not made.

5. **Initial Direct Costs:** Initial Direct Costs, (e.g. commission and legal fees), incurred by Lessors in negotiating and arranging a lease to produce Finance Income and are either —

    a) recognised immediately in the Profit & Loss Statement, or

    b) allocated against the Finance Income over the lease term.

Example:

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Kasyapa Ltd has taken an asset on lease from Varuna Ltd for a period of 3 years. Annual Lease Rentals are Rs.6 Lakhs payable at the end of every year. The Residual Value guaranteed by Kasyapa is Rs.2 Lakhs where as Varuna expects the estimated salvage value to be Rs.5 Lakhs at the end of the lease term. If the Fair Value of the asset at the lease inception is Rs.15 Lakhs and the interest rate implicit in the lease is 12%, compute the Net Investment in the Lease from the viewpoint of Vanilla Ltd and the annual Finance Income.

(F(A/c)-RTPI)

Answer: Analysis from Lessor's point of view –

(A)	**Gross Investment :**	**Rs.**
	Minimum Lease Payments receivable (6,00,000 x 3)	18,00,000
	Guaranteed Residual Value (GRV)	2,00.000
	Unguaranteed Residual Value (UGRV)	3.00,000
		23,00,000
(B)	**Net Investment (PV of above 23,00,000 (& 12%)**	
	Present Value of minimum Lease Payment (6,00,000 x Annuity)	14.41.140
	Present Value of GR + UGRV 5,00,000 x 0.7118	3,55,900
		17,97,040
(C)	**Unearned Finance Income (A-B)**	**5,02,960**

B. Operating Leases in the Financial Statement of Lessor:

1. **Asset Recognition:** The Lessor should present an asset given under Operating Lease in its Balance Sheet under Fixed Assets.

2. **Income Recognition :** Lease Income (excluding receipts for services provided e.g. insurance and maintenance), should be recognised in the Statement of Profit & Loss on a Straight Line Basis over the Lease term, even if it is not received on that basis, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

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3. **Cost Recognition:** Costs, including depreciation, incurred in earning the Lease Income are recognised as an Expense.

4. **Initial Direct Costs :** initial Direct Costs incurred specifically to earn revenues are either — (a) deferred and allocated to income over the lease term in proportion to the recognition of rent income, or (b) are recognised as an expense in the statement of profit and loss in the period in which they are incurred.

5. **Depreciation:** Depreciation of Leased Assets should be on a basis consistent with the normal depreciation policy of the Lessor for similar assets. the Depreciation charge should be calculated on the basis set out in AS-6.

6. **Impairment Losses:** To determine Whether a Leased Asset has become impaired, the Lessor should apply AS-28 that sets out the requirements for review of the carrying amount of an asset, determination of recoverable amount of an asset and principles for recognition or reversal, of an impairment loss.

7. **Selling Profit:** A Manufacturer or Dealer Lessor does not recognise any Selling Profit on entering into an Operating Lease because it is not the equivalent of a sale.

C. Finance Leases in the Financial Statements of Manufacturer / Dealer Lessor:

1. **Option to Customers:** Manufacturers or dealer offer customers the choice of either buying or leasing an asset. A Finance Lease by a Manufacturer or Dealer Lessor gives rise to two types of income-

   a) Profit or Loss equivalent to the Profit or Loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts, and

   b) Finance Income over the lease term.

2. **Sale Recognition:** The Manufacturer or Dealer Lessor should recognise the transaction of sale in the Profit & Loss Statement for the period, in accordance with the policy followed by the enterprise for outright sale.

3. **Sales Revenue:** The Sales Revenue recorded at the commencement of a Finance Lease term by a Manufacturer or Dealer Lesser is the Fair

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Value of the asset. When Present Value of Minimum Lease Payments accruing to the Lessor computed at a commercial rate of interest < Fair Value, the amount recorded as Sales Revenue = Present Value so computed.

4. **Cost Recognition:** Cost of Sale (in respect of Leased Asset) = Cost or Carrying amount of the Leased Asset less Present Value of the Unguaranteed Residual Value (URV).

5. **Selling Profit:** Selling Profit Selling Profit = Sales Revenue less Cost of Sale. It is recognised in accordance with the policy followed by the enterprise for sales.

6. **Low Rates of Interest:** To attract Customers, Manufacturer or Dealer Lessors quote artificially low rates of interest, which would result in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, Profit on sale should be restricted to that which would apply if a commercial rate of interest were charged.

7. **Initial Direct Costs:** Initial Direct Costs are recognised as an Expense at the commencement of the lease term, because they are mainly related to earning the Manufacturer's or Dealer's selling profit.

Example: Following information is in respect of a Manufacturer Lessor. Explain how you will treat this under AS-19. (a) Fair Value of the asset at the inception of lease = Rs.5,60,000, (b) Present Value of MLP accruing to the Lessor, discounted at commercial rate of interest = Rs.5,00,000, (c) Cost of Leased Asset at the commencement of lease = Rs.4,16,000, (d) Present Value of URV = Rs.12,000, (e) Initial Direct Costs (sales Commission) = Rs.18,000, (1) Gross Investment in the Lease = Rs.5,96,000, (g) Lease Term = 36 months.

Answer: Analysis from Lessors' (Manufactures' / Traders') Point of View:

(A)	**Gross Investments (Receipts) given**	5,96,000
(B)	**Net Investments (Selling Price)**	
	Present Value of Minimum Lease Payments 5,00,000 Present Value of Unguaranteed Residual Value 12,000	5,12,000
(C)	**Acq. Cost (Cost of Manufacturing)**	**4,16,000**

(D)	**Sales Commission**	**18,000**

Remark:

1)	Gross Profit (B-C) 5,12,000 – 4,16,000 Less: Sales Commission	96,000 (18,000)
	Operating Profit	**78,000**
2)	Gross Investment	5,96,000
	Net Investment	(5,12,000)
	Un earned Finance Income	**84,000**

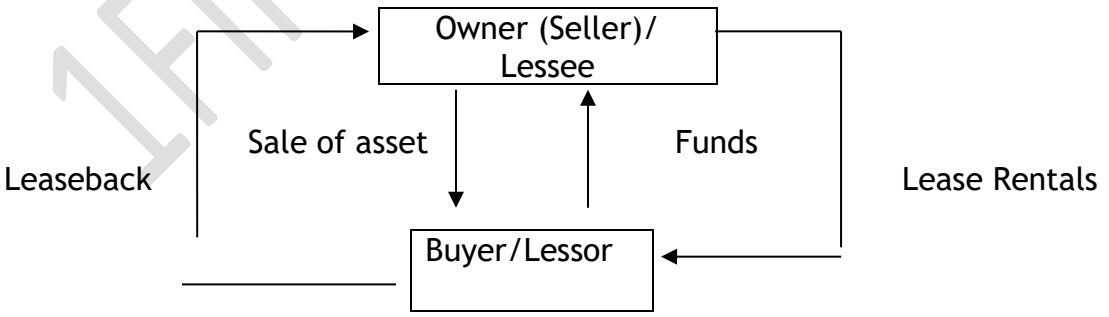
Treatment of Initial Direct Costs

Lease transactions often require lessors and lessees to incur certain costs directly attributable to conclude a lease arrangement. These would include commission, legal charges and consultant's fees for negotiating and finalizing a lease plan. These charges are to be capitalized only in case of finance lease in the books of lessee.

Sale and Leaseback Transactions

A sale and leaseback transaction involve the sale of an asset by the owner and the leasing of the same asset back by the buyer (lessor) to the vendor (lessee). Sale and leaseback transaction have been shown in following figure:

Leaseback transaction has been shown in following figure:



The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved:

(A) Sale and Leaseback Transaction results in a Finance Lease:

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1. **Effect of Transactions:** When an asset is sold and leased back, it effectively results in the same asset being capitalized at a different amount and is similar to revaluation of that asset.

2. **Deferral:** Any Excess or deficiency of Sales proceeds over the carrying amount should not be immediately recognised as Income or Loss in the Profit & Loss Account of the Seller-Lessee.

3. **Amortisation:** Such Gain / Loss arising as above, should be deferred and amortised over the lease term in proportion to the depreciation, of the Leased Asset.

4. **Impairment Losses:** No adjustment is necessary in respect of Fair Value, unless there has been an impairment in value, in which case the carrying amount is reduced to recoverable amount as per AS-28.

(B) Sale and Leaseback transaction results in an Operating Lease:

1. When the transaction established at Fair Value, there has been effect a normal sale transaction and any Profit or Loss should be recognised in the Profit & Loss Account immediately.

2. If Sale Price < Fair Value, any Profit or Loss should be recognised immediately. However. if the loss is compensated by Future Lease payments at below Market Price, it should be deferred and amortised in proportion to the Lease Payments over the period for which the asset is expected to be used.

3. If Sale Price > Fair Value, the excess of Sale Proceeds over Fair Value should be deferred and amortised over the period for which the asset is expected to be used.

4. If the Fair Value at the time of a Sale and Leaseback Transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and Fair Value should be recognised immediately.

Example illustrating the application of Para 50 and Para 52:

Particulars	**Situation 1**	**Situation 2**	**Situation 3**	**Situation 4**
Fair Value at the time of Sale &	Rs.1,00,000	Rs.1,00,000	Rs.1,00,000	Rs.1,00,000

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Leaseback				
Sale Proceeds	Rs.1,00,000	Rs. 88,000	Rs.1,15,000	Rs.1,15,000
Carrying amount of Asset	Rs.96,000	Rs.96,000	Rs.1. I 2,000	Rs.96,000
Application of Para 52 F Impairment Loss]	Not Applicable	Not Applicable	Impairment Loss = Rs. 12,000	Not Applicable
Application of Para 50 [Profit & loss is the difference between sale proceeds and carrying amount of asset]	Profit = Rs. 4,000 recognised immediately	Loss = Rs.8,000 recognised immediately (see note)	*Profit = Rs.15.000 deferred and amortised over period of use.	Applicable = Rs.4,000 profit is to be recognised immediately & Rs. 15,000 shall be deferred

Note: If the loss is compensated by Future Lease Payments at below Market Price, it should be deferred and amortised in proportion to the Lease Payments over the period for which the asset is expected to be used.

*Since Impairment Loss of 12,000 is recognised, the Revised Carrying Amount of the Asset will be Rs.1,00.000 (by reducing the Carrying Amount to the Fair Value). Hence Profit will be Rs.1,15,000 — Rs.1,00,000 = Rs.15,000.

Disclosure

AS-19 requires that the finance lease and the operating lease should be disclosed in the financial assets by both the lessor and the lessee. The disclosure requirements are:

Disclosure by Lessee:

Finance Lease: In case of finance lease, the lessee should disclose:

(a) Assets acquired under finance lease as segregated from the assets owned:

(b) The net carrying amount of the leased assets

(c) A reconciliation between the total of minimum lease payments at the balance sheet date and their present value. The total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:

i. Not later than 1 year;

ii. Later than 1 year and not later than 5 years;

iii. Later than 5 years.

Operating Lease: Lease payments under an operating lease should be recognized as an expense in the statement of profit and loss on a straight line basis over the lease term even if the payments are not equal. The lessee should also disclose.

(a) The total of future minimum lease payments for each of the following periods:

(i) Not later than 1 year;

(ii) Later than 1 year and not later than 5 years:

(iii) Later than 5 years.

(b) The total of future minimum sublease payments expected to be received;

(c) Lease payments recognized in the statement of profit and loss for the period.

Disclosure by Lessor:

Finance Lease: In case of finance lease, the lessor should disclose:

(a) A Reconciliation between the total gross investment in the lease, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:

(b) Not later than 1 year:

(c) Later than 1 year and not later than 5 years;

(d) Later than 5 years.

(e) Unearned finance income.

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Operating Lease: Assets leased on operating lease should be shown in the balance sheet as Fixed Assets. as per AS-10. Depreciation on these assets and impairment losses on these assets should be shown in the financial statements.

Lease rentals received in respect in respect of operating lease should be shown as revenue in the Profit & Loss A/c on a straight-line basis or some other systematic basis, over the lease period. Costs including depreciation incurred in earning the lease income are recognized as expense of the period.

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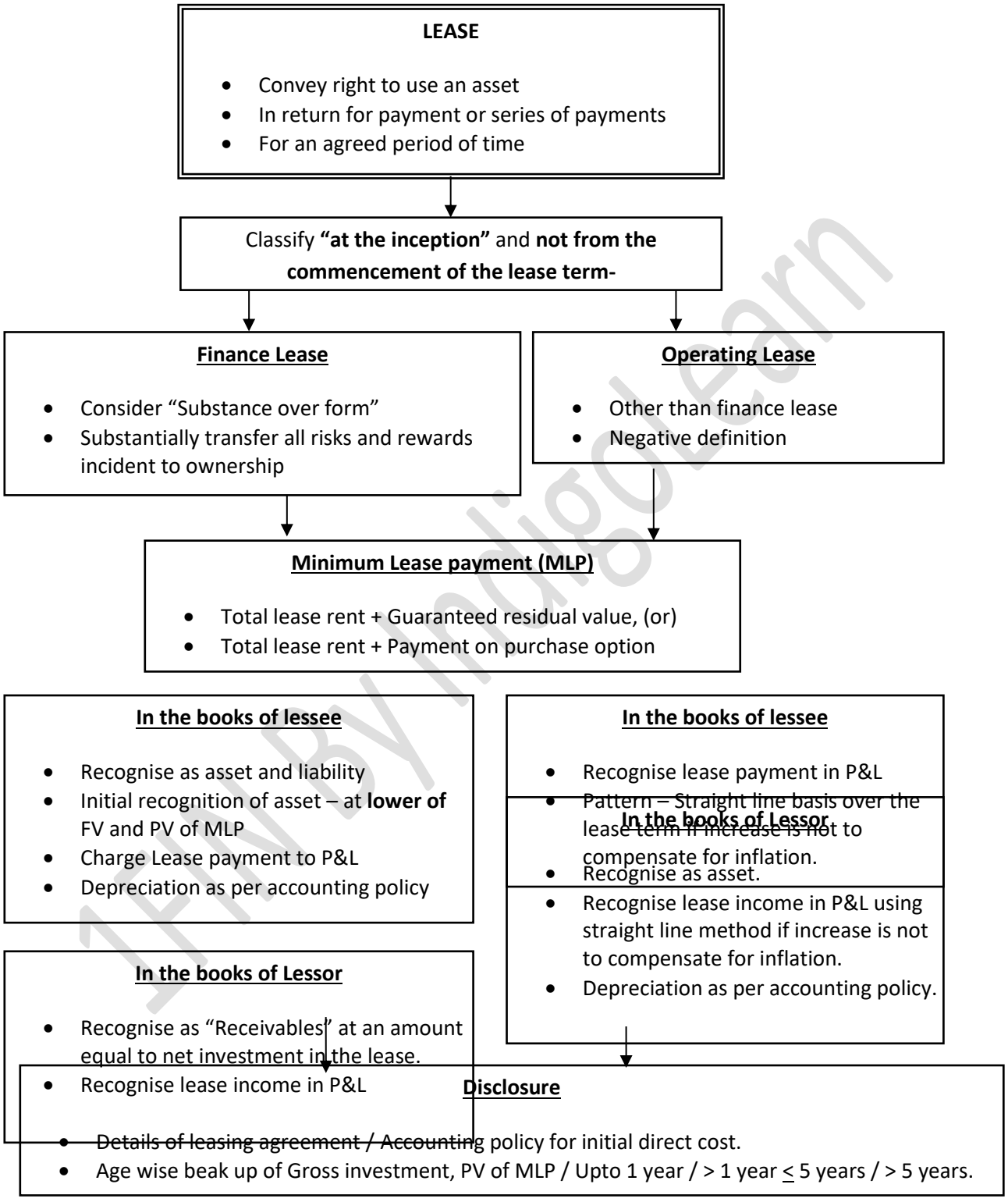
SUMMARY



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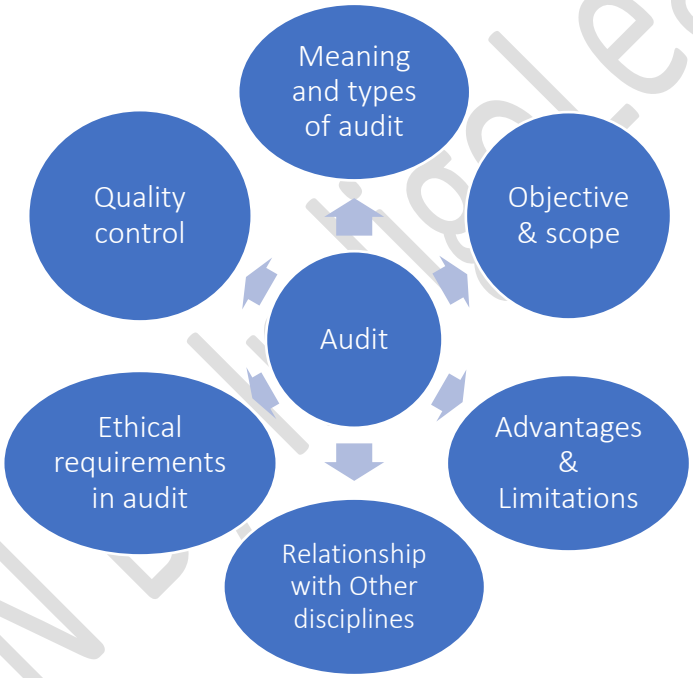
SECTION B: AUDITING (50 MARKS)

Study Note – 6 | Auditing Concepts

6.1 Nature, Scope and Significance of Auditing

OVERVIEW



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1. What is audit?

Definition - 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 an examination is conducted with a view of expressing an opinion thereon.

★ **Independent examination** – Unbiased examination.

★ **Financial information –** The financial statements and accounts of the entity

★ **Any entity** - whether profit oriented or not and irrespective of its size or legal form.

★ **Objective – To give opinion there on** – Auditing gives an assurance that the financial statements are prepared properly and they are not misleading.

2. How is it important for a company form of entity?

Auditing is required for any entity as the auditor will ensure the compliance with accounting standards and relevant statutes.

It is all the more important for a company form of entity because:

★ In a company form of organization, the ownership and management is different. Members invest money into the company and it is managed by a set of people called the board or the management.

★ Management of the company prepares financial statements and presents to the members as proof, that money invested has been properly used.

★ The members are not allowed to interfere in the day to day business of the company. It is also not practically possible for the members to scrutinize and get into the details of the financial statements. And thus, members of the company appoint an auditor to check the management of the company.

★ The auditor reports to the members through an audit report. Thus everyone gets to know about the functioning of the company through the auditor.

3. Define the following terms that are often used in this subject.

a. Appropriate audit opinion
b. Reasonable assurance
c. Material misstatement
d. Fraud and error
e. Financial reporting framework
f. Audit evidence
g. Audit risk

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Appropriate audit opinion –The opinion on financial statements which is a good indicator of the correct position of the company is called appropriate audit opinion.
The auditor is required to give an appropriate audit opinion after conducting the audit.

To give an appropriate audit opinion, the auditor has to be

1. Independent 2. knowledgeable

Independent - The auditor's opinion should be unbiased.
Unbiased – It is not influenced by any prior perception of the auditor.
Knowledgeable – He should gain knowledge of the relevant business to be able to form a correct opinion.

Reasonable assurance – it is the best assurance that the auditor can give. He cannot give a 100% guarantee as the audit is subject to certain inherent limitations. Thus reasonable assurance is the assurance given to the best of his ability and with the information made available.

Material misstatement – A significant mistake in the financial statements. An item is called material if it has the ability to change the decision of the user.

Fraud and error – Error is an unintentional mistake. Something which has happened inadvertently. But fraud is deliberate and intentional mistake.

Financial reporting framework – It is the format in which the financial statements should be prepared and presented. The laws governing different types of entities will provide such format. For companies – The Companies Act 2013 prescribes the format, for Banks – RBI provides the format etc.
Thus, the management must prepare its financial statements as per the prescribed format only. The auditor has to report on the compliance of the same.

Audit evidence – Proof collected during the audit, in order to issue an appropriate audit opinion is called audit evidence.

Audit risk – Audit risk means auditor's objective not being met. That is the risk that the auditor might give an inappropriate opinion. There are 3 kinds of audit risk:

a. Inherent risk
b. Control risk
c. Detection risk

4. What are the overall objectives of audit?

As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:

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- ★ To obtain reasonable assurance
- ★ To ensure whether the financial statements as a whole are free from material misstatement
- ★ To report on the financial statements, and
- ★ To communicate as required by the SAs

5. What is the scope of audit?

Scope of audit –

- ★ To form an opinion the auditor should be satisfied that the accounting information is reliable and sufficient as the basis for the preparation of the financial statements.

- ★ All aspects of the enterprise are covered in audit.

- ★ In forming his opinion, the auditor should decide whether the relevant information is properly disclosed in the financial statements.

- ★ The auditor is not expected to perform duties which are outside the scope of his competence. For example, the professional skill required of an auditor does not include that of a technical expert for determining physical condition of certain assets.

- ★ Constraints on the scope of the audit that impair the auditor's ability to express an unqualified opinion should be set out in his report.

6. What are the major aspects covered in SA 200? OR What are the key qualities that the auditor should possess to complete the audit and issue an appropriate audit report?

There are 5 major aspects covered in SA 200

- ★ **Ethical requirements** in relation to financial statements
  - ➢ Code of Ethics for Professional Accountants (IESBA Code) establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements :
    - **Integrity** - Auditor should have integrity/honesty while conducting an audit.

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- **Objectivity** - He should be independent from the client's operation. Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.

- **Professional competence and due care** - He should be knowledgeable and should exercise due professional care while performing the audit
- **Confidentiality** - he should follow confidentiality by not sharing the client's information with any person except when client permits or when the law governing the entity requires.
- **Professional behavior** – His behavior should be professional ie. He should be uncompromising and disciplined. He should ensure that the team members also possess the same qualities.

★ **Carrying out an audit with professional skepticism**

- Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

- The auditor shall not start the audit with a view that everything is fine or with a view that everything is not fine. He has to approach the audit with alertness.

- The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence.

- Some examples where alertness is required is
  - Audit evidence that contradicts other audit evidence obtained.
  - Overlooking unusual circumstances.
  - Over generalizing when drawing conclusions from audit observations.
  - Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.

★ **Exercising professional judgement wherever required.**

- Professional judgement refers to judgment taken by the auditors based on his or her professional experience.

- In cases involving estimation the auditor has to make professional judgement.

★ **Obtaining sufficient and appropriate audit evidence**

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- Sufficiency refers to quantity of evidence and appropriateness refers to quality of evidence.

- Reasons for failing to obtain sufficient, appropriate audit evidence have to be documented as per the requirement of SA 230 on audit documentation.

★ **Complying with standards on auditing**

- Standards on auditing provide the framework for conduct of an audit. It is mandatory for the auditor to comply with all the relevant SAs.

- However, the auditor can make deviations in the procedure mentioned in the standards as long as the purpose mentioned in the standard is met.

7. **How can the auditor ensure that the financial statements as a whole are free from material misstatements?**

The auditor can ensure this by honestly satisfying himself that:

★ The accounts have been drawn up with reference to entries in the books of account;

★ The entries in the books of account are adequately supported by sufficient and appropriate evidence;

★ None of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;

★ The information conveyed by the statements is clear and unambiguous;

★ The financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and

★ The statement of accounts presents a true and fair picture of the operational results and of the assets and liabilities.

8. **Enumerate the management's responsibilities towards members and towards auditors.**

Following are the management's responsibilities towards members:

- Maintenance of proper books of accounts
- Choosing appropriate accounting policies.

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- Designing internal controls in line with size and nature of entity.
- Prevention and early detection of fraud and error.
- Follow fundamental accounting assumptions
- Ensure that financial statements are in line with proper financial reporting framework.
- Safeguard the assets of the entity.

Following are the management's responsibilities towards auditors:

- Access to books and records of the entity.
- Provide information and explanation whenever asked for.

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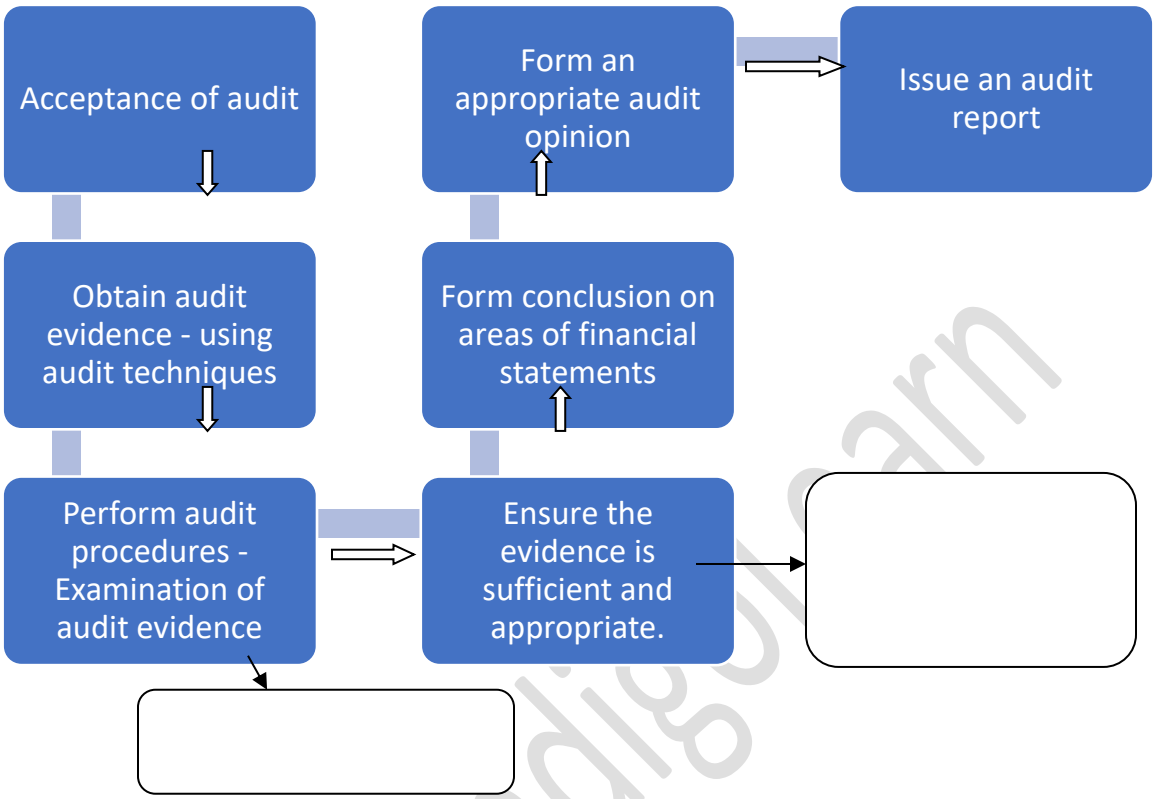
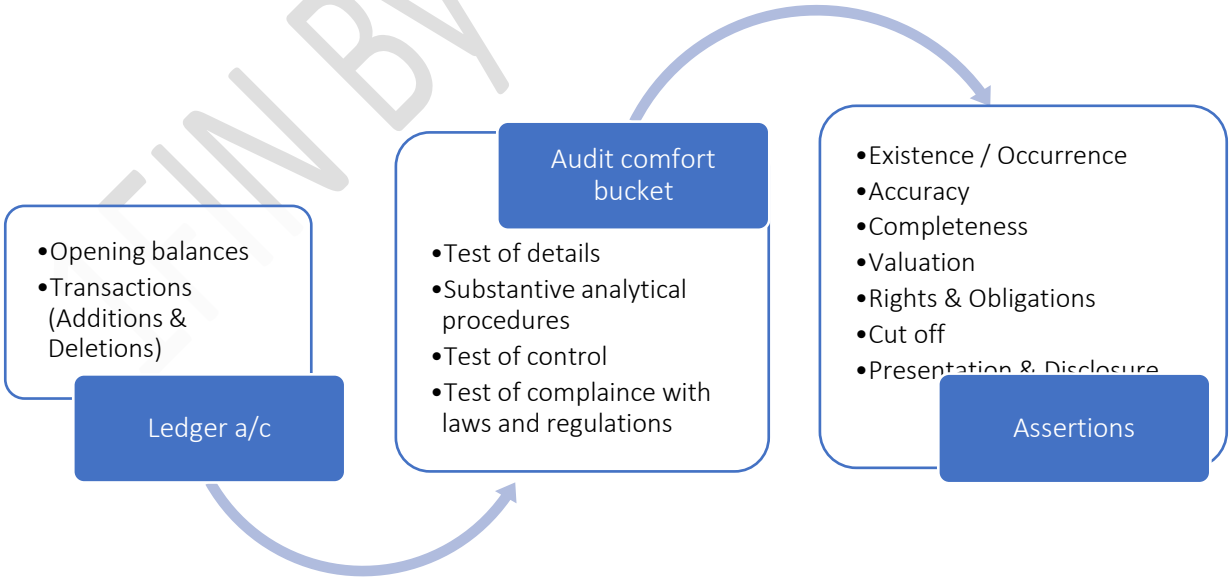
9. What is an audit flow chart?

It describes the process from the beginning to end in an audit engagement.

AUDIT FLOW CHART



10. What is the framework of audit of financial statements? OR what are the principal aspects to be covered in audit?



★ **Ledger A/c**

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- Checking opening balances with the previous year's closing balances.

- Verification of the authenticity and validity of transaction entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.

★ **Test of control**

- Examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions.

- Reviewing the system and procedures of internal control to ensure they are adequate.

★ **Test of compliance with laws and regulations**

- Confirm whether the applicable laws and regulations governing the entity have been complied with.

★ **Test of details**

- Ascertaining that a proper distinction has been made between items of capital and of revenue nature and that the amounts of various items of income and expenditure adjusted in the accounts correspond to the accounting period.

- Checking the result shown by the profit and loss and to see whether the results shown are true and fair.

★ **Substantive procedures**

- Verification of the authenticity and validity of transaction entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.

- Comparison of the balance sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance therewith.

- Obtaining external confirmations

★ **Assertions**

- In representing the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements.

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- Auditor has to verify each of the assertions.

  - Existence / Occurrence – Transactions that occurred pertain to the entity. Assets, liabilities and equity interest exists.
  - Accuracy – Verify the arithmetical accuracy
  - Completeness – all transactions have been recorded
  - Valuation - Assets, Liabilities, and Equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
  - Rights & Obligations - the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
  - Cut off – Transactions are recorded for correct accounting period.
  - Presentation & Disclosure – Appropriate disclosures have been made and the presentation as in accordance with the governing law.

11. How can the audit firm ensure a high quality of audit? OR what are the elements of a system of quality control at the firm level?

The firm's system of quality control should include policies and procedures addressing each of the following elements:

★ **Leadership responsibilities for quality within the firm**

- The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

- Engagement partner is the person who is responsible for the audit and also for the audit report to be issued on behalf of the firm

- He is responsible for communicating the quality control policies to the entire team engaged in the audit.

★ **Ethical requirements**

- Personnel in the firm should follow the principals of independence, integrity, objectivity, confidentiality and professional behavior.

- Personnel should have independence of mind as well as independence of appearance.
- **Independence of mind** – the state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

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- **Independence in appearance** – the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised. (E.g. The judge and the criminal going in the same car)

- Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

★ **Acceptance and continuance of client relationships and specific engagements.**

- The firm must evaluate the client and the risk associated with such audit before accepting the engagement.

- The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed.

- The engagement partner should collect information on significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

★ **Human resources**

- Number of resources - The firm should ensure that it has sufficient number to resources to carry on the audit.

- Skill and competence – Personnel should have sufficient degree of skill and competence.

- Assignment – The audit work should be assigned to every person depending on his competence.

- Delegation – There should be sufficient direction, supervision, and review of works at all levels

★ **Engagement performance**

- The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements

- Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance.

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- This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation,

- The audit partner and personnel should consult experts wherever required.

★ **Monitoring**

- The firms should have policies and procedures which include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.

- The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of whether the quality control system has been appropriately designed and effectively implemented.

- Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

12. what are the elements of a system of quality control at the individual audit level?

The audit partner should confirm on the relevant policies and procedures which are applicable to that particular audit.

It has to be ensured that the work is carried on as per the firm's quality standards, by every person involved in the audit. This can be done by –

Direction – Involves informing assistants about their responsibilities, objectives, and other important matters affecting the nature, timing and extent of their audit procedures.

Supervision by senior audit assistants – monitor progress, obtain information about significant accounting and auditing questions raised, and resolve differences of professional judgement

Review of work performed – to ensure completion of audit work, achievement of objective, consistency of audit conclusions, consideration of significant matters etc.

13. What are the pre-conditions for audit? OR What are the key criteria that the audit firm should consider before accepting the engagement?

★ Pre-conditions to audit – It is an agreement between the management and the

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auditor on the premise on which audit is conducted.

- ★ Before acceptance of audit, auditor has to prepare an audit engagement letter stating the pre-conditions of audit which will be signed by both, the management and the auditor.
- ★ Auditor has to confirm if the management understands and accepts its responsibilities towards members and auditors in the pre-condition of audit.
- ★ As part of pre-conditions, the management agrees for the following:
  - ➢ The use of acceptable financial reporting framework in the preparation of financial statements.
  - ➢ Existence of necessary the internal controls.
  - ➢ To provide the auditor with access to all information such as records, documentation and other additional information that the auditor may request
  - ➢ To provide the auditor with unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.
- ★ The auditor will not accept the audit or if already accepted, will withdraw from the audit IF
  - ➢ There is no specified financial reporting framework or the management does not agree with the framework provided by the auditors
  - ➢ The management or TCWG (Those Charged With Governance) disagree with any of the points of pre-conditions to audit.

14. Who signs the engagement letter?

The two parties that must sign the engagement letter are:

1. Partner / Proprietor who is a chartered accountant and
2. Those charged with governance (Like, CEO, Managing director etc)

15. Is audit mandatory for all entities?

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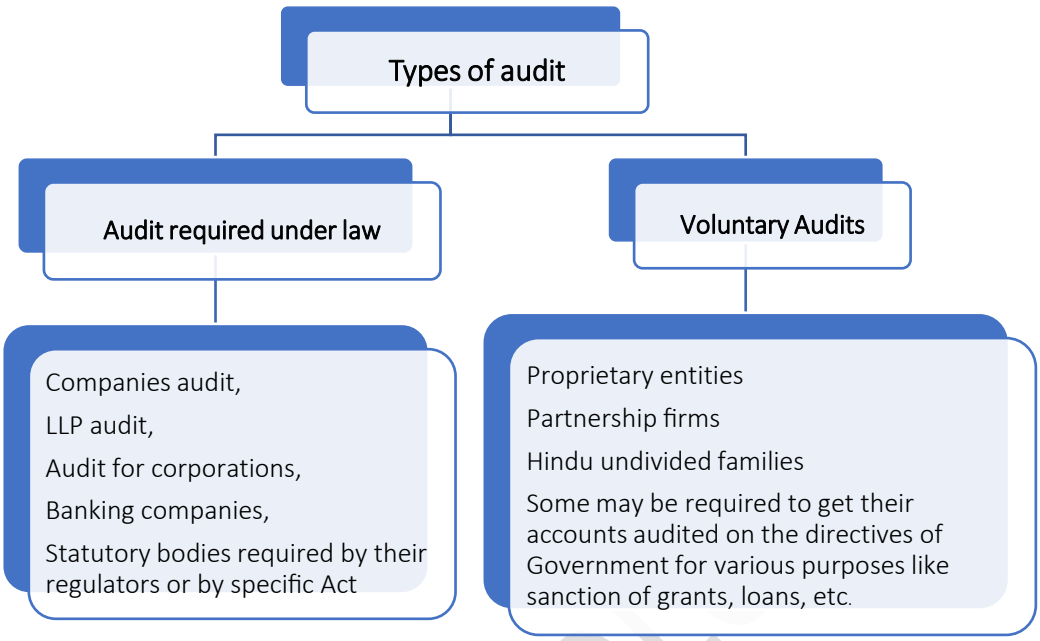

- But the important motive for getting accounts audited lies in the advantages that follow from an independent professional audit.
- That's why large numbers of proprietary and partnership business get their accounts audited.
- The auditor should get the scope of his duties and responsibilities defined by obtaining instructions in writing. It is always a wise precaution to state in the report, accompanying the balance sheets of proprietary or partnership firms or other similar organisations, the nature of the work carried out and explain the important features of the financial statements on which a report has been made.
- A special reference is necessary for non-profit making institutions like schools, clubs, educational institutions, hospitals, associations, etc., irrespective of any internal rules, to get their accounts audited because most of them enjoy government or municipal grants and, generally, for this purpose audited accounts are insisted upon.
- Both public and private trusts have their own reasons to always get their accounts audited.

16. Is it mandatory to mention the scope of work in the audit engagement letter? How is scope agreed upon?

★ SA 210 "Agreeing the Terms of Audit Engagements" states that it is, important, both for the auditor and client, that each party should be clear about the nature of the engagement.

★ It must be reduced to writing and should exactly specify the scope of the work.

★ The audit engagement letter is sent by the auditor to his client

1. Where the audit terms are already given in the laws governing the enterprise - for eg, companies, registered societies, LLPs etc

- The auditor shall refer such mention of audit terms in the engagement letter

2. In case of voluntary audits where audit terms are not prescribed by any law like, partnership, sole proprietorship

- The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate and should mention in the engagement letter.

17. What should be the auditor's response in the following situations?

Situation 1
If there is a conflict between Accounting standards (issued by ICAI) and any provision of the law, governing the enterprise (eg. Companies Act 2013 for companies)

Situation 2
If the auditor is of the opinion that financial reporting framework prescribed by the law governing the enterprise is unacceptable.

Situation 3
If the audit report is prescribed by the governing law and the language used by the law is confusing or misleading and users may misunderstand the information in the financial statement.

Situation 1 and 2

★ The auditor shall ask the management to make additional disclosure in notes to accounts
  - ➢ explaining how they have reconciled the difference between accounting standards and the provision of governing law
  - ➢ the limitation of or the confusion caused by, the financial reporting framework prescribed by the governing law and the actual scenario

★ The auditor may also give an 'Emphasis of matter' paragraph in the audit report

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★ He may also issue a modified opinion if there is disagreement with the management.

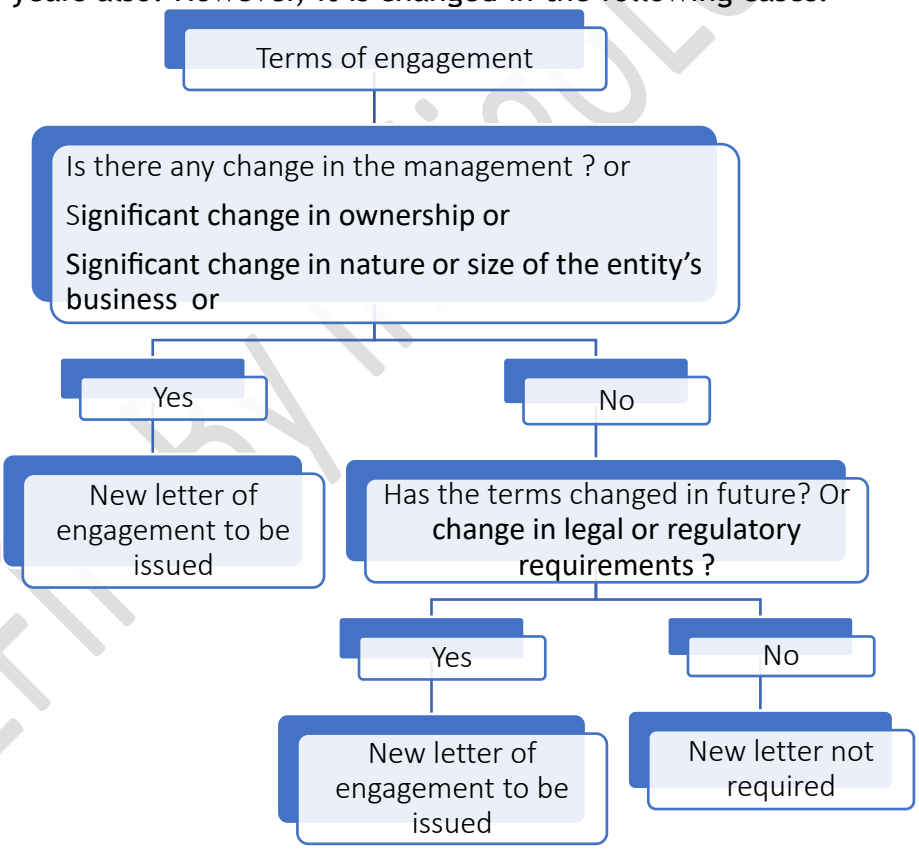
Situation 3

★ The auditor should communicate to the management on the confusion that will be caused because of the language and the additional para that he will add to avoid the confusion.

★ If the management disagrees on the additional para then the auditor may even withdraw from the engagement.

18. Do the terms of an engagement letter singed in one year be relevant for future years as well?

Generally, terms of engagement letter signed for one period will be continued for future years also. However, it is changed in the following cases.



19. Can the management ask the auditor to change terms before completion of the engagement? Does the auditor have a right to reject the engagement in such circumstance?

Yes. The management may request the auditor to change the engagement before

its completion. Such request may result from

1. A change in circumstances affecting the need for the service,
2. A misunderstanding as to the nature of an audit or related service originally requested.
3. A restriction on the scope of the engagement, whether imposed by management or caused by circumstances.

Before taking any decision, the auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement, especially any legal or contractual implications.

The auditor's course of action can be explained through the following table:

Situation	Auditor's response
No reasonable justification for change in audit terms is given by the management.	Need not agree to such change. He may even choose to withdraw from the engagement.
During the course of assignment, the management requests the auditor to limit his scope.	Determine if it is reasonable. If it is not so then withdraw from the engagement.
In spite of reasons given by management, the auditor is unable to agree to the change in terms and believes it provides a lower level of assurance	Withdraw from the audit engagement, where possible and determine whether there is any obligation to report the matter to other parties like management, regulators etc.
If the auditor finds the reasons for change in engagement valid	He will accept the new terms of engagement.
If auditor proposes any change in the terms of engagement	Send a new engagement letter to the client to communicate the revision of terms and take the client's acceptance for the same.

20. What are the advantages of audit?

- Obvious utility is, reliable financial statements on the basis of which the state of affairs may be easy to understand.

- It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders, bankers, Financial Institutions, public at large etc.
- It acts as a moral check on the employees from committing defalcations or embezzlement.

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- Tax computation is made easy
- Loan negotiations and purchase consideration for business becomes easy
- Useful for settling trade disputes for higher wages or bonus
- Useful for determining claims in respect of damage suffered by property, by fire or some other calamity.
- Helps in the settlement of accounts at the time of admission or death of partner.
- Disputes among partners can be easily resolved.
- Helps in the detection of wastages and losses to show the different ways by which these might be checked, especially those that occur due to the absence or inadequacy of internal checks or internal control measures
- Audit ascertains whether the necessary books of account and allied records have been properly kept and helps the client in making good, deficiencies or inadequacies in this respect.
- Government may require audited and certified statement before it gives assistance or issues a license for a particular trade.
- Helps in identifying weaknesses in internal control system and internal reporting system.

21. What are the inherent limitations of audit ?

The auditor cannot reduce audit risk to zero as there are some inherent limitations. These have been enumerated in SA 200.
Audit risk means risk that the auditor may issue an inappropriate opinion. It is of 3 kinds – Inherent risks, control risks and detection risk.

★ <u>Audit is a process of persuasion and not a process of proof</u>

- The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. Sometimes auditor has to satisfy himself with alternative proofs.

★ <u>Auditor obtains reasonable assurance and not absolute assurance</u>

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- Many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.

- There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant

- The existence and completeness of related party relationships and transactions may be difficult to identify.

★ Timelines of financial reporting and balance between benefit and cost may affect the quality of audit.

- There is a balance to be struck between the reliability of information and its cost.
- Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. However, the complexities in transactions may elongate the time.

★ Audit is never absolutely fraud proof.

- Some frauds in which top management is involved cannot be found even if audit is complete.

- Frauds involve sophisticated and carefully organized schemes designed to conceal it.

- An audit is not an official investigation into alleged wrong doing.

- Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

★ Estimation cannot be accurate and reliable

- Preparation of financial statement calls for estimations in many scenarios like, provision for doubtful debts, estimation of useful life of the asset etc.

22. How is auditing related to other disciplines?

The field of auditing as a discipline involves review of various assertions; both in financial as well as in non-financial terms and expressing an opinion thereon.

Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also possesses a good knowledge about the fields in respect

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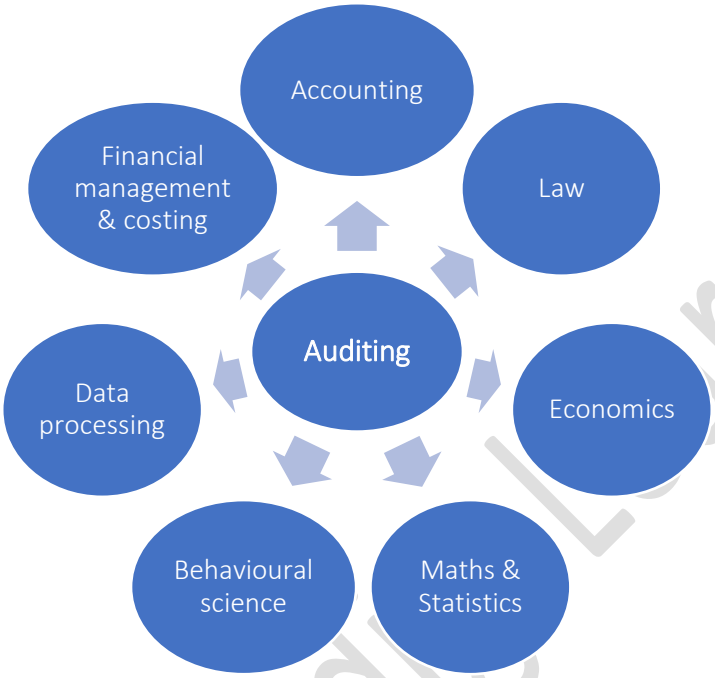
of which he is conducting such a review.



★ Auditing and Accounting

- Both accounting and auditing are closely related with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process.

- It naturally calls on the part of the auditor to have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements.

- It is said that auditing starts where accounting ends.

★ Auditing and Law

- The relationship between auditing and law is very close one. Auditing involves examination of various transactions from the view point of whether or not the

  various provisions of the governing law has been complied with. For eg: Companies are governed by Companies Act 2013, Banks are governed by RBI regulations, Partnerships and LLPs are governed by Partnership Act 1932 and

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LLP Act 2008 etc.

- It necessitates that an auditor should have a good knowledge of business laws affecting the entity. He should be familiar with the law of contracts, negotiable instruments, etc.

- The knowledge of taxation laws is also inevitable as ever entity is required to prepare their financial statements taking into account various provisions affected by both direct and indirect tax laws.

★ Auditing and Economics

- Accounting is concerned with the accumulation and presentation of data relating to economic activity.

- From the auditing viewpoint, the auditors are more concerned with Micro economics rather than with the Macro economics.

- The knowledge of Macroeconomics should include the nature of economic force that affect the firm, relationship of price, productivity and the role of Government and Government regulations.

- Auditor is expected to be familiar with the overall economic environment in which his client is operating.

★ Auditing and Behavioural Science

- The discipline of behavioral science is closely linked with the subject of auditing. While it may be said that an auditor, deals basically with the figures contained in the financial statements but he shall be required to interact with a lot of people in the organization.

- One of the basic elements in designing the internal control system is personnel. Howsoever, if a sound internal control structure is designed, it cannot work until and unless the people who are working in the organisation are competent and honest.

- The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties.

★ Auditing and Statistics & Mathematics

- With the passage of time, test check procedures in auditing have become part

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of generally accepted auditing procedures.

- The auditor is also expected to have the knowledge of statistical sampling so as to arrive at meaningful conclusions.

- The knowledge of mathematics is also required on the part of auditor particularly at the time of verification of inventories.

- The use of data analytics is advancing rapidly in auditing where many organizations are using continuous auditing and continuous monitoring of data to identify risks as part of their system of internal control.

★ Auditing and Data Processing

- Today, organizations are witnessing revolution in the field of data processing of accounts. Many organizations are carrying out their financial accounting activities with the help of computers which can document, record, collate, allocate and value accounting data and information in very large quantity at very high speed.

- The dependence on the accuracy of the programmed instructions given today, the computer is able to carry out each of these activities with complete accuracy.

- With such a phenomenal growth in the field of computer sciences, the auditor should have good knowledge of the components, general capability of the system and the related terms.

- In fact, Computerised Information System auditing in itself is developing as a discipline in itself.

★ Auditing and Financial Management & Costing

- The auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc.

- The auditor is also expected to have a fair knowledge of the institutions that comprise the marketplace.

- The knowledge of various institutions and Government activities that influence the operations of the financial market are also required to be understood by an auditor.

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- While carrying out the audit activity, the auditor is required to evaluate transactions from the accounting aspect in relation to the process through which it has passed through as accounting for by-products; joint- products may also require to be done.

- The knowledge of production process shall become more essential in case of an internal auditor. The auditor shall also require understanding the cost system in operation in the factory and assessing whether the same is adequate for the particular company.

- The understanding of the terminology of the production shall enable an auditor to communicate with production employees in connection with his work.

★ **Conclusion**

- Auditing as a discipline is also closely related with various other disciplines as there is lot of linkages in the work which is done by an auditor in his day-to-day activities.

- Auditing itself is a logical construct and everything done in auditing must be bound by the rules of logic. Ethical precepts are the foundations on which the foundation of the entire accounting profession rests.

- The knowledge of language is also considered essential in the field of auditing as the auditor shall be required to communicate, both in writing as well as orally, in day-to-day work.

- Auditing is also closely related with other functional fields of business such as finance, production, marketing, personnel and other general areas of business management.

23. Define the role of IAASB and AASB?

★ In 1977, the International Federation of Accountants (IFAC) was set up with a view to bringing harmony in the profession of accountancy on an international scale.

★ In pursuing this mission, the IFAC Board has established the International Auditing and Assurance Standards Board (IAASB) to develop and issue, in the public interest and under its own authority, high quality auditing standards for use around the world.

★ The IAASB functions as an independent standard-setting body under the auspices of IFAC.

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★ The objective of the IAASB is
- to serve the public interest by setting high quality auditing standards
- to facilitate the convergence of international and national standards,
- enhancing the quality and uniformity of practice throughout the world
- and strengthening public confidence in the global auditing and assurance profession.

★ The IAASB achieves this objective by establishing high quality auditing standards and guidance for
- Financial statement audits that are generally accepted and recognized by investors, auditors, governments, banking regulators, securities regulators and Other key stakeholders across the world;
- Other types of assurance services on both financial and non-financial matters;
- Other related services;
- Quality control covering the scope of services addressed by the IAASB; and
- Publishing other pronouncements on auditing and assurance matters,

★ ICAI is a member of the IFAC and is committed to work towards the implementation of the guidelines issued by the IFAC.

★ ICAI constituted the AASB (erstwhile Auditing Practices Committee) to review the existing auditing practices in India and to develop Engagement and Quality Control Standards (erstwhile Statements on Standard Auditing Practices) so that these may be issued by the Council of the Institute.

★ The main function of the AASB is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute.

★ While formulating the SAPs in India, the AASB gives due consideration to the international auditing guidelines issued by the IAASB and then tries to integrate them to the extent possible in the light of the conditions and practices prevailing in India.

★ These standards apply to all entities whether profit oriented or not, and irrespective of its size, or legal form (unless specified otherwise)

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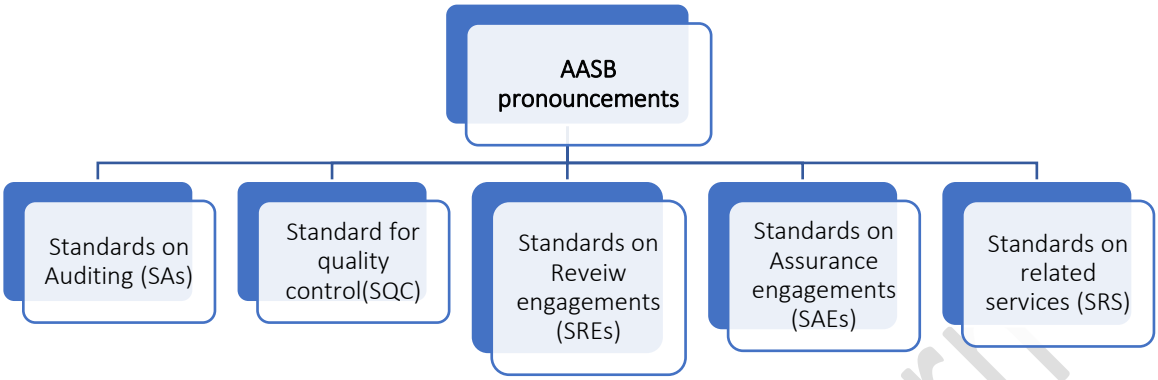

★ While discharging their attest function, it will be the duty of members of the Institute to ensure that the Standards are followed in the audit of financial information covered by their audit reports.

★ If for any reason a member has not been able to perform an audit in accordance with the Standards, his report should draw attention to the material departures there from.

★ Auditors will be expected to follow Standards in the audits commencing on or after the date specified in the statement. It is obligatory upon members of Institute to adhere to these standards whenever an audit is carried out.

★ The Institute has, from time to time, issued 'Guidance Notes' and 'Statements' on a number of matters.

★ 'Guidance Notes' : are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may rely in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty.

★ Guidance Notes are recommendatory in nature. There are however a few guidance notes in case of which the Council has specifically stated that they should be considered as mandatory on members while discharging their attest function.

24. What are the threats to an auditor's independence?

The Code of Ethics for Professional Accountants prepared by the International Federation of Accountants (IFAC) identifies five types of threats. These are:

★ **Self-interest threats** - which occurs when an auditing firm, its partner or associate could benefit from a financial interest in an audit client.

Examples include

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(i) direct financial interest or materially significant indirect financial interest in a client,
(ii) loan or guarantee to or from the concerned client
(iii) undue dependence on a client's fees and, hence, concerns about losing the engagement,
(iv) close business relationship with an audit client,
(v) potential employment with the client, and
(vi) contingent fees for the audit engagement.

★ **Self-review threats** - which occurs when an auditor also appointed for non-audit engagement.
Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service, design and implementation of information technology systems etc.
This also occurs when a member of the audit team was previously a director or senior employee of the client.

★ **Advocacy threats** - which occurs when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company or becomes the client's advocate in litigation and third party disputes.

★ **Familiarity threats** - which occurs when auditors form relationships with the client where they end up being too sympathetic to the client's interests. For example:
(i) close relative of the audit team working in a senior position in the client company,
(ii) former partner of the audit firm being a director or senior employee of the client
(iii) long association between specific auditors and their specific client counterparts,
(iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.

★ **Intimidation threats** - which occurs when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

➢ Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
➢ When such threats exist, the auditor should either desist from the task or put in

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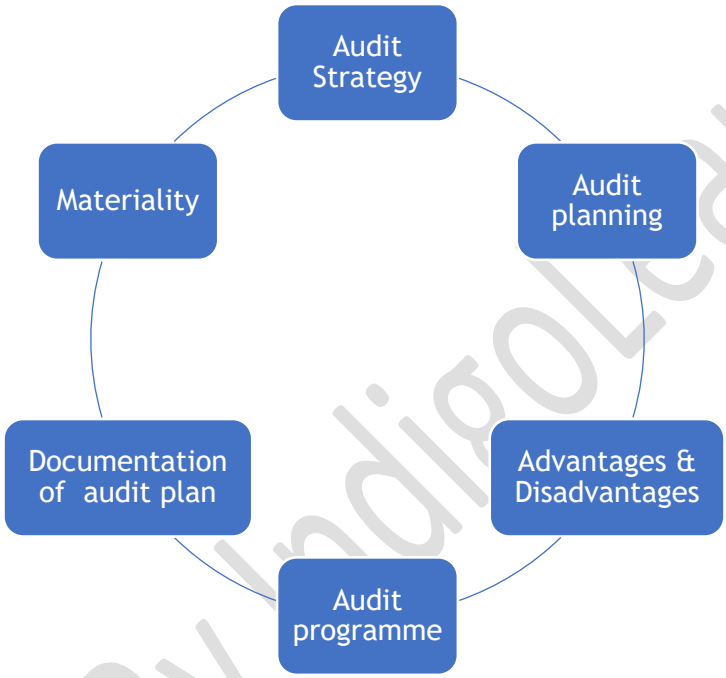
place safeguards that eliminate them.

- If safeguards are inadequate, he should reject the work.

6.2 Audit Engagement, Audit Programme, Audit Wroking Papers, Audit Notebook, Audit Evidence and Audit Report

Overview



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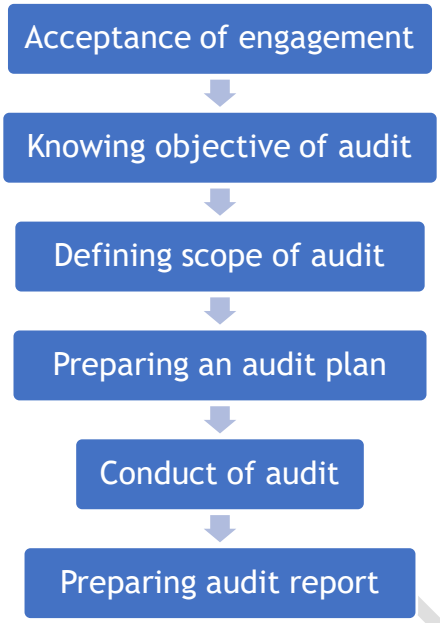

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1. What is audit planning?

★ It is said, 'Well begun is half done'. Thus audit planning is the **preparatory work done by the auditor before he starts the audit**. It is an essential step in conducting the audit. Audit flow chart is given below

★ SA-300, "Planning an Audit of Financial Statements" further emphasizes that planning is not a discrete phase of an audit, but rather a continual and iterative process. Plans should be further developed and revised as necessary during the course of the audit.

★ Per SA- 300 the process begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.

★ **The auditor shall establish an overall audit strategy** that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

★ **Plans must cover the following:**

- **Understanding business environment** - Acquiring knowledge of the client's accounting systems, policies and internal control procedures.

- Understanding the environment in which the client operates helps in **making the planning more effective.**
- **Study of Internal control** – This helps in establishing the expected **degree of reliance to be placed** on internal control. ie. the extent to which internal controls are strong.
- This highlights the areas that need focus. A detailed plan is required for such areas.
- **Determining and programming the nature, timing, and extent of the audit procedures to be performed -**
- Nature helps to decide on the audit procedure to be applied e.g. Whether we should apply compliance testing or substantive testing.
- Timing involves decisions like whether audit should be commenced at the end of the year or if surprise checks during the year is required etc.
- **Coordinating the work to be performed** - This includes decisions regarding the audit team size, the delegation of work etc.

2. What are the benefits of audit planning?

There are plenty of benefits of planning. Some are mentioned below:

★ **Critical risk areas can be identified and verified** – It helps the auditor to devote appropriate attention to important areas of the audit.

★ **Audit issues are identified and resolved in time** – Any issue that arises during the course of audit is addressed immediately. Such a mechanism should be inbuilt as part of audit procedure.

★ **Conduct of audit in efficient and effective manner** – It helps the auditor to properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.

★ **Selection of engagement team members** – Based on the risk analysis and complexity of transactions, appropriate engagement team members are selected with appropriate levels of capabilities and competence to respond to anticipated risks, and the work is assigned accordingly.

★ **Audit work coordination becomes easy** - It facilitates the direction and supervision of engagement team members and the review of their work.

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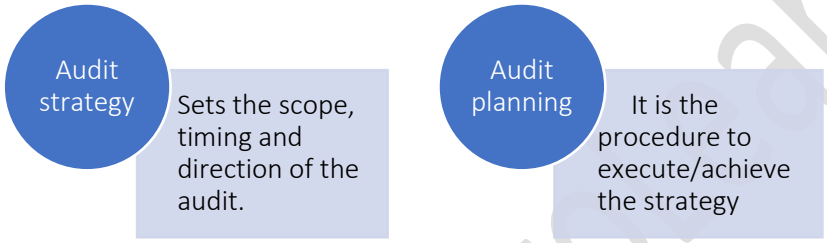
★ **<u>Using work of others (internal auditors, branch auditors, experts etc) is made easy</u>** – It assists, where applicable, in coordination of work done by auditors of components and experts.

3. Is audit strategy and audit plan one and the same?

★ In very simple terms, strategy refers to Where one wants to reach and planning refers to how to reach there.



★ Thus, the audit planning is based on the strategic goals of the audit firm.

★ Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the audit strategy.

★ The audit strategy and the detailed audit plan are closely inter-related since changes in one may result in consequential changes to the other.

4. How is the audit strategy helpful to the auditor?

The process of establishing the overall audit strategy assists the auditor to determine :

★ The **resources to deploy for specific audit areas** - such as
- ➢ The use of appropriately experienced team members for high risk areas,
- ➢ The involvement of experts on complex matters etc.

★ The **number of resources to allocate** to specific audit areas - such as
- ➢ The number of team members assigned to observe the inventory count
- ➢ The extent of review of other auditors' work in the case of group audits,

★ **Time of resources deployment** -Example
- ➢ whether at an interim audit stage or at key cut-offdates

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- how many days for internal control testing etc.

★ **How such resources are managed, directed and supervised -** Example

- when team briefing and debriefing meetings are expected to be held
- how engagement partner and manager reviews are expected to take place (for example, on-site or off-site).

What are the parameters (or steps) involved in Establishment of Overall Audit Strategy? Give suitable examples.

In establishing the overall audit strategy, the auditor shall

★ Identify the **characteristics of the engagement** that define its scope -

- Number and locations or branches to be audited
- Nature of business (eg: Manufacturing, service oriented etc) and number of business segments
- Previous experience gained about the client etc.

★ Ascertain the **reporting objectives** of the engagement to plan the timing and the nature of the communications required -

- When should the audit be completed and by when the audit report should be submitted?
- Who from the management team should be reached in case of clarifications?
- Whom should be updated on the status of audit work throughout the engagement?

★ Consider the factors that, in the auditor's professional judgment, are significant in **directing the engagement team's efforts -**

- Suppose the client has started a new factory then transactions relating to the factory should be checked more thoroughly

★ Consider the results of **preliminary engagement activities**-

- Whether the auditor has collected any preliminary information through questionnaires etc. before starting the audit
- whether knowledge gained on other engagements performed for the same entity

★ Ascertain the **nature, timing and extent of resources necessary** to perform the engagement

5. What is included in an audit plan?

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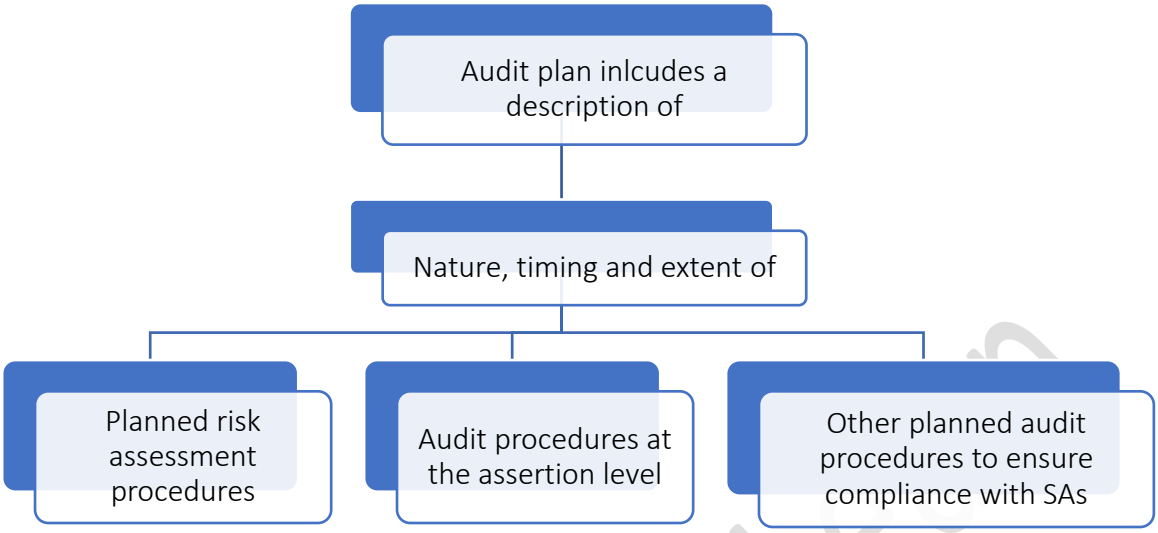

★ Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.

★ Planning of the auditor's risk assessment procedures occurs early in the audit process.

★ However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures

6. Elaborate the meaning Nature, timing and extent of audit procedures.

★ **Nature**-Refers to kind of work that needs to be done.

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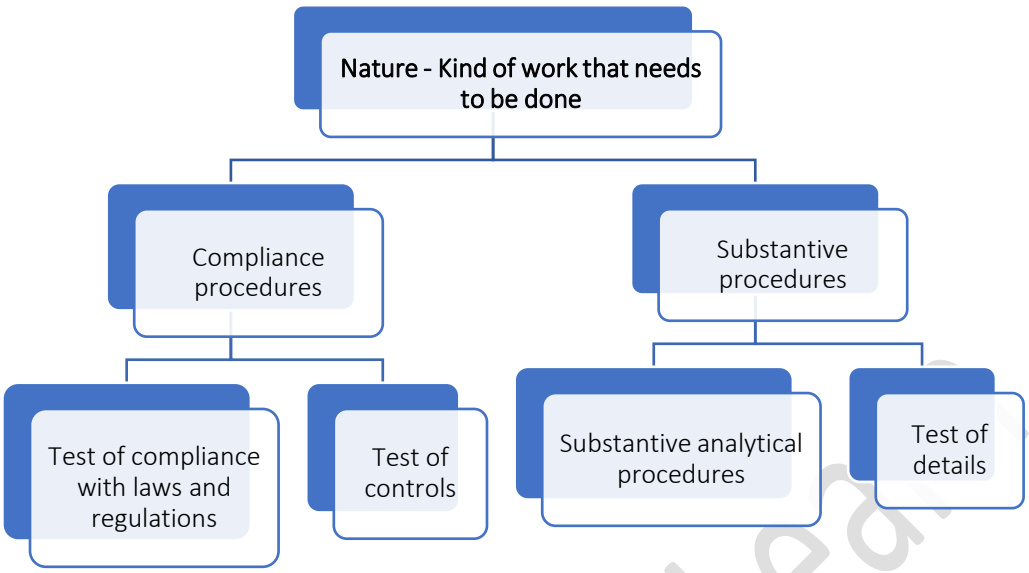

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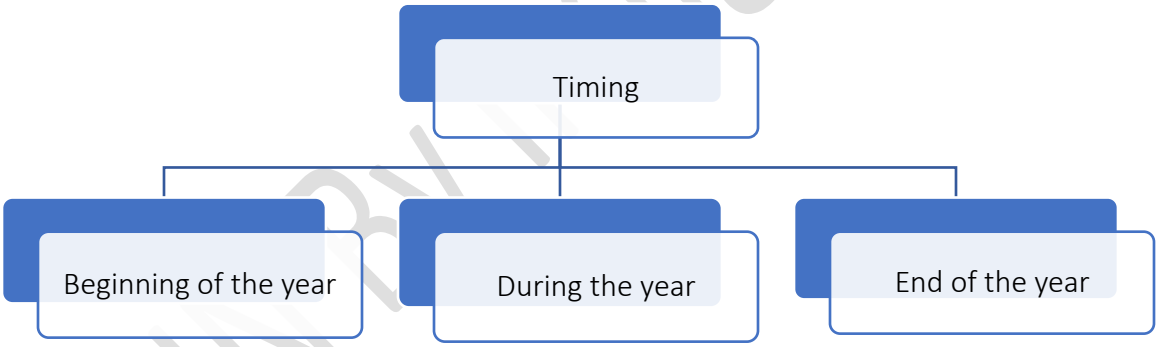
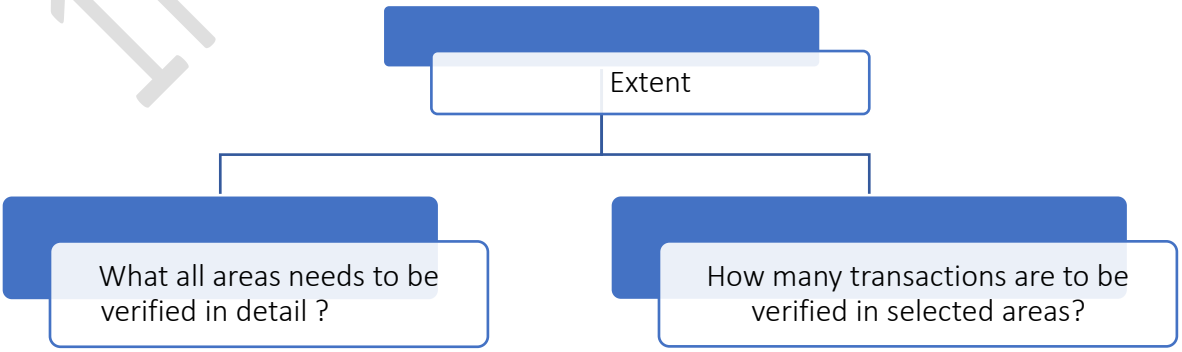
★ **Timing of audit procedures** - Refers to time when the audit procedures have to be performed. For eg: If the auditor wants to verify the cash balance as on 31st March, then physical verification has to happen on that day itself.



★ **Extent** - Refers to the scope of work to be included.



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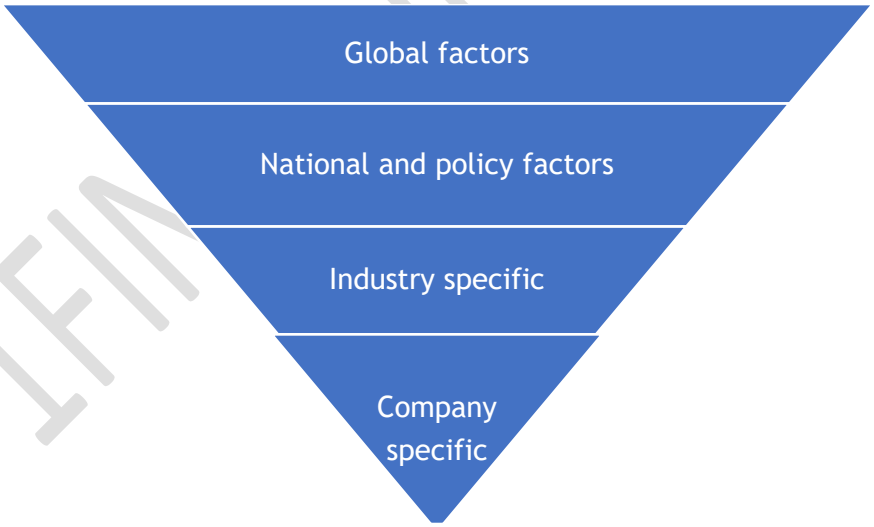
One of the important principles in developing an overall audit plan is Knowledge of the Client's Business. In fact, without adequate knowledge of client's business, a proper audit is not possible. What should the auditor know as part of knowledge of client's business ? Explain with examples.

Yes. Knowledge of client's business is the primary requirement for audit planning. As each business has its own risk. Only a complete knowledge of client's business will help him in performing risk assessment procedures.

In order to get the knowledge of client's business the auditor will have to obtain the understanding of the following factors which affect the client's business:

1. Global factors
2. National and policy level factors
3. Industry specific factors and
4. Company specific factors.

The information is gathered in the above order only. Thus the auditor will first get the understanding of macroeconomic factors (or external factors) and then come to company specific factors.



★ **Global factors**

- Competitive environment like demand, cost of raw material in the global market.
- An entity with components in multiple tax jurisdictions, has additional risk

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★ **National and policy factors**–

- Income tax rates, Government schemes etc.

★ **Industry specific factors**

- Technological developments, such as those related to the entity's products, Shortage of skilled labour etc.
- Supplier and customer relationships, such as types of suppliers and customers.

★ **Company specific factors** –

- Non-financial factors like production capacity, headcount, input-output ratio
- Financial factors like Past performances, turnovers, employee cost etc.

7. Specify the key information about the company that helps the auditor in his risk assessment.

About the company, the auditor should have knowledge of the following information:

- Ownership and governance structures
- The types of investments that the entity is making and plans to make
- Capital decisions like joint ventures, mergers etc.
- Transactions outside the entity's normal course of business-like leasing of premises, equity transactions etc.
- The entity's selection and application of accounting policies, including the reasons for changes thereto.
- The entity's objectives and strategies, and those related business risks.

The above information helps the auditor

- To perform risk assessment procedures
- To identify areas of special audit consideration,
- To evaluate the reasonableness, both of accounting estimates and management representations and
- To make judgements regarding the appropriateness of accounting policies and disclosures

8. Is Audit planning a continuous process or a discrete one?

- Planning is definitely not a discrete process, but rather a **continual and iterative process.**

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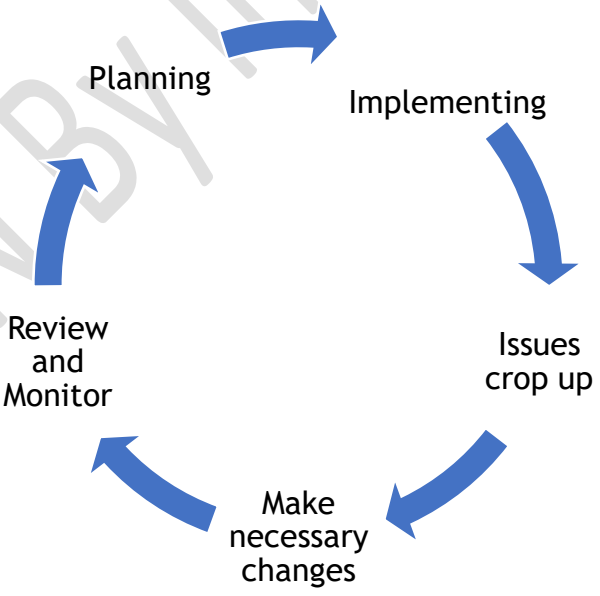
- It begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.

- A good audit plan is never rigid. It has the inbuilt flexibility to **make changes based on the circumstances.**

- The auditor shall **update and change** the overall audit strategy and the audit plan as necessary during the course of the audit.

- The change in planned nature, timing and extent of further audit procedures may happen -
  - When information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures
  - When unexpected events or changes in conditions occur,
  - When audit evidence obtained from the results of audit procedures necessitate a change.

- Thus, the iterative process is inevitable.



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9. By discussing the nature and timing of detailed audit procedures with management, is the responsibility of audit strategy and audit plan shared with the management? Does such a action result in compromising the effectiveness

of audit?

- The overall audit strategy and the audit plan remains the **auditor's responsibility.** By no means it can, be shared with the management.

- However, **to coordinate** some of the planned audit procedures **with the work of the entity's personnel** such discussions are necessary.

- When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit.

- The **involvement of the engagement partner and other key members** of the engagement team in planning the audit **enhances the effectiveness** and efficiency of the planning process. It is because of their experience, expertise and insights.

10. What do you understand by Direction, Supervision and review in the context of audit planning? What factors influence them?

- Direction refers to **giving guidance to the audit team by the engagement partner**. The guidance is given both while framing the audit plan and also while executing it.

- Supervision and review refers to the **constant overview of the plans** by the superiors and engagement partner.

- It provides a **constant feedback and support mechanism** to ensure the achievement of audit goals.

- Thus, the auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

- The factors that influence the nature, timing and extent of direction, supervision and review are:

  a. The size of the audit entity.
  b. The complexity of the audit entity.
  c. The area of the audit
  d. The assessed risks of material misstatement
  e. The capabilities and competence of the individual team members

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performing the audit work.

11. What should be documented as part of audit plan ?

The following should be documented:

★ The overall audit strategy – It is a record of
- Key decisions considered necessary to properly plan the audit and
- Communicate significant matters to the engagement team.

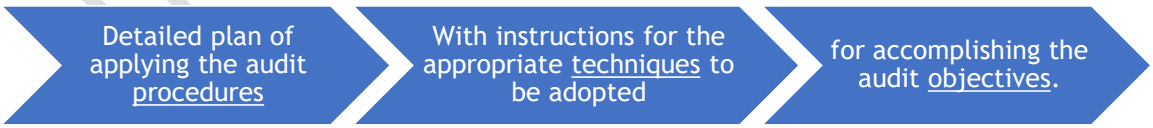
★ The audit plan–It is a record of
- The planned nature, timing and extent of risk assessment procedures &
- Further audit procedures at the assertion level in response to the assessed risks

★ Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes– It is a record which explains
- Why the significant changes were made,
- The overall strategy and audit plan finally adopted for the audit and
- The appropriate response to the significant changes occurring during the audit.

12. What is an audit programme? How is it related to audit plan and audit strategy?

An audit programme is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives.

It is a **list of examination and verification steps** to be applied and set out in such a way that the inter-relationship of one step to another is clearly shown.



Audit programme is nothing but an elaborate description of steps to execute audit plan. Thus it ensures the accomplishment of audit plan. And Audit plan ensures the accomplishment of audit strategy.

The relationship between audit plan, strategy and programme can be shown as below.

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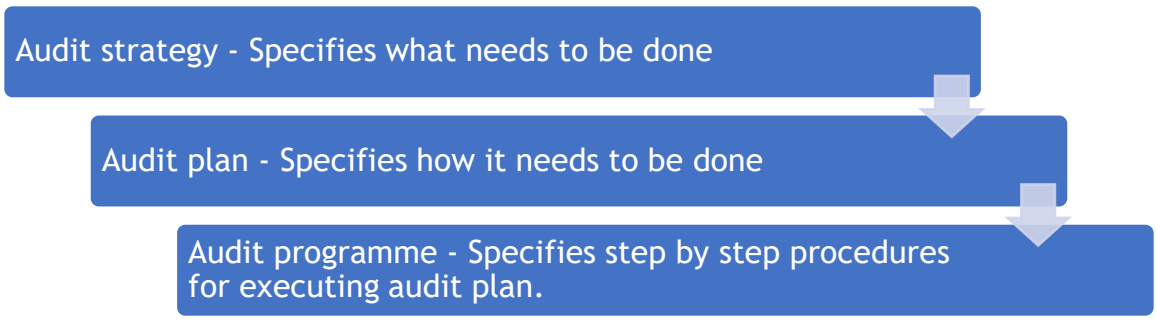

13. What are the features of an audit programme?

The following are the features of an audit programme:

★ **<u>One Audit Programme for every audit.</u>**

The following factors vary from assignment to assignment.

- Nature of business, their size and composition
- Work which is suitable to one business may not be suitable to others,
- Efficiency and operation of internal controls and
- The exact nature of the service to be rendered by the auditor

Thus, one audit programme applicable to all business under all circumstances is not practicable. We need to draw a separate audit programme for every engagement.

The Assistant engaged - Be encouraged to keep an open mind

The engagement team should be instructed to

- **Trust the audit programme**
  The trust can be built by involving them in the planning phase itself.
- **Keep an open mind and focused view**
  Open mind refers to being vigilant and make necessary changes to the programme wherever required and
  Focused view refers to ensuring that the procedure followed helps to meet the objective.
- **Note and report significant matters** coming to his notice, to his seniors or to the engagement partners.

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So long as the suggested change is not approved by the principal, every team member should stick to the initial programme. This is only to ensure that only genuine changes are made.

★ **Periodic Review of The Audit Programme**

The auditor prepares a standard audit programme keeping in mind the

- nature, size and composition of the business
- the dependability of the internal control
- His past experience with such engagement
- and the given scope of work

However periodic review of the audit programme should be done to assess

- If there are any inadequacies in collecting the proper evidence
- If there is any procedure which is redundant and need not be carried on
- If it is relevant to the audit, based on the changed facts and circumstances

The client's operations and internal control should also be reviewed periodically

If periodic review is not done

- any change in the business policy of the client may not be adequately known
- the auditor may have to face legal consequences for negligence of duty.

14. What are key factors to be kept in mind while drawing an audit programme?

The following are the key factors to be kept in mind while drawing an audit programme:

(1) Stay within the **scope and limitation** of the assignment.
Example of scope – The various laws that the entity has to comply with.
Example of limitation – The strength of internal control

(2) Determine the evidence reasonably available and identify the **best evidence for deriving the necessary satisfaction.**

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For every assertion, there will be multiple evidences. The auditor should understand what the possible evidences are available with the entity and which one provides most corroborative evidence.

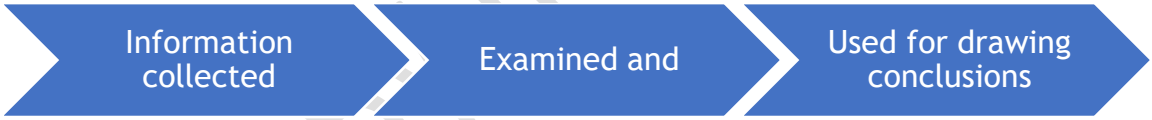
(3) Apply only those steps and **procedures which are useful** in accomplishing the verification purpose in the specific situation.
Every procedure should be drawn keeping the objective in mind. For eg. The best way to verify cash balance is physical counting.

(4) Consider all **possibilities of error**.
This does not mean that the procedures should be drawn with a doubtful mind but instead they should be drawn with a vigilant mind.

(5) **Co-ordinate the procedures** to be applied to related items.
This refers to the order in which the procedures have to be carried on. Because evidence regarding one area may also provide suggestions regarding another area.

15. Audit Programme is designed to provide Audit Evidence. Elaborate this point.

Audit Evidence is defined as the information collected, examined and used by the auditor in arriving at the conclusions on which the auditor's opinion is based.



It can be either from an **internal source or** from an **external source**.

As per the audit flowchart (discussed in chapter 1), audit techniques are applied to obtain audit evidence.

And audit procedures are performed to examine the audit evidence. In other words, audit procedures are aimed at ensuring the sufficiency and appropriateness of the audit evidence. So that appropriate opinion can be formed.

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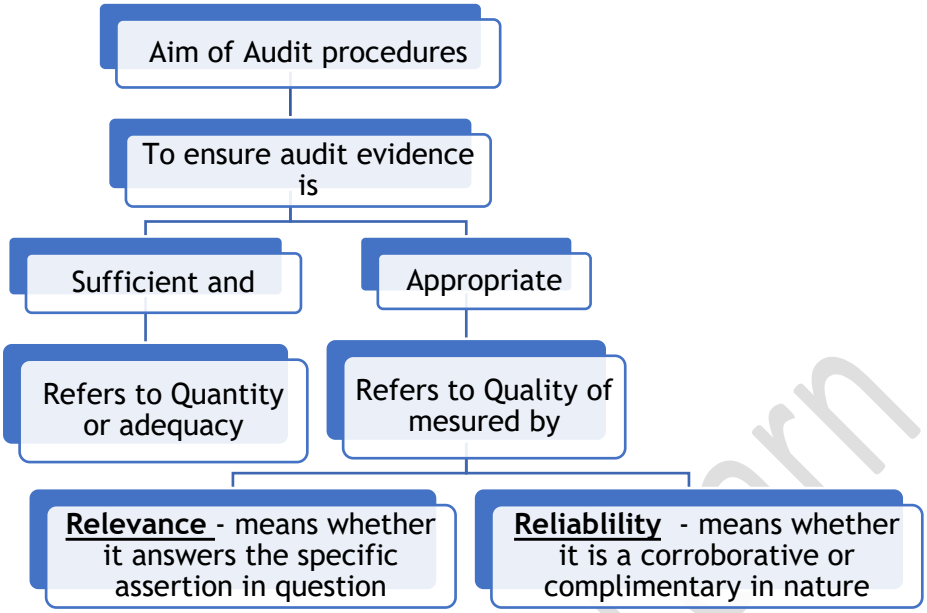

What is **best evidence is a matter of expert knowledge and experience**. This is the primary task before the auditor when he draws up the audit programme.

In all cases **one procedure may not bring the highest satisfaction** and thus he has to collect many evidences for the same assertion.

Each evidence is weighed to ascertain its weight to prove or disprove the assertion.

16. Name few avenues which provide audit evidence.

Following are few types of audit evidences:

i. Documentary examination,
ii. Physical examination,
iii. Statements and explanation of management, officials and employees,
iv. Statements and explanations of third parties,
v. Arithmetical calculations by the auditor,
vi. State of internal controls and internal checks,
vii. Inter-relationship of the various accounting data,
viii. Subsidiary and memorandum records,
ix. Minutes,
x. Subsequent action by the client and by others.

17. How is an audit programme drawn? OR Mention the steps in developing the audit programme.

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★ **Written Audit Programme** :Once the detailed programme is written, it is **easy to communicate** it to the engagement team.

★ **Audit Objective and Instruction to Assistants**: The programme should contain

- Audit objectives for each area and
- A set of instructions to the assistants with sufficient details

This gives great **clarity to the team** as to what is expected out of them or what is course of action in every scenario.

Thus, it becomes a **means to control the proper execution** of the work.

★ **Reliance on Internal Controls :**The auditor, should have an understanding of the accounting system and related internal controls for determining **the nature, timing and extent of required auditing procedures**.

As part of compliance procedure, the auditor has to check

- If controls exists
- If they are adequate and
- If they are operating effectively.

This will help him decide the nature, timing and extent of substantive procedures.

However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence.

The auditor should also consider the coordination from the client, the availability of assistants, and the involvement of other auditors or experts.

★ **Timings of Performance of Audit Procedures**: The auditor **normally has flexibility** in deciding when to perform audit procedures.
However, in **some cases**, the auditor may have **no discretion** as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.

★ **Audit Planning :** The audit procedures should be aligned to the audit plan, which in turn should aligned to audit strategy.
Planning ideally commences at the conclusion of the previous year's audit.
Planning and procedures are subject to change as the audit progresses.

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18. What are advantages and disadvantages of audit programme?

The **advantages** of an audit programme are:

- It provides **clear set of instructions** to audit assistants. They know what is exactly expected out of them.
- It provides a **total perspective of the work** to be performed. Audit programme is aligned to the audit plan which is in turn aligned to the audit strategy. This is more important for large audits.
- It helps in **Selection of audit team** on the basis of capabilities.
- A written document always ensures that **all areas and issues relevant to audit are considered**. Without a written and pre-determined programme, work is carried out on the basis of some 'mental' plan which may result in ignoring or overlooking certain books and records.
- It ensures **accountability of audit assistants**. The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.
- The principal can **control the progress of the various audits** in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.
- It serves as a **guide for audits to be carried out in the succeeding year**.
- It serves as **evidence in the event of any charge** of negligence being brought against the auditor. It may be of considerable value in establishing that he exercised reasonable skill and care that was expected of professional auditor.

The **disadvantages** are:

- The work may **become mechanical** and particular parts of the programme may be **carried out without any understanding of the object** of such parts in the whole audit scheme.
- The programme **may become rigid and inflexible** if changes are not made based on new developments. For eg. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.
- **Incomplete audit programmes** may increase the risk of material misstatement.

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- **Inefficient assistants may take shelter** behind the programme i.e. defend deficiencies in their work on the ground that no instruction in the matter is contained therein.

- A hard and fast audit programme may **kill the initiative of efficient and enterprising assistants.**

All these **disadvantages may be eliminated** by

- **Extensive supervision** of the work carried on by the assistants

- The auditor must have a **receptive attitude** as regards the assistants and

- The assistants should be encouraged to **observe matters objectively** and bring significant matters to the notice of supervisor/principal

19. What is materiality and how it is related to audit planning?

★ **Definition and Usage** - Materiality refers to a limit to decide what is important and what is not important.

Materiality is an important consideration for an auditor to evaluate whether the financial statements reflect a true or fair view or not.

It has the following benefits:

- It helps the auditor to focus on important areas in the audit.
- It enables the auditor to select audit procedures
- It enables to support the audit opinion at an acceptably low degree of audit risk

★ **SA 320** - SA 320 on "Materiality in Planning and Performing an Audit" requires that an auditor should consider materiality and its relationship with audit risk while conducting an audit.

There is an inverse relationship between Audit risk and materiality levels. Ie when the level of risk is low the materiality levels are high and vice versa.

As per SA 320

- It is the auditor's responsibility to apply the concept of materiality in planning and performing the audit of financial statements.

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- The auditor's determination of materiality is a matter of professional judgement.

- Any error or misstatement is considered to be material if it is likely to affect the decision making of users of financial statements.

- The auditor's preliminary assessment of materiality related to specific account balances and classes of transactions helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures.

- Concept of materiality is used in audit
  - At the planning stage
  - At the execution stage
  - In evaluating the effect of identified misstatements on the audit
  - In evaluating the effect of uncorrected misstatements on the audit
  - In forming an opinion on financial statements.

20. What should the auditor know to decide on the 'materiality' level? What are the types of materiality levels?

The auditor should have the understanding of the following for deciding the materiality level.

1. Understand the business.
2. Understand how financial statements are prepared.
3. Understand that many estimates are used for the financial statements and these estimates may be different from actual.
4. Understand what users may consider as material or important.

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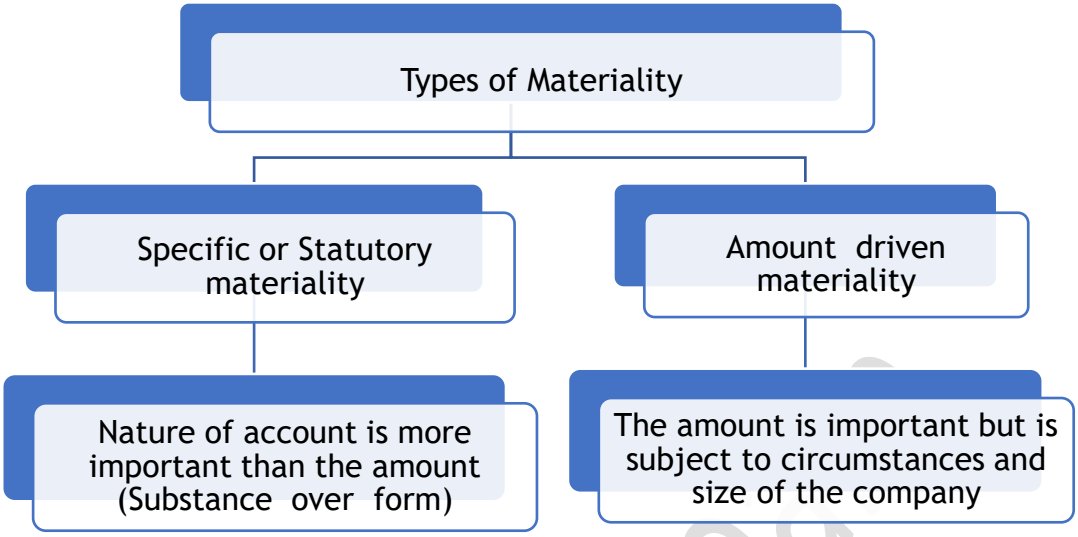

21. Name few areas of statutory materiality.

The following have to be verified completely irrespective of the amounts involved

1. Share capital
2. Reserves and surplus
3. Statutory items
4. Taxation and
5. Legal expenses

22. What are the key aspect of setting up materiality levels?

★ **Phases of Materiality computation**

1. Overall materiality - computed on the basis of size of the company, which is set based on a benchmark which could be profit, turnover or net assets.
2. Planning materiality – Computed on the basis of audit risk
3. Summary of difference. (Dealt in SA 450)

★ **Determining materiality and performance materiality**

When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole.

If, in the specific circumstances of the entity, there is one or more particular

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classes of transactions, account balances or disclosures for which misstatements of lesser amounts in aggregate exceeds theoverall materiality (in such a way that it influences the economic decisions of users), then he should determine levels for such classes of transactions, account balances or disclosures.

Planning materiality = Adjusted overall materiality after considering the company specific risk.

Once planning materiality is determined, the overall materiality becomes redundant.

★ **Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole**

Determining materiality involves the exercise of professional judgment.

A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (eg. Assets, liabilities, equity etc.)
- Items on which the attention of the users of the particular entity's financial statements tends to be focused (eg. Profit, revenue or net assets)
- The nature of the entity, where the entity is at in its life cycle,
- the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed.
- The relative volatility of the benchmark

In relation to the chosen benchmark, relevant financial data ordinarily include

- Prior periods' financial results and financial positions
- The period to-date financial results and financial position
- Budgets or forecasts for the current period
- Significant changes in the circumstances of the entity
- Relevant changes of conditions in the industry or economic environment

★ **Revision in Materiality levels**

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Materiality levels for financial statements as a whole or materiality level or levels for particular classes of transactions, account balances or disclosures may be subject to change due to

- Change in circumstances that occurred during the audit,
- Availability of new information, or
- Change in the auditor's understanding of the entity and its operations

If the materiality level is lowered, he has to determine if whether the nature, timing and extent of the further audit procedures remain appropriate.

23. What are the factors to be documented with regard to the materiality?

The audit documentation shall include the following amounts and the factors considered in their determination:

- Materiality for the financial statements as a whole;
- The materiality level or levels for particular classes of transactions, account balances or disclosures ;
- Performance materiality ; and
- Any revision as the audit progresses

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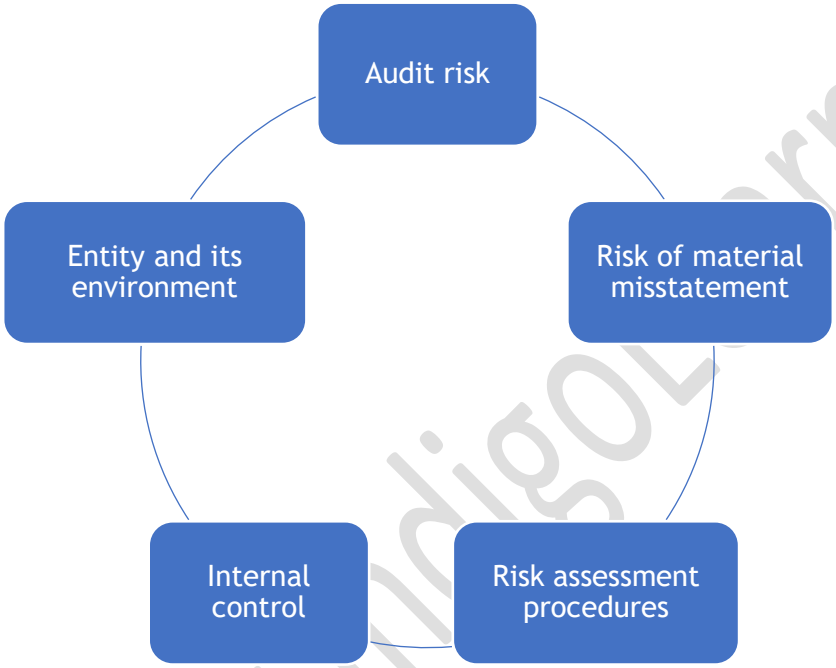
6.3 Internal Check, Internal Control, Internal Audit - Industry Specific

Overview



1. **What is audit Risk and what is risk of material misstatement? What are the types of audit risk ?**

★ Risk means deviation from expectation. It denotes the possibility that the objective might not be met.

Audit risk = **Risk that the auditor gives an inappropriate audit opinion.**

Risk of material misstatement = **Risk that the financial statements are materially misstated prior to audit**

★ Misstatement refers to a difference between the amount, classification,

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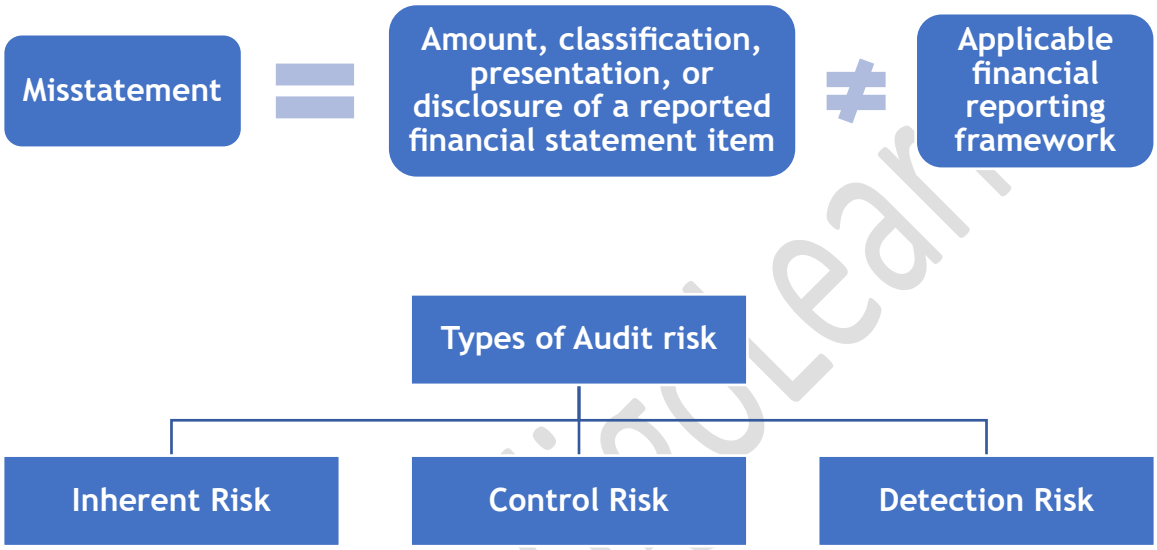
presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

★ Misstatements can arise from error or fraud.



★ **Inherent Risk** – It is risk of misstatement in financial statements arising due to an error or omission as a result of factors other than a failure of control.

★ Inherent risk is likely to be higher where a high degree of judgement or estimation is involved or where transactions of the entity are highly complex. Because in such cases, those accounts are generally vulnerable to higher risk.

★ Inherent risk factors are considered while designing tests of controls and substantive procedures.

★ Management will decide on the level of controls based on the inherent risks identified.

★ Inherent risks are based on size and nature of business. Thus management is responsible for planning and implementing controls based on the size and nature of business.

★ External circumstances giving rise to business risks may also influence inherent

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risk. For example, technological developments might make a particular product obsolete.

★ **Control risk** – It is risk of controls designed by management being **weak or non-existent** and thereby not arresting inherent risk.

★ Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

★ Internal control can only reduce but not eliminate risks of material misstatement in the financial statements. This is because of the inherent limitations of internal control.

★ The possibility of human errors or mistakes, or of controls being circumvented by collusion. Accordingly, some control risk will always exist.

★ **Detection risk** – Risk that procedures performed by auditor to reduce audit risk to an acceptably low level will **not detect a misstatement that exists** and which could be **material either individually or when aggregated** with other misstatements.

2. How is risk of material misstatement assessed?

The risks of material misstatement may exist at two levels:

The overall financial statement level- It refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

The assertion level for classes of transactions, account balances, and disclosures- Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

3. If every business has unique risk, how can the auditor identify the risk?

The auditor can identify the risk **by understanding the business environment.** In order to get the knowledge of client's business the auditor will have to obtain the understanding of the following factors which affect the client's business:

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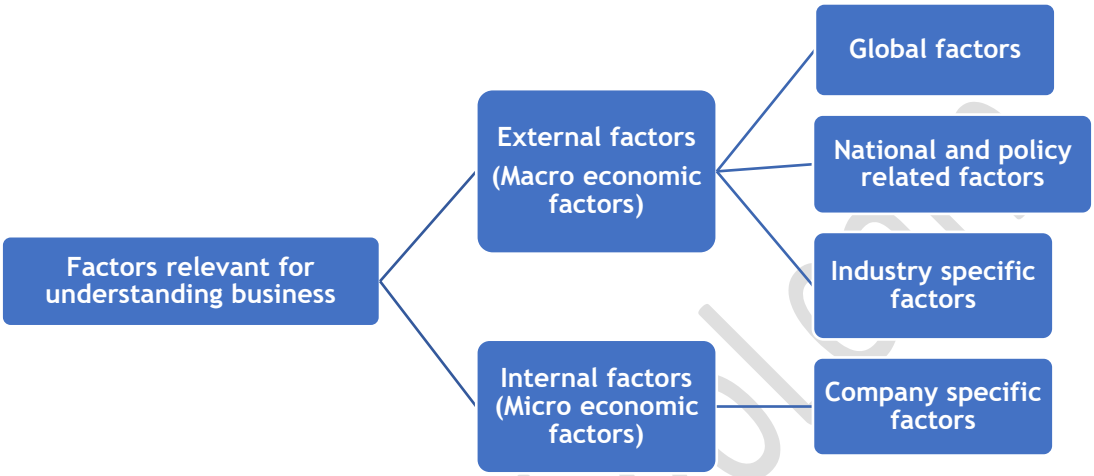
5. Global factors
6. National and policy level factors
3. Industry specific factors and
4. Company specific factors



The information is gathered in the above order only. Thus the auditor will first get the understanding of macroeconomic factors (or external factors) and then come to company specific factors.

★ **Global factors**

- Competitive environment like demand, cost of raw material in the global market.
- An entity with components in multiple tax jurisdictions, has additional risk

★ **National and policy factors**-

- Income tax rates, Government schemes etc.

★ **Industry specific factors**

- Technological developments, such as those related to the entity's products,Shortage of skilled labour etc.
- Supplier and customer relationships, such as types of suppliers and customers.

★ **Company specific factors** -

- Non-financial factors like production capacity, headcount, input-output ratio
- Financial factors like Past performances, turnovers, employee cost etc.

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- The nature of the entity, including:
  - (i) its operations;
  - (ii) its ownership and governance structures;
  - (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
  - (iv) the way that the entity is structured and how it is financed;

  This enables the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

  Apart from this the auditor should get an understanding of joint ventures, partnerships etc. which pose new risks.

4. What is included as part of risk assessment procedure?

★ **Risk assessment procedure - A basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels**

★ **Enquiries of management and others within the entity -** helps to understand what they perceive as the risk factors. The auditor should enquire not only the management and those charged with governance but also internal auditors, legal counsels and employees of all departments like marketing and sales personnel, information system personnel etc.

★ **Use of analytical procedures -** Implies using ratios, trends etc to see what the new risk factors are. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information. It helps to identify the existence of unusual transactions or events, and amounts

★ **Observation and inspection -** This supports inquiries of management and others. This includes observation or inspection of:
- The entity's operations
- The entity's premises and plant facilities.
- 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).

★ **Information obtained in prior periods -** The auditor should check his working papers

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for all the previous years. This will give him an information of critical areas and about the strength of the internal control. For example, if any fraud was noticed in the last year, then the auditor has to be more cautious in that area for the current year also.

★ **Discussion among engagement teams -** understanding of the entity, its environment and the risk assessment is a continuous process. So, the auditor should ensure free flow of communication and regular discussion with the engagement team. This will help him focus on all areas involving risk.

5. What are the aspects of identifying and assessing the risk of material misstatement?

There are 5 aspects to identify and assess the risk of material misstatement

1. Assessment of risks of material misstatement at the **financial statement level**
This risk affects the financial statements as a whole. The following are some indicators of such risks:

- Management's lack of competence
- Management's lack of integrity
- Weak internal controls etc.

2. Assessment of risks of material misstatement at the **assertion level.**
The auditor should identify such risks in order to determine the nature, timing and extent of other audit procedures.

3. The entity's **selection and application of accounting policies.**
The entity cannot apply or change any accounting policy with an intention of manipulating profits. Thus The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

4. Objectives, strategies and related business risks.
The objectives and strategies also have their own risks. For example,
Industry development, expansion by way of new products and services, geographical expansion, new accounting requirements etc.

5. Measurement and review of Entity's financial performance.
Auditor should understand if there are pressures to achieve performance targets which may increase the risk of material misstatement. These measures include,

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Budgets, incentives and compensation to employees linked to their performance, credit rating agency reports etc.

6. What are the steps that the auditor should take as part of risk assessment procedure?

1. The auditor shall **identify and assess the risks of material misstatement** at:
   i. **The financial statement level**
   ii. **The assertion level for classes of transactions, account balances, and disclosures**
2. Identify risks throughout the process of obtaining an **understanding of the entity and its environment**.

3. **Identify relevant controls** that can prevent or detect material misstatements.

4. Assess the identified risks, and **evaluate** whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

5. Consider the **likelihood of misstatement** and assess its materiality. Consider if there is a possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

7. Throw some light on the framework provided by SA 315 on how internal controls can be analysed by the auditor.

SA315 provides an interesting framework for auditors to consider how internal controls can be analysed in a business. It helps to understand how different aspects of an entity's internal control may affect the audit.
It divides the internal control in 5 components.

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Control environment	Risk assessment	Infomration and communication	Contol activities	Monitoring of controls
•Type of organisation •Ethics and principles of the entity •People governing the entity •Policies of the entity	•Kind of people who wrok in the organisation • Technology used • Growth plans •Business models • Locations of the business	•Accounting controls for recording the transactions	•Policies and procedures like • Variance analysis between budgets and actuals •physical security of assets •segregation of duties	•Ongoing monitoring on daily activities • Information processing ie. audit trail from beginning to end •cross verification

8. What is not included as part of audit risk?

1. Audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.
2. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

9. What is internal control, what are the types of internal control that any organization should implement and what will the auditor ensure while checking the internal control?

- Internal controls refers to the processes and procedures laid by management to ensure that there is no material misstatement in the financial statements.
- For example if an organization wants to order raw material, then the process starting from selecting a suitable vendor to accounting the receipt of the raw material, including the ensuring of quality and quantity of it is called as internal control.
- According to the nature, there are 3 type of internal control and according to process they can be divided into 2 types.

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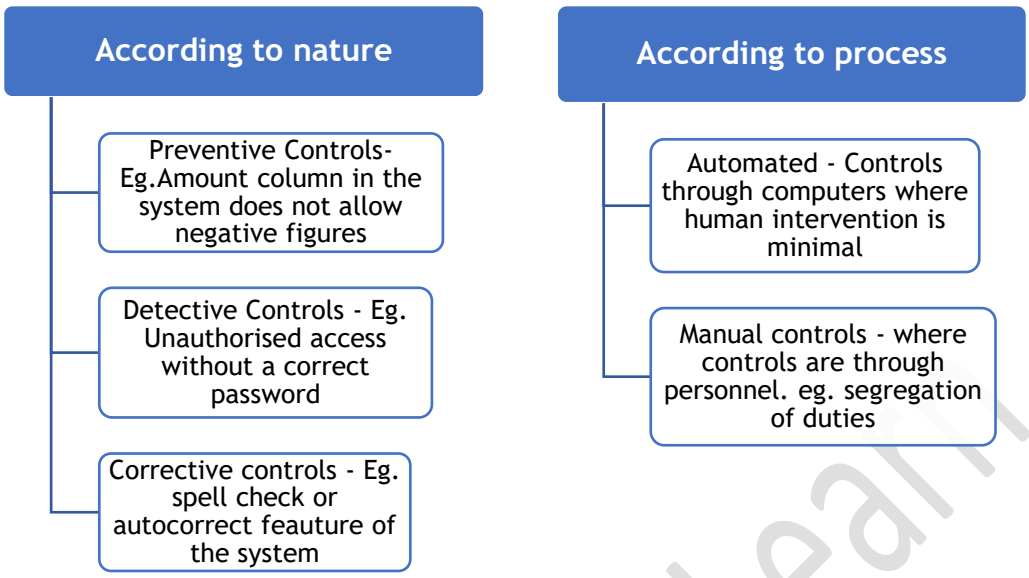

- **The auditor has to ensure that the internal controls prevent, detect and correct material misstatements, regarding financial statements.**
- As per management's discretion, internal controls can be Manual, automated or semi-automated. In case of automated process, the auditor needs to perform CIS audit (Computer Information Systems audit)
- For all the areas, where risk is identified, the auditor has to ensure
  - If controls exists
  - If controls are adequate
  - Does controls operate effectively
- The auditor needs to form an overall understanding of the strength of controls. This will enable him to decide on the extent of substantive procedures to be carried on.

10. Define internal control as per SA315? What are its objectives? How does understanding the internal controls help the auditor?

★ **Definition**

As per SA-315,"Identifying and assessing the risk of material misstatement through understanding the entity and its environment", the internal control may be defined as

- The process designed, implemented and maintained
- By those charged with governance, management and other personnel

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- to provide reasonable assurance about the achievement of an entity's objectives
- with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations.

★ Objectives of Internal Control

- **Transactions are executed in accordance with managements general or specific authorization;**
- All transactions are **promptly recorded** in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;
- **Assets are safeguarded** from unauthorized access, use or disposition; and
- **Verification of existence of physical assets** regularly – The recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

★ Benefits of Understanding of Internal Control

An understanding of internal control assists the auditor in :

- Identifying types of potential misstatements
- Identifying factors that affect the risks of material misstatement, and
- Designing the nature, timing, and extent of further audit procedures.

11. How does the auditor assesses control risk? OR how does the auditor report when control deficiencies are identified ?

- When making control risk assessments, the auditor consider:
  - The **control environment's influence over internal control**. A control environment that supports the prevention, and detection and correction, of material misstatements allows greater confidence in the reliability of internal control and audit evidence generated within the entity.
  - Evaluations of the related **IT processes that support application** and IT-

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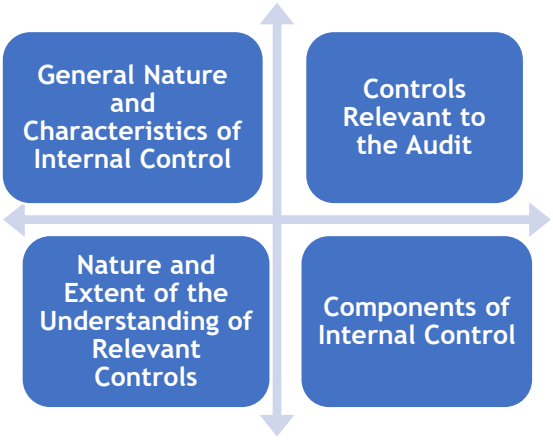
dependent manual controls.

- The **expectation of the operating effectiveness** of controls based on the understanding of entity's processes.

- When auditor identifies deficiencies and reports on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls.
- The auditor concludes that they support a **'rely on controls'** risk assessment, if he thinks it is appropriate. Otherwise he will change control risk assessment to **'not rely on controls.'**
- When control deficiencies are identified and auditor identifies and tests more than one control for each relevant assertion, he evaluates control risk considering all of the controls he has tested.

12. Controls would include both financial as well as non-financial aspects of an entity. Should the auditor get an understanding of every aspect of internal control?

- The auditor shall obtain an **understanding of internal control relevant to the audit**. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit.
- It is a **matter of the auditor's professional judgment** whether a control, individually or in combination with others, is relevant to the audit.
- The auditor puts **more focus on areas that have greater impact on financial statements.**
- The auditor can understand the internal controls by the understanding the following four aspects of it:



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13. How can the auditor understand the general nature and characteristics of Internal control?

The auditor can understand the general nature and characteristics of Internal control by understanding the **purpose and limitations of Internal control**.

★ **Purpose of Internal Control**:

Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

- The reliability of the entity's financial reporting;
- The effectiveness and efficiency of its operations;
- Its compliance with applicable laws and regulations; and
- Safeguarding of assets.

★ Limitations of Internal Control:

- Internal control can provide only **reasonable assurance.**
  Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. They don't provide absolute assurance.
  Inbuilt control for unforseen event is not possible.
- **Human judgment in decision-making:**
  Human judgment in decision-making can be faulty. Human error may result in breakdowns in internal control. The possibility of biased decision cannot be ruled out.
- **Lack of understanding the purpose:**
  The operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.
- **Collusion among People:**
  Controls can be circumvented by the collusion of two or more people. Inappropriate management may also override of internal control. For example,

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management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition.

- **Judgements by Management**:
  In designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.
  Management choices can be sub-optimal.
- **Limitations in case of Small Entities:**
  Smaller entities often have fewer employees due to which segregation of duties is not practicable. In a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. However, the owner-manager may be more able to override controls because the system of internal control is less structured.

14. What are the factors which make any particular control relevant to audit? Or what are the aspects that influence the auditor's professional judgement regarding test of controls ?

There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement.
The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance.
However, not all of these objectives and controls are relevant to the auditor's risk assessment. Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit includes the following:

- Principles of Materiality.
- The significance of the related risk.
- The size of the entity and the nature of the entity's business, including its organization and ownership characteristics.
- The diversity and complexity of the entity's operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations.
- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

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The auditor will delve deep into the following types of control:

Controls over the completeness and accuracy of information

Controls over the completeness and accuracy of information produced by the entity is relevant to the audit. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Controls relating to operations and compliance objectives may also be relevant to an audit.

Internal control over safeguarding of assets

Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

Controls relating to objectives that are not relevant to an audit

An entity generally has controls relating to objectives that are not relevant to an audit and therefore will not be considered by the auditor. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations such as an airline's system of automated controls to maintain flight schedules, but these controls ordinarily would not be relevant to the audit.

The statute may require the auditor to report on compliance with certain internal controls

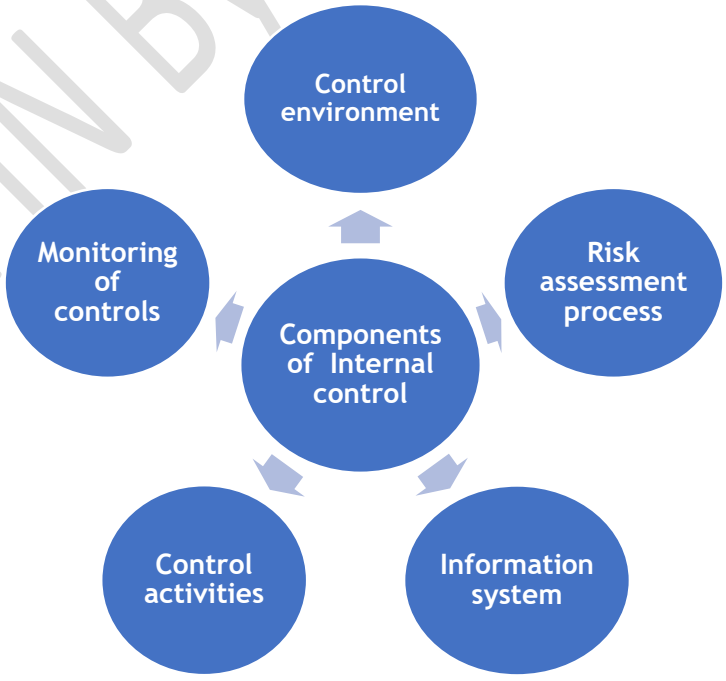
In certain circumstances, the statute or the regulation governing the entity may require the auditor to report on compliance with certain specific aspects of internal controls as a result, the auditor's review of internal control may be broader and more detailed.

15. How will the auditor find out about the controls which will individually or in combination of few other controls ensure that misstatement, frauds and errors

don't happen in financial statements.

- The auditor has to understand the nature and extent of the relevant Controls.
- **Evaluating the design of a control** involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements.
- Implementation of a control means that the control exists and that the entity is using it.
- Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include-
    - Inquiring of entity personnel.
    - Observing the application of specific controls.
    - Inspecting documents and reports.
    - Tracing transactions through the information system relevant to financial reporting.
- Inquiry alone, however, is not sufficient for such purposes. He has to personally check if the controls are effectively operating.
- Obtaining an understanding of an entity's controls is not sufficient to **test their operating effectiveness**, unless there is some automation that provides for the consistent operation of the controls.

16. What are the Components of internal control?



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17. Elaborate the elements of control environment.

Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

★ **Communication and enforcement of integrity and ethical values**

These are essential elements that **influence the effectiveness of the design, administration and monitoring of controls**.

★ **Commitment to competence**

Management's consideration of the competence levels for particular jobs and whether right **persons with requisite skill and knowledge** are appointed.

★ **Participation by those charged with governance**

Attributes of those charged with governance such as:

- Their independence from management.
- Their experience and stature.
- The extent of their involvement and the information they receive, and the scrutiny of activities.
- The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

★ **Management's philosophy and operating style**

Characteristics such as management's:

- Approach to taking and managing business risks.
- Attitudes and actions toward financial reporting.
- Attitudes toward information processing and accounting functions and personnel.

★ **Organizational structure**

The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

★ **Assignment of authority and responsibility**

Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.

★ **Human resource policies and practices**

Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

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18. Explain the Entity's Risk Assessment Process as a component of Control Environment.

- The entity's risk assessment process forms the basis for the risks to be managed.
- If that process is appropriate, it would assist the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.
- The auditor shall obtain an understanding of whether the entity has a process for:

  (a) Identifying business risks relevant to financial reporting objectives;

  (b) Estimating the significance of the risks;

  (c) Assessing the likelihood of their occurrence; and

  (d) Deciding about actions to address those risks.

19. How can the auditor gain be understanding of the information system, including?
the related business processes, relevant to financial reporting?

The auditor shall obtain an understanding of the following:

(a) The **classes of transactions** in the entity's operations that are **significant to the financial statements**;
Transactions can be divided into categories or classes and then accordingly traced their reporting in financial statements. For example – Based on geographic locations (domestic/ international) based on nature (sales/ purchases), based on means of recording (digital/maual) etc.

(b) The **procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred** to the general ledger and reported in the financial statements;
This refers to the trail of transactions from beginning to end ie from its originating source to ultimately appearing in financial statements.



Understand the controls at each of the above level.

(c) The related accounting records, **supporting information** and specific accounts in the financial statements that are used to initiate, record, process

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and report transactions;
This refers to the various supporting documents that gets generated at each level of recording the transaction. For example – For an inventory, the various supporting documents are Purchase order, Invoice, Goods receipt note, Gate pass etc. The auditor has to understand that there is not only a supporting document at each level but also that such document is approved by an authorized person. This can either be under a manual system or an electronic system.

(d) How the **information system** captures events and conditions that are significant to the financial statements;
This refers to capturing of all those information which needs to be disclosed as part of financial statement as a result of compliance to any applicable law. Every information which is required to be disclosed as a matter of statutory compliance should be captured properly.

(e) The **financial reporting process** used to prepare the entity's financial statements;
This refers to the process of preparing the financial statements from the books of accounts is strong and effective to ensure that there is no possibility of errors. This is a control at the last step ie the step at which financial statements are prepared. For example, how information from branches is incorporated in the financial statements.

(f) **Controls surrounding journal entries**
The primary mode of recording a transaction is journal entry. Thus, from journal entry, any transaction will reach the financial statements. Thus, the auditor has to understand all the controls at the point of recording journal entries to ensure they are

- Recorded by authorized persons
- Recorded in proper manner
- Verified by a senior
- Approved by a senior.

20. The financial roles and responsibilities are Communicated to the concerned personnel by the management. What are the key considerations that the auditor should keep in mind while understanding the same?

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The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities. This includes

1. Communications between management and those charged with governance; and
2. External communications, such as those with regulatory authorities.

The key considerations that the auditor should keep in mind while understanding the same are :

(i) Communication by the entity of the financial reporting roles and responsibilities would involves providing an understanding of **individual roles and responsibilities** pertaining to internal control over financial reporting.

(ii) It includes **understanding by employees** as to how their activities relate to the work of others and the means of reporting exceptions to higher level within the entity.

(iii) Communication may take such forms as **policy manuals** and financial reporting manuals.

(iv) **Open communication channels** help ensure that exceptions are reported and acted on.

(v) Communication may be **less structured and easier to achieve in a small entity** than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

21. What are the control activities which are relevant to the audit and which the auditor considers necessary to assess the risks of material misstatement?

- An auditor requires an understanding of only those **control activities related to significant class of transactions, account balance, and disclosure in the financial statements** and the assertions which he finds relevant in his risk assessment process.
- **Control activities are those policies and procedures laid by the management to ensure that significant transactions are accounted properly.**
- Control activities, whether within IT or manual systems, have various objectives and are **applied at various organizational and functional levels**.
- Thus, control activities relevant to audit are:
  - Control activities that relate to significant risks and those that relate to **risks for which substantive procedures alone do not provide sufficient appropriate audit evidence**; or

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- Those that are considered to be **relevant in the judgment of the auditor**;

➢ Specific control activities for any significant transaction include the following:

Physical controls	Segregation of duties	Authorisation	Performance review	Information processing
•The safeguarding of physical documents and files.	•The Record keeping function and the custodial function should not be with the same person.	•One will initiate the transaction, one will verify it and a concerned authority will approve it.	•If the processes and procedures are operating effectively	•How the information is flowing across the organisation through these control activities

22. In exercising judgment as to which risks are significant risks, What shall the auditor consider?

In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

(a) Whether the risk is a **risk of fraud**;

(b) Whether the risk is related to **recent** significant economic, accounting, or other **developments** like changes in regulatory environment, etc., and, therefore, requires specific attention;

(c) The **complexity** of transactions;

(d) Whether the risk involves significant transactions with **related parties**;

(e) The **degree of subjectivity** in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

(f) Whether the risk involves significant transactions that are **outside the normal course of business** for the entity, or that otherwise appear to be unusual.

23. What is significant risks and how is it identified?

➢ Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement.

➢ Significant risks often relate to significant non- routine transactions or judgmental matters.

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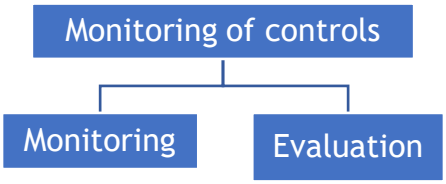
- Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently.
- Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.
- Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:
  - Greater management intervention to specify the accounting treatment.
  - Greater manual intervention for data collection and processing.
  - Complex calculations or accounting principles.
  - The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.
- Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:
  - Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
  - Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

24. What do you mean by monitoring of controls and how does it help the auditor?

The last Component of Internal Control is monitoring of controls. This function can be divided into 2 parts – 1. Monitoring 2. Evaluation.



Monitoring of controls is a **process to assess the effectiveness of internal control** performance over time and includes taking necessary remedial actions.

Monitoring refers to ensuring that **proper control exits** and that they are adequate. **Evaluation** refers to ensuring that they are **operating effectively**.

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Ongoing monitoring activities are often built into the normal recurring activities of an entity and include **regular management and supervisory activities**.

Management's monitoring activities may include **using information from communications from external parties** such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

In case of **small entities**, it is often accomplished by management's or the owner-**manager's close involvement** in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to **remedial action** to the control.

25. Why internal control should be evaluated?

The auditor needs **reasonable assurance that the accounting system is adequate** and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance.

Thus, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme.

Benefits of Evaluation of Internal Control to the Auditor are as follows:

(i) whether errors and frauds are likely to be located in the ordinary course of operations of the business;

(ii) whether an internal control system is in use, is it adequate, and operating as planned by the management;

(iii) whether an effective internal auditing department is operating;

Internal control = Internal check + Internal audit.

(iv) whether the controls adequately safeguard the assets;

(v) how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned;

(vi) how reliable the reports, records and the certificates to the management can be;

(vii) the extent and the depth of the examination that he needs to carry out in the different areas of accounting;

(viii) what would be appropriate audit technique and the audit procedure in the given circumstances;

(ix) what are the areas where control is weak and where it is excessive; and

(x) whether some worthwhile suggestions can be given to improve the control

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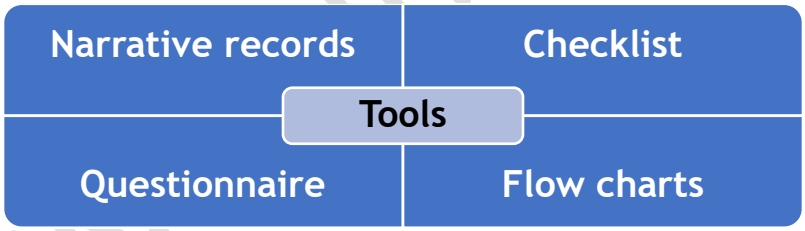
system

26. What are the tools available with an auditor to evaluate the internal controls?

- A review of the internal control can be done by a **process of study, examination and evaluation of the control system** installed by the management.
- The first step involves determination of the control and procedures laid down by the management.
- By reading company manuals, studying organisation charts and flow charts and by making suitable enquiries from the officers and employees, the auditor may ascertain the character, scope and efficacy of the control system.
- In many cases, very little information is available in writing; the auditor must ask the right people the right questions if he is to get the information he wants.
- It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry.
- To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following tools



★ **The Narrative Record**

- This is a **complete and exhaustive description of the system** as found in operation by the auditor.
- **Actual testing and observation are necessary** before such a record can be developed.
- It may be recommended in cases where no formal control system is in operation and would be **more suited to small business**.
- The **basic disadvantages** of narrative records are:

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(i) The system in operation is quite **difficult to comprehend**.

(ii) To **identify weaknesses** or gaps in the system.

(iii) To **incorporate changes** arising on account of reshuffling of manpower, etc.

A Check List

- This is a **series of instructions and/or questions which a member of the auditing staff must follow and/or answer**.
- When he completes instruction, he initials the space against the instruction.
- Answers to the check list instructions are usually **Yes, No or Not Applicable**.
- This is again an **on the job requirement** and instructions are framed having regard to the desirable elements of control.
- The complete check list is **studied by the Principal**/Manager/Senior to ascertain existence of internal control and evaluate its implementation and efficiency.

Internal Control Questionnaire

- This is a **comprehensive series of questions** concerning internal control.
- This is the **most widely used form** for collecting information about the existence, operation and efficiency of internal control in an organization.
- An important advantage of the questionnaire approach is that **oversight** or omission of significant internal control review procedures is **less likely to occur** with this method.
- With a proper questionnaire, all internal control evaluation can be **completed at one time** or in sections.
- The **review** can more easily be made on an **interim basis**.
- In the questionnaire, generally questions are so framed that a **'Yes' answer denotes satisfactory position** and a '**No' answer suggests weakness**. Provision is made for an explanation or further details of 'No' answers. In respect of questions **not relevant to the business, 'Not Applicable'** reply is given.
- The questionnaire is usually issued to the client and the client is requested to get it **filled by the concerned executives and employees**.

A Flow Chart

- It is a **graphic presentation** of each part of the company's system of internal

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control.

- A flow chart is considered to be the **most concise way of recording** the auditor's review of the system.
- It **minimizes the amount of narrative explanation** and thereby achieves a consideration or presentation not possible in any other form.
- It gives **bird's eye view** of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.

★ **Best tool** - Each tool has its share of advantages and disadvantages so the auditor has to use his profession judgement to decide which tool can be used based on the requirement of information.

27. Discuss the significance of testing the controls.

- After assimilating the internal control system, the auditor needs to examine **whether and how far the same is actually in operation**.
- For this, he resorts to actual testing of the system in operation. This is done on a selective basis.
- He can plan this testing in such a manner that all the important areas are covered in a period of, say, three years. Selective testing is done by application of procedural tests and auditing in depth.
- Test of controls are performed to obtain audit evidence about the effectiveness of the
  - Design of the accounting and internal control system ie. Whether they are designed to prevent, detect and correct material misstatements. And
  - Operation of internal controls throughout the period.
- Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions.

- Test of controls may include:
  - **Inspection of documents** supporting transactions and other events.
  - **Inquiries** about, and **observation** of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
  - **Re-performance** involves the auditor's independent execution of procedures or controls for example, reconciliation of bank accounts, to

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ensure they were correctly performed by the entity.

- Testing of internal control operating on **specific computerized applications** or over the overall information technology function, for example, access or program change

28. How is audit risk and materiality related? what are the steps to apply materiality in audit?

- In conducting an audit of financial statements, the **overall objectives of the auditor** are
  - to obtain reasonable assurance
  - about whether the financial statements as a whole
  - are free from material misstatement,
  - whether due to fraud or error,
  - thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework;
  - and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

- The auditor obtains reasonable **assurance by obtaining sufficient appropriate audit evidence** to reduce audit risk to an acceptably low level.
- Audit risk is the risk that the auditor expresses an **inappropriate audit opinion** when the financial statements are materially misstated.
- Audit risk is a function of the risks of material misstatement and detection risk.
- Materiality and audit risk are considered throughout the audit, in particular, when:
  (a) Identifying and assessing the risks of material misstatement;
  (b) Determining the nature, timing and extent of further audit procedures; and
  (c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

★ **Phases of Materiality computation**

1. Overall materiality - computed on the basis of size of the company, which is set based on a benchmark which could be profit, turnover or net assets.
2. Planning materiality – Computed on the basis of audit risk
3. Summary of difference. (Dealt in SA 450)

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★ **The steps to apply materiality in audit is as follows:**

1. List out all the account balances
2. Segregate accounts of statutory materiality
3. Identity high risk areas
4. Sort the remaining accounts in descending order of amounts
5. Group small accounts cumulating to the level of planning materiality and ignore them.
6. Conduct audit of remaining areas.

29. What all needs to be documented at the time of identifying, assessing and assessing risk?

The auditor shall document:

(a) The **discussion among the engagement team** and the significant decisions reached;

(b) Key elements of the understanding obtained regarding each of the **aspects of the entity and its environment**

(c) Understanding obtained of **each of the internal control components**,

(d) the **sources of information** from which the understanding was obtained;

(e) the **risk assessment procedures performed**;

(f) The identified and assessed **risks of material misstatement** at the **financial statement level and at the assertion level** ; and

(g) The risks identified, and **related controls.**

30. If the entity has an internal audit function, then how will the auditor monitor the controls?

If the entity has an internal audit function, the auditor shall obtain an understanding of the following :

- The internal audit function's responsibilities and how the internal audit function fits in the entity's organizational structure -
  - The objectives of an internal audit function vary widely depending on the size and structure of the entity and the requirements of management.
- The activities performed, or to be performed, by the internal audit function.
  - The entity's internal audit function is likely to be relevant to the audit if its activities are related to the entity's financial reporting.
  - If it relates to entity's financial reporting, then the auditor will use the work of the internal auditors to modify the audit procedures to be performed.

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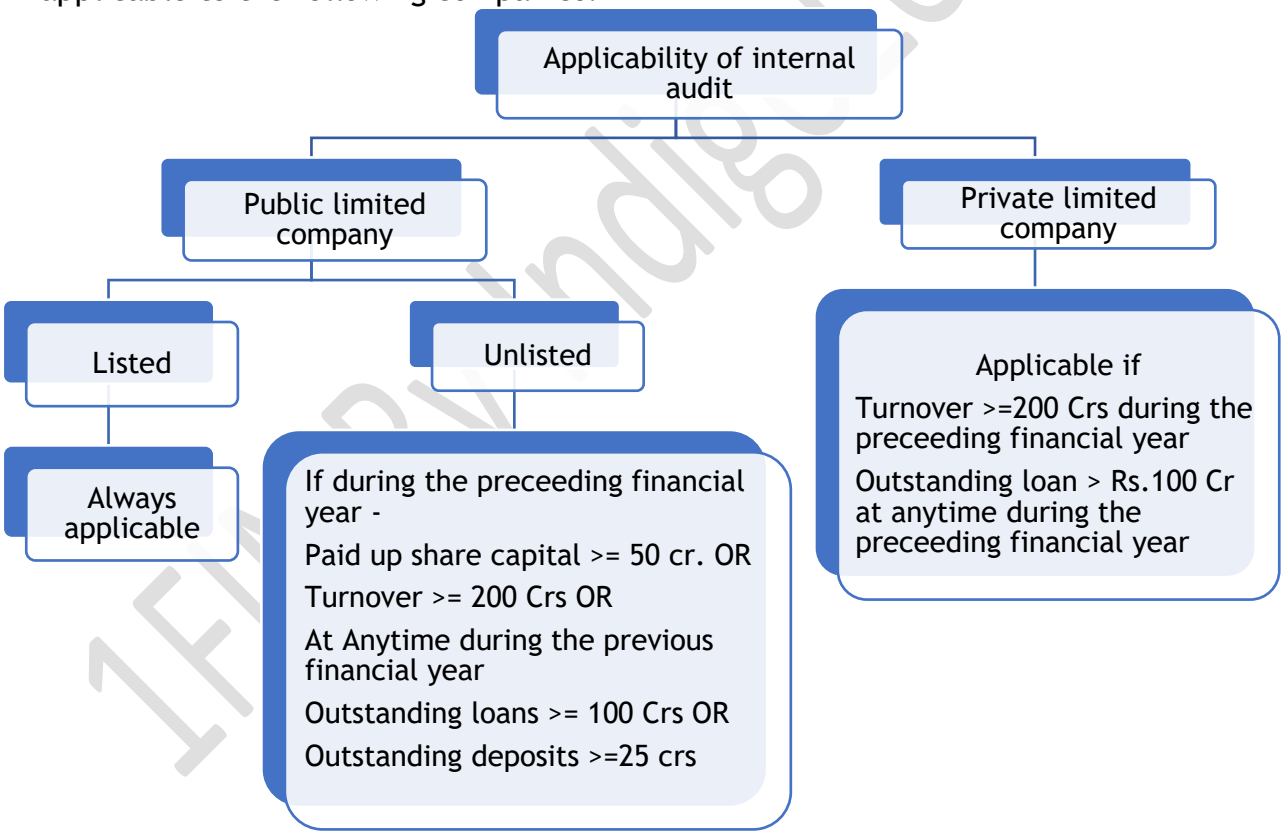
31. What is internal audit? Enumerate the provisions contained in Companies Act 2013 regarding the applicability of internal audit.

★ **Internal Audit means** –

- An independent management function, which involves
- A continuous and critical appraisal of the functioning of an entity
- With a view to suggest improvements thereto and
- Add value to and strengthen the overall governance mechanism of the entity,
- Including the entity's strategic risk management and internal control system.

★ **Applicability** - As per section 138 of the Companies Act, 2013 internal audit is applicable to the following companies:



It is provided that an existing company covered under any of the above criteria shall comply with the requirements within six months of commencement of such section.

★ **Who can be appointed as Internal Auditor?**

- A Chartered accountant or a Cost accountant (whether engaged in practice or not),

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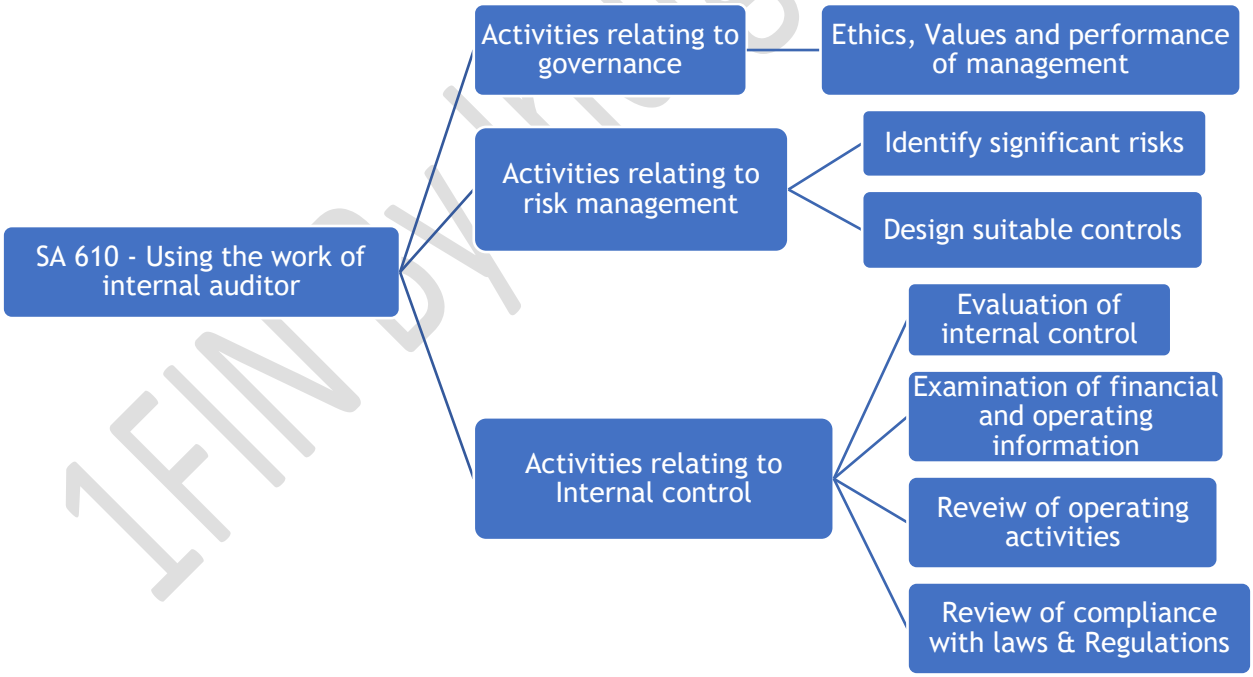
- Such other professional as may be decided by the Board
- The internal auditor may or may not be an employee of the company.

★ **Who appoints an internal auditor?**
Audit committee of the company or the board

★ What is scope of work

- The central government may by rules prescribe the manner and intervals in which internal audit shall be conducted and reported to the board.
- But the act has neither specified the scope nor the time frame for conducting an internal audit. Thus, the audit committee or the board shall formulate the scope, functioning, periodicity, methodology and reporting requirements for conducting the internal audit.

32. What is the objectives and scope of internal audit functions as enumerated under SA-610?



As per SA-610, "Using the Work of an Internal Auditor", 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. It includes the following:

★ **Activities Relating to Governance**:

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The internal audit function assesses

- The governance process
- Ethics and values of the management and those charged with governance
- Performance management and accountability
- Communicating risk and control information to appropriate areas of the organization

★ **Activities Relating to Risk Management**:

The internal audit function may assist the entity by

- Identifying and evaluating significant exposures to risk
- Contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process).
- The detection of fraud.

★ Activities Relating to Internal Control:

The internal audit function is assigned

- **Evaluation of internal control**: Specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto.
- In doing so, it provides assurance on the control.
- **Examination of financial and operating information:** To review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
- **Review of operating activities:** To review the economy, efficiency and effectiveness of operating activities, including non-financial activities of an entity.
- **Review of compliance with laws and regulations:** To review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

33. Give a brief note on Committee on Internal Audit (CIA).

- Considering the increasing importance of internal auditing, the Institute of Chartered Accountants of India has constituted a Committee on Internal Audit (CIA) as a non- standing committee on February 5, 2004.
- The CIA was constituted with the object of formulating Standards and Guidance Notes on Internal Audit.

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- Now it is known as Internal Audit Standard Board.
- The Board has, till date, issued eighteen Standards on Internal Audit (SIAs) (which are recommendatory in nature).
- The SIAs aim to codify the best practices in the area of internal audit and also serve to provide a benchmark of the performance of the internal audit services.
- While formulating SIAs, the Board takes into consideration the applicable laws, customs, usages and business environment and generally accepted auditing practices in India.

34. What do you mean by internal financial control? Enumerate the provisions of Companies Act 2013 which emphasis on internal financial control.

- Section 134(5) explains the meaning of internal financial controls as,
  - "the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to
  - company's policies,
  - safeguarding of its assets,
  - prevention and detection of frauds and errors,
  - Accuracy and completeness of the accounting records, and
  - The timely preparation of reliable financial information."
- From the above definition, it is clear that internal financial controls are 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."
- Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors' report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.
- Accordingly, reporting on internal financial controls 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.
- 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**

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internal financial controls over financial reporting."

- It is **carried out along with an audit of the financial statements**.
- Reporting under Section 143(3)(i) is dependent on the underlying criteria for internal financial controls over financial reporting adopted by the management. That is **management is ultimately responsible**.
- However, any system of internal controls provides only a **reasonable assurance** on achievement of the objectives for which it has been established.
- The auditor shall **use the concept of materiality** in determining the extent of testing such controls.
- Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the **board report** of all companies to state the details in respect of **adequacy of internal financial controls** with reference to the financial statements.
- The inclusion of the matters relating to internal financial controls in the directors responsibility statement is in **addition to the requirement** of the directors stating that they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

35. What is the difference between internal financial control and internal control over financial reporting?

Internal Financial Control as per Section 134(5)(e), "the policies and procedures adopted by the company for ensuring the orderly and effcient 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."

On the other hand, Internal controls over financial reporting-is concerned with safeguards that the organization has regarding preparation and presentation of financial statements.

Thus Internal controls over financial reporting is addition to whatever the auditor does as per sec 134(5)(e).

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Study Note – 7 | Provision relating to Audit under Companies Act

7.1 Auditor's qualifications, disqualifications, appointment, remuneration removal, powers and duties

Qualifications of auditor

The provisions relating to eligibility, qualifications and disqualifications of an auditor are governed by section 141 of the Companies Act, 2013. The main provisions are stated below:

1. **Individuals** – A person shall be eligible for appointment as auditor, only if he is a Chartered Accountant, holding Certificate of Practice.

2. **Firm** (Including LLP) – Majority of its partners should be Chartered Accountants, holding Certificate of Practice. Where a firm is appointed as the auditor, only the partners who are Chartered Accountants shall be authorized to act and sign on behalf of the firm.

NOTE – LLPs can operate with non-CA partners in line with international standards.

Case Study - 1

Preksha, a member of the ICAI, does not hold a Certificate of practice. Is her appointment as an auditor valid?

Answer

***Qualifications of an Auditor**: A person shall be qualified for appointment as an auditor of a company, only if one is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949. Under the Chartered Accountants Act, 1949, only a Chartered Accountant holding the certificate of practice can engage in public practice. Preksha does not hold a certificate of practice and hence cannot be appointed as an auditor of a company.*

Disqualifications

Under sub-section (3) of section 141 along with Rule 10 of the Companies (Audit and Auditors) Rule, 2014 (hereinafter referred as CAAR), the following persons shall not be eligible for appointment as an auditor of a company, namely:-

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1. **Body Corporate (Except LLP)**
2. **An officer or employee of the Company.**
3. **A partner or employee of the officer or employee of the Company.**
4. **A person who, or his relative, or partner**
    a. Holding any security of/ interest in the company/ its subsidiary/ its holding/associate or any fellow subsidiary.
        i. The relative may hold security or interest in the company of face value not exceeding Rs.100000.
        ii. If the relative acquires security or interest of face value exceeding Rs.100000,
        iii. Further, in the event of acquiring security or interest by a relative above the threshold limit of Rs.100000, it should come back to the prescribed limits within 60 days of such acquisition of interest, failing which the auditor will be deemed to have vacated the office.
    b. Indebted to the Company/ its subsidiary/ holding/ associate/ fellow subsidiary in excess of Rs. 500000. (i.e. the limit is applicable to the person, or his relative or partner)
    c. Has given guarantee or provided any security in connection with indebtedness if third party to the Company/ its subsidiary/ its holding/ associate/ fellow subsidiary for more than Rs. 100000.
5. **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**
    a. The term "directly or indirectly" above includes a relative.
    b. Business relationship doesn't include –
        i. Professional services of a CA firm.
        ii. Transactions in ordinary course of business as a customer. E.g. Telecom, Hospitals, Hotels, Airlines etc.
6. **A person whose relative is –**
    a. **A Director; or**
    b. **Is in the employment of the Company as a Director or a key managerial personnel.**
7. **A person who**
    a. **Has been convicted by court of an offense involving fraud; and**
    b. **A period of ten years has not elapsed since the date of conviction.**
8. **A person who is in full time employment elsewhere; or a person who is holding appointmnet as auditor for more than twenty companies.**
9. **Any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in section 144.**

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NOTE – If any of these disqualifications are attracted after appointment, then the auditor shall be deemed to have vacated the office.

Case Study - 2

Comment on the following:

Mr. Amar, a Chartered Accountant, bought a car financed at Rs. 7,00,000 by Chaudhary Finance Ltd., which is a holding company of Charan Ltd. and Das Ltd. He has been the statutory auditor of Das Ltd. and continues to be to even after taking the loan.

Answer

According to section 141 (3)(d) (ii) of the Companies Act, 2013, a person is not eligible for appointment as auditor of any company, if ***he 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.***

In the given case Mr. Amar is disqualified to act as an auditor under section141 (3)(d) (ii)) as he is indebted to M/s Chaudhary Finance Ltd. for more than 5,00,000 Rs.

Also, according to Section141 (3)(d) (ii) he cannot act as an auditor of any subsidiary of Chaudhary Finance Ltd. i.e. he is also disqualified to work in Charan Ltd. & Das Ltd. Therefore, he has to vacate his office in Das Ltd. Even though it is a subsidiary of Chaudhary Finance Ltd.

Hence audit work performed by Mr. Amar as an auditor is invalid, he should vacate his office immediately and Das Ltd must have to appoint any other CA as an auditor of the company.

Case study – 3

An auditor purchased goods worth Rs. 501,500 on credit from a company being audited by him. The company allowed him one month's credit, which it normally allowed to all known customers.

Answer

Purchase of goods on credit by the auditor*: Section 141(3)(d)(ii) of the Companies Act, 2013 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding five lakh rupees.*

Where an auditor purchases goods or services from a company audited by him on credit, he is definitely indebted to the company and if the amount outstanding exceeds rupees five lakh, he is disqualified for appointment as an auditor of the company.

It will not make any difference if the company allows him the same period of credit as it allows to other customers on the normal terms and conditions of the business. The auditor cannot argue that he is enjoying only the normal credit period allowed to other customers. In fact, in such a case he has become indebted to the company and consequently he has deemed to have vacated his office.

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Case Study – 4

Ram and Hanuman Associates, Chartered Accountants in practice have been appointed as Statutory Auditor of Krishna Ltd. for the accounting year 2013-2014. Mr. Hanuman holds 100 equity shares of Shiva Ltd., a subsidiary company of Krishna Ltd.

Answer

Auditor holding securities of a company : As per sub-section (3)(d)(i) of Section 141 of the Companies Act, 2013 along with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, 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.*

Provided that the relative may hold security or interest in the company of face value not exceeding rupees one lakh.

Also, as per sub-section 4 of Section 141 of the Companies Act, 2013, 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.

In the present case, Mr. Hanuman, Chartered Accountant, a partner of M/s Ram and Hanuman Associates, holds 100 equity shares of Shiva Ltd. which is a subsidiary of Krishna Ltd. Therefore, the firm, M/s Ram and Hanuman Associates would be disqualified to be appointed as statutory auditor of Krishna Ltd., which is the holding company of Shiva Ltd., because one of the partner Mr. Hanuman is holding equity shares of its subsidiary.

Case Study – 5

'B' owes Rs. 5,01,000 to 'C' Ltd., of which he is an auditor. Is his appointment valid? Will it make any difference, if the advance is taken for meeting-out travelling expenses?

Answer

Indebtedness to the Company: As per Section 141(3)(d)(ii) of the Companies Act, 2013, a person who, or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company, or a subsidiary of its holding company, for an amount exceeding Rs. 5,00,000/- then he is not qualified for appointment as an auditor of a company. Accordingly, B's appointment is not valid, and he is disqualified as the amount of debt exceeds Rs. 5,00,000. Even if the advance was taken for meeting out travelling expenses particularly before commencement of audit work, his

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appointment is not valid because in such a case also the auditor shall be indebted to the company. The auditor is entitled to recover fees on a progressive basis only.

Case Study – 6

Mr. Fat, auditor of Thin Ltd., has his office and residence in the building owned by Thin Ltd. Mr. Fat has been given 10% concession in rent by the company as compared to other tenants.

Answer

As per SA 200, "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with standards on auditing", In the case of an audit engagement it is in the public interest and, therefore, required by the Code of Ethics, that the auditor be independent of the entity subject to the audit. The Code describes independence as comprising both independence of mind and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

In the instant case, Mr. Fat has his office and residence in the building owned by Thin Ltd. who are subject to audit by Mr. Fat. Giving 10% concession in rent may be due to some other reasons other than holding auditor ship of Thin Ltd. It may be due to being very old tenant or due to office and residence in the same building or Mr. Fat might have carried out major renovation and so on. Thus, in the instant case unless and until there is direct proof, giving 10% concession in rent does not affect independence of the auditor in expressing his opinion on the audit of Thin Ltd.

Appoinment of auditors (Under Section139(1) of the Companies Act, 2013)

1. 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.
2. Competent authority for appointment are –
   a. If constitution of Audit Committee is needed for company, then Audit Committee;
   b. Else, Board of Directors.
3. The Competent Authority, if Audit Committee, shall recommend auditor to the Board for consideration.
   a. If the Board doesn't agree with the recommendation--- it shall refer back to Audit Committee for reconsideration, with reasons.
   b. If the Board agrees with the recommendation--- it shall recommend appointment of such auditors to members in AGM.
4. In case of disagreement between the Audit Committee and the Board of Directors

a. If the Audit Committee agrees with the Board's reasons for reconsideration, then it shall place the Board's recommendation before members in AGM.
b. If the Audit Committee disagrees with the Board's reason for reconsideration, the Board shall record reasons for disagreement and send this fact to the members for their consideration in AGM.

5. Prior to the appointment, a certificate shall be obtained from the Auditor stating that the
   a. Auditor **is qualified** for appointment;
   b. Auditor **is not disqualified** for appointment;
   c. Proposed appointment is as per the Act, and **within the limits** prescribed.
   d. **Disclosure of any cases of professional misconduct** pending against the proposed auditor or his firm, or his partner.
6. **Form ADT-1** shall be filed with the ROC **by the company**, within 15 days of meeting in which the auditor is appointed or re-appointed. Also, the concerned auditor shall be informed.
7. **Ratification of appointment**: the appointment shall be subject to ratification **in every AGM** till the 6th meeting by way of passing of **an ordinary resolution.**

If not ratified, the Board of Directors shall appoint another individual or firm as its auditor or auditors after following the procedure laid down in this behalf under the Act.

Term of Auditor

Applicability of section 139(2): "Rotation of Auditors" is applicable to the following "class of companies"

Category	**Rotation Applicable u/s 139 (2)**
Listed Companies	Yes
Unlisted Public Companies	PUC >= Rs. 10 Crores
Private Companies	PUC >= Rs. 50 Crores
Unlisted/Private Companies	Public Deposits + Borrowings >= Rs. 50 Crores

Term of Auditors:

Individual Auditor	Term: One term of 5 years	Cooling period: 5 years
Audit firm	Term: Two terms of 5 years	Cooling period: 5 years

Firms with common partners – If firm that has just completed its term and proposed firm has common partners, then such proposed firm would be ineligible to be appointed as auditors.
Example –

- *M/s Krishna & Associates is an audit firm having 2 partners namely Mr. Krishna and Mr. Shyam. Mr. Shyam is also a partner of another audit firm named M/s Kukreja & Associates.*
- *M/s Krishna & Associates was appointed as the auditors in the company Golden Smith Ltd. for two consecutive periods i.e. from year 2014 to year 2024.*
- *Now, if Golden Smith Ltd. wants to appoint Ms Kukreja & Associates as its audit firm, it can not do so because Mr. Shyam was the common partner between both the Audit firms.*
- *This prohibition is only for 5 years i.e. upto year 2029. After 5 years Golden Smith Ltd. may appoint M/s Kukreja & Associates as its auditors.*

Transitional Provisions –

1. Transition period for Companies existing on or before commencement of the Act is 3 years from the date of commencement of this Act.
2. Period for which office as auditor is held prior to commencement of this act should also be considered for rotation and cooling period.
3. The incoming auditor or audit firm should not be in same network of audit firms as the outgoing auditor; i.e, firms operating or functioning under the same brand name, trade name or common control.

If a signing partner resigns from the firm which is appointed as auditor of a company and joins another firm, then such other firm is ineligible for appointment as auditor for 5 yrs i.e cooling period rule applies.

Illustration explaining rotation of an individual auditor

Number of consecutive years for which an individual auditor has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which he may be appointed in the same company (including transitional period)	Aggregate period which the auditor would complete in the same company in view of column I and II

I	II	III
5 Years (or more than 5 years)	3 years	8 years or more
4 years	3 years	7 years
3 years	3 years	6 years
2 years	3 years	5 years
1 year	4 years	5 years

Illustration explaining rotation of an audit firm

Number of consecutive years for which an audit firm has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which the firm may be appointed in the same company (including transitional period)	Aggregate period which the firm would complete in the same company in view of column I and II
I	II	III
10 Years (or more than 1 0 years)	3 years	13 years or more
9 years	3 years	12 years
8 years	3 years	11 years
7 years	3 years	10 years
6 year	4 years	10 years

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5 years	5 years	10 years
4 years	6 years	10 years
3 year	7 years	10 years
2 years	8 years	10 years
1 years	9 years	10 years

Case Study – 7

No Annual General Meeting (AGM) was held for the year ended 31st March, 2014, in XYZ Ltd., Ninu is the auditor for the previous 3 years, whether she is continuing to hold office for current year or not.

Answer

Tenure of Appointment: Section139(1) of the Companies Act, 2013 provides that 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. But in this regard, it is to be noted that the company shall place the matter relating to such appointment of ratification by member at every Annual General Meeting.

In case the annual general meeting is not held within the period prescribed, the auditor will continue in office till the annual general meeting is actually held and concluded. Therefore, Ninu shall continue to hold office till the conclusion of the annual general meeting.

Resolution by members

- Members may resolve to rotate partners of appointed audit firm at intervals

OR

- The audit shall be conducted by more than one auditor.

This resolution is optional.

Joint Auditors' reappointment

2 or more firms / individuals are to be appointed in such a way that both or all the joint auditors do not complete their term in the same year.

Appointment of First Auditor for other than a Government Company

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The first auditor of a company, other than a Government Company, shall be appointed by:

- **Board of Directors SHALL ⟶ within 30 days of registration of company**

OR

- **Members MAY ⟶ within 90 days, at Extraordinary General Meeting**

TERM: Till the conclusion of the **first annual general meeting**

Appointment of First Auditor in case of a Government Company

- **By Comptroller& Auditor General ⟶ within 60 days of registration of company**
  - **OR**
- **By Board of Directors ⟶ within the NEXT 30 days**
  - **OR**
- **Members shall appoint ⟶ within next 60 days at EGM**

TERM: Till the conclusion of the **first annual general meeting.**

Case Study – 8

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

The first auditors of Health and Wealth Ltd., a Government company, was appointed by the Board of Directors.

Answer

Appointment of the First Auditor by the Board of Directors: Section 139(6) of the Companies Act, 2013 (the Act) lays down that "the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company".

Thus, the first auditor of a company can be appointed by the Board of Directors within 30 days from the date of registration of the company.

However, in the case of a Government Company, the appointment of first auditor is governed by the provisions of Section 139(7) of the Companies Act, 2013. Hence in the case of M/s Health and Wealth Ltd., being a government company, the first auditors shall be appointed by the Comptroller and Auditor General of India.

Thus, the appointment of first auditors made by the Board of Directors of M/s Health and Wealth Ltd., is null and void.

Case Study – 9

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Managing Director of PQR Ltd. himself wants to appoint Shri Ganpati, a practicing Chartered Accountant, as first auditor of the company. Comment on the proposed action of the Managing Director.

Answer

Appointment of First Auditor of Company: Section 139(6) of the Companies Act, 2013 (the Act) lays down that "the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company".

In the instant case, the appointment of Shri Ganapati, a practicing Chartered Accountant as first auditors by the Managing Director of PQR Ltd by himself is in violation of Section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor first auditor of the company within one month of registration of the company.

In view of the above, the Managing Director of PQR Ltd should be advised not to appoint the first auditor of the company.

Appointment of Auditor (other than first auditor) in case of a Government Company (U/S 139(5))

C &AG SHALL appoint within 180 days from COMMENCEMENT of financial year 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,**

TERM: Till the conclusion of the annual general meeting.

Case Study – 10

Nickson Ltd. is a subsidiary of Ajanta Ltd., whose 20% shares have been held by Central Government, 25% by Uttar Pradesh Government and 10% by Madhya Pradesh Government. Nickson Ltd. appointed Mr. P as statutory auditor for the year.

Answer

According to Section 139 (7) of the Companies Act, 2013, a Government company is defined "as any 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 of a Government Company as thus defined". The auditors of a government company shall be appointed or re- appointed by the Comptroller and Auditor General of India.

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In the given case Ajanta Ltd is a government company as its 20% shares have been held by Central Govt, 25% by U.P. State Government and 10% by M.P. State Govt. Total 55% shares have been held by Central and State governments. Therefore, it is a Government company.

Nickson Ltd. is a subsidiary company of Ajanta Ltd. Hence Nickson Ltd. Is covered in the definition of a government company. Hence the Auditor of Nicksons Ltd. can be appointed only by C & AG.

Therefore, appointment of 'P' is invalid, and 'P' should not give acceptance to the Directors of Nicksons Ltd.

Filling of a casual vacancy (Under section 139(8))

- **BOD MAY fill casual vacancy in office of Auditor → within 30 days of vacancy (reasons OTHER than resignation)**
- **Vacancy as a result of RESIGNATION → Appointment shall also be approved in General Meeting convened within 3 months of Board's recommendation**
- **Casual Vacancy for C&AG appointed auditors → within 30 days BY C&AG**
  - **OR**

    → Within next 30 days BY BOD

Scenario	**Who?**	**When?**
Casual Vacancy **(Except Resignation)**	Board of Directors	Within 30 days
Resignation	Recommended by Board & Approved by shareholders in General Meeting	Within 3 months of Board Recommendation
Casual Vacancy for C&AG appointed Auditors	C&AG or Board of Directors	Within 30 days

<u>TERM OF CASUAL VACANCY AUDITOR</u>: Until the conclusion of the next annual general meeting.

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Resignation by Auditor

- If the Auditor has resigned from the company, he shall file within a period of 30 days from the date of resignation, a statement in Form ADT 3.
    - In case of government companies, the auditor shall file such statement
        - with the Comptroller and Auditor-General of India
        - Company and
        - ROC.
    - In other cases,
        - with the company and
        - ROC
- The auditor shall indicate the reasons and other facts as may be relevant with regard to his resignation, in the statement.

Penalty on non-compliance shall not be less than Rs 50,000 but which may extend to Rs 5 Lacs.

Case Study – 11

'At the AGM of ICI Ltd., Mr. X was appointed as the statutory auditor. He, however, resigned after 3 months since he wanted to give up practice and join industry. State, how the new auditor will be appointed by ICI Ltd and the conditions to be complied for.

Answer

Appointment of New Auditor in case of Resignation: Section 139(8) of the Companies Act, 2013 deal with provisions relating to appointment of auditor caused due to casual vacancy. A casual vacancy normally arises when an auditor ceases to act as such after he has been validly appointed, e.g., death, disqualification, resignation, etc. In the instance case, Mr. X has been validly appointed and thereafter he had resigned.

The law provides that in case a casual vacancy has been created by the resignation of the auditor (as in this case), the Board cannot fill in that vacancy itself, such appointment shall also be approved by the company at general meeting convened within three months of the recommendation of the board and then he shall hold office till the conclusion of the next annual general meeting.

In this case the casual vacancy has been created on account of resignation. Therefore, Board of Directors will have to fill the vacancy within thirty days and such appointment shall be approved by the company at the general meeting within three months of the recommendations of the board.

The new auditor so appointed shall hold office only till the conclusion of the next annual general meeting.

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The provisions of the Companies Act, 2013 applicable for the appointment of an auditor in place of a retiring auditor would equally applicable in the instant case are given below:

i. *Section 140(4)(i): Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor.*
ii. *Section 115: Special notice is to be given by such number of members holding not less than one percent of total voting power or holding shares on which such an aggregate sum of not exceeding five lakh rupees has been paid upto the date of the notice. The notice shall be sent by the members to the company at least seven days before the date of the meeting*
iii. *Section 140(4)(ii): On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.*
iv. *Section 140(4)(iii): Representation if any, received from the retiring auditor should be sent to the members of the company.*
v. *Section 139: Before any appointment or reappointment of auditors is made at an annual general meeting, a written certificate is to be obtained from the auditor proposed to be appointed that his appointment will be in accordance with the limits specified in Section 141(3)(g).*
vi. *The incoming auditor should also satisfy himself that the notice provided for under Sections 139 and 140 has been effectively served on the outgoing auditor.*

Case Study – 12

M/s Young & Co., a Chartered Accountant firm, and Statutory Auditors of Old Ltd., is dissolved on 1.4.2014 due to differences of opinion among the partners. The Board of Directors of Old Ltd. in its meeting on 6.4.2014 appointed another firm M/s Sharp & Co. as their new auditors for one year.

Answer

a) *Section 139(8) of the Companies Act, 2013 lays down that the Board of Directors may fill any casual vacancy in the office of an auditor provided that where such vacancy is caused by the resignation of an auditor, the vacancy shall be filled in general meeting.*
The expression "casual vacancy" has not been defined in that Act. Talking its natural meaning it may arise due to a variety of reasons which include death, resignation, disqualification, dissolution of the firm etc. Furthermore Section 139(8) stipulates that any auditor appointed in a casual vacancy shall hold office until the conclusion of the next AGM.
In the instant case the action of the board of directors in appointing M/s Sharp & Co. to fill up the casual vacancy due to dissolution of M/s Young & Co., is correct. However, the board of directors are not correct in giving them appointment for one year. M/s Sharp & Co. can hold office until the conclusion of next AGM only.

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Reappointment of retiring Auditor

1. At any annual general meeting, a retiring auditor may be re-appointed at an AGM, if—
   - he is not disqualified for re-appointment;
   - he has not given the company a notice in writing of his unwillingness to be re-appointed; and
   - a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.
2. 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.
3. **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.**

Constitution of Audit Committee (Sec 177)In addition to listed companies, following classes of companies shall constitute an Audit Committee -

a. **Public companies with a paid-up capital >= Rs.10 Cr**
b. **Public companies having turnover >= Rs.100 Cr**
c. **Public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits > Rs. 50 Cr**

Case Study – 13

Under what circumstances the retiring Auditor cannot be reappointed?

Answer

In the following circumstances, the retiring auditor cannot be reappointed:

1. A specific resolution has not been passed to reappoint the retiring auditor.
2. The auditor proposed to be reappointed does not possess the qualification prescribed under section 141 of the Companies Act, 2013.
3. The proposed auditor suffers from the disqualifications under section 141(3), 141(4) and 144 of the Companies Act, 2013.
4. He has given to the company notice in writing of his unwillingness to be reappointed.
5. A resolution has been passed in AGM appointing somebody else or providing expressly that the retiring auditor shall not be reappointed.
6. A written certificate has not been obtained from the proposed auditor to the effect that the appointment or reappointment, if made, will be in accordance within the limits specified under section 141(3)(g) of the Companies Act, 2013.

Removal of Auditor before expiry of term

- The auditor may be removed from his office before the expiry of his term by
  - a **special resolution of the company**, and

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- After obtaining the **previous approval of the Central Government** (fee paid application form ADT 2)

- The application shall be made to the Central Government **within 30 days of the resolution passed by the Board**.
- The Company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.
- The auditor shall have an opportunity of being heard.

Case Study – 14

Why is Central Government permission required, when the auditors are to be removed before expiry of their term, but the same is not needed when the auditors are changed after expiry of their term?

Answer

Permission of Central Government for removal of auditor under section 140(1) of the Companies Act, 2013: Removal of auditor before expiry of his term i.e. before he has submitted his report is a serious matter and may adversely affect his independence. Further, in case of conflict of interest the shareholders may remove the auditors in their own interest. Therefore, law has provided this safeguard so that central government may know the reasons for such an action and if not satisfied, may not accord approval.

On the other hand, if auditor has completed his term i.e. has submitted his report and thereafter, he is not re-appointed then the matter is not serious enough for central government to call for its intervention. In view of the above, the permission of the Central Government is required when auditors are removed before expiry of their term and the same is not needed when they are not re-appointed after expiry of their term.

Appointment of Auditor other than the retiring Auditor

- *If the retiring auditor has not completed a consecutive tenure of 5 years or 10 years, as the case may be, **special notice** shall be required for*
  - *a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or*
  - *Providing expressly that a retiring auditor shall not be re-appointed.*
- *On receipt of notice of such a resolution, the company shall send a copy thereof to the retiring auditor.*
- *Outgoing auditor has the right to give representation, —*
  - *in the notice of resolution given to members, stating fact that representation has been made*
  - *send a copy of the representation to every member of the company to whom notice of the meeting is sent*

*If a copy of the representation is **not sent** as aforesaid, it shall be read out at the meeting, and a copy shall be filed with Registrar*

Auditor's remuneration

- The remuneration of the auditors of a company shall be fixed by the company in

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general meeting or in such manner as the company in general meeting may determine.

- In the case of first auditor, remuneration may be fixed by the Board.
- The remuneration shall include the fee payable, expenses incurred in connection with the audit and any facility extended to him, but not remuneration paid to him for any other service rendered at the request of the company.

Ceiling on number of Audits

- The number of audits held at any point of time shouldn't exceed 20.
- In the case of a firm of auditors, the ceiling limit of 20 shall be applicable **for every partner** of the firm who is not in full time employment elsewhere. This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be 3 × 20 = 60 company audits.
- Where a chartered accountant is a partner in a number of auditing firms, all the firms in which he is partner or proprietor **will be together entitled to 20 company audits** on his account.

Powers of Auditors

1. Right of access to books of accounts and vouchers.
2. Right to obtain information and explanation from officers.
3. Right to receive notices and to attend general meeting.
4. Right to report to the members of the company on the accounts examined by him.
5. Auditor can exercise lien on books and documents placed at his possession by the client for non-payment of fees, for work done on the books and documents.
6. The auditor shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.

Case Study – 15

Give your comments and observations on the following:

a) KBC & Co. a firm of Chartered Accountants has three partners, K, B & C; K is also in whole time employment elsewhere. The firm is offered the audit of ABC Ltd. and is already holding audit of 40 companies.

b) At an Annual General Meeting of a listed company, Mr. R a retiring auditor after completing the tenure of five consecutive years of his service claims that he has been reappointed automatically, as the intended resolution of which a notice had been given to appoint Mr. P, could not be proceeded with, due to Mr. P's death.

Answer

a) Ceiling on Number of Company Audits: As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if

- *he is in full time employment elsewhere.*
- *if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies.*

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In the firm of KBC & Co., K is in whole-time employment elsewhere, therefore, he will be excluded in determining the number of company audits that the firm can hold. If B and C do not hold any audits in their personal capacity or as partners of other firms, the total number of company audits that can be accepted by KBC & Co., is forty, and in the given case company is already holding forty audits, therefore, KBC & Co. can't accept the offer for audit of ABC Ltd.

b) *Term of Auditor: Section 139(2) of the Companies Act, 2013 deals with the term of an Auditor which provides that listed companies and other prescribed class or classes of companies (except one person companies and small companies) shall not appoint or reappoint an individual as auditor for more than one term of five consecutive years.*

In the given case, notice has been given of an intended resolution to appoint some person or persons in the place of a retiring auditor, and by reason of the death, incapacity or disqualification of that person or of all those persons, as the case may be, the resolution cannot be proceeded with and consequently casual vacancy in the office has been created."

Therefore, as per Section 139(8) of the Companies Act, 2013, casual vacancy to be filled by the Board of Directors within thirty days. Thus, the claim of Mr. R would not hold good.

Case Study – 16

PBS & Associates, a firm of Chartered Accountants, has three partners P, B and S. The firm is already having audit of 45 companies. The firm is offered 20 company audits. Decide and advise whether PBS & Associates will exceed the ceiling prescribed under Section 141(3)(g) of the Companies Act, 2013 by accepting the above audit assignments?

Answer

Ceiling on number of audits: Before appointment is given to any auditor, the company must obtain a certificate from him to the effect that the appointment, if made, will not result in an excess holding of company audit by the auditor concerned over the limit laid down in section 141(3)(g) of the Act which prescribes that 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 person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies.

In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.

If Mr. P, B and S do not hold any audits in their personal capacity or as partners of other firms, the total number of company audits that can be accepted by M/s PBS & Associates is 60. But the firm is already having audit of 45 companies. So the firm an

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accept the audit of 15 companies only, which is well within the limit, specified by Section 141(3)(g) of the Companies Act, 2013.

Case Study – 17

What will be position of the Auditor in the following cases:

A, a chartered accountant has been appointed as auditor of Laxman Ltd. In the Annual General Meeting of the company held in September 2013, which assignment he accepted. Subsequently in January 2014 he joined B, another chartered accountant, who is the Manager Finance of Laxman Ltd., as partner.

Answer:
Disqualifications of an Auditor: Section 141(3)(c) of the Companies Act, 2013 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company.

Sub-section (4) of Section 141 provides that an auditor who incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor.

In the present case, A, an auditor of M/s Laxman Ltd., joined as partner with B, who is Manager Finance of M/s Laxman Limited, has attracted clause (3) (c) of Section 141 and, therefore, he shall be deemed to have vacated office of the auditor of M/s Laxman Limited.

Case Study – 18

Y, is the auditor of X Pvt. Ltd. In which there are four shareholders only, who are also the Directors of the company. On account of bad trade and for reducing the expenses in all directions, the directors asked Y to accept a reduced fee and for that he has been offered not to carry out such full audit as he has done in the past. Y accepted the suggestions of the directors.

Answer
Restricting Scope of Audit: Y may agree to temporary reduction in audit fees, if he so wishes, in view of the suggestions made by the directors (perhaps in accordance with the decision of the company taken in general meeting). But his duties as a company auditor are laid down by law and no restriction of any kind can restrict the scope of his work either by the director or even by the entire body shareholders.

There is no concept of full or part audit under Section 143 of the Companies Act, 2013. Further, remuneration is a matter of arrangement between the auditor and the shareholders.

Section 142 specifies the remuneration of an auditor, shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

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His duties may not necessarily commensurate with his remuneration. Y,therefore, should not accept the suggestions of the directors regarding the scope of the work to be done.

Even if Y accepts the suggestions of the directors regarding the scope of work to be done, it would not reduce his responsibility as an auditor under the law. Under the circumstances, Y is violating the provisions of the Companies Act, 2013.

Case Study – 19

While conducting the audit of a limited company for the year ended 31st March, 2014, the auditor wanted to refer to the Minute Books. The Board of Directors refused to show the Minute Books to the auditor.

Answer

Right of Access to Minute Books: Section 143 of the Companies Act, 2013 grants powers to the auditor that every auditor has a right of access, at all times, to the books and account including all statutory records such as minute books, fixed assets register, etc. of the company for conducting the audit.

In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company.

It is, therefore, essential for the auditor to refer to the Minute Books. In the absence of the Minute Books, the auditor may not be able to vouch/verify certain transactions of the company.

In case the directors have refused to produce the Minute Books, the auditor may consider extending the audit procedure as also consider qualifying his report in any appropriate manner.

Case Study – 20

Mr. Budha, Statutory Auditors of Secret Ltd. was not permitted by the Board of Directors to attend general meeting of the company on the ground that his right to attend general meetings is restricted only to those meetings at which the accounts audited by him are to be presented and discussed.

Answer

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According to Section 146 of the Companies Act, 2013 the auditors of a company are under an obligation to attend any general meeting of the company and not only those meetings at which the accounts audited by them are to be presented and discussed.

In the instant case, the board of directors of Secret Ltd., have no right to restrict Mr. Buddha from attending the general meeting and Mr. Buddha has every right to attend such meeting as conferred by Section 146.

Thus, the action of the board of directors is contrary to the provisions of law and curtails the right of the auditor.

Case Study – 21

At the Annual General Meeting of the Company, a resolution was passed by the entire body of shareholders restricting some of the powers of the Statutory Auditors. Whether powers of the Statutory Auditors can be restricted?

Answer

Restrictions on Powers of Statutory Auditors: Section 143 of the Companies Act, 2013 provides that an auditor of a company shall have right of access at all times to the books and accounts and vouchers of the company whether kept at the Head Office or other places and shall be entitled to require from the offices of the company such information and explanations as the auditor may think necessary for the purpose of his audit.

These specific rights have been conferred by the statute on the auditor to enable him to carry out his duties and responsibilities prescribed under the Act, which cannot be restricted or abridged in any manner. Hence, any such resolution even if passed by entire body of shareholders is ultra vires and therefore void.

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Duties of auditor

Duty to Report: As per sub section 3 of section 143 of the Companies Act, 2013, the auditor's report shall also state –

a) whether he has sought and **obtained all the information and explanations** which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
b) whether, in his opinion, **proper books of account** as required by law have been kept by the company
c) **returns** adequate for the purposes of his audit have been received from branches not visited by him, for branches audited by persons other than him;
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 u/s 164(2);
h) any qualification, reservation or adverse remark relating to the **maintenance of accounts** and other related matters;
i) whether the company has adequate **internal financial controls system** in place and the operating effectiveness of such controls;
j) such other matters as may be prescribed.

Section 146 requires auditor to attend AGM either in person or through representative unless exempted by the Company.

LATEST ADDITION: Further, Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes that the auditor's report shall also include views and comments on the following matters, namely: -

- whether the company has disclosed the impact, if any, of **pending litigations** on its financial position in its financial statement;
- 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;
- whether there has been any delay in transferring amounts, required to be transferred, to the **Investor Education and Protection Fund** by the company.

LATEST ADDITION: **Duty to report fraud** – Report to Central Government in sealed cover with RPAD in form ADT 4 within 60 days of his knowledge of fraud after following this procedure

a. Send a report in this regard to BOD / AC and seek reply <=45 days
b. Upon receipt of such reply, send report of auditor along with replies to CG <=15 days of receipt of reply
c. If no reply is received in 45 days' time, send a report to CG indicating this fact.
d. Penalty for failure to follow this procedure is >=1L, <=25L

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2. Duty to report on any other matter specified by Central Government.
3. Duty to state the reason for qualification or negative report.
4. Duties and powers in relation to Brach audit and the Branch Auditor.
5. The auditor shall attend the AGM either by himself or through his authorized representative. Thus, **it is compulsory for him to attend the meeting unless otherwise exempted by the company.**

Case Study – 22

Give your comments on the following:

Mr. X, a Director of M/s KP Private Ltd., is also a Director of another company viz., M/s GP Private Ltd., which has not filed the financial statements and annual return for last three years 2010-11 to 2012-13. Mr. X is of the opinion that he is not disqualified u/s 164(2) of the Companies Act, 2013, and auditor should not mention disqualification remark in his audit report.

Answer

a) *Disqualification of a Director under section 164(2) of the Companies Act, 2013:*

Section 143(3)(g) of the Companies Act, 2013 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as director under section 164(2) of the Companies Act, 2013.

As per provisions of Section 164(2), if a director is already holding a directorship of a company which has not filed the financial statements or annual returns for any continuous period of three financial years shall not be eligible to be reappointed as a director of that company or appointed in other company for a period of five years from the date on which the said company fails to do so.

In this case, Mr X is a director of M/s KP Private Ltd. as well as of M/s GP Private Ltd., And, M/s GP Private Ltd., has not filed the financial statements and annual return for last three years. Hence the provisions of section 164(2) are applicable to him and as such he is disqualified from directorship of both the companies.

Therefore, the auditor shall report about the disqualification under section 143(3)(g) of the Companies Act, 2013.

Case Study – 23

An auditor became aware of a matter regarding a company, only after he had issued his audit opinion. Had he become aware of the same prior to his issuing the audit report, he would have issued a different opinion.

Answer

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Section 146 of the Companies Act, 2013 empowers the auditors of a company to attend any general meeting of the company; to receive all the notices and other communications relating to the general meeting, unless otherwise exempted by the company, and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors.

Where the auditor has reason to believe that the directors concealed deliberately a serious fact from the shareholders which came to his note after issuance of the audit report, he should exercise this right. Normally speaking, an auditor considers subsequent events only up to the date of issuance of the audit report.
The discovery of a fact after issuance of the financial statements that existed at the date of the audit report which would have caused the revision of the audit report, requires the auditor to bring this to the notice of shareholders.

Likewise, it may be advisable for the auditor to attend the meeting with a view to bringing to the notice of the shareholders any matter which came to his knowledge subsequent to his signing the report and if it had been known to him at the time of writing his audit report, he would have drawn up the report differently; or where the accounts have been altered after the report was attached to the accounts.

Case Study – 24

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

a) *The auditor of Trilok Ltd. did not report on the matters specified in sub-section (1) of Section 143 of the Companies Act, 2013, as he was satisfied that no comment is required.*
b) *The members of C. Ltd. preferred a complaint against the auditor stating that he has failed to send the auditor's report to them.*

Answer

a) *Comment on Matters Contained under Section 143(1) of the Companies Act, 2013: Section 143(1) of the Act deals with duties of an auditors requiring auditor to make an enquiry in respect of specified matters.*

   The matters in respect of which the enquiry has to be made by the auditor include relating to loans and advances, transactions represented merely by book entries, investments sold at less than cost price, loans and advances shown as deposits, etc.

   Since the law requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein.

   If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. Therefore, the auditor of Trilok Ltd. is correct in non-reporting on the matters specified in Section 143(1).

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b) *Dispatch of Auditor's Report to Shareholders: Section 143 of the Companies Act, 2013 lays down the powers and duties of auditor. As per provisions of the law, it is no part of the auditor's duty to send a copy of his report to members of the company.*

The auditor's duty concludes once he forwards his report to the company. It is the responsibility of company to send the report to every member of the company. In Re Allen Graig and Company (London) Ltd., 1934 it was held that duty of the auditor after having signed the report to be annexed to a balance sheet is confirmed only to forwarding his report to the secretary of the company. It will be for the secretary or the director to convene a general meeting and send the balance sheet and report to the members (or other person) entitled to receive it. Hence in the given case, the auditor cannot be held liable for the failure to send the report to the shareholders.

Case Study – 25

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

a) A Ltd. has its Registered Office at New Delhi. During the current accounting year, it has shifted its Corporate Head Office to Indore though it has retained the Registered Office at New Delhi. The Managing Director of the Company wants to shift its books of account to Indore from New Delhi, as he feels that there is no legal bar in doing so.

b) The Board of Directors of a company have filed a complaint with the Institute of Chartered Accountants of India against their statutory auditors for their failure to attend the Annual General Meeting of the Shareholders in which audited accounts were considered.

Answer

a) Shifting of Books of Account: As per section 128(1) of The Companies Act 2013, every company shall keep at its registered office proper books of accounts. It is permissible, however, for all or any of the books of accounts to be kept at such place in India as the Board of Directors may decide but, when a decision in this regard is taken, the company must file within seven days of such decision with the Registrar of Companies a notice in writing giving full address of the other place.

Conclusion: In view of the above provisions, A Ltd should maintain its books of account at its registered office at New Delhi. The Managing Director is not allowed to shift its books of account to Indore unless decision in this behalf is taken by the Board of Directors and a notice is also given to the Registrar of Companies within the specified time. The auditor may, accordingly, inform the Managing Director that his contention is not in accordance with the legal provisions.

b) Auditor's Attendance at Annual General Meeting: Section 146 of the Companies Act, 2013 confers right on the auditor to attend the general meeting.

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The said section provides that all notices and other communications relating to any general meeting of a company also to be forwarded to the auditor. Further, it has been provided that the auditor shall, unless otherwise exempted, entitled attend any general meeting and has the right to be heard at such general meeting which he attends on any part of the business which concerns him as an auditor.

Therefore, the section casts a duty on the auditor to attend the annual general meeting. Therefore, the complaint filed by the Board of Directors is valid.

Case Study – 26

M/s XYZ & Co., auditors of Goodwill Education Foundation, a recognized nonprofit organisation feels that the standards on auditing need not to be applied as Goodwill Education Foundation is a non-profit making concern.

Answer

a) *Compliance with Standards on Auditing: As per sub section 9 of section 143 of the Companies Act, 2013, every auditor shall comply with the auditing standards. Further as per sub section 10 of section 143 of the Act, the Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority:*

b) *Provided that until any auditing standards are notified, any standard, or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.*

c) *Further, the Preface to Standards on Auditing gives the scope of the Standards on Auditing. As per the Preface, the SAs will apply whenever an independent audit is carried out; that is, in the independent examination of financial statements/information of any entity; whether profit oriented or not and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion thereon.*

d) *Also, while discharging their attest function; it is the duty of the Chartered Accountant to ensure that SAs are followed in the audit of financial information covered by their audit reports.*

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e) *In the given case, even though the client is a non-profit oriented entity the SAs shall apply and the auditor shall be guilty of professional misconduct for failing to discharge his duty in case of non-compliance with SAs.*

Prohibited Services for auditors

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. But such services shall not include any of the following services (whether such services are rendered *directly or indirectly* to the company or its holding company or subsidiary company), namely

a. Accounting and bookkeeping 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 [this excludes services permitted by ICAI as per professional ethics]; and
i. Any other kind of services as may be prescribed [E.g. Prohibited services by CA in practice as per ICAI like Portfolio management, Underwriting and Stock broking are under this category]

Note – If an auditor or audit firm who or which has been performing any non-audit services on or before the commencement of the Companies Act, 2013, shall comply with the provisions of this section (i.e. section 144) before the closure of the first financial year after the date of such commencement

Case Study – 27

Give your comments on the following:

a) Mr. Aditya, a practicing-chartered accountant is appointed as a "Tax Consultant" of ABC Ltd., in which his father Mr. Singhvi is the Managing Director.

b) You, the Auditor of A Ltd., have been considered for ratification by the members in the 4th general meeting as the sole auditor, where you were one of the joint auditors for the immediately preceding three years and the said joint auditors are not re-appointed.

Answer

a) Appointment of a Practicing CA as 'Tax Consultant': A chartered accountant appointed as an auditor of a company, should ensure the independence in respect of his appointment as an auditor, else it would amount to "misconduct" under the Chartered Accountants Act, 1949 read with Guidance Note on Independence of Auditors.
In this case, Mr. Aditya is a "Tax Consultant" and not a "Statutory Auditor" or "Tax Auditor" of ABC Ltd., hence he is not subject to the above requirements.

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b) *Appointment of Sole Auditor: When one of the joint auditors of the previous years is considered for ratification by the members as the sole auditor for the next year, it is similar to non-re-appointment of one of the retiring joint auditors.*

As per sub- section 4 of section 140 of the Companies Act, 2013, special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or, as the case may be, ten years, as provided under sub-section (2) of section 139 of the said Act. Accordingly, provisions of the Companies Act, 2013 to be complied with are as under:

1. *Ascertain that special notice u/s 140(2) of the Companies Act, 2013 was received by the company from such number of members holding not less than one percent of total voting power or holding shares on which an aggregate sum of not less than five lakh rupees has been paid up on the date of the notice not earlier than three months but at least 14 days before the AGM date as per Section 115 of the Companies Act, 2013 read with rule 23(1) and 23(2)of the Companies (Management and Administration) Rules, 2014*
2. *Check whether the said notice has been sent to all the members at least 7 days before the date of the AGM as per Section 115 of the Companies Act, 2013 read with rule 23(3) of the Companies (Management and Administration) Rules, 2014.*
3. *Verify the notice contains an express intention of a member for proposing the resolution for appointing a sole auditor in place of both the joint auditors who retire at the meeting but are eligible for re-appointment.*
4. *The notice is also sent to the retiring auditor as per Section 140(4)(ii) of the Companies Act, 2013.*
5. *Verify whether any representation, received from the retiring auditor was sent to the members of the company.*
6. *Verify from the minutes book whether the representation received from the retiring joint auditor was considered at the AGM*

COMPANIES (AUDITOR'S REPORT) ORDER, 2016

✓ **Applicability of the CARO – 2016**

Every report made by the auditor under section 143 of the 2013 Act for financial year commencing on or after 1 April 2014 should include CARO – 2015.

✓ **Companies covered under the CARO – 2015**

Applies to **every company** (except companies that are excluded, see below), including a foreign company as defined under section 2(42) of the 2013 Act i.e. any company or body corporate incorporated outside India which:

- has a place of business in India whether by itself or through an agent, physically or through an electronic mode, and
- conducts any business activity in India in any other manner.

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✓ **COMPANIES EXCLUDED FROM CARO APPLICATION:**

- **Banking company** as defined under section 5(c) of the Banking Regulation Act, 1949
- **Insurance company** as defined under the Insurance Act,1938.
- Companies incorporated with **charitable** objects, etc. i.e. companies licensed to operate under section 8 of 2013 Act
- **Private company (other than holding or subsidiary of a public company)**:
  - with a paid-up capital and reserves not more than Rs. 1 crore
  - does not have outstanding loan exceeding Rs. 1 crore from any bank or financial institution, and
  - does not have a turnover exceeding Rs. 10 crores at any point of time during the financial year
- **One-person company** as defined under section 2(62) of the 2013 Act i.e. a company which has only one person as a member
- **Small company** as defined under section 2(85) of the 2013 Act i.e. a company other than a public company:

Following companies will **not qualify as a small company:**

- a holding or a subsidiary company,
- a company registered under section 8 of 2013 Act, or
- a company or body corporate governed by any special Act

MATTERS TO BE REPORTED IN THE CARO – 2016 (12 CLAUSES)

- When Auditor's response to any of the reporting matters is **UNFAVOURABLE/QUALIFIED**, the auditor should state the reason for such response
- When Auditor is unable to express any opinion in response to a particular question, the audit report should indicate such fact together with the reasons why it was not possible to provide a response to such a question.

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Fixed assets (Para 3(i))	• Whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets? • Whether these fixed assets have been physically verified by the management at reasonable intervals? • Whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account? • whether the title deeds of immovable properties are held in the name of the company?
Inventories (Para 3(ii))	• Whether physical verification of inventory has been conducted at reasonable intervals by the management? • whether any material discrepancies were noticed on physical verification, and if so, whether the same have been properly dealt with in the books of account?
Granting of loans to certain parties (Para 3(iii))	▪ Whether the company has granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 189 of the 2013 Act. If so: • whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest; • whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular; • if the amount is overdue, state the total amount overdue for more than 90 days and whether reasonable steps have been taken by the company for recovery of principal and interest
Loans, investments, guarantees Para 3(iv)	in respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.

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Acceptance of deposits (Para 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 Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? - If not, the nature of such contraventions be stated; - If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?
Maintenance of cost records (Para 3(vi))	Where maintenance of cost records has been specified by the Central Government under section 148(1) of the 2013 Act, whether such accounts and records have been made and maintained?
Deposit of statutory dues (Para 3(vii))	a) Is the company regular in depositing undisputed statutory dues including: – provident fund– income-tax, wealth tax, duty of customs, value added tax, employees' state insurance, sales-tax, service tax, duty of excise, cess and any other statutory due 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 have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned department shall not constitute a dispute.)
Accumulated losses and incurrence of cash losses (Para 3(viii))	Whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than 50 per cent of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year?

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Default in repayment of dues (Para 3(viii))	Whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported.
Application of money raised through public issue (Para 3(ix))	- whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. - If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;
Fraud reporting (Para 3(x))	Whether any fraud on or by the company has been noticed or reported during the year? If yes, the nature and the amount involved is to be indicated.
Managerial Reporting (Para 3(xi))	- whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated by the provisions of section 197 read with Schedule V to the Companies Act, 2013? - If not, state the amount involved and steps taken by the company for securing refund of the same;
Nidhi Company (Para 3(xii))	- whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability and - whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;
Related parties transactions (Para 3(xiii)	- whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 - whether the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards;
Preferential allotment (Para 3(xiv))	- whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and

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	- if yes, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. - In case of non-compliance, provide the details in respect of the amount involved and nature of non-compliance;
Non-Cash Transactions (Para 3(xv))	- whether the company has entered into any non-cash transactions with directors or persons connected with him - and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with;
RBI Registration (Para 3(xvi))	- whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 - and if so, whether the registration has been obtained.

7.4 Miscellaneous Audit

Introduction: - A financial statement audit is the examination of an entity's financial statements which consists of Balance Sheet, Profit & Loss Account, Cash Flow Statement, Notes to account and accompanying disclosures. The purpose of a financial statement audit is to **add credibility** to the reported financial position and performance of a business.

Audit Framework

While performing the audit of financial items, an auditor has to go through certain sort of framework which is as under:-

A) Ledger Account: - While doing the audit of the ledger account there should be clarity as what items should come under particular ledger account.

- **In case of Balance Sheet Items:-**
  - Check the opening balances with the last year audited closing balances.
  - Check whether there are any additions and deletions during the year.

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- **<u>In case of profit and loss items</u>:-**
  - Check the transactions occurring during the period

B) <u>Test of Details</u>: - Under test of details certain Audit assertions needs to be verified which are as follows.

1. **Existence /occurrence**:
   a. Existence is to confirm that the assets were in existence on the date of balance sheet by physical inspection, comparison of assets registers with general ledger balances.
   b. Occurrence is the assertion for all P&L items and additions & deletions to ascertain whether the transactions during the period have actually taken place **{Risk addressed**: **Fictitious entries}.**
   c. Auditor shall ascertain that all the assets and liabilities are actually in existence as on Balance Sheet date.
   d. All the transactions for the period so recorded have actually occurred.
2. **Accuracy:** The basis for invoice preparation is accurate and also the amount of invoice is accurately recorded in the books. **{Risk addressed: Error of Commission}**
3. **Completeness:** In transactions, all related costs/items have been considered. Similarly, all the transactions have been correctly and completely recorded **{ Risk addressed : Error of omission}**
4. **Valuation/ Measurement:** The values at which assets/liabilities are carried in the books on balance sheet date are appropriate i.e. neither overvalued not undervalued. {**Risk addressed: Risk of over/under valuation of balance sheet items.}**
5. **Rights and obligation:**
   a. To ascertain that all the assets as on balance sheet are the rights of the entity. Similarly, all liabilities are the obligations of the entity.
   b. Further, there might be certain obligations attached to rights of the company, which requires suitable disclosure in the financial statements. Ex: Fixed assets offered on charge in connection with secured loan raised**. {Risk addressed : Not being the original owner, claiming to be the owner of any asset/ liability}**
6. **Cut off:**

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a. This assertion is relevant for all P&L items and additions & deletions to assets and liabilities.

b. All the transactions in which risk and reward in the property got transferred to or from the entity during the period, for which financial statements are prepared, shall be accounted in the relevant account period. **{Risk Addressed : Violation of periodicity concept of accountancy}**

7. Presentation and disclosure:

a. Transactions should be recorded in appropriate accounts.

b. Correct accounts should be debited and credited.

c. Applicable accounting standard and regulatory requirements shall be borne in mind while recording transactions.

d. Suitable disclosures shall be made if required.

{Risk addressed: Presentation and disclosure not in accordance with applicable financial reporting framework.}

C) **Test of controls**: - These are the process designed, implemented and maintained to provide reasonable assurance about the achievement of the entity's objectives with regard to:-

- The **reliability** of the entity's financial reporting**;**
- The **effectiveness and efficiency** of its operations;
- Its **compliance** with applicable laws and regulations; and
- **Safeguarding** of assets, and compliance with applicable laws and regulations.

D) **Analytical procedures: -**

- Analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.
- These can help auditor to identify inconsistencies in financial statements.

BALANCE SHEET ITEMS

Audit of Share Capital

Every company's lifecycle starts with raising of capital. The receipt of applications for shares and allotment of shares are two important aspects of every issue of capital as

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these constitute the legal basis of the transactions related to purchase of shares. Therefore, an auditor should be careful while doing the verification process.

Audit procedures while auditing share capital are as follows: -

A) Ledger A/c:-

- Tally the opening balance of share capitals to the previous year audited financial statements.
- Check the additions and deletions to share capital through fresh issue or bonus issue and reduction in the share capital.

B) Test of Compliance with laws & regulations

- Check the provisions of companies Act regarding: -
  - Whether the authorized Capital of the company is as per capital clause of Memorandum of association
  - Verify the terms related to fresh issue mentioned in the prospectus has been complied by the company.
  - Check the compliance of
    - Section 52- in case of shares issued at premium,
    - Section 53 - when the shares are issued at discount,
    - Section 54- in case of Sweat equity shares of the Companies Act.
  - Examine whether the provisions for forfeiture of shares are followed by the company.
  - In case of Reduction of capital verify whether board resolution has been passed along with a special resolution passed in the member meeting. Also verify that the memorandum of association of the company has been suitably **altered**.
- Check the Registrar of companies (RoC) provisions regarding:-
  - Whether form PS 3 & PS 4 is filed with RoC
  - Whether FCGPR form is filed with RBI (**in case of foreign shareholders).**
- Check whether fee for the increase in authorized capital is paid to Registrar of company.

C) Test of Controls: -

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- Check whether the compliance officer has followed appropriate procedures for issuing shares.
- Ascertain that there exists an internal check on receipt of amounts along with the application and that the same throughout has continued to function satisfactorily.

D) Analytical Procedure: -

- Check whether the Stamp duty paid is in accordance to the increase in authorized capital.
- Apply analytical procedures for share premium provisions.

E) Test of Details: - Verify the Following assertions:-

Assertions	Audit Procedures
Existence	• Check the forms filed with Roc, Memorandum of company and bank statements in order to verify the existence of share capital.
Occurrence	• Check the **register of members** for allotment of shares. • Check the prospectus, bank statements, various forms etc.
Accuracy	• Extract balances of shareholder's account contained in the share register and tally their total with the balance in the share capital.
Completeness	• Check whether all the aspects related to **shares issues** have been properly accounted.
Valuation	• Obtain a **written confirmation** from company secretary that there were no changes to entity's capital structure during the year. • In case there is change, obtain the **certified copies** of relevant resolution passed at the board meeting. • Verify whether the **paid-up capital** as at the period- end is within the limits of authorized capital.
Rights & Obligation	• Verify the board resolution for allotment. • Verify the share certificates and resisters of members.

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Presentation & Disclosure	• Ensure where the following disclosure as per schedule III of the companies Act, 2013 are made:- ➢ Whether **Authorized** capital, **Issued** and **subscribed** capital and **unpaid** capital are separately shown. ➢ Whether the unpaid capital it should be shown as Calls in arrears. ➢ Whether Shares issued in consideration **other than cash** are separately disclosed. ➢ Disclosure for shares held in company by the following entities: • Holding company • Ultimate holding company • Subsidiaries of the holding company • Associates of the holding company • Subsidiaries of the ultimate holding company • Associates of the ultimate holding company ➢ Details of each shareholder (name, no of Shares & %) **with more than 5% stake.** **Above disclosure should have been made for a period of five years immediately preceding the balance sheet date.**

Audit of Reserves and Surplus

Reserves are the amount appropriated **out of the profits** that are not intended to meet any liability, contingency, commitment or diminution in the value of asset known to exist as at the date of the balance sheet.

Provision is an amount that you put in aside in your accounts to cover a future liability. It is created as a **charge against the profit** which means it is created irrespective of the sufficiency of the profit. Ex: - Provision for tax, Provision for doubtful debts etc.

Revenue reserve represents profits that are available for distribution to shareholders as dividends.

Capital Reserve represents a reserve which does not include any amount regarded as free for distribution through the statement of profit and loss.

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Share premium: - When a company has issued its shares at **amount in excess of the nominal value of shares** it is called shares **issued at premium**. The company has to transfer the amount received through premium to security premium account. **The company can use this amount only for the purpose specified in section 52 of the Companies Act 2013.**

Capital Redemption Reserve (CRR)

The audit procedures generally accepted to be undertaken while auditing reserve and surplus are as follows: -

A) Ledger A/c:-

- Tally the opening balance of reserves and surplus to the previous year audited financial statements.
- Check for addition/utilization from the current year profit /loss Account and appropriation account if any.

B) Compliance with laws and regulation:-

- Check the **minutes** of the board of directors and ensure that the profits are appropriated as per the decision taken by directors.
- Verify whether the requirements of articles of association regarding the appropriation of profit to general or special reserves are duly followed by the company.
- Check whether the management has complied with the required provisions of Companies Act while utilizing any part of the general reserve for **payment of dividend**.

C) Test of Controls:-

- Check whether the required entries are duly **passed and approved** by competent authority.
- Check whether the **board approval** is taken wherever required.

D) Substantive analytical procedures: - Substantive analytical procedures are applicable in case of only **Capital redemption reserve.** (CRR).

- Check whether CRR is created only under following situations:-
  a) In case of redemption of preference shares the nominal value of the shares to be redeemed is put to capital redemption fund.
  b) When a company buys its own shares.
  c) In case of fresh issue of equity or preference share in order to redeem the old preference share, the difference between the face

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value of preference shares and fresh shares issued will be transferred to CRR.

- Verify that this fund is utilized only for **issuing fully paid bonus shares**. No dividend is distributed out of this fund**.**
- Check the calculation for the amount of CRR.

E) Test of Details: The following assertions needs to be verified

Assertions	**Audit procedures**
Occurrence	• Check whether any additions/ utilization to /from the reserve and surplus have actually occurred.
Completeness	• Verify that the reserve and surplus balances that were supposed to be recorded have been recognized in the financial statements.
Valuation	• Check whether the provisions regarding dividend declaration and share premium have been complied.
Presentation and Disclosure	• Ensure the disclosure requirements under part I of Schedule III to the companies act has been made regarding:- ➢ Opening balances, additions, Deduction & closing balances of the reserves and surplus. ➢ **Reserve and Surplus shall be classified as:** a) Capital Reserves; b) Capital Redemption Reserve; c) Securities Premium Reserve; d) Debenture Redemption Reserve; e) Revaluation Reserve; f) Share Options Outstanding Account; g) Other Reserves – (specify the nature, amount and purpose of each reserve) h) Surplus i.e. balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc. (Additions and deductions

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	since last balance sheet to be shown under each of the specified heads)

Audit for Loans and Long-term Borrowings

Liabilities are the financial obligations of an enterprise other than owner's fund. Liabilities include loans/ borrowings, trade payables and other current liabilities.

Verification of the loans and borrowings will be done as follows: -

A) Ledger A/c:-

- Check the opening balance with the previous year's audited closing balances.
- Check any addition or deletion to Loan (i.e. any loan taken or repaid)

B) **Test of Compliance: -** Under test of compliance verify the following:-

- Whether the company is authorized to raise the loans as per its Memorandum.
- Whether the **board approval** is there by passing the board resolution for loan. (check the minutes of board meeting)
- Wherever necessary the **member's approval** is taken in the general meeting.
- There is compliance of **section 180, section 185 and 186** of the Companies Act on the borrowings of company.
- In case of foreign currency loan whether compliance with RBI requirement is there.

C) **Test of Controls**: -

- Check whether the loan documents are **signed** by competent authority.
- Check whether there is proper utilization of loan. **Short term borrowings can't be used for long term borrowings.**

D) **Substantive analytical procedures**: -

- Check the **computation of interest** on loan by using substantive procedures.
- Examine relevant records and documentation supporting the validity and accuracy of loans.

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E) Test of Details: -Verify the following Assertions: -

Assertions	Audit Procedures
Verify existence occurrence and Accuracy	○ Confirm loans and borrowings outstanding and interest payable on them by obtaining direct confirmation from the lender. ○ Examine the **loan agreement** for rate of interest and other terms of loan. Verify that borrowing limits imposed by agreements are not exceeded. ○ Examine **reconciliation** of the books balances with statement of lenders. ○ Agree details of lease and hire purchase creditors recorded to underlying agreement. ○ Check the **arithmetic correctness** of the loan amount.
Completeness	○ Verify that the total amount of loan amount has been reflected in the financial statements. ○ Obtain a schedule of short term and long-term borrowing showing beginning and ending balances and repayments during the year.
Valuation	○ Agree loan balance and loan payables to loan agreement. ○ Check **computation of the amortization** of premium or discount. ○ For foreign currency loans, agree the closing exchange rates used and test the translation calculations.
Rights and Obligation	○ Examine documents evidencing any charge created in respect of loans and advances. Specially examine the requirements of the applicable statue regarding creation and registration of charges. ○ Verify that the **secured loans are shown separately**. Where the **market value** of an asset offered as a security against loan has fallen below the amount of loan outstanding ensure that the loan is classified **as secured only to the extent of market value of security. (**Details of the securities should be mentioned). ○ Check balances are confirmed by **external sources. (SA-505)**

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Cut off	○ Check whether the interest payable as on balance sheet is accounted appropriately. ○ Ensure whether the closing balance of the loan is same as balance confirmation received.
Presentation and Disclosure	○ Examine whether the installments of long-term loans falling due within **next twelve months** have been disclosed in the balance sheet as a **footnote**. ○ Ensure whether the following disclosures required under Companies Act under the heading of long-term borrowings have been complied with: - ▪ Sub –classification as, Non-Current and Current Loan, secured and unsecured, Rupee loan and Forex loan. ▪ For secured borrowings, **nature of security** separately disclosed. ▪ Where loans are **guaranteed by directors or others** are separately disclosed. ▪ For **default** in repayment of borrowing or interest on the balance sheet date following disclosure should be made: - - Period of default -Amount of default

Audit of Trade Receivables/Sundry Debtors

Trade receivables are an essential part of any organization's balance sheet. These are monies which are owned to an organization by a customer. Ex: - sales made on credit.

In order to check the authenticity for receivables following procedures should be performed by Auditor: -

A) <u>Ledger A/c: -</u>

- Check the opening balance with the previous period's audited closing balances.
- Check additions & deletions – Credit sales, Amount recovered & Bad Debts.

B) <u>Test of Controls</u>: -

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- Check whether there are controls in place to ensure that invoices cannot be recorded more than once.
- Ensure that all the invoices are **accounted and approved** by the authorized person.

C) Substantive Analytical Procedures: -

Auditor should make comparison of:

- Current year ageing schedule with that of the previous year.
- Significant ratio and trends pertaining to debtors.
- Budgeted figures with actual figures.
- Closing balances of current year with those of previous year.
- Other ratios and analytical procedures relevant and applicable to the enterprise.

D) Test of Details: Verify the following Assertions: -

Assertions	Audit Procedures
Existence	• Check Invoices, Bank Statements & obtain Balance Confirmation to ensure that the trade receivable exists. • Follow up all the **balance disagreements and non - replies** to the receivables' confirmation.
Occurrence	• Obtain a schedule of debtors duly signed by responsible officer and examine it with reference to individual debtors account. • Inspect underlying documents (such as invoice, credit memos etc.).
Accuracy	• Ensure whether the balances shown in the ledger accounts are consistent with balances as per control accounts.

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Completeness	• Ensure all sales, cash receipts and sales adjustment transactions occurred during the period have been recorded. • Ensure accounts receivables includes all claims on customers at the balance sheet date.
Valuation	• Assess the allowance for doubtful accounts. Review the process followed by the company to derive an allowance for doubtful debts. • Scrutinize and identity those debts which appear **doubtful**, discuss with management their reasons if any of these debts are not included in the provision for bad debts. • Assess bad debt write-offs. • Prepare schedule of movements on bad debts, provision accounts and debts written off and compare the proportion of bad debt expense to sales for the current year in comparison to prior years.
Rights and Obligation	• Check through balance confirmation whether the amount is receivable to the company. • Debtor as a charge for working capital loan should be disclosed.
Cut Off	• Verify the **year-end transactions and balances** to ensure whether the cut -off procedures are appropriately followed.

Presentation and Disclosure	• Check that the **restatement of foreign currency** trade receivables has been done properly.
	• Verify that the split between **more than 6 months and less than 6 months** has been done from the **due date instead of sales invoice date.**
	• Check that the classification of the amount due is properly disclosed as: -
	  ○ Secured
	  ○ Unsecured
	  ○ Doubtful

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	• Verify that proper disclosure has made for the amounts due from
	  ○ Directors
	  ○ Other officers of the company
	  ○ By firms
	  ○ By private companies in which any director is a partner or director or member.
	• Ensure all the transactions with related parties are properly reported in CARO.

Audit of Cash & Cash Equivalents

Cash and Cash equivalent in the form of cash in hand, balances held with bank in current accounts/margin money accounts, fixed deposits, cheques in hand etc. represent the most liquid asset of an enterprise. Utmost professional skepticism needs to be exercised while auditing such balances.

Audit procedures for verification of cash & cash equivalents are as follows: -

A) Ledger A/c: -

- Check the opening balance with the previous period's audited closing balances.
- Check the inflows and outflows of cash during the year.

B) Test of Compliance: - Check whether cash payments are **under the limit of income tax act**.

C) Test of Controls: -

- Check whether Cash is handled by responsible officer.
- Ensure that cashier should not make entries in the books of accounts.
- Carry out surprise verification of cash during the year particularly when the entity is consistently maintaining unduly large cash balance.

D) Test of Details: -

Assertions	Audit Procedures
Existence	• Carry out a physical verification of cash in hand at the end of the year

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	• Carry out surprise checks anytime during the year. • Examine all items of Cash Balance like Main cash balance, petty cash balance, imprest cash with employees etc., simultaneously.
Occurrence	• Examine the Cash Vouchers and Cash Book. • Examine all the other supporting documents such as cash receipts.
Accuracy	Verify mathematical accuracy of recorded cash balance:- • Trace total to the general ledger and to year end bank reconciliations prepared by the client. • Test cash on hand as necessary.
Completeness	• Obtain and review or prepare year-end bank reconciliation. • Obtain a bank cut-off statement directly from the bank to ascertain whether the items on the year -end reconciliation have cleared from the bank and therefore were valid.
Valuation	• The auditor should ensure that all bank account holding **foreign currency have been restated at the closing exchange rates.**
Rights and Obligation	• Verify ownership of cash by carrying out simultaneous physical verification of cash at multiple locations to prevent fraudulent entry for cash.
Cut off	• Check whether the inflows and outflows are accounted in the relevant accounting period.
Presentation & Disclosure	• Ensure disclosure of cash in the financial statements as per recognized practices and relevant statutory requirements. • Ensure that **temporary advances given are not classified under Cash balances.** • If **postage and revenue stamps** exists in a substantial manner towards the year end, they should be **shown separately and not included in the Cash in Hand.**

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A cash certificate should be prepared on the verification date, which should be signed both by the auditor and cashier, each retain a copy of the same.

Audit of Bank Balances

Following Audit Procedures are required to verify the bank balances: -

- Check the opening balance with the previous year audited financial statements and the deposits and withdrawals during the year
- Check whether the provisions of Negotiable Instruments Act regulation and RBI regulations wherever required are duly complied.

Assertions	Audit Procedures
Verify Existence, Occurrence, Completeness, accuracy and valuation.	➢ Compare the entries in the ledger of the client with entries in cash book/bank statement. ➢ Examine fixed deposit receipts and bank advises for verification of fixed deposits made. ➢ Cash in transit should be verified with reference to their subsequent credit in bank account. ➢ In case of stale cheques, the auditor should ensure suitable adjustments have been made in books of account. ➢ Examine the bank reconciliation statement to ascertain the differences. ➢ Verify the total number of bank accounts maintained by the entity. **New account opening requires Board resolutions**. Hence verify the same. ➢ Obtain balance confirmation from the banker. ➢ In case of foreign currency account conversions rates should be checked.

Presentation and Disclosures for Cash and Cash Equivalents: -

Ensure whether the following disclosures as required under Ind AS compliant Schedule III to Companies Act, 2013 have been made: -

i) Cash and Cash equivalents shall be classified as:

a. Balance with banks;

b. Cheques, drafts on hand;

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c. Cash on hand;

d. Others (specify nature)

ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

iii) Balances with banks to the extent held as **margin money or security against the borrowings, guarantees, other commitments** shall be disclosed separately.

iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

v) Bank deposits with **more than 12 months** maturity shall be disclosed separately.

Audit of Inventories

Inventories are the tangible property held for **-**

- Sale in the ordinary course of business or
- in the process of production for such sale or
- For consumption in the production of goods or services for sale**.**

Verification for inventories will be done as follows: -

A) **Ledger Account**: -

- Check the opening balance of inventory with the previous year's audited closing balance.
- Check for the purchases and issue of inventory during the year through stock registers.

B) **Test of Compliance**: -

Check for the compliance of **AS-2 (valuation of inventories)** for the following: -

- Recording inventory movement
- Valuation of inventory issued
- Valuation of closing balance. (**Cost or Net realizable value whichever is less).**

C) **Test of controls**: -

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- Ensure inventory **custody & issues** are done by authorized person.
- Verify **stores and other material ledgers** including purchase, issue and closing balance.
- Review the instructions for **stock take** and physically attend the stock take.
- Ensure whether the **stock records** are updated by the management on continuous basis.

D) **Analytical procedures**: - Conduct analytical procedures for: -

- Quantitative reconciliation of input-output
- Previous year Vs. Current year comparison
- Ratio Analysis
- Comparison with industry standards and budgets.

E) Test o f Details: - Verify the following assertions

Assertions	**Audit procedures**
Existence	• Conduct the physical verification of inventories to check: -1) Existence of inventory 2) Condition of inventory. • **Management is responsible for the physical verification of inventory;** auditor has to verify whether management has conducted the same. • Ensure the **method of physical verification** is fool proof. • Ensure the physical verification sheets are signed by both management and auditor. • **Pick samples randomly** to ensure all items and aspects for verification are covered. • Ensure **outside party stocks are not included** in the company's inventory list. • Physical verification should be done at the **end of the financial year.**

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Occurrence	• Check Delivery challans and gate passes, and goods received notes, bin card details etc. to check whether transaction has actually been occurred.
Accuracy	• Verify the clerical and arithmetical accuracy of inventory listings. • Reconcile physical counts with general ledger control total.
Completeness	• Examine non- financial information related to inventory, such as weights and measures. • With respect to **tagged** inventory, perform tests for omitted transactions and test for invalid transactions.
Valuation	• Examine the method adopted by the management for inventory valuation(FIFO**, LIFO or weighted average system)** • Ensure that the valuation of inventory is as per **AS-2** and the **condition of inventory** is recognized in their valuation.
Rights & obligation	• Vouch recorded purchases to underlying documentation. (purchase requisition, purchase order, vendor invoice • Evaluate the consigned goods. Examine client correspondence, sales and receivables records, purchase documents. • Review consignment agreements. • Examine invoices for evidence of ownership • Obtain a **declaration from the third party duly signed** by the authorized personnel in case inventory is held by third party confirming that the inventory belongs to the entity and is held by the third party on behalf of the entity.
Cut Off	• Check invoices, gate passes, delivery challahs, GRN's etc. • Perform purchase and sale cut- off tests. Trace shipping documents (bill of lading and receiving

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	reports, inventory records) to inventory records immediately **before and after year-end.**
Presentation and Disclosure	• Ensure whether the following disclosures as required under In AS compliant Schedule III to companies Act, 2013 have been made: - • Whether **mode of valuation** has been stated separately for each class of inventory. • Whether inventory has been classified as- • Raw materials • Work-in –progress • Finished goods • Stock in trade • Stores and spares • Loose tools • Others (specify nature) • Whether **goods in transit** have been disclosed separately under each sub-head of inventory

Audit of Fixed Assets

Fixed assets may be defined as an asset

- which is held with the intention that it will be used for **the production or provisions of goods and services and**
- not for sale in the **normal course of business** and
- Such use shall have the potential to give **future economic benefits** to the enterprise.

Fixed asset can be further classified as Tangible Fixed Assets and Intangible Fixed Assets.

Fixed Assets Tangible includes Land, Building, Plant & Equipment, Furniture & Fixture, Vehicles, Office Equipment, and Computers etc.

For the audit of Tangible Fixed Asset, we need to understand the difference between **Revenue Expenditure and Capital Expenditure**.

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Revenue Expenditure: -

An expenditure, the benefits of which shall be exhausted in the process of earning revenue within a short span of time **, maximum period being one year** are classified under Revenue Expenditure. **Revenue expenditure are charged to P/L Account** Example: - Cost of raw material and stores consumed in the process of manufacture/ production, Rent, rates and taxes, Power and Fuel, Repairs, maintenance and renewals of fixed Assets, Legal and professional charges etc.

Capital Expenditure: - An expenditure incurred for the following purpose will be classified under capital expenditure: -

- Acquiring fixed assets, which are held not for resale but for the use within the business, whose benefits will last for multiple of accounting period.
- Making additions / enhancements to the existing fixed assets with the intent to increase earning capacity of the business.
- Minimizing the cost of production.

All such expenditures are added to the cost of assets.

Expenses which are essentially of revenue nature, if incurred for creating an asset or adding to its value for increasing productivity are also regarded as of Capital Nature.

Audit Procedures required to be undertaken while auditing tangible fixed assets are as follows: -

A) **Ledger Account**: -

- Check the opening balances of fixed assets with the previous year's audited closing balances.
- Check any addition & deletion in the fixed assets account through the fixed asset register.

B) **Test of Compliance**: -

- Check whether all the accounting standard related to fixed assets have been complied.
- Verify whether the **board approvals** have been obtained for purchase of assets.
- Check **Board & Members resolution** for major sale as per companies Act.

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C) **Test of Control**: -

- Check whether the purchase of fixed asset is made by the authorized person on behalf of the entity.
- Physical verification is done regularly

D) Substantive Analytical Procedures: -

Apply Substantive analytical procedures for **depreciation (SA520)**

E) Test of Details

Assertions	Audit Procedures
Existence	• Conduct **physical verification** of fixed assets. **Management is responsible for the physical verification of fixed assets**; auditor has to verify whether management has conducted the same. • Review **client's plan** for performing physical verification, whether done by own staff or third party and the interval for verification. • Verify the **discrepancies** noted based on physical verification and manner in which such discrepancies are dealt.
Occurrence	• In order to ensure that the fixed asset exists vouch all the supporting documents related to fixed assets such as, vendor invoices, purchase agreements, Sale deeds, RCs etc.
Accuracy	• Verify the movement in the fixed assets schedule complied by the management i.e. Opening+ Additions- Deletions= closing and tally the closing balance to the entity's book of account.
Completeness	• Ensure that all the incidental costs to acquisition of the assets are capitalized along with the asset.
Valuation	• Ensure that the valuation of the fixed assets is done in line with the applicable accounting standards.

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	• In order to arrive at the closing balance of assets, the **provision for depreciation** has followed (whether SLM or WDV). • Verify whether any asset damaged is written off.
Rights and obligation	• Verify that all purchase invoices are in the **name of the entity** that entitles legal title to the ownership to the respective entity. • Obtain copies of conveyance deed/ sale deed for all the additions to land and building to ensure that the entity is the legal and valid owner. • Ensure that the **title deed** is in the custody of owners. • In case of mortgage obtain a certificate from mortgagee or his lawyer confirming the possession of the title deed. • Also verify the register of charges, available with the entity to assess the fixed assets that has been **given as security to any third parties.**
Cut off	• Check whether the transaction occurred during the period has been recorded in the current accounting period.
Presentation and disclosure	• Ensure whether the following disclosures as required under Ind AS compliant Schedule III to companies Act,2013 have been made: • Whether all items of property, plant and equipment have been classified as - Land - Buildings - Plant and Equipment - Furniture and fixtures - Vehicles - Office equipment - Other (Specify nature)

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	• Whether the entity has disclosed asset "under lease" both whether operating and finance lease separately under each class of asset. • For each class of property whether the entity has disclosed a reconciliation of the gross and net carrying amounts at the beginning and end of the reporting period showing separately: - - Opening balance of gross carrying amount - Additions - Acquisitions through business combinations - Disposals - Disposals through demergers - Other adjustments (Borrowing cost capitalized) - Closing balance of gross carrying amount. • For each class of property, plant and equipment, whether the entity has disclosed: - Opening accumulated depreciation - Charge for the year - Deduction/other adjustments for depreciation - Closing accumulated depreciation • For each class of property, plant and equipment, whether the entity has disclosed: - Opening accumulated impairment losses - Impairment losses - Impairment reversals - Closing accumulated impairment losses.

Fixed Assets- Intangible Assets Comprising Goodwill Licenses, patents Brand/ Trademark, Computer Software etc.

Meaning: - Intangible assets are those assets: -

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- Which do not have a physical identity but are used by the enterprise for production or supply of goods or for retails to other or for the purpose of administration.
- Such assets do not have physical existence but their presence in the business is pointed out with a value placed there on.
- These assets include the rights and benefits to the owners subject to their utility. For Ex: patent, copyright, trademark etc.

Goodwill internally generated is not recognized as an asset and not covered under AS 26.

Audit Procedures for the verification of Intangible Fixed asset are as follows: -

A) Ledger Account: -

- Check the opening balances of intangible fixed assets with the previous year's audited closing balance.
- Additions to intangible through internally generated or through amalgamations should be checked.

B) Test of Compliance: -

- Check whether principles of **AS 26** are complied with which says that purchase of intangible asset should include stamp duty, legal charges etc. to arrive at the cost of intangible.
- Check whether the internally generated intangible asset meets the criteria of recognition. In case of: -
  - **Research phase**: - No intangible asset arising from research shall be recognized. Expenditure on research shall be recognized **as an expense and charge off.**
  - **Development phase**- Expenditure incurred during this phase should be **capitalized if product is successful commercially** otherwise it should be charge off if conditions of AS -26 are not fulfilled.
- See whether **board approval** has been taken for the purchase of intangible assets.

C) **Test of control:** -

- Check whether authorized personnel has **approved and executed** purchase and sale of intangibles.

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- Verify if proper internal processes and procedures like inviting competitive quotations were followed prior to finalizing the vendor.

D) Substantive Analytical procedures: -

- Check whether the entity has charged the **amortization** on all intangibles.
- Verify that the amortization method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
- Also verify that the management has undertaken an impairment assessment to determine whether an intangible asset is impaired.

E) **Test of details: -** Verify the following assertions in relation to intangibles: -

Existence	• Verify documents related to asset. • Obtain confirmation letters from client's legal adviser as to the validity and existence of intangibles asset. (SA 620 work of an expert)
Occurrence	• Check the documents related to purchase of asset, bank statements, and board approvals. • If the assets have been transferred ensure whether the rights have been transferred related to assets.
Accuracy	• Ensure that all the components related to the cost of assets are taken into consideration for arithmetic accuracy • Obtain list for all additions during the period under audit. And for all material additions verify if such expenditure meets recognition criteria. • Verify the movement in the intangible assets schedule complied by the management i.e. Opening+ Additions- Deletions= closing and tally the closing balance to the entity's book of account.
Completeness	• Assess whether for an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of assets into: - ➢ Research phase.

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	➢ Development Phase
Valuation	• Verify that Amortization principle as per **AS 26** has been complied • Check that Impairment provisions has been followed as per **AS 28**
Rights and obligation	• Ensure whether the following disclosure as required under Ind AS compliant Schedule III to Companies Act, 2013 have been made: - ➢ **For Goodwill** whether the entity has disclosed a reconciliation of the gross and net carrying amounts at the beginning and end of the reporting period showing separately: - • Opening balance of gross carrying amount • Additions • Disposals • Impairments • Other adjustments ➢ Whether all items of **intangible assets** have been classified as: • Brands/ Trademarks • Computer Software • Mining rights • Copy rights and patents and other intellectual property rights, • Licenses and franchise • Of Other (specify nature) ➢ **For each class of intangibles**, whether the entity has disclosed a reconciliation of the gross and net carrying amounts at the beginning and end of the reporting period showing separately:-

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	• Opening balance of gross carrying amount • Additions • Acquisitions through business combinations • Disposals • Disposals through demergers • Other adjustments • Borrowing cost capitalized • Closing balance of gross carrying amount. ➢ For each class of intangibles, whether the entity has disclosed: - • Opening accumulated amortization • Charge for the year • Deduction/ other adjustments for amortization • Closing accumulated amortization ➢ For each class of intangibles, whether the entity has disclosed: - • Opening accumulated impairment losses • Impairment losses • Impairment reversals • Closing accumulated impairment losses

The auditor must verify requirements required by CARO in respect of Fixed Assets.

Audit of Trade Payables and Other Current Liabilities

Liabilities in addition to borrowing include trade payables and other current liabilities. Trade payables are the liabilities owned to suppliers for purchases or services rendered. Verification of liabilities is important to ensure whether any liability is not understated or overstated.

Audit Procedures for the verification of trade payables are as follows: -

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A) **Ledger Account**: -

- Check the opening balances of Trade payables with the previous year's audited closing balances.
- Check the expenses incurred and payment made during the year.

B) Test of Compliance: -

- Check whether all the requirements under **Micro, Small and Medium Enterprises Development Act, 2006 (MSME)** has been complied regarding the payments made to such parties having MSME registration.

C) **Test of Control**: -

- Check whether the management has adequate internal control regarding recording of purchases, invoices are not recorded twice, purchases are for business purpose only.
- Ensure whether the payments are **approved** by the authorized person.
- Test checks few bills for payments made during the period.
- Related party transactions to be verified carefully as **risk of fraud** are more.

D) **Substantive Analytical Procedures**: - Apply substantive procedures to calculate: -

- Creditor Turnover Ratio
- Creditor to credit purchases
- Average payment period

Also obtain the list of vendors with whom company has disputes and any claims from customers, under litigation and compare with previous year.

E) Test of details.

Assertion	Audit Procedures
Existence	• Obtain Balance confirmation from Creditor. • Vouch Subsequent payments to the creditors.
Occurrence	• Inspect documents underlying purchases such as invoices receiving reports purchase order etc. and verify individual creditor's accounts balance against these documents.

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	• Check the invoices raised by the vendors to the company. • Ensure there is no duplicate invoice.
Accuracy	• Verify that the total of the creditor's balance in the schedule agrees with the balances of the total account relating to the bought ledger in the general ledger.
Completeness	• Verify whether all the transactions related to purchase & services received are accounted and there is no **unrecorded liability.** • Verify whether all the **statutory dues** are properly recorded in books of accounts.
Valuation	• Assess the **old outstanding liability** balances-Review the process followed by the company to identity any creditors/ liability needs to be **written back**. • Match ledger balances with direct balance confirmations from the creditor and ensure that both are reconciled. • Perform subsequent period bank statement verification if there are no replies from the creditors for balance confirmation. • Check that the **restatement of foreign currency** trade payables has been done properly.
Rights and obligation	• Check the direct confirmation obtained by the creditors.
Cut off	• Verify the balance confirmations obtained, BRS, Reconciliation for difference in balances to confirm that transaction occurred during the periods are recorded in the current period.
Presentation & Disclosure	• Ensure whether the following disclosures as required under Ind AS compliant Schedule III to Companies Act, 2013 have been made: • Whether the Company has classified a payable as a trade payable if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

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	• Whether the Company has disclosed the following details relating to **micro enterprises and small enterprises** in the notes:
	  ○ **The principal amount and the interest due** thereon (to be shown separately) remaining **unpaid** to any supplier at the end of each accounting year.
	  ○ **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.
	  ○ **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.
	  ○ The amount of **interest accrued and remaining unpaid** at the end of each accounting year.
	  ○ 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.
	• Whether the amount disclosed under other current liabilities are classified as below:
	  ○ Revenue received in advance
	  ○ Other advances (specify nature)
	  ○ Other current liabilities (specify nature)

Audit of Loans and Advances, Other Current Assets.

Loans means money advanced to related or other parties with or without interest while **advances** include amounts recoverable either in cash or in kind or for value to be received accrued interest, e.g., rates, taxes and insurance paid in advance/ prepaid.

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Other current assets primarily include accrued interest on loans/ fixed deposits held, balances with statutory/ governments etc.

A) Ledger A/c: -

- Check the opening balances of Loans & advances, with the previous year's audited closing balance.
- Check the additions and deletions in the loans & advances and current assets.

B) Test of Compliance: -

- Check whether any loans or advances granted is as per the Memorandum and Articles of Association.
- Inspect the minutes of meeting of board of directors to confirm if all material loans and advances were approved by board of directors.
- In case of **related party loans and advances** check the whether they are properly authorized, and the value of such transactions were reasonable. And whether provisions of companies act, and disclosure requirements of accounting standard are complied.

C) Test of Controls: -

- Check whether loans given are approved by the **authorized person**.
- Ensure that the securities against loans are **periodically reviewed**.
- All the documents related to loans and advances are in **safe custody**.

D) **Substantive Analytical Procedures**: -

- If there are **interest on loans** carry out substantive audit procedures.
- Obtain the list of loans and advances under **litigation** and compare with previous period.
- Scrutinize and analyze those loans and advances that appear **doubtful** and discuss the reasons with management for the same.

E) **Test of Details**: -

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Assertion	Audit Procedures
Existence	• For establishing existence of loans and advances, account receivables obtain direct confirmation from the parties who receive that loan.
Occurrence	• Verify the bank statements, loan agreement, and letter from statutory authority from deposits made.
Accuracy	• Obtain list of all advances and other current assets and compare them with balances in the ledger
Completeness	• Check whether all the advances given have actually been recorded • Inspect loan agreements and acknowledgements of parties in respect of outstanding loans.
Valuation	• Assess the allowance for doubtful accounts. Review the process followed by the company to identity doubtful accounts needs to be written off. • Obtain ageing report of loans and advances, **split between current, less than 30 days old, 30-60 days old, 60 -180 days old, 180 -365 days old and more than 365 days old** • Check that the **restatement of foreign currency loans** and advances has been done properly
Rights and obligation	• Check that in the **loan deed** the name of the company exists. • In case of **deposits with statutory authorities**, name of the company should be existing.
Cut off	• Verify the balance confirmations obtained, BRS, Reconciliation for difference in balances to confirm that transaction occurred during the periods are recorded in the current period.
Presentation and Disclosure	• Ensure whether the following disclosures as required under Ind AS compliant Schedule III to companies Act,2013 have been made: ▪ Whether loans have been classified as: -

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	- Security deposits - Loans to related parties (give details) - Other loans (specify nature) ▪ Whether all the above loans have been further sub – classified as: - - Secured - Unsecured - Doubtful ▪ Whether allowance for bad and doubtful loans has been disclosed separately for each category of loans. ▪ Check whether separate disclosure is made in case of loans due from: - - Director(s) of the company - Director(s) of the company jointly with other persons. - Other Officer(s) of the company. - Other Officer(s) of the company jointly with other persons. - Firm(s) in which director is a partner. - Private company (ies) in which director is a director or member. • Other Current Assets. ▪ Whether other current assets are classified as: - - Advances other than capital advances which are further sub –classified as: - ➢ Security Deposits ➢ Advances to related parties (give details) ➢ Other advances (specify nature) - Other current assets (specify nature)

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	▪ For advances, whether separate disclosure has been made for amounts due by: - - Director(s) of the company - Director(s) of the company jointly with other persons - Other officer(s) of the company - Other Officer(s) of the company jointly with other persons. - Firm(s) in which director is a partner - Private company (ies) in which director is a director or a member.

Audit of Provisions and contingent liabilities

Provision: -

- is a **present obligation** of the entity arising from the past events,
- the settlement of which is expected to result in **an outflow** from the entity of resources embodying economic benefits.
- a **reliable estimate** can be made of the amount of obligation.

Example: - Provision for litigation, provision for warranties, provision for employee benefit expenses etc.

Audit Procedures for provisions: -

- Make the **best estimate** of the provision required using the given information. For this check: - records, agreements, legal cases etc.
- Use the **work of the expert** to ensure that provisions are reasonably made. (SA 620). Example Actuary, Lawyer
- Check **reversals or additions** to provisions and the same are accounted for.
- Ensure the compliance of the applicable accounting standards. **Ex AS 29, AS 15.**

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- Check the **legal register** to know the legal cases & disputes pending against the company. And also check & verify BOD minutes to know the updates for the same.
- Check expert opinions and computations.
- Ensure that the presentation & Disclosure as per Schedule III of the companies Act,2013 have been made: -
    - Whether Current/ Non-current provision is split
    - Disclosure is made for each class of provision. (Opening balance & Closing balance)
    - Additional provision increased/ decreased this year.
    - Brief disclosure to be made for each class of asset, specifying (Nature of obligation, expected timing of outflow of resources)
    - Indication of uncertainties of amount and time of provisions.
    - Amount of any expected disbursement.

Contingent Liability

Contingent liabilities refer to: -

- Obligations relating to past transactions or other events or conditions that may or may not arise in future.
- The possibility of a contingent liability crystal ling into an actual liability thus depends upon happening/ non happening of an event.

Example: - Pending litigation against the entity, discounted bills receivable, Guarantees of third-party obligations etc.

Audit Procedures to verify Contingent liabilities are as follows:-

- Obtain a **certificate** from the client that all known contingent liabilities have been included and properly disclosed in the financial statements.
- Review the **minutes of meeting** of board of directors to discover contingency commitments if any.
- Obtain **list of pending legal cases** and check the legal status of pending cases with help of experts.
- Assess the provision made or contingent liability disclosed, is in line with **AS 29**.

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- Whether as per Schedule III of the companies Act,2013 disclosure in the notes to accounts in the following manner:-
  - Whether Contingent Liability have been classified as:-
    - Claims against the company not acknowledged as debt
    - Guarantees
    - Other money for which the company is contingently liable
  - Whether the amount of any guarantees given by the entity on behalf of the directors or other officers of the company has been stated.

PROFIT AND LOSS ACCOUNT ITEMS

Sales

A sales audit is an examination of the entire sales process.

The sales and collection cycle refer to the set of processes that begin when a customer purchases goods or services and ends when the entity receives complete payment for purchase.

An auditor needs to obtain a clear understanding about the organization and its revenue centers to ensure the sales are appropriate. Example: - type of services or products, major selling product, introduction of new product, sales term, major customers etc.

A) **Test of compliance rules & regulation:** Check the following**:-**

- Check that the applicable laws & regulations are compiled regarding sale like GST requirements.
- Check whether accounting treatment is as per **Accounting Standard-9.**

B) **Test of controls**:-Following steps should be taken by auditor to ensure internal control:-

- Examine the internal control system and ascertain whether it operates satisfactorily.
- Examine whether the sales has been authorized by a responsible officer.
- Ensure proper co-ordination between billing and dispatch sections.
- Identify possible **loopholes** in the system whereby cash collected from sales could be misappropriated.

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- Authority for granting **special discounts** should be examined.
- Review the **related party transactions** for their collectability as well as see whether they are properly authorized.

C) <u>Substantive Analytical Procedures</u>: - Performing substantive audit procedures is must for verification of sales. This includes:-

- Sales trend analysis
- Calculate the ratio of sales return to sales and compare it with previous accounting period.

D) **<u>Test of Details</u>: Verify the following assertions: -**

Assertions	**Audit procedures**
Occurrence	• Examine copies of sales invoices. • Check the sales return with sales invoice, challan, credit note, stock register etc. • Check transactions recorded are supported with proper evidence& there is no error of duplication to avoid risk of fictitious error.
Accuracy	• Examine the entry in sales account as well as in customer's account to ensure their correct posting.
Completeness	• Check whether quantity is appearing in sales register or not and check reconciliation of total sales as per stock records and financial records and excise records.
Valuation	• In case of sale in foreign currency check whether conversion is at appropriate rate and also any "exchange gain/ loss" arising from sales. • Recalculate prices and extensions on sales invoice.
Rights & obligation	• Check whether the sales recorded are actually by the entity. • Ensure no fake transactions are recorded. • Check whether invoices are generated in the **letter head of company.**

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Cut off	• Check the pre -cut off and post cut off transactions to ensure that revenues are recognized in the current accounting period and sales were not tampered towards the period end.
Presentation & Disclosure	• Ensure the following disclosures as per schedule III to companies Act 2013, have been made:- ○ Whether disclosure of sales in respect of each class of goods has been made. ○ Whether revenue from operations is disclosed separately in the notes as revenue arising from:- • Sale of product(include excise duty) • Sale of Services • Other operating revenues ○ Whether brokerage and discount on sales, other than usual trade discount has been disclosed. ○ Whether the transactions with related parties are appropriately disclosed in notes to accounts.

Audit of other Income Comprising interest Income, Dividend Income, and Gain/Loss on Sale of Investments etc.

Any form of income earned by an entity which is not linked to the entity's core business operations is generally classified as other income. Example: - interest on fixed deposits, interest on loans given to third party etc.

Interest income on fixed deposits is recognized on a time proportion basis taking into account the amount outstanding and the applicable interest rate.

Interest income from debt instruments is recognized using effective interest rate.

Dividends are recognized only if:-

- The **entity's right** to receive payment of the dividend is established,
- It is probable that the **economic benefits** associated with the dividend will flow to the entity and
- The amount of the dividend can be **measured reliably**.

Gain / (loss) on sale of investment in mutual fund is recorded as other income on transfer of title from the entity.

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Audit procedures for verifying other income are as follows:-

A) Test of compliance with loss and regulations:-

- Ensure compliance with AS 9 on revenue recognition.
- Check the compliance of SEBI Act wherever required.
- Verify that any tax deducted at source from income is as per the provisions of income tax act.

B) Test of controls:-

- Whether **receipts** are collected by appropriate authority
- Whether **investment documents** are held by proper authority
- See whether **TDS certificates** are promptly received and kept in **safe custody**

C) Substantive Analytical procedure:-

- Check computation of **accrued interest** on cumulative deposits.
- Obtain a **statement** showing interest and dividend income including details such as:-
    - Amount of Investment
    - Date of investment
    - Rate of interest/dividend
    - TDS if any
    - Net receipt

D) Test of Details:

Assertions	Audit procedures

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Occurrence	• Obtain **register of investments**. See the list of fixed deposits opened during the year along with the applicable interest rate. • Check **counterfoils** of interest and dividend warrants along with relevant investments and the dates when normally due and the period to which they relate. • Trace **net receipts** of dividends and interest to the bank statement.
Accuracy	• Verify the **arithmetical accuracy** of the interest calculation by multiplying the deposit amount with the applicable rate and number of days during the period under audit. • Obtain a confirmation of interest and dividend income from the bank and verify that income as per bank reconciles to the calculation shared by the entity. • Also obtain a copy of **form 26AS** and reconcile the interest reflected therein to the calculation shared by client.
Completeness and cut off	• Obtain a **direct confirmation** from the bank /financial institution for deposits still **outstanding** as at the period end.
Rights & obligation	• Verify that the investments are in the name of the entity.
Presentation & Disclosure	• Ensure the following disclosures as per schedule III to companies Act 2013, have been made:- o Whether 'other income' has been classified as • Interest income • Dividend Income • Other non- operating income (net of expenses directly attributable to such income)

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Audit of Purchase

Purchase is another significant process of entity. Auditor should be very careful while doing audit for purchase transaction and internal control to ensure that the entity is not materially misstating its purchases or accounts payable.

Auditor needs to obtain a clear understanding about the organization and its production centers. Ex type of services or products they procure that are used in production, sources of procurement, major vendors, credit period, purchase terms etc.

Audit procedures for verifying purchases are as follows:-

A) Test of compliance rules & regulation:-

- Check whether entity is complying with the **applicable laws** relating to purchases.
- Ensure that in case of purchases made from **related party board approvals are taken.**

B) Test of controls: -

- Examine the internal control system to see that the purchases have been **recorded** starting from the purchase order to disbursement stage.
- Check that the goods receipt note and purchase invoice is **prepared and signed by authorized personnel.**
- Check whether **quality inspection** of goods was done.
- Check entries recorded in purchase return book with reference to debit notes issued and ensure that particulars relating to accounts, suppliers name, quantities etc. are correct.

C) Substantive analytical Procedures: -

- Check any **increase** in the cost of purchase and locate the reasons there off.

  Verify the price charged. It may be agreed price or in line with market price.
- Carry out analytical procedures to acquire audit evidence for the **reasonableness** of purchase quantity and price. Such as Consumption analysis, Stock composition analysis, quantitative reconciliation of closing stocks with opening stock, purchase and consumption.
- Compare purchase on quarterly/monthly basis to note **unusual fluctuations**, actual purchases with budgeted purchases.
- In case of related party purchases perform analytical procedures in relation to price of goods to confirm that price charged is **at arm's length.**

D) Test of Details: -

Assertions	Audit procedures

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Occurrence	• Examine purchases recorded with reference to purchase invoices and underlying documents such as purchases requisition notes, inspection reports, goods received notes, delivery challans etc. • The invoice should be marked 'original' • If the invoices received in duplicate and /or triplicate it should be verified whether original has been lost or mislaid and has not been entered elsewhere in the accounts. • The invoice should not be already verified ones.
Accuracy	• Verify that the supplier's account has been credited with the full amount of the invoice and the deductions in the amount if any • The amount of the invoice should agree with entry in the purchase register.
Completeness	• Verify and confirm that all the purchase transactions are actually recorded by taking direct confirmations from the suppliers. • All the taxes and cess related to the quantity purchased should form part of purchase value unless they are refundable.
Valuation	• Check whether the **values** at which at foreign purchases are converted is appropriate.
Rights and obligation	• Check whether the purchases are made in the **name of the entity.** • The invoice should be addressed to the appropriate branch/factory in case different branches are operated by the client.
Cut off procedure	• Ensure that purchases pertaining to a specific accounting period are not **mixed up** with purchases of the next accounting period. • Auditor should examine material inward records for few days prior to closing date to check that all corresponding invoices have been duly entered in the purchase book and none have been **omitted.**

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Presentation and disclosure	• Ensure the following disclosures as per schedule III to companies Act 2013, have been made:- ○ Whether purchases of **stock -in -trade** has been specifically disclosed ○ Whether **changes in inventories** of finished goods, stock in trade and work-in-progress has been specifically disclosed. ○ Whether the **transactions with related parties** are appropriately disclosed in notes to accounts.

Audit of employee benefits expense

All the expenses incurred by the employer for the benefit of employees are employee benefit expense. Example salary, bonus, commission, post-employment benefits such as gratuity, superannuation, leave encashment, provident fund contribution etc.

Auditor should have a clear understanding about the organization and its hiring, appraisal and retirement process to ensure that such expenditure is appropriate and as per applicable accounting standards and generally accepted accounting principles.

Audit procedures for verifying employee benefit expense are as follows:-

A) Test of compliance of rules and regulations:-

- Check Compliance with AS 15 and other employee benefits laws like:-
  - Payment of gratuity Act, 1972
  - Employees provident fund Act, 1952
  - Payment of bonus Act 1965

B) Test Of controls.

- Verify employee benefit **computations and payments** are made by authorized persons.
- Check whether transactions entered and amounts paid **matches with actuary's report.**
- Obtain monthly deposit challans to verify if the **month on month** liability was **subsequently deposited** with the authorities within **defined timelines**.

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C) <u>Substantive Analytical Procedures</u>: -

- Check the monthly expense **reasonability**, comparison with previous accounting period.

D) <u>Test of Details</u>

Assertions	Audit procedures

Occurrence	• Check the **employee records** on a sample and verify all the transactions related to chosen employees:-
	  o Appointment letter, increment letter, leave records
	  o Bank statements
	• On a random basis, correlate from payroll to employee records and vice versa
	• Verify whether **leave policy and attendance records** are considered before making payments.
	• Verify that no expense is recorded in the name of **fictitious** employees

Accuracy	• Check whether amount recorded as employee benefit expense **matches** with actual payments made. • The auditor should check the **quantification** of the gratuity liability. He should ascertain whether the same had been actuarially determined.
Completeness	• Verify that all the **details of employees** are included in the payroll. • To ensure this an auditor may choose sample of employees and ask the pay roll department to share their bank details/ identity proofs etc.
Valuation	• Verify whether the **salary** for the first month and subsequent months was processed as per the **agreed terms.** • For a sample of **resigned employees** obtain their full and final computation and verify whether all their **dues** including post –retirement benefits like gratuity, leave

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	encashment have been **paid** and employee's **acknowledgement** has been **obtained**.
Rights and obligation	• Verify that the **appointment letters** are issued by the company.
Cut off procedure	• Confirm that **liability** for last month has been accounted if salaries are **paid in arrears**, and as **asset** is created if salaries are **paid in advance**. • Confirm that the bonus paid or declared, gratuity to be provided is accounted for the current accounting period.
Presentation and disclosure	• Ensure whether the following disclosure as required under In AS compliant Schedule III to Companies Act, 2013 have been made: o Whether employee benefit expense has been classified as: ▪ Salaries and wages ▪ Contributions to provident and other funds ▪ Staff Welfare expenses.

Audit for depreciation and Amortization.

Depreciation represents **systematic allocation of the depreciable assets over its useful life** related to **tangible fixed assets** and amortization is related to **intangible fixed assets.**

Depreciation and amortization constitute a significant part of over all expenses and have direct impact on the profit/loss of entity. Hence auditor needs to verify that such expenditure is appropriate and accurately calculated.

Auditor needs to consider the following attributes while verifying for depreciation and amortization expenses: -

- Obtain the understanding of entity's accounting policy related to depreciation and amortization and ensure that they are in accordance to applicable accounting standards **(AS10) & GAAP**
- Whether depreciation has been calculated after making adjustment of **residual value** from cost of assets**.**
- Obtain a list of all additions and deletions along with their approval from the authorized person for the same.

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- Ensure the parts of each item of property, plant and equipment that are to be depreciated separately has been properly identified.
- Perform substantive analytical procedures to arrive at the estimated depreciation, compare with actuals and investigate significant variances

Verify the following assertions: -

Assertions	**Audit procedures**
Occurrence	• Check whether the asset exists through **physical verification.** • Obtain the **fixed assets register** maintained by the entity.
Accuracy	• Check the **arithmetical accuracy** of the records, re-compute or compute and ensure depreciation is correctly computed and accounted.
Completeness	• Check whether depreciation is calculated for all assets owned. • Ensure intangibles assets like patents and goodwill have been **properly amortized** over the period. • Ensure all the **capital costs have been included** to arrive at the Cost of assets.
Valuation	• Ensure depreciation on **revalued amount** has been properly accounted from revaluation reserve. • Ensure the amount of depreciation is correctly calculated by the entity using **SLM or WDV** or any other method.
Rights and obligation	• Ensure that the assets are in the **ownership** of company
Cut off procedure	• Ensure depreciation is charged on the assets from date when it is **ready to use**.
Presentation and disclosure	• Ensure whether the following disclosures as required under Ind – AS compliant Schedule III to Companies Act, 2013 have been made: • Accounting Policy for depreciation and amortization

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	• Useful lives of assets as per Schedule III • Residual value of assets • Depreciation method

Audit of other Expenses like power and fuel, Rent, Repair to Building, Plant and Machinery, Insurance, Travelling, Legal and Professional, Miscellaneous Expenses.

In addition to purchases and employee benefit expenses there are other expenditure which are **essential and incidental** to running of business operations. **Example** rent, power and fuel, repairs and maintenance, insurance, travelling, miscellaneous expenses etc. All such other expenses must be properly verified by the auditor.

Audit procedures for verifying other expenses are as follows: -

A) Test of Compliance with laws and regulation: -

- Ensure all the expenses are as per the **agreements.**
- Check **minutes or letter of authorities** wherever required.

B) Test of controls

- Ensure that **payments are authorized** by competent authority.
- Whether the expenditure had **valid supporting documents** like travel tickets, insurance policy, third party invoice etc.
- Whether the expenditure is **qualified as revenue and not capital expenditure.**

C) Substantive Analytical Procedures: -

- Wherever possible, the auditor should prepare a **summary of expenditure** on monthly basis and then analytically compare the trends.
- Auditor should review of **unusual entries**.

D) Test of Details: -

Assertions	Audit procedures

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Occurrence	• In order to check **rent expense,** obtain a month wise expense schedule along with the **rent agreements** • To verify **power and fuel expense** obtains a month wise expense schedule along with the **power bills**. • To verify **insurance expense,** obtain a summary of **insurance policies** taken along with their validity period.
Accuracy	• Check whether the expenditure has been classified under the **correct expense head**.
Completeness and cut off	• Verify whether the expenses are recorded for **all 12 months.** • Check whether the expenditure pertained to **current period** under audit**.**
Rights & obligation	• Ensure whether the expenditure was in relation to the entity's business and **not a personal expenditure**.
Presentation & Disclosure	• Ensure other expenses have been classified under: - o Rent o Insurance o Power and fuel o Repairs and maintenance-Building, Plant and machinery, others o Legal and professional o Printing and stationery o Travel expenses o Miscellaneous expenses

FOCUS POINTS FOR SPECIAL AUDIT WITH REGARD TO EXAMINATIONS:

1. **Constitution / Legal form.**
2. **Charter Documents and laws governing enterprise.**
3. **Incomes:**
   a. **Internal Controls.**
   b. **Analytical review procedure.**
   c. **Test of details.**

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4. **Expenditures:**
    a. **Internal Controls.**
    b. **Analytical review procedure.**
    c. **Test of details.**
5. **Assets:**
    a. **Fixed assets – Initial recognition, Valuation and Physical verification.**
    b. **Current assets – Valuation and Physical verification.**
6. **Liabilities (if any) – Outstanding payables, incomes received in advance, Secured / unsecured loans, Refundable deposits.**
7. **Accounting treatment as per Accounting Standards and GAAPs and applicable taxes.**
8. **Internal controls.**
9. **Others – Special points.**

Audit of Sole Trader:

a. Salient features

1. *Non- Mandatory Audit*: A sole trader is under no legal obligation to get his accounts audited except under Income Tax Act 1961, but it is only subject to the satisfaction of certain conditions such as tax audit u/s 44AB. Some sole trader gets their financial statement audited due to regulatory requirements, such as on a specific instruction of the bank for approval of loans etc. otherwise it is not compulsory.
2. *Scope determination by Engagement letter*: The scope of audit and the conditions under which it is carried out can be determined by the sole trader himself. In order to prevent mis-understanding a written letter of appointment should be obtained by the sole-trader. The letter must define clearly the scope of audit work
3. *Partial Audit:* A sole trader may decide for a partial audit i.e. the audit would be carried out in respect of only a part of the books of accounts.

b. Advantages of Audit to Sole Trader

1. *Moral Check*: It act as a moral check on the employees from committing defalcations.
2. *Tax Liability*: Audited statements of accounts are helpful in setting liability for taxes.
3. *Credit Negotiation*: Financers and Bankers use audited financial statement in evaluating the credit worthiness of individuals in negotiating loan. It is also useful for determining the purchase consideration for a business.
4. *Trade Dispute Settlement*: Audited statements are also useful for setting trade disputes for higher wages or bonus as well as claims in respect of damages suffered by property due to some other calamity.
5. *Control over Inefficiency*: It also helps in the detection of wastages and losses and shows the different ways by which these might be checked especially those that occur due to the absence or inadequacy of internal checks or internal control measures.
6. *Arbitration*: Audited financial statements are useful in settling disputes by arbitration.

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7. *Appraisal*: Audit reviews the existence and operations of various controls in the organization and reports inadequacies, weakness etc. in them. The trader can take suitable action based on the reports.
8. *Assistance to Government*: Government may require audited and certified statements before it gives assistance or issues a license for a particular trade

Audit of Partnership firm:

a. Aspects to be verified in a partnership deed

1. *Name*: Name and style under which the business shall be conducted.
2. *Duration*: Duration of the partnership, if any, that has been agreed upon.
3. *Capital*: Amount of capital that shall be contributed by each partner -whether it will be fixed or could be varied from year to year.
4. *Accounts Closure*: The period at the end of which the account of the partnership will be closed periodically.
5. *Profit sharing*: Proportions in which the profit/losses shall be divided among the partners.
6. *Contribution to losses*: Pattern of contribution to losses by the partners whether the losses shall be borne by the partners or whether any of the partners will not be required to do so.
7. *Provisions*: Provisions regarding maintenance of books of account.
8. *Borrowing powers*: Borrowing capacity of the partnership (when it is not implied in the case of non-trading firms)
9. *Interest on capitals*: Rate of interest allowed on partner's capital and loans provided by partners and the rate at which it will be charged on their drawings and current accounts.
10. *Remuneration of partners*: Amount of remuneration payable to the partners or withdrawals permitted against shares of profit.
11. *Duties*: Duties of the partners as regards the management of firm's business.
12. *Bank Accounts*: Nature of bank accounts which is in operation, single or joint; names of partners who operate the bank account, etc.
13. *Accounting Policies (if any)*: The matters which must be taken into account for determining the profits; profits division among the partners
14. *Investments*: Modes of investment of the available surplus funds of the partnership.
15. *Limitations*: Limitations and restrictions that have been agreed upon; rights and powers of partners; and their implied authority to pledge the firm's credit or to render it liable.

b. Aspects of Partnership deed specifically concerning the auditor

1. Capital contribution by each partner
2. Ratio of profit sharing and loss sharing
3. Whether the partners are entitled to any interest on capital. Payable out of profits
4. Management rights of the partners
5. Salary to partner, if any
6. Rights and duties of partners

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7. The property of the firm must be held and used by the partners exclusively for its business.
8. If a partner derives any profit for himself from any transaction of the firm or from the property or business connections of the firm or the firm name, he must account for and pay to the firm; also the profit from any competing business carried on by other partners' consent must also be accounted for and paid to the firm.
9. The firm is liable to third parties:
   a. If a partner acting within the scope of his apparent authority, receiver misapplies it, or
   b. If the firm in the ordinary course of the business receives money, which is partner
10. No person can be introduced as a partner without the consent of the other partner.
11. Any differences arising as to ordinary matters connected with the business are to the majority of the partners, but no change can be made in the nature of the consent of all the partners.
12. Method of settlement in the event of death or retirement of partners

c. Advantages of audit of a partnership firm

1. To *settle financial dispute amongst partners*
2. Where there are *sleeping or dormant partners*, such partners can be satisfied that there are no frauds if the accounts of the firm are fully audited
3. *Valuation of Goodwill* in the event of Admission, retirement, death and dissolution of partners
4. *Moral Check*: It act as a moral check on the employees from committing defalcations.
5. *Tax Liability*: Audited statements of accounts are helpful in setting liability for taxes.
6. *Credit Negotiation*: Financers and Bankers use audited financial statement in evaluating the credit worthiness of individuals in negotiating loan. It is also useful for determining the purchase consideration for a business.
7. *Trade Dispute Settlement*: Audited statements are also useful for setting trade disputes for higher wages or bonus as well as claims in respect of damages suffered by property due to some other calamity.
8. *Control over Inefficiency*: It also helps in the detection of wastages and losses and shows the different ways by which these might be checked especially those that occur due to the absence or inadequacy of internal checks or internal control measures.
9. *Arbitration*: Audited financial statements are useful in settling disputes by arbitration.
10. *Appraisal*: Audit reviews the existence and operations of various controls in the organization and reports inadequacies, weakness etc. in them. The trader can take suitable action based on the reports.
11. *Assistance to Government*: Government may require audited and certified statements before it gives assistance or issues a license for a particular trade

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d. Aspects that would be considered in auditing the Books of a Partnership Firm

Aspects to be addressed	Auditors' Approach
Agreement Letter	Ensure that the appointment letter, signed by a partner, duly authorized, clearly specifies the nature and scope of audit considered by the partners particularly the limitation, if any, under which the auditor functions
Partnership Deed	Inspect the partnership deed duly signed by all the partners and its registration with the register of firm. Also determine from the partnership deed, the capital contribution, profit sharing ratio, interest on capital, powers and responsibilities of the partners etc.
Minutes Book	Peruse the minutes book, if any, maintained to record the policy decision undertaken by the partners especially the minutes pertaining to authorization of extraordinary and capital expenditure, raising of loans, purchase of assets, extraordinary contracts entered into and other matter which are not routine in nature.
Agreement	Verify that the business in which the partnership is involved is authorized by the partnership agreement, or by any extension or modification of that agreed to subsequently.
Books of Accounts	Investigate whether the books account is reasonable and considered adequate pertaining to the nature of partnership business.
Interest on capital	Verify that the interest on capital calculations is in line with the provisions in partnership deed.
Provision for Tax	Ensure that a provision for tax of the firm payable by the partnership has been made in the accounts prior to arrival at the amount of profit divisible among the partners. Also check various requirements of the legislation applicable to the partnership firm such as Section 44 (AB) of the Income tax Act, 1961 have been complied with
Profit Sharing	Verify that the profits or losses are distributed among or losses are distributed among the partners in the profit-sharing ratio as agreed.

e. Reports on the accounts of Sole traders and Partnerships:

1. The auditor should clearly define the scope of work and nature of records examined.
2. The auditor should clearly mention in this report the extent of responsibilities accepted by him. He should express an opinion on the truth and fairness of accounts only in case of such accounts which have been audited by him.
3. Where accountants have been instructed to prepare but not to audit, the report should be titled "Accountant's Report" and not "Auditors Report."
4. Where the auditors are instructed to carry out specific checks, then carry out the same.

Example of an Accountant's Report on Unaudited Financial Statements

To.....
On the basis of information provided by management we have compiled the balance sheet of ..... *(name of the entity)* as of March 31, XXXX and the statement of profit and loss for the period then ended. The balance sheet and the statement of profit and loss are in agreement with the books of account. We have not audited or reviewed these financial statements and accordingly express no opinion thereon.
Date:

For A & Co.
Firm registration number
Signature (Name of the partner and membership number)
Partner
Chartered Accountants

Limited Liability Partnership

Meaning: - Limited liability partnership (LLP) is a form of partnership organizations where some or all partners have limited liabilities. In an LLP, each partner is not responsible or liable for another partner's misconduct or negligence.

An LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. A "Statement of Accounts and Solvency" in prescribed form shall be filed by every LLP with the **Registrar every year.**

The accounts of every LLP shall be audited in accordance with Rule 24 of LLP, Rules 2009.

LLPs Liable for Audit

- Only the LLP whose **turnover** exceed **40 Lakh rupees** or whose **contribution** exceed **25 Lakh rupees** are required to annually get their accounts audited by any Chartered Accountant in practice.
- LLPs that are exempted from mandatory audit may also get their accounts audited if the partners decide to get the accounts of such LLP audited.

Filing Annual Return: -

- Every LLP would be required to file annual return in **Form 11 with ROC within 60 days from the closure of financial year.**
- The annual return will be available for public inspection on payment of prescribed fees to Registrar.

Filing Annual Accounts: -

All LLPs are required to submit statement of Account and Solvency in **Form 8 within 30 days from the end of six months the financial year** to which the statement of Account and Solvency relates.

Powers of Registrar: -

- To obtain such information which he may consider necessary, for the purpose of carrying out the provisions from any designated partner or employee.
- To summon any designated partner or employee to appear before him, in case any information has not been furnished or he is not satisfied with the information furnished to him.

Appointment of Auditor by Designated Partners

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LLPs have to appoint Auditor for each financial year unless it is exempt from audit. The Designated Partners may appoint an Auditor: -

- At any time for the first financial year but before the end of first financial year.
- Within 30 days before the end of Financial year (other than the first financial year)
- To fill the casual vacancy in the office of Auditor.
- To fill the casual vacancy caused by removal of Auditor

The partners may appoint the auditors if the designated partners have failed to appoint them.

Books of Accounts: -

Limited Liability Partnership are required to maintain books of account in respect of their income and expenditure

The books of account shall contain: -

- **Particulars of all sums of money received and expended** by the limited liability partnership and the matters in respect of which the receipt and expenditure takes place;
- **A record of the assets and liabilities** of the limited liability partnership;
- **Statements of cost** of goods purchased, inventories, work-in-progress, finished good and cost of goods sold; and
- **Any other particulars** which the partners may decide.

Advantages /Purpose/Need of Audit: -

- **Deducting frauds and errors: -** Audited Accounts helps in deducting errors &frauds and verification of financial statements.
- **Settlement of Disputes**: - Disputes, if any between any partners in matter of accounts can be settled with the help of audited accounts.
- **Lending Money**: -Banks & Financial institutions lend money on the basis of audited accounts.
- **Improving Management: -**Periodical visits and suggestions by auditor help in improving the management of LLP.
- **Settlement of Accounts**: -For settling accounts between partners at the time of admission, death, retirement, insolvency etc. audited accounts are required.

Auditor's Duty Regarding Audit of LLP

1. **Definite Instructions: -** The auditor should get definite instructions in writing for the work to be performed by him.

2. The auditor should mention: -
    - Whether the records appear to be correct & reliable
    - Whether he has obtained all information & explanation necessary for his work.
    - Whether any restriction was imposed on him.

3. Regarding LLP Agreement the auditor should mention: -
    - Nature of business of LLP
    - Amount of Capital contributed by each partner
    - Duration of partnership
    - Drawings allowed

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- Salaries, commission etc. payable to partner.
- Borrowing power of LLP
- Rights and duties of partners
- Method of settlement of accounts between partners at the time of admission, retirement etc.
- Any loans advanced to partners
- Profit sharing ratio

4. Check minutes books tor any resolution passed regarding the accounts.

Audit of Incomplete records

1. The examination of records and documents is one of the most important techniques through which an auditor collects evidence. Therefore, in case the records and documents maintained by an enterprise are incomplete, it would prove to be a great handicap to the auditor.

2. **An auditor may face the situation of incomplete records under the following circumstances:**

a. **Where records are kept on single entry basis; or**

b. **Where records are kept on double entry basis, but some of the records are destroyed accidentally, or are seized by authorities, or are otherwise not available for the auditors examination due to similar reasons.**

3. Under the second circumstance, an ideal approach for carrying out audit would be that the auditor may direct the management of the enterprise to complete or reconstruct the accounting records, e.g., if vouchers are available but the cash book, journal and the ledger are not maintained, then the cash book, journal and ledger should be written up.

4. However, if vouchers are also not available, then cash book/journal/ledger will have to be prepared by correlating the evidence available, e.g., memoranda records, bank statements, statements from outside parties, etc. Even though such books which are prepared may not be complete but may still contain useful information for the auditor.

5. On the other hand, when books are maintained on single entry basis, then the management of the enterprise would be asked to write up the books, to the extent possible, as they would have been written up under double entry system.

6. In any case, **the following steps would be required to conduct an audit:**

a. Ascertain that the balance sheet or statement of affairs as at the beginning of the year should be prepared and all the relevant accounts should be opened in the ledger. Normally, under the single-entry system, cash, bank, and personal accounts are maintained.

b. Confirming that all entries on receipt side of the cash book are posted in the ledger, even by opening new account(s) wherever necessary.

c. Check that all entries on the payment side of cash book are posted in the ledger.

d. Confirming that all entries appearing in bank account are posted in the ledger.

e. Analyze personal accounts of debtors. This will provide vital information regarding credit sales, sales returns, discounts allowed, bills received, bills

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dishonored, etc. It would be necessary to post such items to relevant accounts, to complete the double entry from the debtors' accounts.

7. Similarly, it would be necessary to analyze the creditors' accounts and post entries relating to credit purchase made, discounts earned, purchases return, bills payable issued to suppliers, bills payable dishonored, etc., to relevant accounts.

8. From an auditor's viewpoint, the supervisory controls exercised by the owners are generally less reliable and hence while auditing incomplete records, auditor will largely depend on extensive substantive procedures and obtain external evidence, physical examination/ observation, management representation and perform analytical procedures.

9. Based on sufficiency and appropriateness of audit evidence, auditor shall issue an appropriate opinion. If there is any limitation on scope of work owing to lack of information, he may issue qualified or disclaimer of opinion, as appropriate.

Audit of an Educational Institution:

Aspects	Auditors' Approach
Constitution	Examine the Trust Deed or Regulations and determine the constitution of the organization. Also note down the provisions affecting accounts, contained in the Regulations.
Minutes Book and Charter Documents	Carefully examine the minutes of the Managing Committee's or Governing Body's meetings, noting down the resolutions affecting the accounts. Confirm that the decisions undertaken are duly complied with, for operation of Bank accounts, approval of expenditure.
Fees obtained from Students	• Verify the names entered into the Student's Fees Register for each term or month, along with the class, Registers showing the students name on roll and testing the amount of fees charged • Check that the system of internal check ensures proper issuance of demand against students for fees outstanding. • Verify the fees received by the comparison of counterfoils of receipts provided with the entries in the Cash Book. • Mark out the collections in the Fees Register to ensure that the revenue earned from such source has been duly accounted for. • Determine whether the fees paid in advance is duly considered under the approval of proper authority. • Check the admission fees with admission slips duly signed by the College Principal and ensure that the amount is credited to a Capital Fund or Separate Account decided by the Managing Committee. • Verify whether the fines for late payment, absence, etc. have been either collected or foregone under proper authority. • Determine whether hostel dues were recovered before the closure of the student's accounts and refund of their deposited caution money. • Report to the Managing committee, old huge arrears on account of fees, dormitory rents, etc. if any.

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Other Incomes	• Check the rental income earned from landed property with Rent Receipts and Agreements. • Affirm the income from endowments and legacies and also the dividend and interest from investment and verify the securities with respect to investment held. • Verify any local authority or government grant with the grant memo. If any expenses have been disallowed for the grant purpose, determine the reasons for it.
Expenditure	• Determine the operation of internal control system over the various heads of expenditures. • Affirm the various items of expenditure, noting down the abnormal or heavy items, if any. Get the appropriate explanations for noteworthy items of expenditure.
Taxation	• Verify that tax exemptions under the Income Tax Act are enjoyed by the institutions • In case of TDS from rents, interest, etc. check whether the refund claim has been made • Investigate that the conditions subject to which exemption has been granted, have been followed or complied with.
Accounting Adjustments	• Verify the fixed assets and ensure that sufficient depreciation has been provided • Verify the capital fund and other liabilities • Ensure that caution money and other deposits paid by students during admission are shown as liability in B/S and not transferred to revenue, unless and until they are not refundable • Note that the investments which represent endowment fund for prizes have been kept separate and any income in excess of such prizes is accumulated and invested along with the corpus. • Confirm that separate accounts statement has been prepared with regards to Scholarship Fund, Games Fund, Staff Provident Fund, Hostel Fund, etc.
Financial Information	Verify whether the form and manner of presenting financial information comply with the Accounting Standards and applicable legal requirements.
Certificates	Get the appropriate representation of management and certificates with respect to various aspects covered during the audit course.

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Case Study – Exam Question

Mention any six points to be considered for good internal control for collection of tuition fees from students of college

Internal control points for collection of tuition fees:

a. *There must be a clear-cut tuition fee structure approved by the college council.*

b. *The challan or paying in slip should contain necessary fields for identifying the roll number of the student, class, and period for which fees is paid etc. The slips should have such number of counterfoils to cross check the remittance.*

c. *The paying in slip when filled by the students, should be checked for its correctness as to applicable amount etc. by one clerk and the amount should be entered in a scroll. He must initial the slip which authorizes the cashier to accept the fees as per slip.*

d. *The cashier scroll and the authorizing officer/s scroll should be checked by an officer daily.*

e. *All remittance should be banked each day. No amount should be allowed to be spared for meeting any type of expense.*

f. *Alternatively, the fees may be directly remitted into bank and banker's daily remittance slip should be scrutinized by college officers.*

g. *Arrears list should be periodically prepared from the students rolls. Any concession, remission of tuition fees should have approval of competent authority.*

h. *Delayed remittance should carry fines or compensating charges for delay.*

i. *When students are readmitted after removal for non-payment of fees, the admission should carry the permission of competent authority.*

Audit of a Charitable Institution

Aspects to be addressed	Auditors' Approach
Formation/ Constitution/ Legal Form	• Determine the formation of charitable institution and note down the financial powers of the executives and managing committee. • Investigate the relevant byelaws or trust deed for determining the powers and duties of the Managing Committee or Board of trustees
Functions	• Investigate the functions being carried on by the institution and verify whether they are within the permitted objects of the institution. • Scrutinize the minutes book of the Managing Committee regarding various financial decisions constituting the decision on sale or purchase of investment, acquisition or disposal of fixed assets, donation receipts, endowment, etc.
Funds	• Note the specific conditions attached to the funds operated by the trust. • Confirm whether the objectives in operating each fund are fulfilled.
Subscriptions and Donations	• Determine the changes if any, with regards to annual or life membership subscription for during the year. • Determine that there is sufficient internal control over the issue of official receipts, custody of receipt books not used, printing of receipt books, etc. • Investigate the internal check system regarding the money received from box collection, flag days, etc. • Ensure proper control system over collections and also ensure that they have been properly accounted.

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	• Verify the total subscription and donation received with the figures published in the issued reports of Charitable Institutions.
Legacies	• Verify the amount received with the agreement in this regard and other available information.
Grants	• Verify the amount received with the relevant correspondence receipts and minute books and gain a certificate from the responsible official indicating the amount of grant received.
Income from Investment	• Affirm strongly the amount received with the interest and dividend, counterfoils and computation of interest on securities for sale or purchase of investment. • Ensure that appropriate dividend is received; also compare the dividend received with the investment list to confirm that dividend has been received with respect to all investment.
Rents	• Inspect the rent roll and tenancy agreements with respect to rent amount and due date. Also, affirm strongly the rent receipts with rent roll, cash book and counterfoils of receipt book.
Specific Functions	• Affirm strongly the gross receipts and payments in respect to any specific function and confirm that the proceeds of all tickets issued are accounted for after making allowance for return.
Income Tax Refunds	• Verify the refund of TDS on dividend or interest from the Income Tax Authorities as Charitable Institutions are provided exemption from income tax.
Expenditure	• Affirm strongly the payment of grants and it should be paid only for charitable purpose. • Verify the schedules of securities held and inventories of properties held. • Confirm that the trustees or any officials are not benefited out of the charitable institution. • Carry physical verification of securities, title deeds and movable properties. • Verify the cash and bank balances. • Confirm that any fund contributed for a specific purpose is used for that particular purpose only.

Audit of NGOs

NGOs are non-profit making organization which raise funds from members, donors or contributors and spend them for the provisions of various services to the society. They also receive donation of time, energy and skills for achieving their social objectives like imparting education, providing medical facilities, economic assistance to poor, managing disasters and emergent situation.

Constitution: NGO's can be incorporated in the following ways:

1. As a society under Society Registration Act, 1860 or

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2. As a trust under the Indian Trust Act 1882.
3. As a company u/s 25 of the Companies Act, 1956.

Examples of NGO's are religious organization, voluntary health and welfare agencies, charitable organizations, hospitals, old age homes, CRY etc.

1) Main sources of funds for an NGO:

1. **Revolving fund contribution:** The aim of this fund is to revolve the amount by giving temporary loans. The interest income earned there from is added to the fund.
2. **Corpus contribution:** A contribution made towards the capital corpus of an NGO is known as corpus contribution.
3. **Specific donations:** These are acquired for specific purposes like acquiring fixed assets.
4. **Contributions in kind** includes assets such as land, building, vehicles etc.
5. **Other income:** Advertisement fees from members:
   i. Subscriptions
   ii. Income from fund raising concerts.

2) Application of funds:

1. Establishment costs.
2. Maintenance expenses.
3. Office and administration expenses.
4. Program / Project expenses.
5. Charity.
6. Donation and contributions given.

3)Planning of audit

1. The auditor must obtain knowledge about the client's activities, recent amendments, etc.
2. The constitutional form and organizational structure of the NGO should be carefully studied and reviewed.
3. Decisions taken by the board, committee, managing body etc. can be evaluated by an analysis of the respective minute books.
4. Study and verify the applicability of the accounting system, procedure, internal control and internal check.
5. Materiality levels should be determined.
6. Nature and timing of the various audit report and other communications must be set.
7. The expert's opinion and his report can be involved.
8. The previous year audit report should be thoroughly studied.

4)Audit Programme: The sequential order of assets, liabilities, incomes and expenditure must be maintained to see that no material items get omitted.

1. Corpus fund:

(i) Vouch it with reference to Agreement/Letter from donors

(ii) Tally the interest income with the investment register and physical investment in hand.

2. Reserves Vouching:

(i) Transfer of amt. from projects/programmers with donor letters and board resolutions.
(ii) Transfer of gross value of asset from capital reserve to general reserve and adjustment during the years.

3. Ear-marked funds:

Check: - requirements of donor institutions, board resolutions of NGO, rules and regulations of the schemes of ear-marked funds.

4. Project/Agency balances:

Vouch - the disbursement and expenditure as per agreement with donor for each of the balances.

5. Loans:

Vouch - With loan agreement.
- Receipt - counter foil issued.

6. Fixed assets:

- Vouch - acquisition/sale/disposal/ depreciation.
- Verify - its approval by appropriate authority.
- Check - donor's letter or agreement for grant, and the title for immovable property.

7. Investments:

- Check - the investment register, and - the investments physically; to ensure that the name of the NGO is included in it.
- Verify - approval of appropriate authority.
- Refer bank account - for the principal and interest amount of the investment.

8. Cash in hand:

- Verify, at the year end, physically, the cash in hand and the imprest balance.
- Check that it tallies with the books of account.

9. Bank balance:

- Check the bank reconciliation statement (BRS).
- Ascertain details for:
  - Old outstanding balances.
  - Unadjusted amounts.

10. Stock in hand:

Verify and obtain certificate from management for its quantities and valuation.

11. Programme/Project expense:

- Verify the agreement with the donor or contributor for the particulars project or programme in order to find out the condition.
- If it involves contracts-then:
  - check its conditions and
  - Ensure that income tax is deducted, deposited and return filed.

12. Establishment expenses:

- Verify that the PF, Life insurance premium, ESI and their administrative charges are deducted, contributed and deposited in the prescribed time.
- Verify the office and other administrative expenses like postage, stationery, traveling etc.

5) Audit of NGO's income:

(i) Contributions and grants for projects and programmers:

Check:

(a) agreement with donor and grant letter- to ensure that money received has been accounted for.

(b) that all foreign contribution receipts-are deposited in FCRA (Foreign Contribution (regulation) Act, 1976) Accounts.

(ii) Receipt from fund raising programme:

Verify:

(a) the internal control system.

(b) who is the person responsible for the collection of funds.

(c) mode of payment.

(d) collections are counted and deposited in the bank daily.

(iii) Membership fees:

(a) Check:

- the fees received with the membership register.
- that proper classification is made between.
- entrance fees.
- annual fees.
- life membership fees.

(b) Reconcile the fees received and fees to be received during the year.

(iv) Subscriptions:

(i) Check or compare:

(a) subscription register with receipt issued.

(b) receipt issued with subscription rate schedule.

(ii) Reconcile - subscription received with printing and dispatch of corresponding magazines, circulars and periodicals.

(v) Interests and Dividends:

Check interest received and receivable with investments held during the year.

CASE STUDY

1Q) State any six important points to be examined by you, as an auditor, in verifying the correctness of bank balance of an Educational Institution which deposits all its collection/receipt in separate collection account of a bank

Ans) For verifying the balances lying with bank in collection account, the auditor should adopt following procedure:

a. *Examine and compare the pay-in-slips with the entries in the ledger account of the educational institute.*

b. *Check the casting, carry forwards and balancing of ledger account.*

c. *Compare the entries in the ledger account with the bank statement.*
d. *Review the bank reconciliation statement for its correctness.*
e. *Scrutiny the subsequent period bank statement to ensure that items of reconciliation are subsequently cleared.*
f. *Verify the balance confirmation certificate.*

2Q) The Vidhwat college, an institution managed by Dayal Trust, has received a grant of Rs.1.35 Crores from Government Nodal agency for funding a project on rural health system in India. Draft an audit programme for auditing this fund in the accounts of the college

Ans) a) Examine Grant sanction letter:
i. *Check the purpose and conditions relating to the use of monies.*
ii. *Any express restrictions / prohibitions on the use of the moneies for certain purpose.*
iii. *Manner of investment of grant amounts.*
iv. *Reporting requirements to nodal agency.*
b. *Minutes book shall be perused to verify:*
i. *Resolution passed relating to use of grant.*
ii. *Decisions taken have been duly complied with.*
c. *Expenses audit:*
i. *Examine the receipt and payment account of the fund.*
ii. *Test check few expenditure entries along with supporting documents, to ensure genuineness of the claims and payments.*
iii. *Ensure that the fund is not misappropriated.*
d. *If the grant had been used for creation of fixed asset, verify such asset so created.*
e. *Verify investments of the funds as on the balance sheet date.*
f. *Obtain certificate from bank towards confirmation of Bank balance as on the Balance sheet date.*

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Audit of a Hospital

Aspects to be addressed	Auditors' Approach
Internal Check	• Investigate the internal check with regards to issues and receipts of stores, lines, apparatus, clothing, instruments, etc.

	• Confirm that the purchase is made appropriately and is recorded in the Stock Register and the issue is made only against an appropriate authorization.
Income from Services	• Investigate the Bill Register of patients and also the copies of bills issued to them. • Test check some of the bills with the attendance records of the patients to see that the bills are correctly prepared • Verify that the bills are issued to all the patients who have paid any amount according to the rules of the hospital • Get satisfactory explanations of the unbilled and concessional billing cases.
Collection of Cash	• Verify collection of cash from Cash Book along with receipt counterfoils and other evidences such as copies of patient's bills, dividend warrants, rent bills, etc. • Carry unexpected cash verification at all cash handling locations on the same day. • Verify whether there is an existence of procedure for deposit of all cash collections on the same day and also that the procedures have been followed.
Grants and Donations	• Verify whether the receipts of grants, if any, are duly accounted for. • Determine that the legacies and donations received for specific purpose are so applied. • Confirm that appropriate classification between Revenue and Capital with respect to various grants has been made.
Income from Investment	• Analyze the Property and Investment Registers to check that collections of income have been made through rent from properties, dividend and interest on securities, etc. • Verify whether the dues collectible are properly followed up with the concerned parties.
Purchases and Expenses	• Affirm strongly the purchases and expenses and get satisfactory explanations for non-recurring and abnormal items, prevailing if any. • Verify whether appointment of staff and their salary increments have been appropriated and authorized by the Trustees/Managing Committee. • Verify whether the Capital Expenditure is incurred only if the Trustees/Managing Committee has sanctioned. • Make comparison of the total value of various items of income and expenditure with the budgeted amount for them. Peruse the variance reports submitted to the management.
Stock-in-Trade	• Get the closing inventories of assets, stocks and stores physically examined.

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	• Make comparison of their total value with the particular ledger balances. • Verify whether income tax liability is properly ascertained and provided for. • If the institution is eligible for exempting the income tax, verify whether refund to TDS is properly claimed.
Registers	• Examine the bonds shares, Scripts and Title Deeds of Properties and make comparison of their particulars with that of Property and Investment Registers.
Balance Sheet Items	• Verify the fixed assets and confirm that sufficient depreciation has been provided for. • Examine in detail the accounts of sundry creditors for goods, auditors for services and also analyze if there are any abnormal movements verify Share Capital, Reserves and surplus, Secured Loans and Unsecured Loans.
Compliance with Accounting Standards	• Verify whether the form and way of presenting financial information comply with the Accounting Standards and applicable statutory requirements.
Management Representation and Certificate	• Get proper management representation and certificates with respect to various aspects covered during the audit course.

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Audit of a Club

Aspects to be addressed	**Auditors' Approach**
Formation	• Investigate the formation of club and powers of the governing body. Study the relevant rules or byelaws pertaining to preparation and finalization of accounts. • Inspect the minutes book of the Governing Body and ensure whether the powers have been appropriately exercised.
Members Entrance Fees	• Affirm strongly the receipts on account of entrance fees with the application of members, counterfoils issued and minutes of the Managing Committee.
Subscription of Members **{May 2005, May 2010}**	• Affirm strongly the subscription of members with the counterfoils of receipts issued to members. • Mark out the receipts of selected periods to the Members Register

	• Reconcile the total amount of subscription due with the amount collected and outstanding. • Check the total of various columns of Members Register and tally them across. • Check the Members Register to determine the dues areas and examine whether necessary steps have been taken for their recovery. The amount considered irrecoverable, if any, must be written off. • Check bank statements in case of direct bank remittances for remittances in foreign currency and remittance by way of e-payment gateways. • Confirm that arrears of subscription for the previous year are brought over correctly and arrears for the year under audit and advance subscription received is correctly adjusted.
Services Charges from Members	• Verify the internal check system with regards to members being charged for (a) Foodstuffs and drinks provided, (b) Fees chargeable for specific services rendered e.g. billiards, tennis, etc. • Mark out the debits for a selected period from subsidiary register maintained with respect to supplies and services to members to ensure that the account of members have been debited by the amounts recoverable from them.
Purchases	• Affirm strongly the purchase of sports items, furniture, crockery, etc. and mark out their entries into particular stock registers. • Also affirm strongly the purchase of foodstuff and drinks, etc. and test their sale price in order to ensure that normal rates of profit have been earned on their sale. • Carry physical verification of closing stock on unsold provision and stores and check the valuation. • Check the stock of furniture, sports material and other assets physically with particular, stock registers or inventories prepared at the year-end.
Investment and income tax	• Investigate the share scraps and bonds with respect to investments. Check their current value for disclosure in final accounts and also determine the arrangement for their safe custody are satisfactory. • Check the accrual of income there from and provision of income tax thereon.
General	• Verify the fixed assets and confirm that sufficient depreciation is provided. Examine in detail

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	the accounts of Sundry Creditors for goods, Creditors for services and analyze if there are any abnormal movements. • Verify whether the form and way of presenting the financial information comply with Accounting Standards and applicable statutory requirements. • Get proper management representation and certificates with respect to various aspects covered during audit course.

Audit of Cinema Hall

Aspects to be addressed	Auditors' Approach
Internal Control System	Verify that adequate and proper internal control system and procedures have been designed and fulfilled i.e. with regards to tickets for entrance in hall to be pre-printed for each show and class and serially numbered and bound into books having separate series for advance booking issued and are under the charge of a responsible official.
Cash Collection	Reconcile the statement of tickets sold with the collection of cash at the end of the show referring to the counterfoils collected at the entrance to the hall.
Free Pass	Verify that appropriate authority prevails for Free Passes.
Entertainment Tax	Verify the entertainment tax collected with the total tickets issued for each class.
Advertisement Slides	• Vouch other income from advertisement slides referring the relevant registers and agreements. • Cross verify the advertisement income based on the Slides Register and shots exhibited kept at cinema.
Expenditure Verification	• To verify that the expenditure incurred on advertisement and repairs and maintenance are not capitalized accounted as revenue expenditure. • Check that appropriate depreciation on fixed assets has been charged with regards to the useful life of the assets having respective reference to the asset. • Affirm strongly the expenditure incurred on film hired with relevant bills of distributors with reference to agreements.
Advance to Distributors	• Inspect the unadjusted balance out of the advances paid to the distributor against the film hire contracts to check that they are good and recoverable.

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	• Check whether adequate provision is made with respect to irrecoverable advances. • Verify whether all advances in respect to film already running are fully adjusted.
Restaurant	• If the restaurants are run by the cinema, its accounts must be investigated covering the purchase and sale of drinks, etc. and confirm that the closing stock of these items have been duly considered. • If the restaurant is let out, enquire into the arrangement for collection of share in the restaurant income which may either be a fixed sum or fixed percentage of the takings.

Audit of a Hotel {Nov 1989, May 1991, May 1994, May 2005, Nov 2009}

Aspects to be addressed	Auditors' Approach
Internal Control Room Sales	• Verify the Room Sales, Collection from the guest register. • Sometimes, daily occupancy reports and exit reports are prepared. In such case test check a few reports with the guest register and with the individual guest's bill to ensure proper billing. • See whether standard room rates have been charged in different guests bills. In case there is variation, get the satisfactory explanation and sanction for the same.
Internal Control Restaurant, Billing and Sales.	• All Sales points in a hotel make both cash and credit sales. The auditor must see the internal control system as regards: (i) Procedure for billing customers for room services and sundry services, (ii) Procedure for issue of provisions and commodities. (ii) Safe custody of edibles wines, linen etc. He should : • Perform the compliance test to ensure the internal control system operates effectively. • Reconcile the total sales reported with the total of the bills issued by the sale point. • Check the numerical control system to ensure that all bills are included in the total. • Verify a few restaurant bills by reference to KOT's (Kitchen Order Tickets) or basic records.

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	• Trace the cash elements of sales in the cash book and the credit sales in total and detail to the guest's bills.
Internal Control on Stocks.	• Examine the documentation procedure in respect of stock since hotel stock are readily (a) portable & (b) saleable. • Perform compliance tests to ensure that all such documentation is accurately processed. • Ensure that movements of provision and goods in or out of the stores take place only after proper authorization and recording. • Supervise the physical stock taking and test checking pricing calculations. • Verify the basis of valuation adopted for stocks.
Casual Labor	Generally the hotels employ casual labor to a very large extent. Hence the auditor should: • Examine the wage payment registers and attendance records to see whether any manipulation has been made. • Verify whether adequate records, as needed by law, wherever applicable, have been maintained.
Commission Payments	• Verify that the amounts due are recovered from agents as per the term of credit allowed. • Check the commission, if any, paid to agents by reference to the agreement.
Fixed Assets	• Obtain a schedule of fixed assets and verify whether adequate depreciation has been provided at the prescribed rates. • Verify whether the capitalization and depreciation policies have been followed properly or not. Conduct physical inspection of fixed assets and get management certificates for periodic inspections. Examine the method of recording the assets.
Statutory Compliance	• Note the provisions, rules and regulations of various laws governing the operation of hotels. • Verify whether the condition of license for running the hotel have been complied with. • Check whether all the foreign exchange transactions have been properly entered into appropriately and reported.
Analytical Review	• Compare the expenses and receipts with the figures of the previous year. Work out the occupancy rate and compare it with similar other hotels.

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General	• Examine the customer's ledger on a sample basis in depth to see that all charges that should be made to the customers are actually made. • Check whether income receivable but not yet billed has been accounted. • See whether provision for replacement of current assets is made. • Verify the share capitals, reserves, secured and unsecured loan. • Obtain the appropriate management representation and certification respect of various aspects covered during the course of audit.

Audit of the leasing transaction of a Leasing Company

Aspects to be addressed	Auditors' Approach
Relevant Introductory Arrangements	• Note down the relevant provisions of the Companies Act, 1956 or any other governing legislation applicable to the company, and study the impact of the directions, if any issued by the relevant authority such as RBI. • Note down the relevant provisions of Memorandum of Association and Articles of Association. • Obtain list of books of accounts, registers, memoranda records and accounting policies adopted by the company. • Examine the Minutes of Board Meeting and note the delegation of powers to execute lease agreements, sanction for various agreements, authorization for purchasing certain assets, etc.
Internal Control	Examine the existence and operation of internal control procedures on the following aspect: • Determination of credit analysis of the lease such as lessee's ability to meet the commitment under lease, past credit records, capital strength, availability of collateral security, etc. • Executions of documents for lease transactions. • Receipts and accounting of lease transactions, in accordance with AS 19 on Leases. • Sanction for incurring expenditure and purchase of assets under lease agreements.
Lease Agreements	Examine the clauses of the lease agreement with reference to the following points : • Description of the lesser, lease, equipment and location of installing the equipment (the

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	stipulation that equipment would not be displaced from the location described except for repairs. For identification, the lesser may also need plates or markings to be connected with the equipment.) • Note the amount of lease tenure, payment date, late charges, deposits or advances, etc. • Stipulation to terminate agreement i.e. whether the equipment should be returned to the lesser and the cost should be borne by the lessee. • Stipulation regarding subletting right i.e. whether the agreement prohibits the lessee from assigning or subletting equipment and authorizes the lesser to do so. • Nature of lease agreement as to whether it is an operating lease or finance lease and accounting treatment in either case in line with AS 19.
Substantive Procedure	Test check some of the lease agreements with reference to following aspects: • Terms and conditions of the form of lease proposal submitted. • Contents of invoice and its custody aspects as lease is a long term contract. • Acceptance letter obtained from the lessee showing that the equipment is received in order and is also accepted by the leases. • Resolution of the board authorizing a respective director for the execution of lease agreement. • Copies of insurance policies on various assets obtained by the lesser for his records. • List of clients from whom the lease rents are overdue, reconciliation statement and balance confirmation. • Sufficient amount of provision for bad and doubtful debts referring to the recovery of payments, litigation's, subsequent realizations etc. • Proper accounting treatments of the assets have been given on lease or repossessed.

GOVERNMENT AUDIT AND AUDIT OF LOCAL BODIES

1) Government Audit:

The U.N. handbook on 'Government Auditing and Developing Countries' defines Government Auditing as:

'The systematic, professional and independent examination of financial administrative and other operations of a public entity, for the purpose of evaluating and verifying them and presenting a report containing comments, conclusion and recommendations and expressing the appropriate professional opinion in respect of financial statements'.

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In India, the government audit is discharged by the independent statutory authority known as Comptroller and Auditor General of India, the head of the agency Indian Audit and Accounts Department.

2) Comptroller & Auditor General:

Appointment: The C & AG shall be appointed by the President of India and shall not be removed from the office except on the ground of proven misbehavior or incapacity.

Remuneration: The C& AG should be paid remuneration equivalent to that of a Supreme Court Judge.

Removal: C & AG will be removed only when the parliament house decides to do so.

Powers and duties (articles 149): They are to be followed as per the C &AG Act, 1971.

Maintenance of Accounts (articles 150): Accounts will be maintained as per the description given by the President to C & AG.

Submission of accounts (articles 151): The report of the C & AG shall be submitted to the President/Governor who shall cause them to be laid before the parliament house.

3) Duties of the C & AG:

	What is to be done
Compilation and submission of Accounts	The C & AG should compile the accounts pertaining to annual receipts and disbursements of the Union or State or Union Territory and submit these to the President or Governor or Administrator.
Rendering Assistance in Accounts Maintenance	The C & AG should provide such information to the Union or State or Union, as they may require from time to time and render such assistance for preparing annual financial statements as they reasonably ask for.
Auditing and Reporting	a. The C & AG should audit and report on: All the expenditures from **Consolidate Fund** of India/State/Union Territory having a Legislative Assembly and to determine whether the monies disbursed were legally available for and applicable to the purpose and service for which they are applied and whether the expenditures comply with the authority governing it. All the transactions of Union or State pertaining to **Contingency Funds and Public Accounts.** All the trading, manufacturing, **Profit & Loss Accounts and Balance Sheets** and other subsidiary accounts kept in any department of a Union or State.
Auditing Receipts and Expenditure	The C & AG should audit and report on all the receipts and expenditure of anybody or authority substantially financed by Consolidated Fund of India or State or Union Territory. For such purpose, a body or authority shall be treated as substantially financed if the amount of grant or loan in year is: 1. More than Rs. 25 lakhs 2. More than 75% of the total expenditure of that body or authority.

Auditing Grants or Loans	This applies to the grant or loan of any specific purpose, provided from the Consolidate Fund of India or State or Union Territory, to anybody or authority other than a Foreign State or International Organization. The C & AG should examine in detail the procedures by which the approving authority satisfies itself the fulfillment of the conditions of providing such grants or loans.
Auditing Receipt of Union or State	The C & AG should audit all the receipts payable into the Consolidated Funds of India or State or Union Territory. He may satisfy himself that the rules and procedures have been designed to make an effective check on the assessment, collection and proper allocation of revenue and are duly being observed.
Auditing Stores and Stock Accounts	The C & AG should be authorized to audit and report on the stores and stock accounts kept in any office or department of the Union or State.
Auditing Government Companies and Corporation Accounts	The C & AG should exercise such powers and duties according to the provisions of Companies Act, 1956, pertaining to Government Companies and Corporations.

Powers of C &AG

He can inspect any office of accounts under the control of the union or state government.

1. He may require that any accounts, books, papers and other documents, which are relevant to the transactions under audit, be sent to specified places.
2. He can put such questions, as he may consider necessary, to the person in charge.
3. He can call for such information as he may require for the preparation of any account or report.
4. **Supplementary audit**:
   a. He is empowered to conduct a supplementary or test audit of the accounts of a company and for the purpose of such an audit in any form as he may by general or special order, direct to require information or additional information to be furnished to authorized person on the required matter.
   b. Accordingly, the C &AG has issued directions to the auditors in detail and further is empowered to conduct supplementary audit in any such manner as he thinks correct.

5) Audit of Government Expenditure

The auditor examines the fulfillment of conditions for incurring government expenditure. It involves:

a. Audit of rules and orders
b. Audit of sanctions
c. Audit against provision of funds

d. Propriety audit
e. Performance audit

Audit of expenditure of government organization or department is conducted by the C & AG of India. It is a major constituent of the government audit. The basic standards established for expenditure audit are to confirm that there is provision for funds authorized by the competent authority setting the limits within which expenditure can be incurred. **These standards are as follows:**

1. The expenditure incurred comply with the relevant provisions of the law and according to the Financial Rules and Regulation constructed by the competent authority. Such audit is known as "**Audit against Rules and Orders**."
2. There is either special or general sanction allowed by the competent authority authorizing the expenditure. Such an audit is known as **"Audit of Sanctions."**
3. There is provision for funds out of which expenditure is incurred and also it is authorized by the competent authority. Such audit is known as **"Audit against Provision for Funds."**
4. The expenditure has been incurred with due regards to the broad and general principles of the financial propriety. Such audit is known as **"Propriety Audit."**
5. Various programmers' scheme and project in which huge financial expenditures have been incurred or being run economically and are yielding results expected from them. Such audit is known as **"Performance Audit."**
6. The propriety audit and performance audit suggest completely, a different approach, adopted by the C & AG as against the regulatory audit. In propriety, audit the C & AG brings out the cases of avoidable, improper or unfruitful expenditure even though the expenditure has been incurred in compliance with the existing rules and regulations. Performance audit goes even a step ahead and has a quite comprehensive approach as it includes **3 Es i.e. Efficiency, Economy and Effectiveness.**

(a)Audit against Rules and Orders

The auditors have to ensure that the expenditure incurred complies with the relevant provisions of the legal enactment and is according to the financial rules and regulations framed by the competent authority.

Rules and orders: The rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:

- Expenditure from consolidated fund and the contingency fund of India or State.
- Presentation of claims against Government, withdrawing monies from the consolidated fund, Contingency fund and Public Accounts of India/State, and in general the financial rules prescribing the detailed procedure to be followed by Government servants in dealing with Government transactions; and
- Rules and Orders regulating the conditions of Service, Pay and allowances and pensions of Government servants.

The function of Audit is to carry out examination of various rules, regulations and orders issued by the executive Authorities to see that:

i. They are not inconsistent with any provisions of the Constitution or any laws made there under.
ii. They are consistent with the essential requirements of audit & accounts as determined by the C & AG.
iii. They do not come in conflict with the orders of, or rules made by any higher authority and
iv. In case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule making power.

(b)Audit of Sanctions

The auditor has to ensure that each item of expenditure is covered by:

1. A Sanction, either
   i. General or
   ii. Special

2. The authority sanctioning:
   i. is it competent for the purpose?
   ii. by virtue of the powers vested in it by the provisions of the constitution and of the laws, rules or orders made hereunder; or
   iii. By the rules of delegation of financial powers made by an authority competent to do so.

(c)Audit against Provision of Funds

There are two aspects, which have to be considered while carrying out an audit against provision of funds:

(i) To determine that the expenditure has been incurred on the purpose for which the grant and appropriation has been provided, and

(ii) To ensure that the amount of such expenditure does not exceed the appropriation made.

(d)Propriety Audit

In propriety audit, the auditor tries to bring out the cases of avoidable, improper and unfruitful expenditure even though the expenditure has been incurred in compliance with the existing rules and regulations.

1. Audit against propriety endeavor to ensure that the expenditure comply to the principle as stated below:

   a. The expenditure must not be prima facie more than except in the occasions demanded. Each and every public officer is expected to maintain the same alertness with respect to the expenditure incurred from public amounts as a person of ordinary prudence would do with respect to the expenditure of his own amount.

   b. No authority should use its powers of approving expenditure to pass an order which will be directly or indirectly to its own advantage.

   c. Public amounts should not be used in the favor of a particular person or section of the community until and unless:

   - The expenditure amount involved is insignificant or
   - A claim for the amount could be enforced in the court of law and

- The expenditure is in pursuance of a recognized policy or custom

d. The allowances amount such as traveling allowances, provided to meet expenditure of a particular type, should be regulated that the allowances are not wholly the sources of profit to the recipients.

e. It may be expressed that the executive departments are responsible for enforcing economy in public expenditure. The function of auditor is to bring into the notice of the proper authorities, the wastage in public administration and the case of avoidable, improper and unfruitful expenditure.

f. Identify cases of improper, avoidable or anfractuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.

g. This will ensure a reasonably high standard of public financial morality when auditors look into the wisdom, faithfulness and economy, of transactions.

(e)Performance Audit / Full scope audit:

The scope of audit has been extended to cover 3 E's i.e. Efficiency, Economy and Effectiveness audit which is also known as Performance audit or Full Scope audit.

(i)Efficiency Audit examines the execution of various schemes or projects and their economical operation and also whether they are yielding the results expected from them i.e. the relationship between the goods and services produced and resources used to produce them and examination with the purpose of finding out the extent to which operations are performed in an economical and efficient manner.

(ii)Economy Audit examines the acquisition of financial resources, human resources and physical resources economically by an entity and whether the approving and spending authorities have observed economy.

(iii)Effectiveness Audit is performance appraisal of the programmers, schemes, projects with reference to the overall targeted goals as well as the efficiency of means adopted for achieving these goals.

(iv)Efficiency-cum-performance audit, anywhere used is an objective examination of the financial and operational performance of an organization, programme, function or authority and is oriented towards identification of opportunities for greater economy and effectiveness.

The procedure of performance audit covers:

1. **Identification of topic**
2. **Preliminary study**
3. **Planning and execution of audit**
4. **Reporting**

Generally, the performance audit is conducted by the government with respect to various expenditures incurred. While the trends towards comprehensive approach for conducting the performance of full scope audit are visible, the coverage and depth of evaluation may vary on the basis of statutory limits

6) Audit of receipts:

The audit of receipts is concerned with the following:

1. **Assessment:** Whether all revenues or other debts due to government have been correctly assessed, realized & credited to Government account by the designated authorities.
2. **Procedure of collection:** Whether adequate regulations & procedures have been framed by the department or agency concerned to secure an effective check on assessment, collection & Proper allocation of cases.
3. **Implementation:** Whether such regulations and procedures are actually operated.
4. **Monitor over irregularities and frauds:** Whether adequate checks are imposed to ensure the prompt detection & investigation of irregularities, double refunds, fraudulent or forged refund vouchers, or other loss of revenue through fraud or willful omission or negligence to levy or collect Taxes or to issue refunds, and
5. **Review and suggestion:** Review of systems and procedures to see that the internal procedures adequately secure correct and regular accounting of demands collection & refunds & pursuant of dues up to final settlement & to suggest improvements. The extent of audit under each of the above category is determined by the C&AG. These are neither negotiable nor questioned. This audit is conducted both:
    a. **Centrally** - Where accounts and Original vouchers are kept, and
    b. **Locally** - Where the drawing and disbursing functions are performed.

7) Audit of stores and stocks in respect of Government Audit

	Documents to be vouched	**Aspects to be vouched**
1.	Compliance with Rules & Procedures	Determine whether the Regulations which govern purchase, receipt and issue, custody, sale and stock taking of stores are well-devised one & properly carried out.
2.	Purchase of stores	Confirm that- The price paid are reasonable and agree with those shown in the contract for the supply of stores, and The quality and quantity certificates are provided by the inspecting and receiving units.
3.	Accounts of Receipts, Issues & Balances	Verify the accuracy, correctness and reasonableness of the balances in stocks referring to the specified patterns consumption level and stock holding level. Conduct periodic stock verification for ensuring their existence. Revise the reasonableness of charging the costs to consumption in case of priced stores ledgers. Examine in detail the approval obtained for write- off, if any.

8) Audit of Commercial Accounts

The Governments also involves itself in commercial activities and to fulfill this purpose it may incorporate the following types of enterprises such as:

1. Departmental enterprises involved or engaged in commercial and trading operations which are subject to the same laws, financial and other regulations as other government department and agencies.
2. Statutory bodies, Corporations created by specific statues, mostly financed by governments in the form of loans, grants etc.
3. Government Companies set up under the Companies Act, 2013

All the enterprises or entities stated about are required to maintain accounts on commercial basis.

9) Audit Mechanism:

The audit of departmental enterprises is undertaken by the C&A G in the same manner as any other government department. Audit of statutory bodies depends upon the nature and type of governing statues.

In respect of Government Companies audit is conducted by Statutory Auditor appointed by the C& AG. In addition to this C& A G conducts a supplementary test audit. Further the powers of C & AG are:

1. **Direction:** To direct the way in which the company's accounts will be audited by the auditor and to give such an auditor instruction in regard to any matter relating to the performance of his function as such.
2. **Supplementary Audit:** To conduct a supplementary or test audit of the company's accounts and for the purpose of such audit, to require information or additional information to be furnished to authorized person or persons, on the required matters, in such form, as the C& AG may by general or special order direct.
3. **Report:** The Statutory auditor will submit a copy of his audit report to C & AG who shall have the right to comment upon or supplement the audit report in such a way as he may think fit.

The comments or supplement made on the audit report must be placed before the company, at the same time and in the same manner as the audit report. Thus, two layers of audit are conducted by a Government Company, one by the statutory auditor, and other by C&AG. Audit done by C&AG is a mixture of government and commercial audit. The nature and the scope of audit is influenced by the concept of autonomy and accountability.

10) Audit of Municipal Authorities / Local Bodies:

Local self- Government refers to administration of a locality i.e. Village, Town, City etc., by a body representing the local inhabitants possessing fairly large autonomy, raising at least a part of its revenue through local taxation property taxes, fees & licenses, professional tax, non, tax incomes e.g. rent, government grants etc. and spending its income on services which are regarded as local services district from state and central services.

(a)Types: Municipal Government in India covers five different types of urban local authorities:

i. Municipal Corporations
ii. Municipal Councils
iii. Notified Area Committees
iv. Town Area Committees
v. Cantonments Committees

(b)Functions: The functions of Municipal Authorities are endowed with specific local functions covering:

i. Regulatory
ii. Maintenance and
iii. Development activities.

(c)Sources of funds: The auditor verifies the following income with the available evidence:

i. Properly taxes & Octroi
ii. Profession tax
iii. Non - mechanized vehicles tax
iv. Taxes on advertisements
v. Taxes on animals & boats
vi. Tolls
vii. Show tax
viii. Different types of grants from the state
ix. Administration.

(d) Application of fund: The Auditor vouches following expenditures for the accuracy & propriety:

(i)General administration & revenue collection
(ii)Public health
(iii)Public safety
iv. Education, Public works etc.

(e) Objectives of Audit

Reporting on:

i. Reporting on the fairness of the content and presentation of financial statements
ii. Reporting upon the strengths and weaknesses of systems of financial controls
iii. Reporting on the adherence to legal and / or administrative requirements
iv. Reporting upon whether value is being fully received on money spent, and
v. Detection and Prevention of error, fraud and misuse of resources.

(f) Grants: Local bodies receive three types of grants from the state administration:

- **General Purpose Grants:** These are to substantially bridge the gap between the needs and resources of the local bodies.
- **Specific Purpose Grants:** To provide certain services or to perform certain tasks in the local area.
- **Statutory and Compensatory Grants:** These grants are given to local bodies to compensate on account of loss of any revenue on taking over of a tax by the state Government from the Local Government.

(g) Salient features of Financial Administration of Local Bodies

The salient features of Financial Administration of Local Bodies may be grouped under three heads:

1. **Budgetary Procedures:**
   The objective of local bodies budgetary procedures are:
   i. financial accountability
   ii. control of expenditure and
   iii. ensuring that funds are raised and spent by the executive department according to the rules and regulation and within the approval limits and authorization by the Legislature or Council.
   The various aspects covered in budgeting are:
   (i) Determination of taxation levels, fees, rates, and
   (ii) Laying down the ceilings on expenditure, under revenue and capital heads.

2. **Expenditure Control:**
   The Central and State level, there is a clear-cut demarcation between the legislature and executive. In case of the local body, the legislative powers are vested in the council while executive powers are delegated to the officers. Generally, all the matters of regular revenue and expenditures are delegated to the executive wing. In case of special situation such as reduction in property taxes, refund of security deposits, etc. approval from the legislative wing i.e. Municipal Council should be obtained.

3. **Accounting System:**
   Municipal Accounting System has traditionally been prepared under the cash system. However, in recent years, it is being changed into the accrual system in some states such as Tamil Nadu. **This accrual system of accounting is characterized by:**
   i. Subsidiary and Statistical Registers for assets, cheques, taxes, etc.
   ii. Separate Vouchers for every type of transaction.
   iii. Compulsory monthly Bank Reconciliation.
   iv. Submitting summary reports on periodical basis to different authorities at regional level.

Audit of Co-operative Societies

Introduction: -

A Co-operative society is an autonomous body of people united voluntarily to meet their common economic, social and cultural needs through a jointly –owned controlled enterprise.

The Co-operative Societies Act 1912 contains the fundamental law regarding the formation and working of the Co-operative Societies in India and is applicable in many states.

Important Provisions of Co-operative Societies Law

Qualification of Auditors: - Following persons can act as an auditor for audit of co-operative society:-

- **A chartered accountant** within the meaning of the Chartered Accountant Act - 1949 or
- A person who holds a **government diploma** in Co-operative Accounts or in Cooperation and Accountancy or
- A person who has served as an **Auditor in the co-operative society department of a government.**

Appointment of Auditor:-

- An auditor of a co-operative society is appointed by the **Registrar** of Co-operative Societies.
- The auditor so appointed conducts the audit on behalf of the Registrar and submits his report to him and also to the society.
- The audit fees are paid by co-operative society according to the statutory scale of fees prescribed by the Registrar.

Books Accounts and other records of Co-operative Societies:-

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 co-operative society.

For example, in Maharashtra the co-operative societies are required to maintain books and accounts in respect of following:-

i. All sums of money received and expended by the society.
ii. All sales and purchases of goods by the society.
iii. Assets and liabilities of the society.

The society is at liberty to maintain such additional records according to its convenience and which it thinks fit more useful for clarity and detailed explanation. For example:-

a. Property and Investment Register
b. Fixed Deposit Register
c. Surety Register
d. Daily Cash Sales Summary Register
e. Register of collection from Debtors if credit sales allowed by Bye laws.
f. Loan Disbursement and Recovery Register in case of credit society.

Restrictions on share holdings:-

According to section 5 of the Act, where **liabilities of the members of a society is limited,** no member of a society other than a registered society can hold more than **20% of the shares capital or shares of the society worth more than Rupees one thousand.**

The auditor of a co-operative society will be concerned with this provision so as to watch any breach relating to holding of shares.

Restrictions on loans :-(section 29)

- A registered society shall not make a loan to any person **other than a member.**
- With the special sanction of the Registrar, a registered society may make a loan to another registered society.

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- The State Government has the power and can prohibit or can put restrictions on the loaning power of the society to its members or to other societies in the interest of society and its members.

Restrictions on borrowings :-(Section 30)

A registered society may accept loans and deposits from its members and others subject to the restrictions and limits of the bye-laws of the society.

Investment of funds: - According to section 32 of the Central Act, a society may invest its fund in any one or more of the following:-

a. In the Central or State Co-operative Bank
b. In any of the securities specified in section 20 of the Indian Trusts Act, 1882.
c. In the shares, securities, bonds or debentures of any other society with limited liability.
d. In any co-operative bank other than a Central or State co-operative bank as approved by the Registrar on specified terms and conditions.
e. In any other money permitted by the Central or State Government.

Appropriation of profits-(section 33)

A prescribed percentage of the profits should be transferred to Reserve Fund, before distribution as dividends or bonus to members.

Contribution to Charitable purposes: - (section 34)

A registered society may, with the sanction of the Registrar, contribute an amount **not exceeding 10% of the net profits** remaining after the compulsory transfer to the reserve fund for any charitable purpose.

Investment of Reserve Fund outside the business or utilization as working capital

Some of the State Acts Provide that a society may use the Reserve Fund:

- In the business of a society , as working capital
- Invest as per provisions of the Act
- For some public purposes likely to promote the object of the society.

Contribution to Education Fund:-

Some of the State Acts provide that:-

- Every society shall contribute annually towards the Education Fund of the State Federal Society, at the appropriate rate prescribed.
- Contribution to the Education Fund is **a Charge on the Profits and not an Appropriation of Profits.**

Special Features of Co-operative Societies Audit

The general process of auditing includes the areas such as

- Posting Checking,
- Vouching, Ledger Scrutiny,
- Verification of Assets& Liabilities,
- Review of Balance Sheet

However, the special features of Co-operative audit while conducting the audit are as follows:-

1. **Examination of overdue debts:-**

- Overdue Debts have to be classified and reported by the auditor into 2 categories, i.e**. between 6 months to 5 years and more than 5 years.**

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- A further analysis of these overdue debts from the viewpoint of chances of recovery will have to be made and will be classified as good or bad.
- The auditor will have to ascertain whether proper provisions for doubtful debts are made and whether the same is satisfactory.

2. **Overdue Interest:-**
- Overdue Interest should be excluded from Interest outstanding and accrued due while calculating profit.

3. **Certification of Bad Debts:-**
- Writing off of bad debts must be authorized by the managing committee or certified by the auditor (wherever the law so requires) as irrecoverable losses.

4. **Valuation of Assets and Liabilities:-**
- The auditor will have to ascertain existence, ownership and valuation of assets.
    - Fixed assets should be valued at cost less adequate provision for depreciation. All incidental expenses incurred in the acquisition and installation expenses of assets should be properly capitalized.
    - Current assets are valued at cost or market price, whichever is lower.
- Regarding the liabilities the auditor should see that all known liabilities are brought into the account, and contingent liabilities are stated by way of note.

5. **Adherence to Co-operative Principles:-**
- The Auditor needs to assess the extent of achievement of the objects of the co-operative society, not in terms of profits, but in terms of social benefits to its members.
- While auditing the expenses, the auditor should see that they are economically incurred and there is no wastage of funds.
- The principles of propriety audit should be followed for the purpose.

6. **Observations of the Provisions of the Act and Rules:-**
- The auditor has to ensure that all the rules &regulations and bye laws of the Co-operative Societies Act have been followed.
- If any deviations exist, their financial implications have to be reported by the auditor.
- Some of the State Acts contain restriction on payments of dividend , which should be noted by the auditor.

7. **Verification of Members' Register and examination of their pass books:-**
- The Auditor has to examine the passbooks of the members in order to verify the loans given, repayment made, and confirmation of loan balances.
- Test –checks to be carried out based on the Auditor's discretion, in order to safeguard the interests of the members and to mitigate frauds.

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8. **Special report to the Registrar: -** During the course of audit, if the auditor notices that there are some **serious irregularities** in the working of the society, he may report these special matters to Registrar.

Circumstances in which special report is required:

i. **Personal profiteering** by members of managing committee in transaction of the society, which are detrimental to the interest of the society.

ii. **Detection of fraud** relating to expenses, purchase, property and stores of the society.

iii. **Mismanagement** (decisions of management against co-operative principles).

iv. In the case of **urban co-operative banks**

- Disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof.
- Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

(9) Audit classification of society

- After a judgment of an overall performance of the society, the auditor has to award a class to the society. This judgment is to be based on the criteria specified by the Registrar.
- It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification.
- The auditor should be very careful, while making decision about the class of society.

(10) Discussion of Draft Report with Managing Committee

- On conclusion of the audit the auditor should ask the Secretary of the society to convene a meeting of the managing committee to discuss the draft audit report.
- The audit report should never be finalized without discussion with the managing committee.

Rights and Duties of Auditor of Co-operative Societies

- The Registrar or any other person authorized by him by general or special order in writing shall audit the accounts of registered society **once at least in every year.**
- The audit includes an examination of overdue debts, if any, and valuation of the assets and liabilities of the society.
- The auditor has right to access to all the books, accounts, papers and securities of the society, and every officer of the society has to furnish the required details.

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On completion of audit, the auditor has to submit his audit report to the society and to respective authorities.

Matters requiring reporting:-

The audit report has to be submitted in the prescribed form specified by the Registrar. The auditor has to state:-

- Whether he has obtained all the necessary information and explanations which to the best of his knowledge and belief were necessary for the purpose of audit.
- Whether in his opinion and to the best of his information and according to the explanations given, the said accounts give all the information required by the Act.
- Whether the Profit and Loss Account of the society gives a true and fair view of the Profit and Loss made by the society.
- Whether the Balance Sheet drawn up as at the end of the year gives a true and fair view of the state of affairs of the society as on the given date.
- Whether in his opinion, proper books of account as required by the Act, the Rules and the byelaws of the society have been properly maintained.
- Whether the Balance Sheet and the Profit and Loss Account examined by him are in agreement with the books of account and returns of the society.

The auditor will have to give qualifying observations, if any of the answers to the above-mentioned matters are negative.

Schedules forming part of Audit Report:

The form of the audit report to be submitted by the auditor contains a number of matters which the auditor has to state or comment upon. In addition to that, the auditor will have to attach schedules to the report regarding the following information:

- All transactions which appear to be contrary to the provisions of the Act, the rules and byelaws of the society.
- All sums, which ought to have been, but have not been brought into account by the society
- Any material, or property belonging to society which appears to the auditors to be bad or doubtful of recovery.
- Any material irregularity or impropriety in expenditure or in the realisation or monies due to society.
- Any other matters specified by the Registrar in this behalf.

In the case of nil report in any of the above matters, the auditor will have to give a nil report.

Audit, Inquiry and Inspection of Multi-State Co-Operative Societies

Multi-State Cooperative Societies Act, 2002 is applicable to the societies whose objects are not confined to one state.

Books of Account: As per the Multi State Co-operative Society Rules, 2002, every multi state co-operative society shall keep books of account with respect to:

- All sum of money received & expended
- All sales and purchase of goods.

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- The assets and liabilities of the society.
- In the case of Multi State Co-operative Society engaged in production, processing and manufacturing, particulars relating to utilization of materials or labor or other term of cost as may be specified in the bye laws.

Qualifications of Auditors- section 72

A person who is CA can only be appointed as auditor of a multi-state co-operative society. Following persons cannot be appointed as auditor:-

- Body Corporate
- Officer/Employee of Multi State Cooperative Society
- Partner/Employee of Officer/ Employee of Multi State Cooperative Society.
- A person who is indebted to multi state co-operative society or who has given guarantee in connection with a loan of third party to multi state cooperative society for an amount exceeding **one thousand rupees**

Appointment of Auditors- (section 70)

First Auditor	▪ First Auditor shall be appointed by BOD within one month of registration. ▪ If BOD fails, company may appoint first auditor at general meeting. ▪ Auditor so appointed hold office till conclusion of first AGM.
Subsequent Auditor	▪ Subsequent auditors are appointed at each AGM. ▪ Auditor so appointed hold office till conclusion of next AGM.

Power and duties of Auditors. (Section 73)

Powers – Sec .73(1):-

- Right of access at all times to the books, accounts and vouchers whether kept at the head office or elsewhere.
- Entitled to require from the officers or other employees such information and explanation as required by auditor to conduct his duties.

Duties – Sec .73 (2):-

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Conduct Inquiry	• Whether loans and advances made on the basis of security have been properly secured and whether the terms on which they are made are not prejudicial to the interests of the society or its members. • Whether transactions which are represented merely by book entries are not prejudicial to the interest of the society. • Whether **personal expenses have been charged to revenue account** and • Where any shares that are **allotted for cash**, whether cash has been actually received and if not whether the position as stated in the account books and balance sheet as correct not misleading.
Making Report to the members	• On the accounts examined by him • Balance Sheet and Profit &Loss Account and on • Every other document required to be part or annexed to the balance sheet or profit &loss account. Which are laid before the society in general meeting. The report shall state whether , in his opinion and to the best of his information and explanations given to him, the accounts give a true and fair view- • In the case of the balance –sheet, of the state of the multi-state co-operative society's affairs at the end of its financial year and • In the case of the profit and loss account, of the profit or loss for its financial year.

Power of Central Government to direct special audit in certain cases:- (Section 77)

Central Government may pass an order for the **special audit** if they are of opinion:-

- That the affairs of any Multi –State co-operative society are not in accordance with co-operative principles or prudent commercial practices or with sound business principles; or
- That any Multi –state co-operative society is being managed in a manner likely to cause serious inquiry or damage to the interests of the industry or business to which it pertains; or

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- That the financial position of any Multi –State Co-operative society is such as to endanger its solvency.

Such audit shall be conducted either by a **Chartered Accountant or Auditor of Multi State Co-operative society**

Powers and Duties:- Same as covered in section 73 except that the audit report will be submitted to Central Government instead of society.

Inquiry by Central Registrar- Sec 78

Circumstances when inquiry may be hold or ordered

The Central Registrar may, on a request from:-

- a federal cooperative to which a multi –state co-operative society is affiliated
- a creditor
- not less than 1/3rd of the members of the board
- not less than 1/5th of the total number of members of a multi-state cooperative society

hold an inquiry or direct some person by order in writing in this behalf to hold an inquiry into the constitution, working and financial condition of a multi-state cooperative society.

Power of person conducting inquiry:-

- Access to books, accounts, documents, securities, cash and other properties belonging to society.
- Require the officer to call the general meeting and where the officer fails to do so, he shall have the power to call himself.
- May summon any person who is reasonably believed by him to have any knowledge of the affairs of the society, to appear before him at any place and can examine such person on oath.

Inspection of multi state cooperative societies –sec 79

Circumstances when inquiry may be hold or ordered

(Same as above)

Powers of person conducting inspection

- Access to all books, accounts, papers, securities, stock and other property of that society. And can take them into custody if any irregularities are discovered.
- Verify the cash balance of society
- Call board or general meeting if necessary.

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