6
The Company Audit

6.1 Introduction

The shareholders of the company are the real owners of the Company. They invest their money in the company. However the management of the company lies in the hands of the directors. Generally the shareholders do not have the skills required to understand the financial statements. Thus audit of accounts of company has been made compulsory in order to protect the interest of the shareholders. Audit of accounts ensures that the statements of account are properly drawn up and they disclose all the requisite information. Auditor must also ensure that the company has not violated any of the provisions contained in the companies Act, 1956. Although compliance with the relevant provisions of the companies Act, 1956 is the responsibility of the directors and officers of the company, nevertheless the auditor must make a report to the shareholders where non compliance results in affecting the accounts materially.

6.2 Appointment of Company Auditor

The following are the important considerations regarding the appointment of the company auditor :

6.2.1 Who can be Auditor - Section 226 of the Companies Act, 1956 deals with the qualification of company auditors. It intends to ensure that the auditors are independent of the companies they audit. A body corporate can not be appointed as an auditor because it has a limited liability. Clause (b) of sub-section (3) of Section 226 of the Act disqualifies an officer or employee of the company from being appointed as its auditor. According to a clarification of the Department of Company Affairs the legal position is as follows:

> "Where the chartered accountant is employed whole-time, he is an employee of the company. In other cases, generally speaking there would appear to be only a contract for service and not a contract of service between the company and chartered accountant, In *Dhrangadhra Chemicals Works v. State of Saurashtra (1957 S.CA, p. 216)* the Supreme Court has laid down that the *prima facie* test for determination of the relationship between master and servant is the existence of the right in the master to supervise and control the work done by the servant not only in matter of directing that work the servant is to do, but also the manner in which he shall do his work, or to borrow the words of Lord Uthwatt, the proper test is whether or not the hirer had authority to control the manner of execution of the act in question. Applying this test in any case, where the chartered accountant is consulted only professionally on income tax matters by a company, he can not be

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said to be an officer or employee of the company.

"A Chartered Accountant's main business is to render professional service for reward like a lawyer or a doctor. Where such service is rendered professionally and not as an officer or employee of the company, a chartered accountant is not disqualified under Section 226(3)(b) of the Companies act, 1956".

It is, however, clear that there is no prohibition on a relative of a director or a partner of such relative to be appointed as an auditor. The provisions of Section 297(1) would also not apply to the appointment of such a person as an auditor because an audit is in the nature of rendering personal service obtained not on the basis of the lowest tender but on account of professional expertise irrespective of cost involved. However, the appointment of an auditor who is a relative of a director or a firm of auditors in which a director of the company or his relative is a partner would be an office of profit under Section 314 requiring the consent of the company by a special resolution, if the total monthly remuneration exceeds prescribed limits (Section 314). Prior consent of the company and approval of Central Government (Company Law Board) would also be required in appropriate cases. Moreover, a chartered accountant in practice shall be deemed to be guilty of professional misconduct under the Chartered Accountants Act, 1949 if he expresses his opinion on the financial statements of any enterprise, in which he, his firm or a partner in his firm or any of his relatives have a substantial interest, unless he discloses the interest also in his report. The term "relatives" is to be construed with reference to Section 6 of the Companies Act. Similarly, the expression "substantial interest" is to have the same meaning as is assigned thereto under Explanation 3 to Section 13 of the Income Tax Act, 1961. Further, clause (d) of sub-section (3) of Section 226 of the Act states that a person indebted to the company for an amount exceeding ₹ 1,000 or a person who, has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding ₹ 1,000 is not qualified for appointment as an auditor. Some special situations are discussed below:

(a) In this context, a question may come up as to whether such indebtedness would arise in cases where, in accordance with the terms of appointment by a client, the auditor recovers his fees on a progressive basis as and when a part of the work is done without waiting for the completion of the whole job. According to the Research Committee of the Institute "a question often arises as to whether indebtedness arises in cases where in accordance with the terms of his engagement by a client (e.g. resolution passed by the general meeting) the auditor recovers his fees on a progressive basis as and when a part of work is done without waiting for the completion of the whole job. In these circumstances, where in accordance with such terms, the auditor recovers his fees on a progressive basis, he cannot be said to be indebted to the company at any stage."

(b) A question of indebtedness may also be raised where an auditor of a company purchases goods or services from the company audited by him. In such a case, if the amount outstanding exceeds ₹ 1,000, irrespective of the nature of the purchase or period of credit allowed to other customers, the provisions concerning disqualification of auditors as contained in Section 226(3)(d) will be attracted.

(c) Another question which arises for consideration is whether a partner is disqualified from appointment as auditor when the firm of which he is a partner is indebted to the company

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in excess of the limit prescribed and whether the firm is disqualified from appointment as auditor when a partner of the firm is indebted in excess of the prescribed limit. In both cases disqualification will apply because when a firm is appointed as an auditor, each partner is deemed to be so appointed and when a firm is indebted each partner is deemed to be indebted.

(d) There may also be situations in which, though the appointment is made in the individual name of a partner, the work is in fact carried out by the firm and the fees are credited to the account of the firm. In such situations, the firm will be deemed to be acting as auditor and the disqualification will be attracted in the case of indebtedness either of firm or a partner.

Section 226(3) has been amended by the Companies (Amendment) Act, 2000 whereby a person holding any security carrying voting rights after a period of one year from December 13, 2000 shall be disqualified from being appointed as auditor of the company. The aim of the provision is to curb possible insider trading on the part of auditors.

6.2.2 Reappointment of Auditors - The Companies Act, 1956 stipulates that the office of an auditor in a company is a continuing one and, therefore, has laid down that an auditor shall hold office from the conclusion of the annual general meeting in which he is appointed till the conclusion of the next annual general meeting. Except in cases of appointment of the first auditor, appointment or filling of casual vacancies in the office of the auditor, companies are required to appoint the auditor or auditors in the annual general meeting as a routine feature. The appointment is subject to the following conditions:

(i) The auditor proposed to be appointed or re-appointed must possess the qualifications prescribed under Section 226 of the Companies Act, i.e., he must be a Chartered Accountant (holding Certificate of Practice) within the meaning of the Chartered Accountants Act, 1949 or a Restricted State Auditor [Section 226(l) & (2)].

(ii) A firm of Chartered Accountants whereof all the partners practising in India are qualified for appointment may also be appointed as the auditor in its firm name [Section 226(l)].

(iii) The proposed auditor does not suffer from the disqualifications enumerated in sub-sections (3) and (4) of Section 226 of the Companies Act.

(iv) In the case of re-appointment of the retiring auditor, it should be ensured that:

  (a) he has not given notice to the company in writing of his unwillingness to be re-appointed;

  (b) no resolution has been passed at the annual general meeting appointing somebody else instead of the retiring auditor or providing expressly that the retiring auditor shall not be reappointed;

  (c) no notice of the intended resolution to appoint some other person or persons in place of retiring auditor was received by the company that could not be proceeded with due to death, incapacity or disqualification of other person or persons [Section 224(2)].

  (d) a written certificate has been obtained from the proposed auditor to the effect that the appointment or re-appointment, if made, will be in accordance with the limits specified in sub-section (1B) of Section 224.

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Appointment in a general meeting of the company means appointment by the shareholders of the company. Upon an auditor being appointed in the annual general meeting, the company is to give intimation thereof to the concerned auditor within seven days of the appointment, whether it is a case of a new auditor being appointed or the retiring auditor being re-appointed. The auditor, in his turn, upon receipt of the intimation from the company about his 'appointment' is required to send a written communication to the concerned Registrar of Companies within 30 days of the receipt of the intimation stating whether he has accepted or declined the appointment.

It should also be noted that the auditors shall hold office until conclusion of the next annual general meeting meaning thereby that the non-holding of the next annual general meeting or its adjournment without considering the business of appointment or re-appointment of auditors, shall in no way affect the factual conclusion of the next annual general meeting of the company. Notionally, it cannot be presumed that the auditor's term expires on the date on which the annual general meeting ought to have been held. A detailed clarification has been issued by the Department of Company Affairs in this regard according to which:

> "The tenure of an auditor is laid down in Section 224(l); it is from the conclusion of the annual general meeting to the conclusion of the next annual general meeting and cannot therefore, be for any particular year or financial year as such. The duty of the auditor is laid down in Section 227(2), whereunder the auditor in office has to audit every balance sheet and profit and loss account and every other document in it or annexed to it which is laid before the general meeting held during his tenure of office. In view of the provisions in Section 224(l), there can only be one annual general meeting held during the tenure of office of any particular auditor. That also shows that the auditor's appointment is not related to any particular balance sheet or profit and loss account or to any particular financial year.
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> "In the above context the Board decided that the tenure of an auditor appointed under Section 224 of the Companies Act will continue upto the factual conclusion of the next general meeting held by the company."

6.2.3 Defective appointment - Where the appointment of a person as the auditor in the annual general meeting is void *ab initio,* it appears that the provision of Section 224(3) will be attracted and the appointment of the auditor can be made by the Central Government.

Filling of a casual vacancy - A casual vacancy in the office of the auditor can be filled by the Board of Directors, provided such vacancy has not been caused by the resignation of the auditor. In the case of a casual vacancy arising on account of resignation, only the company in general meeting can fill the vacancy. The expression 'casual vacancy' has not been defined in the Act. Taking its natural meaning, it stands for the vacancy created by the auditor ceasing to act after he was validly appointed and the appointment was accepted. This may arise due to a variety of reasons which include death, resignation, disqualification, dissolution of the firm of auditors, etc. The provision to require filling of casual vacancy caused by the resignation of the auditor by the annual general meeting is in consonance with the principle of auditor's independence. This process may bring out facts regarding the auditor's resignation to the notice and scrutiny of the shareholders. Any abuse of authority or financial impropriety by the

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management that might have contributed to the resignation will be known. If the resigning auditor could be found to be conscientious and honest the general meeting may even request him to reconsider his decision and take appropriate steps to cure the evils, if any, in the management. The auditor appointed to a casual vacancy shall hold office till the conclusion of the next general meeting. However, it should be noted that a casual vacancy does not arise in the office of auditors on the expiry of one year of their appointment if the annual general meeting is not held in time. According to the Annual Report of the Institute of Chartered Accountants of India for the year ended 31 March, 1971:

> "A case of an alleged unjustified removal of auditors was reported to the Council where the existing auditors were removed and new auditors were appointed by the board of directors before holding the annual general meeting, on the footing that a casual vacancy in the office of the auditors of the company had occurred on the expiry of the period of one year, even though no annual general meeting was held. On a review of the facts and circumstances of the case reported, it was held that the change of auditors sought to be made in the circumstances was not justified and in the Council's opinion the appointment sought to be made of the new auditors was not valid, since no vacancy had arisen in the office of the auditors. The Council felt that the existing auditor continued to be the statutory auditor until the conclusion of the next annual general meeting. The decision was communicated both to existing auditors and new auditors who were also informed that accepting the appointment in such circumstances would not be proper."

6.2.4 Appointment of Auditor by Central Government - Where, at the annual general meeting, no auditors are appointed or re-appointed, the Central Government may appoint a person to fill the vacancy. It is the duty of the company to give notice of the fact that no auditor was appointed in the annual general meeting to the Central Government within 7 days of the annual general meeting. In case of any default to give notice to the Central Government, the company and every officer in default shall be punishable with Fine that may extend to ₹ 5000.

6.2.5 Ceiling on Audits - It has been mentioned earlier that 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 assignments by the auditor concerned over the limit laid down in Section 224(1B). Section 224(1B) of the Companies Act as amended by Companies (Amendment) Act, 1988 provides that no company or its Board of Directors shall appoint or re-appoint any person who is in full time employment elsewhere or firm as its auditor if such firm or person is, at the date of such appointment or re-appointment, holding appointment as auditor of the specified number of companies. Specified number has been defined to mean 20 company audits subject to a further limit of 10 company audits in respect of companies having paid up capital of ₹ 25 lakhs or more. Further it provides that in the case of a firm of auditors, 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.

(Note: It may be noted that the intention of the Central Government in amending this section was to plug the loophole whereby chartered accountants in full-time employment could not be considered for the purpose of conducting company audits. However, the amended section tends to suggest that an individual chartered accountant in full time employment practising as

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a sole proprietor can audit 20 companies while a chartered accountant practising as a sole-proprietor not in full-time employment elsewhere can audit unlimited number of exempted companies).

The limit of 20 company audits is per person. In the case of an auditing firm having 3 partners, the overall ceiling will be 3 × 20 = 60 company audits of which not more than 30 should be in companies having paid-up capital of ₹ 25 lakh or more. Sometimes a single chartered accountant can be a partner or proprietor in a number of auditing firms. In such a case, all the firms in which he is a partner or proprietor will be together entitled to 20 company audits on his account, subject to the sub- ceiling of 10 large company audits. How they allocate the 20 audits between themselves is their affair. Explanation II after sub-section (1C) of Section 224 further amplifies the manner of identifying the audit units for calculating the specified number. Under this explanation, when an auditor is appointed to audit even a part of company's accounts, the part will be considered as a unit of audit for the purpose of calculation of the ceiling. Often one comes across what is known as joint audit when two or more auditors are appointed to audit the accounts of a company. Each of the joint auditors is considered an auditor for the purpose; any joint audit held by an auditor will be included as one audit unit for the purpose of calculating ceiling. However, appointment as a branch auditor will not be counted. The question arises whether the audits of branches of Indian companies and the audits of Indian business accounts of foreign companies which have established their place of business in India and are doing business in India are to be taken into account for computing the limit of 20 companies as laid down in Explanation I of sub-section (1C) of Section 224 of this Act. The Department of Company Affairs clarified that "the branch auditor of Indian companies, appointed under Section 228 of the Act, audits the accounts of the particular branch only for which he is appointed and forwards his report to the auditor appointed under Section 224 of the Act and hence he cannot be equated with the company auditor appointed under Section 224 who has to report to the annual general meeting on the, account of the company as a whole including the branches audited by branch auditor. The words "any part of which" appearing in Explanation II cannot have any reference to branch audit which as noted above does not fit into the context of Section 224. The said words relate to the antecedent number and not companies in so far as they are of any material significance to the context. Hence, the branch audits are not to be included while calculating the specified number of 20 units."

As regards the audit of the accounts of foreign companies, the Department is of the view that they are outside the scope of Section 224 since the definition of company under Section 3 of the Act does not include a foreign company. Hence the audit of the accounts of foreign companies is also not to be included within the specified number of 20 as laid down in explanation I to sub-section (1C) of Section 224 of the Act. A point has been raised as to whether companies limited by guarantee are to be included in reckoning "specified" number of auditors within the meaning of Explanation I to sub-section (1B) and (1C). This has been examined and the Department is of the view that such companies as having no share capital are to be excluded from the reckoning.

The Companies (Amendment) Act, 2000 has also amended Section 224(1B) dealing with ceiling on company audits. Pursuant to this amendment, the private companies will be excluded while computing the ceiling limit of 20 companies, as the case may be. Consequently, the auditor can

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accept audit of any number of private companies subject to the overall limits laid down by guidelines of the Institute. The guidelines finalised by the Council are reproduced below:

"Chapter VIII of Council General Guidelines, 2008 No. 1-CA(7)02/2008 dated 8th August 2008: In exercise of the powers conferred by clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India hereby specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the "specified number of audit assignments of the companies under Section 224 and /or Section 228 of the Companies Act, 1956".

Provided that in the case of a firm of chartered accountants in practice, the specified number of audit assignments shall be construed as the specified number of audit assignments for every partner of the firm.

Provided further that where any partner of the firm of chartered accountants in practice is also a partner of any other firm or firms of chartered accountants in practice, the number of audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the "specified number of audit assignments" in the aggregate.

Provided further that where any partner of a firm or firms of chartered accountants in practice accepts one or more audit assignments in his individual capacity, or in the name of his proprietary firm, the total number of such assignment which may be accepted by all firms in relation to such chartered accountant and by him shall not exceed the "specified number of audit assignments" in the aggregate.

Explanation:

1. For the above purpose, the specified number of audit assignments means :
   (a) in the case of a chartered accountant in practice or a proprietary firm of chartered accountant, thirty audit assignments whether in respect of private companies or other companies.
   (b) in the case of a firm of chartered accountants in practice, thirty audit assignments per partner in the firm, whether in respect of private companies or other companies.

   Provided that out of such specified number of audit assignments, the number of audit assignments of public companies each of which has a paid-up share capital of rupees twenty-five lakhs or more, shall not exceed ten.
2. In computing the specified number of audit assignments:
   (a) the number of such assignments, which he or any partner of his firm has accepted whether singly or in combination with any other chartered accountant in practice or firm of such chartered accountants, shall be taken into account.
   (b) the audit of the head office and branch offices of a company by one chartered accountant or firm of such chartered accountants in practice shall be regarded as one audit assignment.
   (c) the audit of one or more branches of the same company by one chartered accountant in practice or by firm of chartered accountants in practice in which he is

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a partner shall be construed as one audit assignment only.

(d) the number of partners of a firm on the date of acceptance of audit assignment shall be taken into account.

(e) a chartered accountant in full time employment elsewhere shall not be taken into account

3. A chartered accountant in practice as well as firm of chartered accountants in practice shall maintain a record of the audit assignments accepted by him or by the firm of chartered accountants, or by any of the partner of the firm in his individual name or as a partner of any other firm as far as possible, in the following manner:

S.No	Name of the company/Audit Assignment	Registration Number	Date of Appointment	Date of Acceptance	Date on which Form 23-B filled with Registrar of Companies
1	2	3	4	5	6

6.2.6 Auditor not to be appointed except with the approval of the company by a Special Resolution - Section 224A provides for appointment of auditors in certain cases only by a special resolution. It should be remembered that normally an auditor can be appointed or re-appointed by an ordinary resolution. However, in terms of Section 224A, a company in which not less than 25% of the subscribed capital is held by (i) a public financial institution or a government company or the Central Government or any State Government, or (ii) any financial or other institution established by any Provincial or State Act in which a State Government holds not less than 51% of the subscribed share capital, or (iii) a nationalised bank or an insurance company carrying on general insurance business, or (iv) any combination of the above categories, shall appoint or re-appoint an auditor in the annual general meeting only by passing a special resolution. In case the aforesaid company omits or fails to pass a special resolution in the annual general meeting to appoint an auditor or auditors it shall be deemed that no auditor or auditors have been appointed, and thereupon the Central Government's power to appoint the auditors pursuant to Section 224(3) will become exercisable. In determining whether the appointment calls for a special resolution or not the measuring yardstick is the proportion of the subscribed capital held by the various categories mentioned above. If any of them singly or several of them jointly held 25% of the subscribed capital of the company as on the day of the closing of the register of members before the annual general meeting of the company will be covered by the provisions of Section 224A and, consequently, the appointment of the auditor can only be made by passing a special resolution. It should be noted that subscribed capital includes preference share capital also. In this case a doubt has been expressed in some quarters about the material date for considering the 25% holding - as to whether it should be the date of passing of the special resolution. The Department of Company Affairs has clarified that "material date is the date of the annual general meeting at which the resolution is required to be passed. Moreover, since generally articles of association of companies provide for closure of the register of members before the general meeting during a period not exceeding thirty days at any one time, it is unlikely that the position regarding shareholding in the company will be different between the

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date of issue of notice and date of the general meeting. In exceptional cases, however, where a change in the shareholding pattern in the company has taken place between the date of issue of notice of the general meeting and the date of actual passing of this resolution regarding appointment of auditor, the company may either (i) adjourn the meeting to another date, and later issue the required notice in accordance with law, and thereafter, pass a special resolution required to be passed under Section 224A of the Act; or (ii) omit or pass over the item on the agenda regarding appointment of auditor.

In the event of the company adopting the procedure at (ii) above, the situation would then be covered by Sub-section (2) of Section 224A of the Act. It has also been clarified by the Department that irrespective of the circumstances in which a nationalised bank is holding shares (whether beneficially or as security for loan advanced to constituents), if the name of the bank is entered in the register of members of the company as holder of shares, such holding of shares will have to be taken into account for the purposes of Section 224A of the Act.

6.2.7 Appointment of Auditor of a Government Company - A Government company has been defined in Section 617 of the Companies Act 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." In respect of any Government company appointment of auditor is governed by the provisions of Section 619 of the Companies Act, 1956. According to this Section, the auditor of a Government company shall be appointed or re-appointed by the Comptroller and Auditor General of India. However, the appointment will be subject to the ceiling discussed above.

The aforesaid provisions applicable to the appointment of auditors of Government companies also apply to another category of companies even though they are not Government companies. This provision is contained in Section 619B of the Companies Act (in force on and from 1.2.1975). If, in a company, not less than 51% of the paid up share capital is held by:

(a) the Central Government and one or more Government companies;

(b) any State Government, or Governments and one or more Government companies;

(c) the Central Government, and one or more State Governments and one or more Government companies;

(d) the Central Government, one or more corporations owned or controlled by the Central Government;

(e) the Central Government, one or more State Governments and one or more corporations owned or controlled by the Central Government;

(f) one or more corporations owned or controlled by the Central Government or the State Governments;

(g) more than one Government company or by combination of above.

The auditor of such a company shall be appointed by the Comptroller and Auditor General of India.

According to the clarification issued by the Department, Nationalised Banks, General

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Insurance Corporation of India and Industrial Development Bank of India are corporations/institutions owned or controlled by the Central Government within the meaning of Section 619B. But co-operative institutions, Industrial Credit and Investment Corporation of India, Unit Trust of India and Industrial Finance Corporation are not covered under Section 619B. However, the aforesaid list of corporations is only illustrative and not exhaustive.

It should be noted that the provision of Section 224A which requires a special resolution for the appointment of auditor and Section 619B have made the acceptance of the position of auditor in a company somewhat difficult. Before acceptance of the appointment given by any company on the strength of an ordinary resolution an auditor should specifically satisfy himself that the company is not covered by either Section 224A or Section 619B which require compliance with special procedure. Otherwise, he may find the appointment to be a nullity.

6.2.8 Auditor appointed at an Annual General Meeting failing to accept appointment - Can the Board of Directors be authorised by the General Meeting to appoint auditors in the event of auditors, appointed at annual general meeting, fail to accept the appointment? For knowing the correct legal procedure that should be followed in such a case, the Research Committee of the Institute had posed the following query to its Counsel:

(1) A company appointed auditors for the current year by a resolution passed in the Annual General Meeting as under:

"Resolved that Shri X (Chartered Accountant) be re-appointed as auditor for the current year on the overall remuneration of ₹ .....only."

"Resolved further that Shri Y (Chartered Accountant) be and hereby re-appointed as a joint auditor for the current year on an overall remuneration of ₹ ..... only. Further resolved that in the event of both or either of the auditors declining the assignments, the Board may fill up the vacancy at their own discretion."

(2) The Board of Directors, subsequently, passed a resolution as under:

"Resolved that in the event of any of the Auditors declining to accept the assignment, Shri Z should be appointed as joint auditor."

(3) The last para of the resolution of the General Meeting and the resolution itself of the Board of Directors, were intended to meet a contingency of the appointments being declined by any or both of the auditors appointed by the General Meeting, since the remuneration fixed by the General Meeting was less than that proposed by the retiring auditors, and as such there was a possibility of the appointments being rejected by the auditors on that account.

(4) Y declined to accept the assignment and Z was called upon to intimate his willingness or otherwise to accept the assignment pursuant to the resolution of the Board of Directors.

The Counsel's opinion was sought on the following points:

(a) Whether the vacancy caused by Y declining to accept the appointment constituted a casual vacancy under Sub-section 6 (a) of Section 224 or due to resignation of an auditor; and

(b) Was the appointment of Z, made by the Board of Directors in place of Y, valid?

The Counsel was of the opinion that the Board of Directors could appoint an auditor only

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under the circumstances completed under Sub-section 5 and under Sub-section 6(a) of Section 224. Further that, in the specific case referred to him for opinion, the refusal of Y to accept the appointment as joint auditor did not create a vacancy either casual or by resignation since Y's appointment had not become effective. Further, the appointment of auditor having been made by shareholders, sub-section (3) could not be invoked. Thus, Z could only be appointed by shareholders at a general meeting.

6.2.9 When appointment is made to fill up a vacancy caused by resignation of the previous Auditor - An auditor, before accepting the appointment in place of an auditor or who has resigned, should verify that the resolution appointing him as the auditor at the general meeting was duly moved and approved by the share holders. In addition, he should refer to the resignation submitted by the previous auditor and also communicate with him so as to ascertain: (i) the circumstances which led up to his resignation; and (ii) whether there existed any circumstances on account of which he should not accept the appointment. He should also see whether the requirements of Section 224 (6) in respect of such an appointment have been complied with.

[*Notes: (1) Though there is no provision in the Act for an auditor ceasing to hold office on becoming bankrupt or insane, it will not be possible for a person of unsound mind or an undischarged insolvent to hold such office, as he will not under Sections 8 and 10 of the Chartered Accountants Act, 1949 have his name on the Register of Chartered Accountants. (2) In the case of appointment of an auditor to act jointly with an existing auditor, the procedure would be similar to that where the existing auditor is being removed (as discussed hereinafter). In practice, however, compliance with the formalities would not give rise to any difficulties, since the existing auditor's consent to the proposal, it is expected, will have been secured in advance. (3) Students should also refer to the Guidance Note on Compliance with provisions of Sections 224 and 225 of the Companies Act in the context of Clause 9 of Part I of the First Schedule to the C.A. Act as reproduced in the Code of Ethics.]*

6.3 Remuneration

Under Section 224(8) of the Act, it is fixed:

(a) in case of an auditor appointed by the Board or the Central Government, may be fixed by the Board or the Central Government as the case may be; and

(b) subject to clause (a) above, shall be fixed by the company in General meeting or in such manner as the company in general meeting may determine. For this purpose, the expression "remuneration" should be deemed to include any sums paid by company in respect of the auditor's expenses.

Students may note that the Act does not require that the remuneration should be fixed at the same meeting of the company at which the appointment is made. It may, therefore, be fixed at a subsequent meeting. Where a retiring auditor has been re-appointed, his remuneration in the absence of any resolution fixing a different remuneration is considered to be the amount already fixed, in respect of the previous appointment. Where, in addition to the normal audit, the auditor is also required to undertake the writing up of the books, to prepare the annual accounts of the company and do the income-tax or secretarial work, he is entitled to receive remuneration in addition to the normal fee for the audit. Such additional remuneration is a

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matter of arrangement with the directors. But any remuneration paid as fees, expenses or otherwise for such service must be disclosed in the Profit & Loss Account. As per Revised Schedule VI, which is applicable from 01.04.2011, the remuneration paid to the auditor is required to be shown in the Profit & Loss Account separately:

(a) as auditor;

(b) for taxation matters

(c) for company law matters

(d) for management services

(e) for other services ; and

(f) for reimbursement of expenses.

In case of joint audit, if other services were rendered by one of the joint auditors or in case of a company having a branch, the other services were rendered by the branch auditor, a disclosure should be made accordingly.

Section 224(8)(aa) has been inserted whereby it is provided that, in the case of an auditor appointed under section 619 by the Comptroller and Auditor General of India, the remuneration shall be fixed by the company in a general meeting or in such manner as the company in general meeting may determine. Earlier this power was vested in the Central Government.

6.3.1 Rendering other services - One often finds that statutory auditors of the companies are called upon to render other services to the client like tax consultancy, internal audit, management consultancy, etc. The issues arising out of this practice have been considered by the Institute of Chartered Accountants of India. The views of the Institute in this regard are given below:

The payments for other services which are statutory required on the face of the published accounts of a company represent perfectly legitimate payments for services rendered by the auditors to the company which services the company needs and from which the benefit derived by the company and the shareholders at large is more than commensurate with the cost thereof. The very fact that the law requires specific disclosure of the payment for other services shows that the Parliament did contemplate rendering of such services and did not consider anything "prima facie" wrong about them. The other services which might be usefully rendered by an auditor of a company against payment of additional fees may comprise the following:

(a) Taxation Representations before the tax authorities and tax planning and advisory services.

(b) Management Services which may include advice on the installation of a costing or budgetary control system, management information system, selection of Senior Personnel in the Finance Department, etc.

(c) Company Law Services which include giving advice in relation to compliance with the various provisions and procedures under the Companies Act.

(d) Investigation of accounts for various purposes, e.g., in case of purchase of business, suspected fraud, etc.

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(e) Advice in connection with amalgamation and merger, scheme of reconstruction and reorganisation, etc.

(f) Valuation of shares of limited companies for various purposes.

(g) Issue of certificates as required by the Government and other authorities for various specific purposes, for example,

  (i) Certificates required by the Reserve Bank of India for exchange control purposes.

  (ii) Certificates of gross profit and available surplus under the Payment of Bonus Act.

  (iii) Certificate for consumption for raw materials, production, exports, etc. required by the Joint Chief Controller of Imports,

  (iv) Certificates at the specific request of lending institutions, both national and international.

  (v) Certificates based on verification of financial records to various Government, public and other authorities.

(h) Special assignments required by a company for its own benefit, for example, a surplus verification of cash or inventories or surprise visit to branches under special circumstances.

(i) Review of systems and procedures and of the internal controls, particularly, in relation to cash transactions, purchases made by the company, inventories' sale effected by the company, etc. Such a review is followed by recommendation for internal control for the benefit of the company.

(j) Audits of ancillary institutions of the company like the Employee's provident fund, etc., in respect of which usually the fees are paid by the company itself.

From the above illustrative list of the various services rendered by the auditors for which additional fees are paid, it will be appreciated that it is only normal and natural for a company to need such services and to pay for them. The next question is whether there is anything wrong in such services rendered by the company's auditors if they are competent to render them. This question may be viewed from the angle of the benefit of the company and the shareholders, on the one hand, and its effect on the independence of the auditor, on the other.

Sometimes, it may be desirable that the services are rendered by the company's own auditor who is expected to have overall knowledge of the accounts and the financial affairs of the company and, also from the point of view of ensuring effectiveness of the work, fairness of the opinion expressed on the certificate issued and also the benefit to the company as well as its shareholders, this is desirable. It is emphasized that the other services rendered are also those which are considered essential and beneficial to the company by the management and they would normally have to be rendered by a professional accountant or other similar agency. If the services are not rendered by the company's own auditor, they will have to be rendered by some other Chartered Accountant or by some other similar agency. The company's auditor with his overall knowledge of the affairs of the company would be in a much better position to render such services compared to others. The cost of other services to the company when rendered by its own auditor may also be comparatively less because he would need to expend less direct time on the job than a person who has not audited the accounts. He can draw upon the work already performed in the course of the audit where as another person may

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need to follow certain procedures which have already been covered by the statutory auditor.

It is usually a matter of advantage to the company and the Income Tax Department if the tax representation of the company is handled by its own auditor. The intimate knowledge which the auditor possesses of the company's business affairs and accounts is of material help in the representation before the tax authorities. Chances of errors and accidental misstatements or omissions are reduced and the tax officers are then able to complete the assessments more expeditiously and with a greater degree of confidence. The work done by the auditor in rendering other services may enable him to get a greater insight into the accounts and affairs of the company, which would enable him to carry out a more effective and more purposeful audit. For example, an auditor who has been engaged for rendering managements services to the company by way of a review of the systems and procedures and the internal control systems of the company would acquire valuable additional knowledge which would certainly help to perform a more efficient audit. It may also be clarified that there is no compulsion on the company to engage its own auditors for rendering other services. If the company so chooses it can engage the services of any other person. It is for the management of the company to judge as to which course would be in the best interest of the company. If the management, for valid reasons, concludes that it can have more efficient and less expensive services from its own auditor, there seems to be no justifiable reason why it should be deprived of such services. In recent time, there has been a growing appreciation in business and industrial circles of the constructive and effective assistance that a chartered accountant can render to the management in various fields. This has opened up new horizons particularly for the young members in the profession who are in a very good position to develop these new skills and to use them to the advantage of every one concerned. An analysis published in the press suggested that it is the bigger firms who derive most benefit from rendering other services. In fact, most young entrants to the profession who, in their early career, would have comparatively fewer clients, do render varied services to their clients with mutual advantage without sacrificing public interest. Many young and promising members of the profession are trained to render management services, taxation and company law services, etc. to their clients. Any unreasonable restriction on company auditors in the matter of rendering other services would unjustifiably hit this young generation whom the Institute considers its pillars of strength. Such a restriction would retard professional development and would at the same time not be in the interests of the company and its shareholders nor in the public interest.

The Institute, of course, is quite mindful of the utmost necessity of ensuring high standard of independence and integrity by its members in the performance of their duties as company auditor. From time to time, the Council of the Institute has issued recommendations to its members with this object in view. For Example, Council General Guidelines, 2008 No. 1-CA(7)02/2008 dated 8th August 2008, issued by the Council lays down that a statutory auditor cannot act as a cost auditor. The Council has also advised its members to refrain from expressing professional opinion on financial statements of a company in which he or his relatives are substantially interested. The Council has also advised the members to be always on guard and not to accept any professional assignment under such circumstances that his independence may be affected. However, the Institute does not consider that there is anything inherently improper in the auditor receiving an additional fee for services rendered under such

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circumstances that his independence is not likely to be adversely affected. It is not proper to suggest that mere receipt of fees for such services is likely to taint the auditor's conscience or that such payment of other fees which under statutory requirements are disclosed on the face of the accounts are made with an untoward or ulterior motive. There is no doubt that an auditor should not seek favour from his client company nor should he have a financial interest in the company if he has to maintain his independence and authority. However, the rendering of useful professional service in consideration of fees is not a matter of favour nor does it amount to have a financial interest in the company. It would, therefore, be entirely incorrect to suggest that a company's auditor compromises his independence or obtains an undue advantage or interest in the company merely by accepting an engagement for rendering other professional services to his client on payment of specific fees for such services.

It may also be stated that the Institute has provided enough safeguard for ensuring proper performance of duties by its members. A very strict disciplinary control is maintained by the Institute and action is quickly taken by the Disciplinary Committee against erring members. In disciplinary matters the standard maintained by the Institute is so high that there has been not a single case where the High Court has enhanced the punishment suggested by the Institute for an erring member. In most of the cases the High Court has reduced the punishment. It may also be pointed out that a practising Chartered Accountant is precluded from engaging in business or activities which are not directly within the scope of his profession. Thus, the other services rendered by a company's auditor are only such services which are directly within the scope of the accountancy profession. Therefore, there is hardly any possibility of any misuse or abuse if other professional services are rendered by the auditor.

The Council issued this note in the hope that it would clarify the matter with regard to the payment of fees to auditors in 'other capacity'. Such services and such payments are perfectly legal and perfectly within the code of conduct and ethics of the professional. There need not be any misgiving in this matter nor any apprehension that by such payments the public interest of the generality of the shareholders is compromised. While the Council of the Institute will continue to exercise the utmost vigilance in order to ensure the highest standards of independence and discipline, it would be a mistake to stand in the way of normal professional development, where such development does, not compromise the auditor's independence or authority. In fact, the Council actively encourages diversification in the professional services rendered by the members of the profession so that new horizons and more avenues of useful and constructive work may open up for the young entrants to the profession. This approach is in keeping with the profession's desire to play its proper role in the affairs of the nation by contributing its utmost for developing the natural resources of the country, increasing the national wealth and improving the standards of the millions of our countrymen.

6.3.2 Recommendations regarding disclosures for payments to auditors for other services- It may happen that the fees paid to the auditor in other capacity may have been fixed or settled in a composite manner in respect to more than one head. In such a case, it is recommended that the composite amount may be disclosed describing that it was fixed as such for the specified matters.

A question arises as to whether, if a company pays fee or remuneration to one of the partners

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of a firm which is acting as its auditor, separate disclosure is required in respect of the fee or remuneration so paid. The Council is of the view that the requirement as to the separate disclosure of fees paid in other capacity should be more properly construed in the context of the spirit behind such requirement and, accordingly, recommends that even in the aforesaid case separate disclosure should be made in respect of fees paid by the company to the partner of the firm which is its auditor.

Sometimes, the company may pay fees in other capacity to one out of several firms of joint auditors. In such a case, in the interest of proper disclosure, it may be indicated that the fee is paid to one of the joint auditors specifying the name of such auditor to whom the fee is paid. Likewise a company may pay fee to its branch auditor appointed under Section 228 of the Companies Act, 1956 for services rendered in other capacity. In such a case also while disclosing the fee paid in other capacity the fact that it was paid to a branch auditor may be specified. It may be noted that according to the Institute of Chartered Accountants of India, there does not arise a situation of conflict, legal or ethical, when the statutory auditor renders other services, e.g., tax advice, management consultancy etc. to the client at the same time.

6.3.3 Management Consultancy and Other Services - As per Chapter IX of Council General Guidelines, 2008, a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he accepts the appointment as statutory auditor of Public Sector Undertaking(s)/Government Company(ies)/Listed Company(ies) and other Public Company(ies) having turnover of ₹ 50 crore or more in a year and accepts any other work(s) or assignment(s) or service(s), in regard to the same Undertaking(s)/Company(ies) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same Undertaking/Company.

Provided that in case appointing authority(ies)/regulatory body(ies) specify(ies) more stringent condition(s)/restriction(s), the same shall apply instead of the conditions/restrictions specified in this Notification.

Explanation:

1. The above restrictions shall apply in respect of fees for other work(s) or service(s) or assignment(s) payable to the statutory auditors and their associate concern(s) put together;
2. For the above purpose,
   - the term “other work(s)" or "service(s)" or "assignment(s)" shall include Management Consultancy and all other professional services permitted by the Council pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 but shall not include:
     - (i) audit under any other statute;
     - (ii) certification work required to be done by the statutory auditors; and
     - (iii) any representation before an authority
   - the term "associate concern" means any corporate body or partnership firm which renders the Management Consultancy and all other professional services permitted

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by the Council wherein the proprietor and/ or partner(s) of the statutory auditor firm and/ or their "relative(s)" is/are Director / s or partner / s and/or jointly or severally hold" substantial interest" in the said corporate body or partnership;

- the terms "relative" and "substantial interest" shall have the same meaning as are assigned under Appendix (10) to the Chartered Accountants Regulations, 1988.

3. In regard to taking up other work(s) or service(s) or assignment(s) of the undertaking/company referred to above, it shall be open to such associate concern or corporate body to render such work(s) or service(s) or assignment(s) so long as aggregate remuneration for such other work(s) or service(s) or assignment(s) payable to the statutory auditor / s together with fees payable to its associate concern(s) or corporate body(ies) do/does not exceed the aggregate of fee payable *for* carrying out the statutory audit.
4. This notification shall apply *for* any appointment(s) on or after 1st April, 2002.

6.4 Functions, Duties and Rights of Auditors

The following are the functions, duties and rights of auditors:

6.4.1 Functions of an Auditor under the Companies Act, 1956 - *The* primary function of an auditor is to report on different types of financial statements prepared in a variety of situations mentioned below:

(i) Reporting on Balance Sheet and Profit & Loss Account - It is the primary duty of the auditor of a company to make a report to the shareholders on the accounts examined by him and on every Balance Sheet and Profit & Loss Account as well as any other document declared by the Act to be part of and annexed to the Balance Sheet or Profit & Loss Account, which are laid before the company in general meeting during his tenure of office. The report should state whether, in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by the Act in the manner so required and give a true and fair view:

(a) in the case of balance sheet, of the state of the company's affairs as at the end of its financial year; and

(b) in the case of the profit and loss account the amount of profit or loss during the financial year.

The matters which should be dealt with by the auditor in his report are set out in detail in sub-section (3) of section 227. Also, the auditor is to inquire and, if necessary, to report on the matters Specified in Section 227 (1A).

Power of Government to amplify the scope of audit - By the Companies (Amendment) Act 1965, sub-section (4A) has been added to section 227 empowering the Central Government to direct, by a general or a special order, that in case of any class or description of companies, as may be specified in the order, the auditor's report should also include a statement on such matters as may be specified therein. It is a general power which authorises the Government to extend the scope of audit in case of a particular class of companies. Exercising this power the Government of India issued the Manufacturing and other Companies (Auditor's Report) Order 1975. This Order was applicable to the following categories of companies:

(a) Manufacturing, mining or processing;

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(b) Supplying and rendering services;

(c) Trading; and

(d) Financing, investment, chit fund, nidhi or mutual benefit companies.

The 1975 Order was replaced by the 1988 Order which came into force w.e.f. November 1, 1988. The 1988 Order has been further substituted by the Companies (Auditor's Report) Order, 2003 (as amended in 2004).

(ii) Report to be set out in the Prospectus - Section 60 (3) of the Companies Act 1958, contemplates three circumstances under which it is necessary for a Chartered Accountant to report on the statements of account, operating results and assets and liabilities of a going company which issues a prospectus. Part II or Schedule II to the set contains the reports to be included in prospectus.

(iii) Certification of Statutory Report - Every public company limited by shares and every company limited by guarantee and having share capital must prepare a statutory report for being placed before the shareholders in accordance with section 165. It should be certified by the auditor of the company, in so far as the report relates to the shares allotted by the company, cash received in respect of such shares and payments of the company. A deemed public company will not be required to hold statutory meeting or issue statutory report if a period of 6 months has expired after incorporation at the time, it is so deemed.

(iv) "Special Audit" (Section 233 A) - It is an audit procedure alternative to investigation when the Central Government is authorised to adopt in the under mentioned circumstances:

(a) when the affairs of the company are not being managed in accordance with sound business principles or prudent commercial practices; or

(b) when it is being managed in a manner likely to cause serious injury or damage to the interest of the trade, industry or business to which it pertains; or

(c) when the financial position of the company is such as would endanger its solvency.

The procedure is a short cut to an investigation and is simpler. It is therefore preferred in cases where, instead of a detailed roving enquiry, information is required on certain specific points. The Central Government is authorised to determine the scope of such an examination so that it may be able to obtain such information as it may require to prove or disprove any suspicion that it may have, either on the basis of any information in its possession or those aroused from a perusal of the statements of account. To conduct such an audit, the Central Government may appoint a person who is a Chartered Accountant, whether or not he is the auditor of the company. The special auditor for purposes of carrying on the audit is invested with the same powers and has the same duties as the statutory auditor except for the fact, instead of making a report to the company; he has to report to the Central Government.The Government on receipt of the report, may take such action on it as it considers necessary but, if it fails to do so within a period of four months from the date of the receipt of the report, the Government is required to send to the company either a copy or the relevant extract of the report with its comments thereon and require the company either to circulate the copy or the extract among the members or have them read before the members at the next General Meeting.

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(v) Report on the Accounts prepared on voluntarily winding-up - When, on company being put to voluntary winding-up, the directors of the company make a declaration of solvency, it should be accompanied by a copy of the report of the auditors of the company on the Profit and Loss Account of the company for the period commencing from the date up to which the last such account was prepared and ending on the latest practicable date, immediately before the declaration is made, as well as, the Balance Sheet of the company on last mentioned date embodying the statement of the company's assets and liabilities as at that date (section 488).

(vi) Report on the Accounts of Liquidators - When a company is being wound up by the Court, its liquidator, at such times as may be prescribed by the Court, but not less than twice at year, present to the Court an account of amounts received and paid by him. It is obligatory for the Court to have the accounts audited (Section 462). Furthermore, in the case of a company, which is being wound voluntarily under the supervision of the Court or by the Court, unless the liquidation is concluded within one year of its commencement, the liquidator must file a statement of receipts and payments in the prescribed form, duly audited:

(a) in the case of a winding-up by or subject to the supervision of the Court, in the Court; and

(b) in the case of voluntary winding -up, with the Registrar (section 551).

But such an audit is not necessary in a case where the provisions of section 462 are applicable.

(vii) Other Duties of the Company Auditor - The auditor can be called upon to carry out the undermentioned duties:

(a) To assist the Inspector appointed by the Central Government either on the application of the members or on a report by the Registrar of Companies under section 235 of the Act, in the investigation of the affairs of the company. Such a duty extends to all persons who were employed as auditors whether as statutory or as internal auditors [section 240 (1) (b)].

(b) To assist Government in the prosecution of directors, provided the auditor is not himself involved in pursuance of the Inspector's report under section 241 of the Act, [section 242 (1)].

(c) To give such reasonable assistance as is necessary in cases where prosecution has been instituted against delinquent officers and members of the company in the capacity of an officer of the company [section 545 (7)].

(d) In the event of his being engaged in the formation of a company, to make a declaration that all the requirements of the Act have been complied with [section 33 (2)].

6.4.2 Nature of duties of a Company Auditor - Though in sub-sections 1A, (2), (3), (4) and 4A of section 227, the duties of the auditor are set out in some detail, the Act does not prescribe the procedures that should be followed for the examination of books of account or verification of assets and liabilities included in the Balance Sheet of a company. Neither does the Act define the scope of such an examination (except requiring verification of propriety of certain transactions stated in sub-section (lA) of Section 227 or looking into the matters specified in the Companies (Auditor's Report) Order 2003, nor does it suggest the attitude of mind with which

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the task should be approached. It is because these are matters in regard to which members, it is expected, would be guided by informed opinion in the profession; especially the statements issued by professional bodies, or by the pronouncements of learned judges in cases concerning the duties and responsibilities of auditors, under different conditions and circumstances.

Generally, it is the duty of the auditor to examine the company's books of account to ascertain that they do, in fact, truly and fairly record the transactions entered into by the company, and to verify that the statements of account, drawn up on the basis of the books, truly and fairly reflect the financial position disclosed by them. The scope and depth of checking of the entries in the books for the verification of the statement of account is, to a large extent, a matter which the auditor must determine himself on taking into account the conditions of the record in the books, existence of the system of internal control and the character of the management. If the books of account do not contain a complete record of the transactions, or are kept in a manner that either the amount of the revenue receipts, or that of expenditure, or the values of assets or the amounts of liabilities cannot be properly ascertained he must report the fact to the shareholders. [Subsection (4) of Section 227]. However, the report should be qualified in this regard only after the auditor has verified the condition of the records.

The directors are responsible for maintenance of accounts and for financial control of the affairs of the company. Under section 209 of the Companies Act, they are responsible for ensuring the maintenance of adequate records and the preparation of annual accounts showing a true and fair view of the state of affairs of the company. They are also responsible for safeguarding the assets of the company. If they fail to exercise the requisite degree of supervision, they cannot plead in defence that the auditor had not drawn their attention to the dangers to which the assets were exposed.

It is a primary duty of the auditor to verify the books of account presented to him for audit and to report on the final statements of account. However, he does not guarantee or certify them as a result, after the audit has been completed, if a fraud is discovered, the auditor would not be liable for any breach of duty or negligence, for any failure to perform his duties competently, provided he had conducted the audit with due care and skill in consonance with professional standards.

It is expected, however, that the auditor would not accept the financial position of the company as shown by books of account, before making a thorough enquiry so as to satisfy himself that the books of account in fact show the true position and it is properly reflected in the statements of account reported upon by him. The compliance with the accounting standards is also required to be ensured by the auditor.

Often, a question is asked that if the internal check is found by the auditor to be inadequate, should he extend his examination to trace down any fraud or would it be enough if he merely reports that the internal check is inadequate. The informed opinion in the profession in this regard is that, it being the duty of the auditor to report any loss or defalcation resulting from the non-existence of internal check, he must extend his examination, if circumstances so warrant, but he need not imagine the specter of a loss which might have been suffered where in fact, no loss has occurred.

Another duty of the auditor is to see that the Balance Sheet of the company is drawn up in the form contained in the of Schedule VI to the Companies Act; also, that the Profit and Loss

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Account contains all the information required to be disclosed according to the Part II of the same Schedule.

The Companies (Amendment) Act, 2000 has further amplified the duties of an auditor under the Companies Act, 1956 by introducing additional reporting requirements under clauses (e) and (f) of Section 227(3) of the Act where by the auditor shall state his observations having adverse effects on functioning of company in thick type or italics [clause (e)] and ascertain whether any Director of the Company suffers any disqualification under section 274 (1)(g) [clause (f)]. The Institute has issued a Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956 explaining in detail the manner of reporting by the auditor.

The Companies (Second Amendment) Act, 2002 has added Clause (g) in section 227(3), whereby the auditor's report shall have to state whether the cess payable u/s 441A has been paid and if not, the details of the amount of cess not so paid. Section 441A provides for levy and collection of cess on turnover or gross receipt of companies.

Cess on Companies - A cess on companies will be levied for purpose of rehabilitation or revival of sick industrial companies. The provisions are made in sections 441A to 441F, which are placed in part relating to winding up of company by Tribunal.

Section 441A(1) provides that there shall be levied and collected, for the purposes of rehabilitation or revival or protection of assets of the sick industrial company, a levy by way of cess. It shall not be less than 0.005% and not more than 0.1% on the value of annual turnover of every company or its annual gross receipt, whichever is more as the Central Government may, from time to time, specify by notification in the Official Gazette.

Every company shall pay to the Central Government the cess referred to in section 441A (1) within three months from the close of every financial year. [Section 441A (2)]. Every company shall furnish, in such form as may be prescribed, to the Central Government and the Tribunal the details of its turnover and gross receipts with payment of cess. [Section 441A (3)]. The Central Government may, be rules made in this behalf, specify the manner in which the cess shall be paid u/s 441A(2) [section 441A(4)].

Can the scope of the audit be restricted - Though the scope of an audit cannot be restricted *(Newton v. Birmingham Small Arms & Co.)* It has been held in *Pendleburys Ltd. v. Ellis Green and Co.* that where the directors of a private company are its sole shareholders and the auditor has reported to the directors that he has not been able to satisfactorily examine the entries in the company's cash book, in view of inadequacy of the system of recording entries, he cannot be held guilty of negligence for not having qualified his report to the shareholders. The decision, though good law at the time it was delivered, may not now provide protection to auditors in similar circumstances, if a third party is aggrieved.

Auditor's Report - An audit report should be clear, specific and complete, in order that anyone who has an occasion to read it may know exactly what is wrong with the company. An Auditor who gives the shareholders "the means of information" in respect of company's financial position, does so, at his peril and runs the serious risk of being held judicially to have failed to discharge his duty *(Lindley L.J in Re London and General Bank).*

True and Fair - By the substitution of these words in the report which an auditor makes on the

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statements of account of a company for the words "true and correct" by the Companies Act, 1956, the scope of the responsibility of the auditor has been widened. The statements of account, as a result should not only correspond with the entries as contained in the books of account but should also present a true and fair view of financial position of the company. This demands:

(a) that the statements must disclose all material facts affecting the profits made, losses incurred, the valuation of assets possessed or liabilities owned by the company. For example, if there has been a loss of some stocks of raw-material by fire, which were not insured, or certain amounts have had to be paid on account of losses suffered in the past, in respect of which no provision existed in the books of account, these facts should be disclosed separately and, if material, commented upon;

(b) that all unusual, exceptional or non-recurring items of income and expenditure must be disclosed separately;

(c) that the propriety of transactions specified in sub-section (1A) of Section 227, where any one of these has been entered into, should be examined;

(d) that the statements of account should neither over or understate the financial position of the company;

(e) that events, subsequent to the close of the year, which enable the auditor to determine in a better way the profits or the financial position of the company, as at the close of the year, must be taken into account;

(f) that the statements of account should be drawn up in conformity with the accepted standards of accounting principles consistently applied from year to year; and

(g) that the accounts should comply with the requirements as to the disclosure contained in Revised Schedule VI to the Companies Act, 1956.

In the context of ascertainment of true and fair view and drafting of the audit report, it is necessary that students also acquaint themselves with the requirement of the Accounting Standards issued by the Accounting Standards Board of the Institute of Chartered Accountants of India. While discharging their attest functions it will be 'the duty of the members of the Institute to ensure that the Accounting Standards are implemented in the presentation of financial statements covered by their audit reports. In the event of any deviation from the standards, it will be also their duty to make adequate course in their reports so that the users of such statements may be aware of such deviations. Now it is incumbent upon the management of a company to ensure whether the financial statements have complied with the accounting should are not in terms of section 211 of the Companies Act, 1956.

6.4.3 Rights of an Auditor - These are set out in detail in Sections 227(l) and 231.

The right of access to the "books of account" and "vouchers" must be construed as a right to inspect all the books of account and records kept whether in compliance with the statutory provision or for financial purpose at a reasonable time, either with or without notice. Section 227 casts a duty specifically on the officers and other persons associated with the management of the company to furnish any particulars or information required by the company or auditor for being included in the Final Accounts or in any documents to be annexed thereto. The auditor's power to

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obtain information and explanation is indeed very wide and, in case any information is refused, the auditor may report to the members that he has not been able to obtain all the information or the explanations he required. It is the duty of the management to balance and agree the books and prepare the final statements of account. Until this has been done, the auditor normally should not start the audit. If a person other than the statutory auditor has been appointed to audit the accounts of a branch or branches, it would be the duty of the branch auditor to forward his report to the statutory auditor before he makes the accounts of the company.

Audit of Accounts governed by Special Acts - The duties and responsibilities of an auditor in case of companies which are governed by a special Act, is much the same as in case of others except to the extent that these have been modified by the provisions contained in the relevant special Act.

Accordingly, sub-section (6) of section 211 of the Companies Act provides that the final accounts of companies governed by a special Act, and drawn up according to requirements thereof, would not be considered as not disclosing a true and fair view on the ground that they do not disclose information not requiring disclosure under the special Act.

6.5 Audit of Branches

The following are the points regarding audit of branches:

6.5.1 Relevant provisions of Companies Act, 1956 - In accordance with the principle of independent professional audit of the company accounts, the Companies Act, 1956 in Section 228 has provided for the audit of accounts of branches. Section 2(9) of the Companies Act, 1956 defines a branch office as:

(i) any establishment described as a branch by the company;

(ii) any establishment carrying on either the same or substantially the same activity as that carried on by the head office of the company; or

(iii) any establishment engaged in any production, processing or manufacturing but does not include any establishment specified in any order made by the Central Government under Section 8.

Under Section 8, the Central Government has the power to declare any establishment falling under (i) or (ii) above as not a branch office in relation to the company owning it. Section 228 of the Companies Act, 1956 provides that where a company has a branch office, the accounts of that office shall be audited either by the company's auditor appointed under Section 224 or by another auditor possessing qualifications prescribed under Section 226. In the case of a branch situated outside India, any of the above or an accountant qualified to act as auditor in the country concerned can be appointed as the branch auditor. The scheme of Section 228 presumes that normally the company auditor shall be appointed as the branch auditor. However a company may decide to have the branch accounts audited by a person other than the company auditor in a general meeting. In such a situation, the company is required to appoint the branch auditor from out of the eligible categories in the same meeting or it is to authorize the Board of Directors to appoint one in consultation with the company's auditor appointed under Section 224.

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6.5.2 Branch Auditor Appointment and Powers - In the opinion of the Institute of Chartered Accountants of India, the appointment of branch auditors in consultation with the company's statutory auditor should not be taken to mean that the statutory auditor is in any way taking responsibility in respect of the work done by the branch auditor. The provision regarding consultation with the statutory auditor only implies that the statutory auditor should be satisfied that *prima facie,* he is not aware of any reason why the proposed auditor should not be appointed as branch auditor. For example, where an auditor or a partner of his has been the subject matter of adverse disciplinary proceedings under the Chartered Accountants Act and the statutory auditor knows it, it may well be necessary for the statutory auditor to bring this to the notice of the Board of Directors.

The branch auditor shall have the same powers and duties in respect of the audit of the branch accounts as the company auditor has in relation to the company accounts. The powers that the company auditor enjoys in relation to branch accounts are the rights (i) to have access at all times to the books of accounts and vouchers of the branch, (ii) to visit the branch, and (iii) to obtain information and explanation considered necessary for the audit of the branch accounts. But the branch auditor, unlike the company auditor, will not have the right to attend the general meeting of the company or to receive the notice and other related communications in connection with the general meeting. The branch auditor is required to prepare a report on the accounts of the branch office examined by him and forward the same to the company's auditor. It is obvious that when the company auditor himself is the auditor for the branch accounts, there cannot be any question of any report being made on the branch accounts audited. He as the auditor for the company, is under a duty to make a report on the consolidated accounts in accordance with Section 227(2) of the Companies Act.

The branch auditor shall receive such remuneration as may be fixed for him by the general meeting appointing him or by the Board of Directors, if so authorised by the general meeting. Also, he is to hold office subject to the terms and conditions specified by the appointing body. Naturally it is reasonable to presume that the branch auditor will not necessarily hold office for the same statutory period as is held by the statutory auditor under Section 224.

6.5.3 Exemption of Branches from audit requirements in certain situations - Though independent professional scrutiny of the branch accounts is the principle in providing audit, the legislature, having regard to the element of materiality and other considerations, has provided that under certain circumstances the accounts of the branch may not be audited [Section 228(4)]. The Companies (Branch Audit Exemption) Rules, 1961 have been issued to provide for the exemptions; under the above Rules a branch of a company carrying on manufacturing, processing or trading activity accounting for average quantum of activity not exceeding higher of ₹ 2 lakhs or 2% of the average total turnover of the company shall be exempt from the purview of compulsory audit of branch accounts. Quantum of activity means the highest out of the following:

(i) the aggregate value of the goods or articles produced, manufactured or processed, or

(ii) the aggregate value of the goods or articles sold and of services rendered, or

(iii) the amount of the expenditure, whether of a revenue or a capital nature, incurred by a branch office during a financial year.

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The average of the quantum of activity is to be computed by including the activities for the three years immediately preceding the year in respect of which the question of exemption is to be determined. In case the company did not exist for all the three years referred to above, the number of years in which the company actually existed will constitute the base of computing the average. It should be noticed that the question of exemption is to be considered every year by reference to the yardstick given above. The exemption discussed above is mandatory in nature, if the condition about the quantum of activity is met. There may be exemption also on other grounds. But these exemptions are discretionary, subject to the satisfaction of the Central Government. The grounds on which exemption may be granted by the Central Government are the following:

(i) If there are satisfactory arrangements for the scrutiny and check at regular intervals of the accounts of the branch office of a company, not carrying on manufacturing or processing or trading activities, by a person who is competent to scrutinise and check the accounts.

(ii) If arrangements are made for the audit of the accounts of the branch office by a person possessing the qualifications necessary for appointment as a branch auditor, even though such person is an employee of the company.

(iii) If a branch auditor is not likely to be available at a reasonable cost, having regard to the nature and quantum of activity carried on at the branch or having regard to any other reason.

(iv) If for any other reason, the Central Government is satisfied that exemption may be granted.

The company auditor in his report is to make a mention about exemption from audit granted to any of the branches of the company under the Companies (Branch Audit Exemption) Rules, 1961.

6.6 Reliance on the Work and Report of the other Auditor

Occasionally, an auditor may be called upon to report on financial statements, part of which has been audited by other auditor or auditors. This phenomenon is particularly present where the accounts of subsidiaries, audited by other auditors, are consolidated with the holding company's accounts also where branch accounts audited by other auditors are merged in the head- office account, this problem arises. In our country, consolidation of the subsidiaries accounts with the holding company's accounts is not a legal requirement. However, listed companies are required to get their accounts consolidated as per the SEBI's requirement. In that connection, companies are required to comply with the requirements of AS-21. Under the Companies Act, 1956 branch accounts may be audited by auditor different from the company auditor provided of course he holds the requisite qualification. The Institute of Chartered Accountants of India has come out with an –SA 600 "Using the Work of another Auditor".

6.6.1 Company's Auditor in relation to Branch Accounts, Branch Audit and Branch Auditor - When the company's auditor himself is the auditor for the branch accounts, he treats the whole company as an audit unit and ensures that the branch accounts have been properly incorporated in the main office accounts. There remains no question of any separate report on the branch accounts for consideration. Also there is no question of any separate and distinct right to visit the branch or to have access to the books, accounts and vouchers. When the branch accounts are audited by a person other than the company's auditor it is necessary to

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define the position of the company auditor in relation to branch accounts and branch auditor. The Companies Act, under Section 228(2), has given a right to the company's auditor to visit the branch and to have access to the books, accounts and vouchers maintained at branch even when the branch audit is conducted by a person other than the company's auditor. Also, the Companies (Branch Audit Exemption) Rules, 1961 has retained this right for the company's auditor in respect of branches granted exemption from audit this is a right given to the company auditor and not a duty cast on him. If in his own assessment of the situation, he considers it necessary for the proper audit of the accounts of the company, he may visit the branch and may have access to the books, accounts and vouchers maintained there; but it is not compulsory that he must visit the branch or branches.

As regards foreign branch of a banking company, however it is sufficient if the company's auditor is allowed access to the copies and extracts from the books and accounts of the branch as have been transmitted to the principal office of India. Under Section 228(3)(c), the company's auditor is required to deal with the branch audit report received from the branch auditor, in preparing his own report. The manner in which to deal with the report is left to him. This requirement is supplemental to the main duty cast on him under Section 227(3)(c) to state in his report whether the branch audit report has been forwarded to him and how he has dealt with the same. It is clear that the law has left the question of how to deal with branch audit report to the company auditor and only requires him to state in his report how he has dealt with the same. In other words, full freedom of judgement has been given to the company auditor to decide *the prima facie* relevance and impact of the branch audit report on the total company accounts. Certain matters may appear material and important in the limited context of the operations of the branch but may be considered not much significant in the setting of the total company accounts. He, therefore, may incorporate the points, if any, made in the branch audit report if he considers the same relevant in making the consolidated accounts true and fair. He, at his discretion may drop any or all the qualifications made in the branch audit report. However, if the branch audit report contains qualifications on matters specially required to be disclosed in the company accounts, pursuant to the Schedule VI requirements, then it is obvious that the company auditor is left with no choice but to incorporate them in his own report after confirming the accuracy of the report, if he so feels. For example, if the branch audit report contains a qualification about non-disclosure of loans granted by the branch to a firm of which a partner is the subsidiary of the company, the auditor has to include it in his report unless he has reasons to doubt the veracity of the branch audit report itself.

It should be understood that this discretion allowed to the company auditor is highly sensible. Since the company auditor is to report upon the combined accounts of the main office and the branches, it is he who can judge the requirements of true and fair in an overall context, having regard to materiality, accounting principles and the requirements of disclosure. For example, if depreciation on the fixed assets of the branch has not been charged in the branch accounts, no doubt the branch accounts will not show a true and fair view and it will be quite legitimate for the branch auditor to qualify his report on that point. But if the company auditor can satisfy himself that such charge of depreciation has been in fact made in the head office books, he will not retain the branch auditor's qualification in his report. It should also be understood that discretion is simultaneously a very big responsibility on the company auditor. If he omits any of

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the qualifications appearing in the branch audit report, without sufficient consideration, he and not the branch auditor will be responsible for the omission.

It seems that in a situation where the branch audit is being conducted by a person other than the company auditor the law has recognised a degree of overlapping responsibility. The legal opinion obtained by the Institute of Chartered Accountants of India and published in the "Opinion regarding certain provisions of the Companies Act, 1956", in this context, holds the view that the company's auditor has a certain measure of responsibility in respect of the accounts and papers of the branch. This is shown by the fact that he has a right to visit the branch and has access to the papers and documents of the branch. He is in substance in overall supervision as the company's auditor and, in that capacity, he has to make disclosure of anything in regard to the branch which he thinks is not in order and which has come to his notice.

The Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India in their SA "Using The Work of Another Auditor" (SA 600) has reviewed the relationship between the statutory auditor and the branch auditor and has come to a conclusion that the statutory auditors would not be responsible for work entrusted to branch auditors except in circumstances which should have aroused his suspicion, about the achievability of work performed by the branch auditor.

The statutory auditor would normally be entitled to rely upon the work of the branch auditor unless there are special circumstances to make it essential for him to visit the branch and / or to examine the books of account and other records of the said branch. When using the work of the branch auditor, the statutory auditor should ordinarily advise the branch auditor of the use that is to be made of his work and report. He should make sufficient arrangements for the coordination of their efforts at the planning stage of his audit. He should advise the branch auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them. Ascertain from the other auditor any limitation on the scope of his work imposed by the terms of engagement. The statutory auditor should also consider the significant audit findings of the other auditor.

The statutory auditor is not required to evaluate the professional competence or independence of the branch auditor, except in situations which create doubt about the professional competence or independence of the other auditor. Where the statutory auditor's report is other than unqualified, the principal auditor should also document how he has dealt with the qualifications or adverse remarks contained in the branch auditor's report in framing his own report. There should be sufficient liaison between the principal auditor and the branch auditor. For this purpose, the principal auditor may find it necessary to issue a written communication to the branch auditor.

The branch auditor, knowing the context in which his work is to be used by the principal auditor, should cooperate with him and assist him actively, for example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time table for audit of the branches, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the branch auditor's work. If the branch auditor qualifies his report, the

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principal auditor should consider whether the subject of the qualification is of such nature and significance, in relation to the financial statements of the entity on which the principal auditor is reporting, that it requires a qualification in his report.

The principal auditor would not be responsible in respect of the work entrusted to the branch auditors, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the branch auditors. When the principal auditor has to base his opinion on the financial statements of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial statements of the entity by indicating the extent to which the financial statements of branches audited by the other auditors have been included in the financial statements of the entity, e.g., the number of branches / divisions audited by other auditors.

6.7 Joint Audit

The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. With a view to providing a clear idea of the professional responsibility undertaken by the joint auditors, the Institute of Chartered Accountants of India had issued a statement on the Responsibility of Joint Auditors which now stands withdrawn with the issuance SA 299 on "Responsibility of Joint Auditors" w.e.f. April, 1996. Basic principles laid down in SA 299 are discussed in following paragraphs:

Division of Work - Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors. The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

Coordination - Where, in the course of his work, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgement by, other joint auditors, he should communicate the same to all the other joint auditors in writing. Thus should be done by the submission of a report or note prior to the finalisation of the audit.

Relationship among joint auditors - In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared as separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible:

(a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may,

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however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

(c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(e) for ensuring that the audit report complies with the requirements of the relevant statute.

If any matters of the nature referred above are brought to the attention of the entity or other joint auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible for those matters. Subject to paragraph (b) above, it is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him; The issues such as appropriateness of using test checks or sampling should be decided by each joint auditor in relation to his own area of work. This responsibility is not shared by the other joint auditors. Thus, it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him. Similarly, the nature, timing and extent of the enquiries to be made in the course of audit as well as the other audit procedures to be applied are solely the responsibility of each joint auditor.

In the case of audit of a large entity with several branches, including those required to be audited by branch auditors, the branch audit reports/returns may be required to be scrutinised by different joint auditors in accordance with the allocation of work. In such cases, it is the specific and separate responsibility of each joint auditor to review the audit reports/returns of the divisions/branches allocated to him and to ensure that they are properly incorporated into the accounts of the entity. In respect of the branches which do not fall within any divisions or zones which are separately assigned to the various joint auditors, they may agree among themselves as regards the division of work relating to the review of such branch returns. It is also the separate and specific responsibility of each joint auditor to exercise his judgement with regard to the necessity of visiting such divisions/branches in respect of which the work is allocated to him.

A significant part of the audit work involves obtaining and evaluating information and explanations from the management. This responsibility is shared by all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility. In cases where specific responsibility of each joint auditor to obtain appropriate information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by him. Each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner. Each joint auditor is entitled to rely upon the other joint auditors for bringing to his notice accounting principles or any material error noticed in the course of the audit. Where separate financial statements of a division/branch are audited by one of the joint auditors, the other joint auditors are entitled to proceed on the basis that such financial statements comply with all the legal and professional

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requirements regarding the disclosures to be made and present a true and fair view of the state of affairs and of the working results of the division/branch concerned, subject to such observations as may be communicated by the joint auditor concerned.

Reporting Responsibilities - Normally, the joint auditors are able to arrive at an agreed report. However, where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the view of the majority of the joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

For the purpose of computation of the number of company audits held by an auditor pursuant to the ceiling rule introduced in the Companies Act, 1956 each joint auditorship in a company will be counted as one unit.

6.8 Gist of Important Circulars

A gist of some important circulars issued from time to time by the Company Law Department is given below:

Another meeting to be held by directors for considering reservation, qualification, etc., made in auditor's report - In case the auditors' remarks are not available to the board at the time of its consideration and authentication of the balance-sheet and profit and loss account under Section 215(3), the board has to meet once again to consider the reservations, qualifications made in auditor's report and give their explanations to the said remarks in terms of Section 217(3) - *Source: Letter No. 8/22(215)/76-CL-V, dated 16-8-1978.*

Need for appointment of independent auditors - Where due to near relationship of an auditor with managing or a whole-time director, the independence of an auditor is likely to be jeopardised, he shall use his good sense, and acting in the best traditions of the profession, refrain from accepting the appointment - *Source: The Chartered Accountant, Vol. XII, Part* XI, *May, 1964 issue.*

Statutory auditor cannot be internal auditor - If the statutory auditor of the company is also the internal auditor, it will not be possible for him to give an independent and objective report under-Section 227. As such a statutory auditor of a company cannot also be its internal auditor - *Source: Circular No. 29/76(1)/[76-CL-V], dated 27-8-1976 as corrected by Circular No. 5/[77(1)/1/76-CL- V], dated 8-4-1977.*

Statutory auditor cannot undertake work of writing books of account - The acceptance of the book-keeping work by the statutory auditor is likely to place the statutory auditor in a rather vulnerable position in the matter of free expression of his professional opinion as an auditor on the annual accounts of the company. Such practice deserves to be discouraged - *Source: Extract from Seventh Annual Report on Working and administration of Companies Act, 1956 - Year ended 31st March, 1963.*

Retiring auditor can be deemed to be reappointed or automatically appointed at annual general meeting- It is not correct to say that in the absence of the resolution to the effect that that retiring auditors shall not be reappointed, the retiring auditors shall stand reappointed as auditors of the company. Where auditors are not appointed or reappointed in accordance with

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the provisions of the Act including section 224(2), as read with sections 225, 190 and 224(3) relating to the Government's power to appoint auditors becomes attracted in the matter - *Source: Circular No. 5/72, dated 21-2-1972.*

Continuation of tenure of auditor up to factual conclusion of next annual general meeting - Where no annual general meeting is held, the tenure of an auditor appointed under section 224 will continue up to the factual conclusion of the next annual general meeting held by the company - *Source: Clarification issued by Department of Company Affairs.*

Signing of Form 23B by auditors in firm's name without disclosing identity of signatory- The intimation in token of acceptance or refusal to accept the appointment is only a ministerial act which can be performed by a duly authorised person on behalf of the auditor's firm. It is, however, necessary that the identity of person who signs Form No. 23B, whether he be a partner or a clerk of the firm, must be disclosed as such, as it will not be enough if the form is signed only in the firm's name, without disclosing the identity of the signatory since the firm has no *locus standi* of its own in the eye of law - *Source: Letter No. 7/26/76-IGC, dated 31-10-1977.*

Requirement of sending certificate by auditors to Registrar - The intimation for the appointment or reappointment of a person or firm as the auditor under sub-section (1C) of Section 224 does not provide for prescribing any form for furnishing the said intimation to the Registrar - *Source: Circular No. 20/75[35/3/75-CL-III], dated 22-9-1975.*

Guarantee companies are not to be counted in reckoning specified number of audits - Such companies as have no share capital, *i.e.* guarantee companies, are to be excluded from the reckoning of 'specified' number of companies within the meaning of *Explanation 1* to sub-sections (1B) and (1C) - *Source: Letter No. 8/12(224)/74-CL.-V, dated 28-9-1974.*

Branch audits of Indian companies and audit of Indian business accounts of foreign companies not to be included while calculating specified number of audits - The branch auditor of the Indian Companies appointed under section 228 audits the accounts of the particular branch only for which he is appointed and forwards his report to the auditor appointed under section 224 and, hence, he cannot be equated with the company's auditors appointed under section 224. Hence, the branch audits are not to be included while calculating the specified number of 20 audits. The audit of the accounts of companies is also not to be included within the specified number of 20 as laid down under *Explanation I* to sub-section (1C) of Section *224 - Source: Circular No. 21/75(35/3/75-CL-III), dated 24- 9-1975.*

Central Government's power to appoint auditors exercisable only where auditors are not appointed in annual general meeting - It is only where an auditor is not appointed at an annual general meeting that the Central Government can exercise the powers under section 224(3*) - Source: Letter No. 35/13/74-CL-III, dated 21-11-1974.*

Material date for appointment or reappointment of auditor is date of annual general meeting at which special resolution is required to be passed - The material date for the appointment or reappointment of an auditor is the date of the annual general meeting at which the special resolution is required to be passed. Moreover, since generally, articles of association of companies provide for closure of the register of members before general meeting during period not exceeding thirty days at any one time, it is unlikely that the position

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regard shareholding in the company will be different between the date of issue of notice and date of the general meeting.

In exceptional cases, however, where a change in the shareholding pattern in the company has taken place, between the date of issue of notice of the general meeting and the actual passing of this resolution regarding appointment of auditor, the company may either:

(i) adjourn the meeting to another date, and later issue the required notice in accordance with the law and thereafter pass the special resolution required to be passed under section 224A, or

(ii) omit or pass over the item on the agenda regarding appointment of auditor.

In the event of the company adopting the procedure at (ii) above, the situation would be then covered by sub-section (2) of section 224A-*Source: Circular No. 2/76(1/176-CL-V), dated 5-6-1976.*

Interpretation of expression "other than retiring" as occurring in section 225(1) - Passing of a resolution in the annual general meeting appointing another person as an auditor of the company without mentioning the words 'instead of him is quite sufficient and valid' under Section 224(2)(c) and similarly a special notice proposing to move a resolution to appoint a new person as an auditor of the company without mentioning the words 'in place of retiring auditor' is sufficient compliance under section 225(l) - *Source: Circular No. 22/76(35/4/76 - CL-III), dated 26- 7-1976.*

Service of copy of special notice to retiring auditors to be effected by registered post- The copy of the special notice under Section 225(2) should be sent to the retiring auditors by the registered AD post-*Source: Circular No. 2/81(1/1/81-CL- V), and 8/20(225)/81-CL-(V), dated 17-10-1981.*

Consequence of non-forwarding of notice to retiring auditors - The effect of non-forwarding of notice under Section 225(2) to the retiring auditors will make the resolution for appointing or removing auditors illegal and ineffective - *Source: Circular No. 35/6/68-CL-III, dated 18-11-1969.*

Proprietary firm, whether qualifies for appointment as auditor - A company must appoint the proprietor of the proprietary firm by his name in his individual capacity as its auditor and the auditor's report will have to be signed by the proprietor himself in his own name - *Source: Circular No. 8/1229/56-PR, dated 20-3-1957.*

Where chartered accountant renders services professionally and not as an officer company, he is not disqualified under section 226(3)(b) - A chartered accountant's main business is to render professional service for reward like a lawyer or a doctor. Where such service is rendered professionally and not as an officer or employee of the company' a chartered accountant is not disqualified under section 226(3)(b) - *Source: Circular Letter* No. *8/1/57-PR, dated 11-7-1957.*

Section 215 not contravened where audit of final accounts is completed before approval of balance sheet by board of directors of company - The Company Law Board does not consider that there is any contravention of section 215 in a case where the audit of the final accounts is completed before the approval of the balance sheet by the board of directors of

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the company - *Source: Letter No. 8/13(215)/65-CL- V, dated 29-9-1996.*

Instances of lapses on part of auditors - The auditors will not be fulfilling their duties if they have given clean certificate on the company accounts audited by them without looking into matters which were clearly relevant to a 'true and fair' view of the affairs of the companies concerned. It would not be a proper discharge of their responsibilities of auditors were not to disclose the infringements of the provisions of the Companies Act or those of the other important laws, much less to draw company's attention to inadequate depreciation, to under- or over-valuation of current assets like stock-in-trade, to improper allocation of reserves, to improper classification of debts and loans, etc*. Source: Extract from Third Annual Report on Working and Administration of Companies Act, 1956 Year ended 31-3-1959.*

Statutory auditor is to refer to branch audit only when branch accounts are audited by a person other than himself - The company's auditor need refer in his report to the branch audit only when the branch accounts are audited by a person other than himself - *Source: Letter No. 8/46(1)/61 -PR, dated 9-5-1961.*

Followance of procedure of section 225 for appointment of branch auditor - The term 'auditor' mentioned in section 225 means statutory auditor. It would be preferable if companies followed the procedure laid down in section 225, in all cases, including that for appointment of branch auditor - *Source: Extract from Minutes of Meeting of Bombay Chambers' Company Law Sub-Committee with Secretary, Department of Company Law Administration, held on 2-6-1961.*

Branch audit can be conducted at head office without visiting branches - For the auditor of the branch accounts there is no compulsion to visit branches, but here again it is a matter for the auditors to decide - *Source: Letter No. 8/16(1)/61-PR, dated 9-5-1961.*

Place of manufacture can be deemed to be branch office for purposes of carrying out audit - The place of manufacture, for the purpose of carrying out an audit, shall be regarded as a branch office and should be audited as such under Section 228 unless it is exempted from audit under the Companies (Branch Audit Exemption) Rules, 1961. As regards any accounts or other papers relating to this branch office kept at the head office, it is for the concerned auditor to decide about the procedure he should follow - *Source: Letter No. 8/16(1)/61-PR, dated 9-5-1961.*

Copy of branch audit report could be sent to the board of directors simultaneously with transmission of original branch audit report to statutory auditor - There can be no administrative objections to a copy of the branch audit report being sent to the board of directors simultaneously with the direct transmission of the original branch audit report to the statutory auditor - *Source: Letter No. I0(1)-CL-VI/61, dated 27-4-1961.*

Interpretation of definition of "accounts" as occurring in Section 228 (3)(c) - The 'accounts' maintained in the branch office would necessarily depend largely on type of businesses carried on in branch. However, two requirements, in addition to the other requirements of Section 227 that might be applicable to any particular branch that have to be complied with, are namely, the auditors should certify that (a) proper books of account have been kept a branch; and (b) that the accounts or returns of the branch show a true and fair view of working of the branch - *Source: Extract from Fifth Annual Report on Working and*

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Administration of Companies Act, 1956 - Year ended 31st March, 1961.

The revised guiding principles on which applications of banking companies for exemption from branch audit be dealt with, were formulated keeping in view the fact that the accounts of the branches of banking companies are generally inspected regularly by their trained inspectors, and the further- fact that many banks have a large number of branch offices spread throughout the *country - Source: Extract from Sixth Annual Report on Working and Administration of Companies Act, 1956 - Year ended 31st March, 1962.*

Signing of auditors' report in firm's name - The partner concerned shall invariably sign in his own hand for and on behalf of the firm appointed to audit a company's accounts, and this is what is required by the provisions of the Act - *Source: Circular No. 26/72 (F. No. 14/12/72-CL- V), dated 29- 7-1972.*

Appointment of a chartered accountant who is not in practice - There is no inconsistency between the provisions of the Chartered Accountants Act and section 233A whereby the Central Government has been empowered to appoint a chartered accountant who is not in practice for the special audit of a company - *Source: Letter No. 8/16(1)/1, dated 9-5-1961.*

Appointment of cost auditors in firm's name - Whether cost audit report could be signed by merely affixing firm's name - In cases where a firm of cost auditors is approved for appointment under sub-section (2) of section 233B, the cost audit report shall be signed by any one of the partners of the firm responsible for the conduct of cost audit in his own hand, for and on behalf of the firm, which has been approved for appointment as cost auditors of the company. In any case, the report should not be signed by merely affixing the firm's name - *Source: Letter No. 52/409/60-CLB, dated 24-8-1984.*

Whether appointment of cost auditor as internal auditor permissible - The cost auditor should not be the internal auditor of a company for the period for which he is conducting the cost audit - *Source: Circular No. 1/83, dated 20-1-1983.*

Whether cost auditor is under legal obligation to make disclosure of full details in his cost audit report - The duties of the cost accountants appointed to conduct an audit of cost accounts of the company flow directly from the above provisions and as such they should in strict compliance therewith ensure that full and complete details in respect of the accounts of the company are furnished in their reports. Any request that certain details may not be disclosed in the report (on any ground whatsoever) should be inconsistent with the object and purpose of the Cost Audit Report Rules and the requirements there under. The cost auditors should, if necessary, bring such instances to the notices of Government by a specific note in their reports - Source: *Circular No. 3/83, dated 18-3-1983.*

6.9 Compliance with Relevant Provisions of the Companies Act, 1956

One of the fundamental duties of the auditor is to verify that the statements of account are properly drawn up and they disclose all the required information. In the process, he must also ascertain that the company has not violated any of the provisions contained in the Companies Act, 1956. Since the auditor is not associated with day-to-day management of the company,

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compliance with the relevant provisions of the Companies Act, 1956 is the responsibility of the directors and officers of the company. Nevertheless, where non-compliance results in affecting the accounts materially, the auditor must make a report to the shareholders. He can properly discharge such onerous duty only if he is aware of the duties of the management prescribed by the Companies Act, 1956.

The Companies Act, 1956 lays down detailed provisions regarding various matters and casts an obligation upon directors and officers of the company to carry out the requirements of the law. Generally speaking, it is the duty of the directors and the management to ensure that the provisions of the Companies Act, 1956 have been complied with. However, where non-compliance with the provisions of the Companies Act, 1956 has a bearing upon the accounts and transactions of the company, the auditor would in the normal course of his inquiry become aware of the breaches of the Act and may have an obligation to bring this to the attention of the shareholders.

6.10 Auditor's Duty under Companies Act, 1956

The following are the duty of an auditor under Companies Act 1956:

(i) Register of mortgages and charges - Every company under Section 143 is required to keep a Register of charges to enter therein all the charges specifically affecting the property of the company as well as the floating charges on the undertaking or on the property of the company. The particulars of each property charged that should be entered in the register are: (a) a short description of the property; (b) the amount of charge: and (c) the names of the persons entitled to exercise the charge. This register should be examined by the auditor to ascertain whether any of the assets belonging to the company except bearer securities, is subject to charge, and, if so, its nature. Section 143(2) of the Companies Act, 1956, lays down that if any officer of a company knowingly omits, or willfully authorises or permits the omission of any entry required to be made in pursuance of Section 143(l), he may be punishable with fine which may extend to five thousand rupees.

(ii) Register of contracts with companies and firms in which the directors are interested - This Register is maintained pursuant to sub-section (1) of Section 301. It contains a record of particulars of contracts or arrangements that attract the provisions of Sections 297 and 299; dates of Board meetings at which contracts were approved and that of the names of directors who voted for or against the proposal. The names of firms and bodies corporate in which the Directors are interested, of which a notice has been given by the directors under sub-section 297(2)(c) are also entered in it.

The provisions of Section 297 are not applicable to; (a) contracts or arrangements for the sale or purchase or supply of goods, materials or services, if the value or cost thereof in any year does not exceed ₹ 5000; and (b) contracts, etc., by banking companies for the collection of bills in the ordinary course of business, and transactions of banking and insurance companies in the ordinary course of business with any director, relative, partner, etc., referred to in Section 297(2) (c).

It is the duty of the auditor to examine the Register to find out whether transactions of purchase or sale of goods in which a director or directors were interested were entered into

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under the sanction of the Board and the directors concerned had disclosed their interest.

(iii) Register of investment or loan made, guarantee given or security provided in relation to any body corporate - In pursuance of sub-section (5) (a) of Section 372A, every company shall keep a register showing the following particulars in respect of every investment or loan made, guarantee given or security provided by it in relation to any body corporate under sub-section (1), namely:

(i) the name of the body corporate; (ii) the amount, terms and purpose of the investment or loan or security or guarantee; (iii) the date on which the investment or loan has been made; and (iv) the date on which the guarantee has been given or security has been provided in connection with a loan.

The particulars of investment, loan, guarantee or security referred to in clause (a) shall be entered chronologically in the register aforesaid within seven days of the making of such investment or loan, or the giving of such guarantee or the provision of such security.

The register referred to in sub-section (5) shall be kept at the registered office of the company concerned shall be open to inspection at such office and extracts may be taken therefrom and copies thereof may be required, by any member of the company to the same extent, in the same manner on payment of the same fees as in the case of the register of members of the company; and the provisions of Section 163 shall apply accordingly.

(iv) Register of investments held in the names of Nominees - Normally, a company is expected to hold investments in its own name [Section 49]. But where under sub-sections (2), (3), (4) and (5) of Section 49, investments have been made in the names of nominees, a register must be kept and the following particulars recorded therein:

(a) the nature, value and such other particulars as may be necessary to identify the shares or securities.

(b) the name of the person or the bank in whose name or custody the shares or securities are standing.

The auditor should examine the register during the course of inspection of securities.

(v) Register of directors, managing director, manager and secretary - Under the provisions of Section 303 of the Companies Act, it is obligatory for a company to maintain a record, in a register, of the names and addresses and that of other particulars relevant for the administration of the Act in respect of all the officers aforementioned. Under sub-section (2) of the aforesaid Section, any change in the officers or any of the particulars of an officer must be incorporated in the register and notified to the Registrar of Companies within 30 days of the change taking place. Particulars of original appointment also should be notified to the Registrar within 30 days of appointment.

The auditor should refer to this register to find out the names of persons who had held different offices during the year under audit to confirm that various transactions entered into by the company have been authorised by a competent person.

(vi) Register of shareholding of directors and manager - It contains a record of the particulars of shares and debentures of the company, as well as those of similar securities in the capital of any other body corporate, which is a subsidiary or holding company or subsidiary

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of the company's holding company held by a director or which lie in trust with him or of which he has any right to become the holder whether on payment or not. This register is being maintained pursuant to the requirement under Section 307.

Where the auditor carries out a share transfer audit, he should see that the purchase and sale of shares by the directors are properly recorded in the register. But in the course of regular audit, he is not expected to check the accuracy of entries in the register.

(vii) Managerial Remuneration - Disclosure in the accounts is made.

A note showing the computation of net profits in accordance with Section 349 of the Act with relevant details of calculation of the commission payable by way of such profits the directors (including managing directors or managers) should be given.

Personal expenses of directors - All payments to directors by way of remuneration or perquisites whether in the case of a public or private company are required to be authorised both in accordance with the provisions of the Companies Act and Articles of Association of the company. In some cases, depending upon the provisions contained in the Articles, the remuneration may require sanction of the shareholders either by an ordinary or special resolution while, in other cases, it may require only approval of the Directors. In the case of public companies and private companies which are subsidiaries of public companies, sanction of the Government is also necessary. If the terms of appointment of a director include payment of expenses of personal nature then such expenses can be incurred by the company. Where, however, the contract with the director or the conditions of employment does not contain any provision for payment of expenses of a personal nature, then there is no warrant for incurring or reimbursement of such expenses by the company and if such expenses are paid the auditor should disclose the fact in his report, as also in the accounts. Attention in this regard is invited to Section 227(IA)(e) of the Companies Act.

(viii) Employees' Securities (Section 417) - All moneys or securities deposited by the employees of a company in pursuance to their contract of service must be kept deposited by the company with a Scheduled Bank or in Post Office Saving Bank Account; or in the State Bank of India within 15 days of receipt; also such moneys or securities must not be used for any purpose except for purpose is agreed to in the contract of service.

(ix) Employees' Provident Fund (Section 418) - All moneys contributed to a Provident Fund constituted by a company for its employees, together with interest accrued thereon shall have to be deposited in a:

(i) Post Office Saving Bank account, or

(ii) Special Account to be opened in the State Bank of India or a Scheduled Bank, or

(iii) where the company itself is a Scheduled Bank, in a special account to be opened by the company for the purpose either in itself or in the State Bank of India or in any other Scheduled Bank; or

(iii) shall be invested in the securities referred to in clauses (a) to (e) of Section 20 of the Indian Trusts Act, 1882

The term contribution referred to above means contribution both by the employee and the

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employer. The deposit is to be made within 15 days of the date of the contribution or of the receipt of or accrual of the interest.

(x) Inter-Corporate Loans and Investments (Section 372A) - 372A (1) No company shall, directly or indirectly:

(a) make any loan to any other body corporate;

(b) give any guarantee, or provide security, in connection with a loan made by any other person to, or to any other person by, any body corporate; and

(c) acquire, by way of subscription, purchase or otherwise the securities of any other body corporate, exceeding sixty per cent, of its paid-up share capital and free reserves, or hundred per cent of its free reserves, whichever is more:

Provided that where the aggregate of the loans and investments so far made, the amounts for which guarantee or security so far provided to or in all other bodies corporate, along with the investment, loan, guarantee or security proposed to be made or given by the Board, exceeds the aforesaid limits, no investment or loan shall be made or guarantee shall be given or security shall be provided unless previously authorised by a special resolution passed in a general meeting:

Provided further that the Board may give guarantee, without being previously authorised by a special resolution, if,

(a) a resolution is passed in the meeting of the Board authorising to give guarantee in accordance with the provisions of this section;

(b) there exists exceptional circumstances which prevent the company from obtaining previous authorisation by a special resolution passed in a general meeting for giving a guarantee; and

(c) the resolution of the Board under clause (a) is confirmed within twelve months, in a general meeting of the company or the annual general meeting held immediately after passing of the Board resolution, whichever is earlier:

Provided also that the notice of such resolution shall indicate clearly the specific limits, the particulars of the body corporate in which the investment is proposed to be made or loan or security or guarantee to be given, the purpose of the investment, loan or security or guarantee, specific sources of funding and such other details.

(2) No loan or investment shall be made or guarantee or security given by the company unless the resolution sanctioning it is passed at a meeting of the Board with the consent of all the directors present at the meeting and the prior approval of the public financial institution referred to in Section 4A, where any term loan is subsisting, is obtained:

Provided that prior approval of a public financial institution shall not be required where the aggregate of the loans and investments so far made, the amounts for which guarantee or security so far provided to or in all other bodies corporate, along with the investments, loans, guarantee or security proposed to be made or given does not exceed the limit of sixty per cent, specified in sub-section (1), if there is no default in repayment of loan instalments or payment of interest thereon as per the terms and conditions of

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such loan to the public financial institution.

(3) No loan to any body corporate shall be made at a rate of interest lower than the prevailing bank rate, being the standard rate made public under Section 49 of the Reserve Bank of India Act, 1934.

(4) No company, which has defaulted in complying with the provision of Section 58A, shall, directly or indirectly:

(a) make any loan to any body corporate; (b) give any guarantee, or provide security, in connection with a loan made by any other person to, or to any other person by, any body corporate; and (c) acquire, by way of subscription, purchase or otherwise the securities of any other body corporate, till such default is subsisting.

(5) (a) Every company shall keep a register showing the following particulars in respect of every investment or loan made, guarantee given or security provided by it in relation to any body corporate under sub-section (1), namely :

(i) the name of the body corporate;

(ii) the amount, terms and purpose of the investment or loan or security or guarantee;

(iii) the date on which the investment or loan has been made; and

(iv) the date on which the guarantee has been given or security has been provided in connection with a loan.

(b) The particulars of investment, loan, guarantee or security referred to in clause (a) shall be entered chronologically in the register aforesaid within seven days of the making of such investment or loan, or the giving of such guarantee or the provision of such security.

(6) The register referred to in sub-section (5) shall be kept at the registered office of the company concerned and (a) shall be open to inspection at such office; and (b) extracts may be taken therefrom and copies thereof may be required, by any member of the company to the same extent, in the same manner, and on payment of the same fees as in the case of the register of members of the company; and the provisions of Section 163 shall apply accordingly.

(7) The Central Government may prescribe guidelines for the purposes of this section.

(8) Nothing contained in this section shall apply

(a) to any loan made, any guarantee given or any security provided or any investment made by,

(i) a banking company or an insurance company, or a housing finance company in the ordinary course of its business, or a company established with the object of financing industrial enterprises, or of providing infrastructural facilities;

(ii) a company whose principle business is the acquisition of shares, stock, debentures or other securities;

(iii) a private company, unless it is a subsidiary of a public company;

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(b) to investment made in shares allotted in pursuance of clause (a) of sub-section (1) of Section 81.

(c) to any loan made by a holding company to its wholly owned subsidiary;

(d) to any guarantee given or any security provided by a holding company in respect of loan made to its wholly owned subsidiary; or

(e) to acquisition by a holding company, by way of subscription, purchases or otherwise, the securities of its wholly owned subsidiary.

(9) If default is made in complying with the provisions of this section, other than sub -section (5), the company and every officer of the company who is in default shall be punishable with imprisonment which may extend to two years or with fine which may extend to fifty thousand rupees:

Provided that where any such loan or any loan in connection with which any such guarantee or security has been given, or provided by the company, has been repaid in full, no punishment by way of imprisonment shall be imposed under this sub-section, and where such loan has been repaid in part, the maximum punishment which may be imposed under this sub-section by way of imprisonment shall be appropriately reduced:

Provided further that all persons who are knowingly parties to any such contravention shall be liable, jointly and severally, to the company for the repayment of the loan or for making good the same which the company may have been called upon to pay by virtue of the guarantee given or the securities provided by such company.

(10) If default is made in complying with the provisions of sub-section (5), the company and every officer of the company who is in default shall be punishable with fine which may extend to five thousand rupees and also with a further fine which may extend to five hundred rupees for every day after the first day during which the default continuous.

Explanation: For the purposes of this section, (a) "loan" includes debentures or any deposit of money made by one company with another company, not being a banking company; (b) "free reserves" means those reserves which, as per latest audited balance sheet of the company, are free for distribution as dividend and shall include balance to the credit of the securities premium account but shall not include share application money.

6.11 Final Accounts Preparation and Presentation

Statutory Requirements - Section 211 governs the form and contents of the Balance Sheet and the Profit and Loss Account. The provisions thereunder, however, are not applicable to an insurance or banking company or a company engaged in the generation or supply of electricity or to any other class of companies for which a form of balance sheet and profit and loss account has been specified in or under the Act governing such class of companies. The provisions that companies, other than those aforementioned, should comply with are:

(a) That every balance sheet of a company should give a true and fair view of the state of affairs of the company as at the lend of financial year and should be in the form set out in Part I of Revised Schedule VI or as near thereto as circumstances admit or such other form as may be approved by the Central Government either generally or in any particular

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case; while preparing the balance sheet, due regard should be had as far as may be to the general instructions for the preparation of balance sheets under heading "Notes" at the end of the Part I; and

(b) That every profit and loss account of a company should give a true and fair view of the profit or loss of the company for the financial year and should comply with the requirements of Part II of Revised Schedule VI, so far as they are applicable thereto.

The Central Government is authorised under sub-section (3) to exempt, by a notification in the Official Gazette, any class of companies from compliance with any of the requirements in Revised Schedule VI if, in its opinion, it is necessary to grant the exemption in the public interest. The exemption may be granted unconditionally or subject to such conditions as may be specified in the notification. The Central Government also may, on the application of or with the consent of the Board of Directors of the company by order modify in relation to that company any of the requirements of the Act as to the matters to be stated in the company's balance sheet or profit and loss account for the purpose of adopting them to the circumstances of the company.

Thus in order that the statements of account of a company may exhibit a true and fair view of the state of affairs of a company, it is necessary:

(i) that the information required by law (as specified in Revised Schedule VI to the Act) should be disclosed; and

(ii) that the same to be displayed in the manner required.

The Companies (Amendment) Act, 1999 has inserted following sub-sections in Section 211 namely:

(3A) Every profit and loss account and balance sheet of the company shall comply with the accounting standards.

(3B) Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following, namely: (a) the deviation from the accounting standards; (b) the reasons for such deviation; and (c) the financial effect, if any, arising due to such deviation.

(3C) For the purposes of this section, the expression "accounting standards" means the standards of accounting recommended by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949, as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under sub-section (1) of Section 210A:

Provided that the Standards of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the Accounting Standards until the Accounting Standards are prescribed by the Central Government under this sub-section.

Constitution of National Advisory Committee on Accounting Standards - The Central Government may, by notification in the official Gazettee, constitute an Advisory Committee to be called the National Advisory Committee to be called the National Advisory Committee on Accounting Standards (hereafter in this section referred to as the "Advisory Committee") to

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advise the Central Government on the formulation and laying down of accounting policies and accounting standards for adoption by companies or class of companies under this Act.

Form of the Balance Sheet - Now a days, the shares in companies are held by a wide variety of persons, a majority of whom are not conversant with the principles of accounting or with the form in which the final statements of accounts are drawn up. As a result, there have been complaints from several quarters that the traditional form in which the balance sheet of a company is drawn up, known as the "T" form, is not satisfactory, for it does not disclose clearly whether the value of the equity of the share holders has increased or decreased and, if so, by what amount. On this ground, it has been suggested that instead, the balance sheet should be drawn up in the columnar form. [Students are invited to see the published accounts of any big company]. The Balance Sheet of a company shall be either in horizontal form or vertical form. Some of the advantages of final statements of account being drawn in a columnar form are as under:

(i) When the final accounts are drawn up in this form, the financial position of the company can be readily comprehended by a layman.

(ii) The profit and loss account discloses clearly the amount of trading or non-trading profit earned during the year, that brought forward from the previous year, and the appropriations out of the total profits recommended by the Board of Directors.

(iii) The Balance Sheet discloses the amount of debt and shareholders' equity. It further discloses the position of assets held against them segregated into fixed assets and working capital.

(iv) The form is capable of presenting together comparative figures of a number of years.

(v) The relationship between the various balances (ratios) can be easily worked out.

Schedule VI –

Ministry of Corporate Affairs [MCA] has hosted the revised Schedule VI to the Companies Act, 1956 which deals with the Form of Balance sheet, Profit & Loss Account and disclosures to be made therein. The revised Schedule VI has been framed as per the existing non-converged Indian Accounting Standards notified under the Companies (Accounting Standards), Rules, 2006 and has no connection with the converged Indian Accounting Standards.

The revised Schedule VI will apply to all the companies uniformly for the financial statements to be prepared for the financial year 2010-11 and onwards.

Part I of Revised Schedule VI contains the form in which the Balance Sheet of a company should be drawn up, and states the information as regards different assets and liabilities which should be disclosed therein.

Part II of the Revised Schedule VI contains the form as regards the preparation and presentation of information in the Profit & Loss Account. It should be noted that no form had been prescribed for Profit & Loss Account in the pre revised Schedule VI. Companies were therefore free to adopt a form they consider suitable according to their own requirements, provided of course, all the disclosures required by this part are made, until 31.03.2011.

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6.12 Significance of True and Fair

The words "true and fair" are not defined in the Companies Act, 1956 except in so far as sub-section (5) of Section 211 of the Companies Act states that the balance sheet and profit and loss account of a company shall be deemed as not disclosing a true and fair view of the state of affairs of the company in case any matter which is required to be disclosed by the provisions contained in Revised Schedule VI or by virtue of a notification issued under sub-section (3) or an order under sub-section (4) is not disclosed.

From the foregoing provision, it could be construed that so long as the statements of accounts are drawn up in conformity with the provisions contained in Revised Schedule VI they would be deemed to disclose a 'true and fair' view of the state of affairs of the company (except in case of companies governed by special Acts).

The foregoing view is broadly correct in as much as, when the balance sheet of a company is drawn up in the form prescribed in Schedule VI to the Companies Act, 1956 and the profit and loss account discloses all the information required by several provisions contained in part II of Revised Schedule VI, the statements of account disclose all material facts which must be considered for studying the profitability of the company and its financial position.

Where, however, the auditor is of the opinion that the information disclosed does not show the correct financial position of the company; he should disclose further information, for example, the current position of trade investments if their market value is below cost.

It will be important to understand here the role played by the Accounting Standards published under the authority of the Council of the Institute of Chartered Accountants of India and other authoritative publications. As per section 211 (3A), it is obligatory upon companies to comply with accounting standards laid down by the Institute of Chartered Accountants of India [Section 211(3A)].

The Companies Act, 1956 apart from prescribing the disclosure requirements in Revised Schedule VI and by way of notes to the Profit and Loss Account, does not dwell upon the accounting practices that should be followed in order to generate the information required to be disclosed. The Institute's Accounting Standards have therefore been formulated with a view to harmonise the diverse accounting policies and practices. It is clear that these standards cannot deal with all nuances of accounting practices. They concentrate on basic matters. They apply only to items which are material. While discharging their attest functions, it will be the duty of the members of the Institute to ensure that the Accounting Standards are implemented in the presentation of financial statements covered by their audit reports. The compliance of the practices recommended by the Accounting Standard in prime facie and predominant evidence in deciding whether the accounts represent a true and fair view.

6.13 Divisible Profits, Dividends and Reserves

Profit is the central theme for almost all business activities. Decision about the future of the business, i.e., whether to close down, expand or modify largely depend on the trend of profits or losses; investors' interest in a business is also dependent upon the yield that they get. For all these, determination of correct profit is obviously important and, no wonder, it is a matter to which

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accountants attach great importance. The auditor must necessarily have regard to generally accepted accounting practices, legal provisions and judicial pronouncements in carrying out his duties. Should more profit be distributed than is permissible, because of a wrong process of computation, it may be treated as paying a dividend out of capital which is legally not permissible unless the company is being wound up. Apart from legal consequences, the management of the business would be depleting capital of the company which may have dangerous results.

Reserves can be created only when there is profit; some reserves can also be utilised to pay dividends. Apart from the specific law governing creation and maintenance of reserves in certain cases, the articles of association of companies generally contain provisions in this respect. In addition, accepted accounting practices suggest situations, where, even in the absence of any specific law, reserves should be maintained. Despite the existence of accounting principles, judicial rulings and legal requirements controversy in these respects cannot be considered to have come to an end. For example, though professional bodies as well as law have tried to distinguish revenue reserves from capital reserves, still there is large scope of disagreement on whether capital reserves are distributable. It is imperative that there should be a clear idea about profit, distributable profit, dividend and reserves. The auditor should, within the broad framework of available guidelines, exercise his own judgement in each case.

A special note in this connection should be taken for depreciation and valuation of stocks, the two major elements influencing the correct determination of profit or loss. These two are related to the valuation of assets of the business which directly and significantly affect the figure of profit or loss. One should be aware of the various possibilities in this regard.

6.13.1 Concept of profit - Like the term "value" in Economics, accountants have used the word 'profit' for many years without assigning a definite meaning to it. This state of affairs has given rise to much uninformed criticism of accountants and their work; added to this is the difficulty an economist and an accountant differ as to computation of profit of a business.

Economist's concept - Profit is the increase the value of total net assets of a business over a period of time after making an allowance for any withdrawal or introduction of capital. This is known as the "Increased Net Worth Theory of Profit". It is ascertained by determining the market value on the two accounting dates of all the assets reduced by the amount of liabilities incurred. The increase or reduction in the net worth is the profit or loss for the intervening period.

Accountant's concept - To an accountant, profit is the margin between operating income and associated expenses as related to a given period of time. Nevertheless, he is conscious of the fact that a business is a continuing operation and its wheels do not cease to grind, as is assumed for the purpose of preparing the periodical statements of account. So, while he agrees that these should be prepared in order that proprietors may have periodical reports of the stewardship, he is conscious of their limitations. It is on this account that he is continually striving to perfect his method to evaluate the expenditure which has not resulted in an income so that, on its exclusion the accounts may become more accurate and meaningful.

In this regard some of the ideas which have dominated the thinking of accountants in the past are: the necessity of preserving the monetary value of the proprietary capital originally contributed, the unpredictable nature of the future course of events and sale as an essential

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step to the emergence of profit. These ideas in due course have developed into a completed fabric of generally "accepted accounting practices" which are stated below:

(i) The book value of fixed assets should be assessed at their historical cost regardless of their market price.

(ii) The book value of current assets should be based on their cost or net realisable value whichever is lower.

(iii) A mere rise in market value is not a profit, but if the asset is a current asset, decline in its market value is a loss.

(iv) No profits are earned unless the product is sold and cash is received or an enforceable obligation against a debtor is created.

(v) In general, underestimation of prospective revenue (i.e., conservatism) is commendable: overstatement is not permissible. This is based on the dictum: anticipate no profits, provide for all losses. No a day, concept of procedure is gaining importance over the conservatism.

(vi) In general, known expenditure or loss even though not incurred should be provided for.

(vii) Consistency of accounting policy adopted from year to year should be ensured as far as practicable.

On a consideration of the aforementioned practices it would appear that if any of them are disregarded, the accuracy of profits disclosed by the statements of account would be vitiated and elements of guess work and uncertainty would creep in.

6.13.2 Valuation of assets - The question of determination of profits is inextricably bound up with the valuation of assets. Therefore, when the basis of valuation is altered or a wrong basis is adopted, it affects the amount of profit or loss disclosed by the Profit and Loss Account. Some of the significant factors which affect the determination of profit are: rate of depreciation of fixed assets, the practice adopted for writing off fictitious assets such as preliminary expenses, the manner in which expenditure on research is adjusted in the accounts, valuation of stock-in-trade, provision for bad and doubtful debts, etc. The different bases on which assets are valued are briefly explained below to show that the method conventionally followed for the determination of profits does not necessarily give profit which have been actually earned. This is because a lot of estimation enters in determining the value of assets and liabilities:

(i) Fixed assets - The charge for depreciation is always approximate. There are several elements of estimation involved in its computation, e.g., the life of the asset, its residual scrap, value of obsolescence, etc. Further, the charge for depreciation is made merely to amortize the original cost. It may or may not at the end of its useful life, result in accumulating enough liquid resources to replace the asset on account of the increase which may have taken place in the replacement cost.

(ii) Intangible assets - Accounting theory so far has not sufficiently developed to prescribe a uniform method of valuation of intangible assets like goodwill, patent rights, technical know - how, etc. This class of assets is thus treated differently by different industries; sometimes even in the same industry their treatment at different units is not the same.

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(iii) Deferred revenue expenditure and other fictitious assets - Again there is no uniformity of treatment of these items. Successful companies write off their preliminary expenses or development expenses, etc. immediately. Less successful ones write them off over a period of years, the argument being that such initial expenditure also benefits future years. The likely issuance of Accounting Standard on "Intangible Assets", would provide the necessary guidance.

(iv) Stock-valuation - There are several senses in which the words "cost" and "net realisable value" may be construed. The rule that profit must only be taken into account when realised by sale is again responsible for some distortion. Its application logically to companies doing long-term construction contracts may involve a great fluctuation in profits from year to year. AS-2 issued by the Institute deals with uniform approach and practice as regards valuation and presentation of inventories.

Judicial rulings on ascertainment of profits - The fact of the three cases given below should be studied carefully:

In Re. Spanish Prospecting Co. Ltd. (1911), the company had contracted to pay a certain salary to some of its staff subject to the condition that they shall not be entitled to draw their salary "except only out of profits" if any, arising from the business of the company. The salary was cumulative. Any arrears were to be payable out of future profits. The company dealt in shares and securities. The company went into liquidation and some of the securities held were sold by the liquidator. It was contended that the proceeds should be credited to the Profit and Loss Account (their book value was nil) in order to enable the staff to receive their arrears to salary. This contention was rejected at first but was upheld by the Court of Appeal. This case establishes the fundamental nature of profit (impliedly the economist's profit).

In Re. Crabtree Thomas vs. Crabtree (1912), the testator left his business to be carried on by trustees and to pay thereof to his wife while she lived and on her death, to a residuary legatee. The trustee charged in the accounts depreciation on machinery. It was contended on behalf of the life tenant that the profits before charging depreciation were paid to her. But it was ruled out on the ground that depreciation must be charged on the assets of a business to arrive at the amount of profit.

Edwards vs. Saunton Hotel Co. Ltd. (1942), a director of the company was to be paid by way of remuneration 20% of the profit "available" for distribution each year. It was held that depreciation on assets calculated on the straight line, method must be deducted from the surplus to arrive at the amount of profit, 20% whereof was payable to the director, but the income tax payable by the company was not to be deducted.

6.13.3 Depreciation under Section 205 of the Companies Act, 1956 - Section 205 prohibits a company from declaring dividend out of its profits before providing for depreciation in the manner laid down in the section. The said section, as amended by the Companies (Amendment) Act, 1988, reads as under:

"Section 205, Dividend to be paid only out of profits -

(1) No dividend shall be declared or paid by a company for any financial year except out of the profits of company for that year arrived at after providing for depreciation in

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accordance with the provisions of sub-section (2) or out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with those provisions and remaining undistributed or out of both or out of moneys provided by the Central Government or a State Government for the payment of dividend in pursuance of a guarantee given by that Government.

Provided that:

(a) if the company has not provided for depreciation for any previous financial year or years which falls or fall after the commencement of the Companies (Amendment) Act, 1960 it will, before declaring or paying dividend for any financial year provide for such depreciation out of the profits of that financial year or out of the profits of any other previous financial year or years;

(b) if the company has incurred any loss in any previous financial year or years, which falls or fall after the commencement of the Companies (Amendment) Act, 1960, then, the amount of the loss or an amount which is equal to the amount provided for depreciation for that year or those years whichever is less, shall be set off against the profits of the company for the year for which dividend is proposed to be declared or paid or against the profits of the company for any previous financial year or years, arrived at in both cases after providing for depreciation in accordance with the provisions of sub-section (2) or against both;

(c) the Central Government may, if it thinks necessary to do so in the public interest, allow any company to declare or pay dividend for any financial year out of the profits of the company for that year or any previous financial year or years without providing for depreciation:

Provided further that it will not be necessary for a company to provide for depreciation as aforesaid where dividend for any financial year is declared or paid out of the profits of any previous financial year or years which falls or fall before the commencement of the Companies (Amendment) Act, 1960.

(1A) The Board of directors may declare interim dividend and the amount of dividend including interim dividend shall be deposited in a separate bank account within five days from the date of declaration of such dividend.

(1B) The amount of dividend including interim dividend so deposited under sub-section (1A) shall be used for payment of interim dividend.

(1C) The provisions contained in sections 205, 205A, 205C, 206, 206A and 207 shall, as far as may be, also apply to any interim dividend.

(2) For the purpose of sub-section (1), depreciation shall be provided either:

(a) to the extent specified in Section 350; or

(b) in respect of each item of depreciable asset, for such an amount as is arrived at by dividing ninety five per cent of the original cost thereof to the company by the specified period in respect of such asset; or

(c) on any other basis approved by the Central Government which has the effect of

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writing off by way of depreciation ninety five per cent of the original cost to the company of each such depreciable asset on the expiry of the specified period; or

(d) as regards any other depreciable asset for which no rate of depreciation has been laid down by this Act or any rules made thereunder; or such basis as may be approved by the Central Government by any general order published in the Official Gazette or by any special order in any particular case:

Provided that where depreciation is provided for in the manner laid down in clause (b) or clause (c), then, in the event of the depreciable asset being sold, discarded, demolished or destroyed the written down values thereof at the end of the financial year in which the asset is sold, discarded, demolished or destroyed, shall be written off in accordance with the provision to Section 350.

(2A) Notwithstanding anything contained in sub-section (1), on and from the commencement of the Companies (Amendment) Act, 1974, no dividend shall be declared or paid by a company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2), except after the transfer to the reserves of the company of such percentage of its profits for that year, not exceeding ten per cent, as may be prescribed:

Provided that nothing in this sub-section shall be deemed to prohibit the voluntary transfer by a company of a higher percentage of its profits to reserves in accordance with such rules as may be made by the Central Government in this behalf.

(2B) A company which fails to comply with the provisions of Section 80A shall not, so long as such failure continues, declare any dividend on its equity shares.

(3) No dividend shall be payable except in cash:

Provided that nothing in this sub-section shall be deemed to prohibit the capitalization or profits or reserves of a company for the purpose of issuing fully paid-up bonus shares or paying up any amount, for the time being unpaid, on any shares held by the members of the company.

(4) Nothing in this section shall be deemed to affect in any manner the operation of section 208.

(5) For the purposes of this section:

(a) "specified period" in respect of any depreciable asset shall mean the number of years at the end of which at least ninety-five per cent of the original cost of that asset to the company will have been provided for by way of depreciation if depreciation were to be calculated in accordance with the provisions of section 350;

(b) any dividend payable in cash may be paid by cheque or warrant sent through the post directed to the registered address of the shareholder entitled to the payment of the dividend, or in the case of joint shareholders to the registered address of that one of the joint shareholders which is first named on the register of members, or to such person and to such address as the shareholders or the joint shareholders may in writing direct.

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Ascertainment of depreciation Section 350 - The amount of depreciation to be deducted in pursuance of clause (k) of sub-section (4) of Section 349 shall be *the amount of depreciation assets* as shown by the books of the company at the end of the financial year expiring at the commencement of this Act or immediately thereafter and at the end of each subsequent financial year at the rate specified in Schedule XIV.

The Companies (Amendment) Act, 2000 w.e.f. 13.12.2000 amended section 350 and deleted the words, "the amount calculated with reference to the written down value of the assets" by the words, "the amount of depreciation assets". Therefore depreciation in future would be with reference to books of account and which may be on SLM basis.

Provided that if any asset is sold, discarded, demolished a destroyed for any reason before depreciation of such asset has been provided for in full, the excess if any of the written down value of such asset over its sale proceeds or, as the case may be, its scrap value, shall be written off in the financial year in which the asset is sold, discarded, demolished or destroyed.

6.13.4 Law relating to dividends -

Sources of dividends - The Companies Act, 1956 lays down the law relating to distribution of profits by making certain provisions under Section 205, Accordingly dividend cannot be declared or paid by a company for any financial year except:

(a) out of profits of the company for the year arrived at after providing for depreciation in accordance with the provisions of Section 205(2), or

(b) out of the undistributed profits or the company for any previous financial year or years arrived at after providing for depreciation in the manner aforementioned and remaining undistributed, or

(c) out of the balances of profit mentioned in (a) and (b) above; or

(d) out of moneys provided by the Central Government or a State Government for payment of a dividend pursuant to the guarantee given by the Government.

Dividends out of current profits -Transfer to reserves - In terms of Section 205(2A) of the Companies Act, no company is permitted to declare or pay dividend for any financial year out of the profits of that year without first transferring to reserve so much percentage of profits of the year as is prescribed under the Companies (Transfer of Profits to Reserve) Rules, 1975. The percentage of profits required to be transferred to reserves have been related to the rate of dividend proposed for the year and are given hereunder:

Rate of dividend	Percentage of profit required to be transferred to reserves
Upto 10%	Nil
Exceeding 10% but not exceeding 12.5%	Not less than 2.5% of the current profits.
Exceeding 12.5% but not exceeding 15%	Not less than 5% of the current profits.
Exceeding 15% but not exceeding 20%	Not less than 7.5% of the current profits.
Exceeding 20%	Not less than 10% of the current profits.

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(i) Arrears of depreciation mentioned in Section 205(1) should also be provided in determining the profit for the purpose of transfer to reserves.

(ii) The profit should be after tax for the above purpose.

(iii) The profit for the above purpose should be determined after debit for Statutory Development Reserve.

(iv) The rates of dividend mentioned in the table above relate to the rates of equity dividend and the portion of dividend in excess of the fixed rate of dividend in respect of the participating preference shares.

(v) The transfer to reserve contemplated in Section 205(2A) does not include any transfer to Development Rebate Reserve, Capital or any special reserve. The reserves contemplated are only the "free reserve".

(vi) A company is absolutely free to transfer to reserves a higher percentage than is indicated in the slabs in the table above, provided the rate of transfer does not exceed 10%. In other words, when the rate of dividend proposed is between "exceeding 10% but not exceeding 12.5%" the corresponding rate for transfer to reserve is 2.5% of the current profits. The company would be free to transfer to reserve any percentage from 2.5% to 10%. The ceiling at 10% for transfer to reserve is in accordance with the provision of Section 205(2A) which requires the transfer "not exceeding 10%".

(vii) Companies are free to carry the residual profit, irrespective of the amount, after dividend and transfer to reserves, in the Profit and Loss Account.

Transfer to reserves exceeding 10% Conditions - The aforesaid requirement of transferring profits to reserve, subject to a ceiling of 10% is not a ban on a higher transfer. A company can transfer to reserve a percentage, of profits higher than 10%. For doing that it must comply with further conditions laid down in the Companies (Transfer of Profits to Reserves) Rules, 1975. If the company wishes to transfer a higher percentage and is also contemplating declaration of dividend it is to ensure a rate of dividend for the year equal to the average rate of dividend declared in respect of the immediately preceding three years. In a case where bonus shares have also been issued in the financial year in which the dividend is declared, or in the three years immediately preceding the financial year, a minimum distribution sufficient for the maintenance of dividends to shareholders at an amount equal to the average amount (quantum) of dividend declared over the three years immediately preceding the financial years is to be ensured. However, if the net profit after tax for the year is lower at least 20% compared to the average net profit after tax at the immediately two preceding years, the company will not be required to ensure the maintenance of the average amount/rate of dividend mentioned earlier.

Where no dividend is declared the amount proposed to be transferred to its reserves from the current profits shall have to be lower than the average amount of the dividends declared over the immediately proceeding three financial years.

Dividends out of past profits - Also, companies are henceforth [i.e., after coming into force of the Companies (Amendment) Act, 1974] forbidden from declaring dividends out of past profits kept in reserves unless declaration conforms to the rules prescribed for the purpose by

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the Central Government or Central Government's prior approval is obtained in case such rules are not complied with [Section 205A(3)].

The rules titled "Companies (Declaration of Dividend out of Reserves) Rules, 1975" provided that in the event of inadequacy or absence of profits in any year, dividend may be declared by a company for that year out of the accumulated profits earned by it in previous years and transferred by it to the reserves, subject to the conditions that:

(i) the rate of the dividend declared shall not exceed the average of the rates at which dividend was declared by it in the five years immediately preceding that year or ten per cent of its paid-up capital, whichever is less;

(ii) the total amount to be drawn from the accumulated profits earned in previous year and transferred to the reserve shall not exceed an amount equal to one-tenth of the sum of its paid-up capital and free reserves and the amount so drawn shall, first be utilised to set off the losses incurred in the year before any dividend in respect of preference or equity shares is declared, and

(iii) the balance of reserves after such withdrawal shall not fall below 15% of its paid-up share capital.

Illustration

(a) Give your views together with reasons on the following proposals:

(i) A company had profit after depreciation and tax of ₹ 17,00,000 for the year 2009-10.

In arriving at this profit a deduction was made of ₹ 3,00,000 in respect of the reserve created on account of Shipping Reserve. The company has proposed a rate of dividend @15% on its equity capital of ₹ 6,00,000 and 10% on the preference capital of ₹ 6,00,000. The company also proposes to transfer to reserves 10% of the current profit.

(ii) The rates of equity dividend declared and paid by a company are as follows:

2008-2009	*15%*
2007-2008	*12%*
2006-2007	*12%*

The company has earned sufficient profit after tax in 2009-10 and wishes to propose a dividend on equity shares at 11% of the current profits and transfer to Reserved 20%. The company has not issued any bonus shares during the last few years. The post-tax profit in 2009-10 is higher than the corresponding profit of each of the previous three years.

(iii) Will it make any difference if the company under (ii) above proposed a rate of equity dividend @ 20%?

(iv) Will it make any difference if the amounts of net profits after tax of the company under (ii) above are as follows?

	₹
2009-2010	*10,00,000*

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2008-2009	*17,00,000*
2007-2008	*15,00,000*
2006-2007	*18,00,000*

(v) A company's profits after tax for several years and equity dividends are given below:

Years	*Net profit after tax (₹)*	*Rate of equity dividend*	*Amount of dividend (₹)*
2010-2009	*10,00,000*	*8% (proposed)*	*8,00,000*
2009-2008	*17,00,000*	*14% (paid)*	*14,00,000*
2008-2007	*15,00,000*	*12% (paid)*	*9,60,000*
2007-2006	*16,00,000*	*10% (paid)*	*8,00,000*

The company wishes to transfer to reserves ₹ 2,00,000 of the current profits. It issued bonus shares during 2008-09.

(b) A company has earned a total sum of ₹ 85 lakhs during the years from 2004-05 to 2008-09. The company has neither declared any dividend nor transferred any amount to the reserves during these years and kept the amount in the Profit & Loss Account. Now the company proposes to appropriate a part of this amount for making payment of dividend for the years 2009-10 in which it has earned a profit of ₹ 18 lakhs. The Board proposes a payment of dividend of ₹ 25 lakhs. Advise the company.

Solution

(a) (i) All the proposals of the company are legally valid. Profit of ₹ 17,00,000 after tax and depreciation is the profit contemplated in Section 205(2A) of the Companies Act as clarified by the Company Law Board. Reserve on account of shipping reserve of ₹ 3,00,000 is an item of prior deduction for determination of the figure of ₹ 17,00,000 on this account. Since the company is proposing a transfer to reserve of 10% of the current profit, there is no problem before the company for declaration of dividend. Under Section 205(2A) of the Companies Act, a transfer not exceeding 10% of the current profits to reserve is required and the question of voluntary higher transfer will arise only if the rate of transfer is higher than 10%. The Companies (Transfer of Profit to Reserve) Rules, 1975 issued under Section 205(2A) of the Companies Act provide for a transfer to reserve of "not less than 5% of the current profits" in respect of the dividend rate exceeding 12.5% but not exceeding 15%. Thereafter transfer to reserve of 5% more up to 10% is valid. As per the clarification of the Company Law Board, fixed preference dividend is not to be considered in Section 205(2A) of Companies Act.

(ii) The proposal is not legally sustainable.

It is a case of voluntary transfer to reserves at a percentage higher than 10% under Section 205(2A) of Companies Act. Any voluntary transfer of profits of a percentage higher than 10% to reserve can be made only when the company complies with the requirements laid down by the Companies (Transfer of Profits to Reserve) Rules.

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When a company declares a dividend and wishes to transfer profit to reserve at a percentage higher than 10%, it is incumbent on it to at least maintain the average rate of dividend declared by the company in respect of the immediately preceding three years. In the present case the average rate of dividend works out to 13%. The dividend proposed in 2009-10, viz. 11% is less than this rate and, therefore the company cannot make a transfer of a higher percentage reserves than 10%. It should also be noted that the company's post-tax profit is not less than the average post-tax profit for the last two years and no bonus shares have been issued by the company during 2009-10 or in the preceding three years which would have permitted transfer to reserves higher than 10% with a reduced rate of dividend.

(iii) Yes, the company's proposal to transfer to reserves @ 20% would be in order in view of the fact that the current year's rate of proposed dividend is higher than the average rate of dividend for the preceding three years.

(iv) Yes, the company's post-tax profit for the year is less than the average post-tax profit of the company for the preceding two years by more than 20%. The post-tax profit for the year is ₹ 10,00,000 whereas the average post tax profit, taking 2008-2009 and 2007-2008 figure into account is ₹ 16,00,000; the former is less than the latter by about 37.5%. Since the current year's post-tax profits is less by 37.5% than the average post-tax profit referred to above, the company is free to make voluntary transfer to reserves at more than 10% without being required to maintain the rate of dividend, as per the Companies (Transfer of Profits to Reserve) Rule, 1975.

Therefore, the company's proposal to pay dividend @11% and transfer to reserve @20% would be valid propositions.

(v) The proposal is in conformity with law. The company has issued bonus shares within the preceding three years and therefore, it is required to maintain the amount of dividend for 2009-10 at least at the level of the average of the amounts paid during the preceding three years. The average aforesaid works out to ₹ 10,53,333. The current year's proposed amount, ₹ 8,00,000 is less than the aforesaid average figure. Therefore, on the first-count the company can not make transfer of ₹ 2 lakhs to reserves. However, compared to the average of corresponding profits to the preceding two years, the profit is 2009-10 is lower by more than 20%; therefore, the company is allowed to pay a lower dividend. Because of this overriding situation the company is not obliged to maintain the average amount of dividend as contemplated in a situation where bonus shares have been issued.

(b) Assuming that the profits arrived at are after providing for depreciation in accordance with the provisions of Section, 205 (2) of the Companies Act, 1956 the company must comply with Section 205(2A) of the Companies Act before it can appropriate ₹ 18 lakhs profit pertaining to the year 2009-10 and the balance amount of profit from the past accumulated profits.

In terms of Section 205(2A) of the Companies Act, no company is permitted to declare or pay dividend for any financial year out of the profits of that year without first transferring to reserve so much percentage of profit of the year as is prescribed under the Companies (Transfer of

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Profit to Reserve) Rule, 1975. The percentages of profits required to be transferred to reserves have been related to the rate of dividend proposed for the year and are given earlier:

According to Section 205A(3) of the Companies Act a company is forbidden from declaring dividends out of the accumulated profits earned by the company in previous years and transferred by it to the reserves, unless such declaration conforms to the rules prescribed by the Central Government. In as much as the given company has not transferred the profit of 2004-05 to 2008-09 amounting to ₹ 85 lakhs to reserves, the rules made under Section 205A(3) viz., "Companies (Declaration of Dividend out of Reserves) Rules, 1975" has no application. Accordingly, the company can freely appropriate past profits towards any insufficiency in the current year. Profit for the purpose of payment of dividend. On an overall basis it may be advised that the company can appropriate any part of ₹ 85 lakhs for payment of dividend in the current year and also it can utilise the profit of ₹ 18 lakhs for the current year for payment of dividend on compliance with the requirement of Section 205(2A).

Restrictions on dividends when debentures not redeemed - When debentures are not redeemed, following restrictions apply on declaration of dividend: (a) Company can declare dividend out of general reserves, only if residual profits after transfer to DRR are adequate (b) In case of new companies, distribution of dividends shall be only with approval of debenture trustees and lead financial institution (c). In case of existing companies, prior permission of lead financial institution will be required if dividend proposed is over 20% or as per loan agreement or if the company does not comply with conditions of financial institutions regarding interest and DSCR (debt service coverage ratio).

Amendments relating to payments of Dividends - As per Section 2(14A), dividend has been defined to include interim dividend also.

Newly inserted sub-section (1A) of section 205 provides that board of directors may declare interim dividend and the amount of dividend including interim dividend should be deposited in a separate bank account within five days from the declaration of such dividend.

A question that arises here is whether the company should transfer profits to reserves and provide depreciation for the whole year before declaring interim dividend.

Based on section 2(14A), read with section 205(1C), it can be concluded that since interim dividend is also dividend, companies should provide for depreciation as required by section 205 and comply with the Companies (Transfer of Profits to Reserves) Rules, 1975 before declaration of interim dividend. The company has to provide estimated depreciation for the full year before declaring interim dividend. If the company does not transfer any profit to reserves, it has to be contended with an interim dividend not exceeding 10 per cent of the paid-up capital.

Distribution of Capital Profit - First we should distinguish the three concepts: Capital profit, Capital Reserve and Capital Receipts.

Capital Profit - The term Capital profit means these profit which arise from transactions which do not fall within the normal activities of the business. For example a trading company sells part of its fixed assets at a price which is higher then the original cost of these assets. Since the company deals in merchandise, the sale of assets, therefore, does from part of its normal

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course of business, hence the resultant surplus from the sale of fixed assets would be capital profit. Strictly Speaking, the Companies Act, 1956 does not make any distinction between capital profits and other profit. Therefore, any profit realized on sale of fixed or on disposal of investments, may be distributed by way dividends. Following two conditions must be satisfied before capital profit distributed:

(i) The surplus is realized, i.e., it is not merely a book entry, like revaluation reserve.

(ii) Such surplus remains after evaluation of the whole of the assets and liabilities has been fairly taken.

Capital Reserve - It was used to be defined as per part-III of Pre Revised Schedule VI to the Companies Act, 1956 does not include any amount regarded as free for distribution through profit and loss account. However, the Guidance Note on Terms used in Financial Statements issued by the Institute of Chartered Accountants of India defines Capital Reserve as a reserve of a corporate enterprise which is not available for distribution as dividend That means the amount in capital reserve can not be used for distribution of dividend.

Capital Receipts - By their nature can not be distributed by way of dividend. Examples of capital receipt include share premium amounts transferred to capital redemption reserve on redemption of preference shares, and profit on re-issue of forfeited shares.

As a result, we have gone over to what is sometimes called the 'balance sheet surplus' approach: the company's cumulative position, involving past years as well as the current year, has to be considered, and dividends can be paid only if justified by the picture as a whole. Special rules apply to public companies and to investment companies. A public company must allow for any excess of unrealised losses over unrealised profits on the capital account - i.e. provision must be made for any unrealised revaluation deficit (Section 264). An investment company (defined in Section 266) may make a distribution out of the surplus on revenue account only (i.e. not including even realised capital profits, but at the same time not being bound to take account of unrealised or realised capital losses), provided that it assets are not reduced to less than one and a half times its liabilities (Section 265).

The position in our country, regulated more by convention than by any law as regards unrealised capital profits, is that the same can be applied for writing off past capital losses. As regards the application of revaluation reserve to write off past revenue loses, the position is to clear. It seems having regard to the provisions of Section 205 of the Companies Act, that revaluation reserve should not be applied to write off past revenue losses because that will facilitate a distribution of dividend without being required to earn a revenue surplus for the purpose. Such profits however, can not be applied in issuing bonus shares as per the Bonus Issue Guidelines issued by the Securities and Exchange Board of India (SEBI) nor in paying up debentures or loan stock or calls on partly paid shares.

The Institute has also issued a guidance note on availability of Revaluation Reserve for issue of bonus shares, which makes it clear that bonus shares cannot be issued by capitalisation of revaluation reserve. If any company (including a private or a closely held public Co.) utilises the revaluation reserve for issue of bonus shares, the statutory auditor of the company should

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qualify his audit report *(vide November '94, the Chartered Accountant, p. 681).* Also refer to Accounting Material)

Previous losses - Though companies do write off capital losses, both unrealised and realised, and either in the year in which they occur or in convenient instalments out of revenue profits, it is not obligatory for them to do so.

Appropriation out of the amount available for distribution as dividend

Although the whole of the amount standing to the credit of the Profit & Loss Account, provided it represents revenue profits or capital profits which are available for distribution on the conditions aforementioned is distributable as dividend, it is often necessary to make appropriations out of the same on various grounds to arrive at the amount which may be distributed as a dividend. Some of these grounds are the following:

(a) For credit to General Reserve - If any part of the profits has been utilized for meeting a capital expenditure or is invested in book debts or stocks, it should not be available for distribution as a dividend. On this account, the amount so invested as well as that proposed to be further invested similarly must be credited to the General Reserve Account. Otherwise, the amount proposed to be distributed will be in excess of the account actually available for distribution in cash or securities readily convertible into cash. It would give rise to an anomalous position, the company having stocks which it cannot sell or books debts it cannot realise, on account of which it will not be able to pay dividends within the time allowed (30 days) which shall result in the management being penalized (Section 207). The Articles of Association of a company may also require that a part of the profit should be credited to the general reserve before any dividend is distributed. In all such cases it would be necessary for the directors to appropriate proper amounts out of profits to comply with the legal necessity.

(b) Amortisation of a debt - At times a company, while raising a loan, may undertake that it would create a fund out of its profits for its payment. For example, the Debenture Trust Deed in respect of a debenture issue made by a company may stipulate that a fixed percentage of profits will be credited annually to the Debenture Redemption Reserve Fund. In such a case, the amount of such an appropriation for credit to the Fund would be a prior appropriation of the profits.

(c) Provision for preferential payments - If a company has issued preference capital, there must be provision to pay the dividend on preference shares at the stipulated rate before any dividend is paid on equity shares. Moreover, if the shares are cumulative, a provision for all the arrears of dividend payable thereon must be first made.

In addition the directors in any year may decide to appropriate a part of the profits considered extraordinary or excessive to the credit of a Dividend Equalization Reserve so as not to raise the rate of dividend distributed beyond what the company could be expected to maintain in the future.

Legal Decisions - The question of divisible profits has been the subject of several legal decisions. Most of these decisions were arrived at on the basis that unless required by the Articles of Association, profits earned could be distributed as dividends before providing for

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depreciation or writing off past losses. After the amendment of Section 205 in 1960, however, these decisions have little applicability.

Application of the principle laid down in the case of *Lee vs. Neuchatel Asphalte Co. Ltd*. (An English case decided in 1889*)*. It has been considered above that there is necessity for provision of depreciation on assets under the provisions contained under Section 205 of the Companies Act. However, on the basis of provisions contained in clause (d) sub-section (2) of Section 205 it could be held that in respect of any asset for which no rate of depreciation has been laid down by the Income tax Act or has been prescribed by the Central Government depreciation need not be provided. On this basis, it could be argued that no depreciation need be provided in respect of goodwill, leaseholds and other similar wasting assets.

It could, therefore, be argued that the principle laid down by the decision in the above mentioned case is still applicable in this country. But, if a company decides to follow this procedure, it would be necessary for it to retain assets sufficient to pay its debts. For if this is not done, it would be a fraud on creditors. It is the position of law propounded in another English Case *Verner vs. Generals and Commercial Investment Trust Ltd [1894 2 Ch. 239].*

Another view in this matter can be that regardless of the fact that the Central Government has not notified any rate in respect of an asset for which no rate has been prescribed under the Income tax Rules, there is an obligation to provide depreciation on every asset on the ground that it is sound accounting practice. In support of this view it has been pointed out that the Institute of Chartered Accountants in England and Wales had recommended to its members as early as January 1945, that depreciation must be provided not only on building, plant and machinery, etc., but also on leaseholds, patents, mines and other similar assets; also that the Company Law Department of the Government of India has clarified by a notification that in its opinion a company is obliged to provide depreciation on the wasting assets before it can declare dividends, even though no depreciation is allowable in respect of these assets under the Income tax Act.

The accounting opinion being in favour of provision of depreciation in respect of every asset, the absence of an order under Section 205(2)(d) specifying the rates at which depreciation should be charged on wasting assets, it is argued, cannot be interpreted to support the legal principle emerging out of the English cases, aforementioned. The Central Government has refrained from issuing the notification presumably on this ground.

It may be noted that with the issuance of accounting standards, the situations described in the preceding paras do not exist any more. In fact, compliance with accounting standards even as per provisions of the Companies Act, 1956 would necessitate provisions of depreciation.

Dividend policy and related financial considerations - Normally an auditor, in the discharge of his duties is not concerned with the policy about dividends. He is merely concerned with the legality and actual payment of the dividend. The basis of legality is provided by the Companies Act, 1956 and the related Articles of Association. However, sometimes auditors are consulted in the matter of deciding upon the quantum of dividend that can be distributed by a company. Apart from this, Chartered Accountants as such also act as consultants to various companies on a number of matters, including dividend. The basic decision about the dividend is that of the management; the shareholders do not have the authority to enhance the sum proposed by the directors unless the

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articles allow such a procedure. On the other hand, the management, because of its very thorough and intimate knowledge of the financial state of affairs of the company and of the business environment, is considered to be the best equipped to deal with the matter.

Dividend is a phenomenon involved with the question of financial management of the company, rationality or feelings of the shareholders and other allied factors; it is therefore very difficult to lay down any definite policy in this regard. However, as a guiding rule a broad frame of policy has often been adopted by companies for guidance in deciding each year the quantum of dividend having regard to the specific situations faced by the company in the concerned year or situations that are in offing. In deciding upon a policy of dividend the financial considerations generally get the place of prominence, though the aspects of shareholders' aspirations are also taken into consideration. A balance is generally struck to bring about compromise and adjustment between these without unduly impairing the financial state of the company. In this context, it should be appreciated that the amount of the profit available as dividend has competing claimants. It is a source of finance so far as the company is concerned. This can often be very profitably employed to finance expansion or diversification or for setting right the adverse working capital or liquidity position.

As a general proposition the following are determinants of dividend policy:

1. Nature of earnings.
2. Re-investment alternative.
3. Dividends and liquidity.
4. Dividends and working capital.
5. Dividends and new capital requirements.
6. Dividends and market value of shares.
7. Tax brackets of shareholders.
8. Stability of dividend.

Payment of dividends

(1) Dividends once declared become the liability of the company and must be paid within 30 days of the date of declaration. Any failure to do so attracts a penalty for the various persons associated with the management [Section 207].

(2) Dividends are not payable except in cash or by a warrant. It is permissible, however, for payment to be made by a cheque.

But the profits or reserves can be capitalised for purpose of issuing fully paid bonus shares subject to the guidelines issued by the SEBI also they may be applied for paying up any amount for the time being unpaid on any share held by the members of the company Section 205(3), surplus obtained on revaluation of asset cannot be applied for the issue of bonus shares.

(3) Dividends can be paid either to the registered holder of a share or to his order or to his banker. But in respect of a share warrant, the payment can be made only to the bearer or his banker.

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(4) According to the provisions contained in Clause 85 of Table A, though a dividend can be declared only in a general meeting, the amount thereof must not exceed the amount recommended for distribution by the Board of Directors. Dividend is payable in proportion to the amount paid up or credited as paid up on shares, if so authorised by the Articles of Association (Section 93). If nothing has been paid on any of the shares, dividend may be declared and paid according to the nominal amount of shares. In the case of a fresh issue of capital the holders unless precluded by the terms of issue, are entitled to receive dividends along with the holders of shares already issued. Unless the foregoing regulation has been excluded or modified by the articles, the same will be deemed as a part thereof.

Section 205A states that where, after the commencement of the Companies (Amendment) Act, 1974 a dividend has been declared by a company but has not been paid or claimed within 30 days from the date of the declaration, to any shareholder entitled to the payment of dividend, the company shall within seven days from the date of expiry of the said period of 30 days, transfer the total amount of dividend which remains unpaid or unclaimed within the said period of 30 days to a special account to be opened by the company in this behalf in any scheduled bank, to be called "Unpaid Dividend Account of..... Company Limited./Company (Private) Limited. The expression "dividend which remains unpaid" means any dividend the warrant in respect thereof has not been encashed or which has otherwise not been paid or claimed.

The dividends that have remained unpaid upto 1.2.1975 shall also have to be transferred to the above mentioned account within six months from 1.2.1975. It is obligatory for the company to pay interest at the rate of 12% for the benefit of the shareholders concerned on any amount of unpaid dividend which has not been transferred to the aforesaid account with the scheduled bank.

Any money which has been transferred to unpaid dividend account of a company and which remains unpaid or unclaimed for a period of seven years from the date of such transfer, the amount shall be transferred by the company to the Fund established under sub- section (1) of Section 205C. When unclaimed dividends are transferred to the Fund, the company must furnish to such authority or committee as the Central Government may appoint, a statement in the prescribed form setting forth in respect of all sums included in such transfer: (i) the nature of sum; (ii) the name and last known addresses of the rightful recipients; (iii) the amount to which each person is entitled; (iv) the nature of his claim thereof; and (v) such other particulars as may be prescribed.

The company shall be entitled to a receipt from the authority or committee under sub-section (4) of Section 205C for any money transferred to it to the Fund and such a receipt shall be an effectual discharge of the company in respect there of [sub-section (7)]

205C. Establishment of Investor Education and Protection Fund –

(1) The Central Government shall establish a fund to the called the Investor Education and Protection Fund (hereafter in this section referred to as the "Fund").

(2) There shall be credited to the Fund the following amounts, namely:

(a) amounts in the unpaid dividend accounts of companies;

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(b) the application moneys received by companies for allotment of any securities and due for refund;

(c) matured deposits with companies;

(d) matured debentures with companies;

(e) the interest accrued on the amounts referred to in clauses (a) to (d);

(f) grants and donations given to the Fund by the Central Government. State Governments, companies or any other institutions for the purposes of the Fund; and

(g) the interest or other income received out of the investments made from the Fund;

Provided that no such amounts referred to in clauses (a) to (d) shall form part of the Fund unless such amounts have remained unclaimed and unpaid for a period of seven years from the date they became due for payment.

Explanation: For the removal of doubts, it is hereby declared that no claims shall lie against the Fund or the company in respect of individual amounts which were unclaimed and unpaid for a period of seven years from the dates that they first became due for payment and no payment shall be made in respect of any such claims.

(3) The Fund shall be utilised for promotion of investor awareness and protection of the interests of investors in accordance with such rules as may be prescribed.

(4) The Central Government shall, by notification in the Official Gazette specify an authority or committee, with such members as the Central Government may appoint, to administer the Fund, and maintain separate accounts and other relevant records in relation to the Fund in such from as may be prescribed in consultation with the Comptroller and Auditor General of India.

(5) It shall be competent for the authority or committee appointed under sub-section (4) to spend moneys out of the Fund for carrying out the objects for which the Fund has been established.]

The Companies (Amendment) Act, 1988, added a new Section 206A according to which payment of dividend and allotment of bonus and right shares to the transferee to be held in abeyance till the title to shares is decided. This Section requires that where any instrument of transfer of shares has been delivered to the company for registration and the transfer of such shares has not been registered by the company, it shall transfer the dividend in relation to such shares to the special account referred to in Section 205A unless the company is authorised by the registered holder of such shares in writing to pay such dividend to the transferee specified in such instrument of transfer. Further the company shall also keep in abeyance in relation to such shares any offer of right shares and any issue of fully paid up bonus shares.

The auditor may take the following steps to ensure that the dividend has been paid only out of profits:

(a) Check whether dividend was declared out of profits arrived at after providing for depreciation.

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(b) If no depreciation was provided, ensure that approval was obtained from the Central Government before declaring dividend [Section 205(1)(c)].

(c) Check whether:

(i) the depreciation was provided according to provisions of Section 205(2).

(ii) the minimum prescribed amount had been transferred to reserves according to the Companies (Transfer of Profits to Reserves) Rules, 1975, before declaring any dividend.

(iii) conditions governing transfer of higher percentage complied with.

(iv) a board resolution recommending dividend was passed.

(v) register of members was closed as per the provisions of Section 154.

(vi) the dividend was declared only in the annual general meeting.

(vii) dividend has been paid in the prescribed manner within 30 days of time to the registered holder or to their order (Section 207).

(viii) Amount of dividend deposited in a separate bank account within five days from the date of declaration of dividend.

(ix) permission of Reserve Bank of India was obtained for payment to non-resident shareholders before the dividend was remitted to them.

(x) intimation sent to stock exchange, in case of listed company.

(xi) there were any complaints regarding non-payment or delay in payment of dividend? If, so, whether corrective action was taken.

Documents Involved - 1. Annual Report, 2. Dividend payment Register, 3. Dividend warrant, 4. Minutes of Board/General Meeting, 5. Form 1 of the Unpaid Dividend Rules, etc., 6. Reserve Bank of India's Receipt/Approval, 7. Correspondence with Central Government, 8. Register of Members, 9. Unpaid Dividend Account/Register, 10. Notice of Closure for Register of members.

Interim Dividend - The definition of term dividend has been modified to include interim dividend also. Prior to amendment in the Companies Act, 1956, the interim dividend could be declared by the Board of Directors only if there was an authorisation in the Articles of Association to do so. However, the same has to be regularised at the general meeting because interim dividend was a dividend paid by the directors any time between two annual general meeting. A mere resolution of the directors resolving to pay a certain amount as interim dividend did not create a debt enforceable against the company for it was always open to the directors to rescind the resolution before payment of the dividend as decided in the leading case *PNB Ltd. vs. Union of India.* It was further held that an interim dividend announced by the Board of Directors would not, unlike a final dividend declared by the company at the annual general meeting, created a debt as the Board may subsequently rescind the resolution and cancel the announcement. The distinction between interim and final dividend was that unlike interim dividend, a final dividend once declared by the company in general meeting was a debt and created an enforceable obligation.

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However, with the commencement of the Companies (Amendment) Act, 2000 w.e.f. December 13, 2000, interim dividend stands at par with the final dividend. Therefore, all aforesaid requirements applicable in case of final dividend would also apply to interim dividend.

As stated earlier, section 205A has been amended to provided for interim dividend as well.

Payment of dividend and the Income tax Act - Payment of dividends by a company though basically governed by the provisions of the Companies Act, has to reckon with a number of provisions contained in the Income tax Act, having direct or indirect relevance to the determination of the amount of dividend. The Companies Act, 1956 has prescribed the manner of determination of the amount of dividend in Section 205. In particular it requires provision for depreciation, setting off of past losses and transfer to reserves of a prescribed percentage of the profits. It also provides for the circumstances under which dividend can be paid out of past profits. The manner of payment of the dividend is also provided for in the Companies Act. It may be mentioned that any deviation from these provisions will render the dividend illegal. The payment of dividend is a corporate phenomenon based on accounting, financial and legal considerations. The accounting and legal considerations are highly related. In determining the accounting profit, as indicated above a number of provisions from the Income tax Act have got to be considered. For example, distributable profit of a company gets conditioned by the requirements to create and retain reserves e.g. investment allowance reserves. It may be pointed out that any departure from the provisions of the Income tax Act will not make the payment of dividend illegal but may increase the tax liability of the company.

Should all fictitious assets be written off before distribution of dividends? - The Accounting Standards Board of ICAI has issued a guidance note on terms used in financial statements where the term 'fictitious asset' has been described as an item grouped under assets in a balance sheet which has no real value. The guidance note cites the example of the debit balance of the profit and loss statement. We can also give other examples like, (1) Goodwill recorded at a particular figure whereas the company may have no goodwill at all in the ordinary commercial sense, (2) Patents appearing in the balance sheet which in fact are useless.

There is no mandatory rule in accounting or any legal requirement that fictitious assets must be written off before declaration of dividend. This is more in the nature of preferable practice but is not mandatory in its nature. Accordingly it may be said that though writing off of fictitious assets on a proper accounting consideration is desirable, it is not mandatory. However, the following points must be noted in this regard:

If there exists debit balance in the profit and loss account, depreciation, if any, contained therein should first be set off before declaration of dividend out of current profits. Similarly, if capital profit is sought to be distributed as dividend, all fictitious assets must be first written off. This is for the reason that one of the conditions for use of capital profits for dividend purposes is a complete revaluation of all assets and liabilities which should result in a surplus.

In the case of *Verner vs. The General Commercial Investment Trust Ltd.,* it was held that a company may pay dividends if it is solvent and is acting within its articles that distribution of dividend is permissible if there exists revenue surplus even though some portion of the value of the assets disclosed in the balance sheet may turn out to be fictitious.

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6.13.5 Reserves - The term 'reserves' was not defined in Part III of Pre Revised Schedule VI except negatively (and neither is defined in Revised Schedule VI), in the sense that the profits retained in the business not having any of the attributes of a 'provision' are to be treated as reserves; also provisions in excess of the amount considered necessary for the purposes, than were originally made are to be considered as reserve. It is thus evident that the provisions are a charge against profits while reserves are an appropriation of profits. Also, provisions that prove to be in excess of amounts required or having been made liberally, are in addition thereto, are reserves. The Guidance Note on Terms used in Financial Statements issued by the Institute of Chartered Accountants of India defines Reserves as the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets of for a known liability. The reserves are primarily of two types: (a) Capital Reserves and (b) Revenue Reserves.

Such a distinction is essential for disclosing in the balance sheet the amount by which the equity of the shareholders has increased with the accumulation of undistributed profits. The distribution is carried further by segregating the reserve which is made up of fortuitous gains, unconnected with business activity (e.g., appreciation in values of fixed assets, receipts on account of share premiums), from those appropriated out of profits for credit to revenue reserve; the first is described as a capital reserve and the second merely as a reserve. The Companies Act does not specify the categories of accretions to the shareholders funds which are to be credited to the Capital Reserve, except indirectly by providing that the amounts, which in the opinion of directors can not be distributed as a dividend through the Profit and Loss Account are to be credited to such a reserve. The language of the provision appears to suggest that directors are vested with an unrestricted right to decide which of the amounts to be credited to the Capital Reserve subject only to provisions of the Act as regards certain funds not being available for distribution as dividend. But, it is not so, for they cannot violate the accepted principles of accountancy which determine whether or not an item of income is capital or revenue. It may also be remembered that an appropriation once made can be revoked. Therefore, if subsequently conditions arise, which show that amounts appropriated earlier to the Capital Reserve are distributable as dividends, directors can alter their earlier decision.

The following are examples of amounts retained in the business that are credited to one reserve account or another:

(1) Securities Premium Account (Capital Reserve).

(2) Capital Redemption Reserve Account created in pursuance of provision contained in Section 80 of the Companies Act (Capital Reserve).

(3) Profit on reissue of forfeited share (Capital Reserve).

(4) Amounts retained for equalisation of dividends (Revenue Reserve).

(5) General Reserve built up for the future developments of business (Revenue Reserve).

Attention of the students is drawn to the provisions of Section 205(A) of the Companies Act, discussed earlier, about restrictions in the utilisation of past profit kept: in reserves for dividend purposes.

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6.13.6 Deferred Taxation - It is a common experience that the profit or loss as per the Profit and Loss Account will be different from the income ultimately assessed to income tax. It is also generally different from the income shown in the tax-return submitted to tax authorities'. Consequently the taxation liability that is provided for in the accounts does not bear any direct relationship to the profit disclosed and readers of such account are left to guess the reasons. For instance, income tax should be treated on the same footing as is done in case of other expenses i.e., accounted for on accrual basis. From a management point of view income tax is an item of expense rather than an appropriation of pre-tax profit. AS-22 on "Accounting for Taxes on Income" now requires that tax should be treated as an expense. Students are advised to go through AS-22 on "Accounting for Taxes on Income".

6.13.7 Non-provision of proposed dividend - It has been noticed that a large number of companies do not provide for the proposed dividend but either carry forward the balance on the Profit and Loss Account or transfer an amount to the general reserve and charge the dividend to the profit and loss account or to the reserve when payment is made. The Council of the Institute of Chartered Accountants of India has considered the issues involved and is of the view that proposed dividend does not represent a liability, nor does it amount to a provision, pending the approval of the shareholders in the general meeting. The Council is further of the opinion that merely because the form, as given in the Pre Revised Schedule VI of the Companies Act, requires proposed dividend to be shown under "Current Liabilities and Provisions" it does not mean that in fact the proposal for the dividend becomes a liability or is necessarily a provision. The form of accounts laid down under the Insurance Act, 1938 and the Banking Regulation Act, 1949 do not require proposed dividends to be shown in respective balance sheets, and this does not impair the true and fair view of such balance sheets. Since, however the form of the balance sheet prescribed under Pre Revised Schedule VI, Part I-A requires, "proposed dividends" to be shown under Provisions at paragraph 3(XIV) of Part II of the same Schedule requires the "proposed dividends" to be disclosed, the Council is of the opinion that though on correct accounting principles, the proposed dividend does not become a liability, the attention of the shareholders would have to be drawn to the fact that no appropriation has been made for the proposed dividend, the amount in respect of which should be specified. The Council, therefore, has recommended that the fact that the provision for proposed dividend has not been made should be disclosed by means of a note in the accounts and that the auditor should refer to the note in his report and make his report subject thereto.

The Revised Schedule VI which is applicable from 01.04.2011 requires disclosure of the amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share to be disclosed separately. It also requires separate disclosure of the arrears of fixed cumulative dividends on preference shares. The Old Schedule VI specifically required proposed dividend to be disclosed under the head "Provisions." In the Revised Schedule VI, this needs to be disclosed in the notes. Hence, a question that arises is as to whether this means that proposed dividend is not required to be provided for when applying the Revised Schedule VI.

Further, as per AS-4 "Contingencies and Events Occurring After the Balance Sheet Date", there are events which, although take place after the balance sheet date are sometimes reflected in the financial statement because of Statutory requirement or

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because of their special nature and such item includes the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered in the financial statements.

Keeping this in view and the fact that earlier the disclosure of provision for proposed dividend was statutory requirement as per Old Schedule VI, hence it was adjusting event as per AS 4 and was provided for. However, this statutory requirement has been changed to disclosure by way of notes as per Revised Schedule VI. Therefore, provision for proposed dividend is non-adjusting event.

6.13.8 Non-provision of tax in the accounts - The Council of the Institute of Chartered Accountants of India has taken note of the fact that there is a practice prevalent whereby companies do not make provision for tax even when such a liability is anticipated. It has expressed the view that on an overall consideration of the relevant provisions of law, non-provision for tax (where a liability is anticipated' would amount to contravention of the provisions of Sections 209 and 211 of the Companies Act. Accordingly, it is necessary for the auditor to qualify his report and such qualification should bring out the manner in which the accounts do not disclose a "true and fair" view of the state of affairs of the company and the profit or loss of the company. An example of the manner in which the report on the balance sheet and the Profit and Loss Account may be qualified in this respect is given below:

> "The company has not provided for taxation in respect of its profits and the estimated aggregate amount of taxation not so provided for is ₹..... including ₹..... for the Year ended on .....To the extent of such non-provision for the year, the profits of the Company for the financial year under report have been overstated and to the extent of such aggregate non provision, the reserves of the company appearing in the said balance sheet have been over-stated and the current liabilities and provisions appearing in the said balance sheet have been understated".

6.14 Depreciation

There are different methods for charging depreciation:

6.14.1 Method of providing for depreciation - Section 205(2) of the Companies Act, 1956 lays down the following alternatives for providing the depreciation:

(a) To the extent specified in Section 350 - Section 350 provides that the amount of depreciation should be the amount of depreciation shown as per books of account.

(b) Straight line method - Alternatively depreciation may be calculated by dividing 95% of the original cost of the asset to the company by its specified period. According to Section 205(5)(a), specified period of any depreciable asset is "the number of years at the end of which at least 95% of the original cost of that asset to the company will have been provided for by way of depreciation if depreciation were to be calculated in accordance with the provision of Section 350". Schedule XIV to the Companies Act also provides the straight line depreciation rates in respect of various categories of assets. These rates have the effect of writing-off 95% of the original cost of an asset on straight line basis

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over the same period in which the aforesaid percentage of the original cost would be written off if depreciation were provided on writing down value basis.

(c) Any other basis - Depreciation can also be charged on any other basis provided it has effect of writing-off 95% of the original cost of the asset on the specified period and it is writing-off 95% of the original cost of the asset on the expiry of the specified period and it is approved by the Central Government.

In respect of depreciable assets for which no rate has been prescribed under Schedule XIV to the Companies Act, depreciation is to be provided on a basis approved by the Central Government.

Schedule XIV to the Companies Act, 1956 - Schedule XIV which has been inserted by the Companies (Amendment) Act, 1988 and as altered by GSR 756(E), Ministry of Law, Justice and Company Affairs, Department of Company Affairs specifies depreciation rates both on the written down value basis and the straight line basis. The SLM rates of depreciation have been worked out by dividing 95% of the original cost of an asset by its specified period. For example, in the case of factory buildings (for which the WDV depreciation rate prescribed in Schedule XIV is 10%), the specified life is 28.43 years. Thus the corresponding SLM rates for the factory buildings would be 3.34% (i.e. 95/by 28.43) per annum.

The WDV rates prescribed in Schedule XIV are relevant in the context of Section 350 which can also be followed by a company for providing depreciation under Section 205 for the purpose of declaration or payment of dividends. The straight line method of depreciation permitted under Section 205 is one of the bases for charging depreciation. As straight line depreciation rates have been specified in Schedule XIV to the Companies Act, there would be no need for a company to calculate these rates.

Schedule XIV also provides separate depreciation rates for single shift, double shift and triple shift working. This has set at rest the controversy that whether or not depreciation has to be provided on multiple shift working. Schedule XIV provides rate of depreciation for extra shift working for only certain categories of plant and machinery. It also list 23 items of plant and machinery falling within the general category in respect of which no extra shift depreciation is allowed. The rates of depreciation prescribed in Schedule XIV for various categories of depreciable assets implicitly recopied that the rates of depreciation represent true commercial depreciation.

It has been specifically provided that in case any addition is made to any asset during the financial year, depreciation should be calculated on pro-rata basis from the date of such addition. Similarly where an asset is sold, discarded, demolished or destroyed during the financial year, depreciation should be provided upto the date on which the asset is sold, discarded, demolished or destroyed.

The Companies (Amendment) Act, 1988, provided that Schedule XIV shall be deemed to have been inserted in the principal Act from 2nd April, 1987. The amendments to Section 205 and Section 350 have been notified to come into force from 15th June, 1988.

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