

# 8

## The Company Audit – II

### Question 1

Comment on the following:

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

### Answer

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

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

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

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

- (b) **Disclosure of Guarantee Given by a Company on Behalf of its Subsidiary:** Z Ltd., in its books of account is required to record a contingent liability of ₹ 10 lakhs for the guarantee given by it for payment of excise dues of its subsidiary, to the Court. In the

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event, the subsidiary failed to meet its obligation, Z Ltd. would be required to pay ₹ 10 lakhs to the authorities concerned.

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

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

### Question 2

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

### Answer

**Adjustment of Profit Arising on Hire-purchase Sale Transaction:** The nature of a hire-purchase transaction makes it absolutely clear that a person does not become owner till the last instalment has been paid.

As per AS 9 on “Revenue Recognition”, credit for the amount of profit arising from hire purchase sales is not taken into account until the instalments of sales price have been realised. Therefore, it is distributed proportionately over the hire purchase period.

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

### Question 3

*As an auditor comment on the following situations:*

- (a) A company had acquired a 10 Tonner delivery van valued at ₹ 6.5 lakhs on instalment basis from a dealer. During the year, the company paid ₹ 1.5 lakhs being the instalment for the year and provided depreciation on the said amount paid.*
- (b) A company received a subsidy of ₹ 1 crore for establishing an undertaking in the backward/notified area.*

**Answer**

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

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

- (b) **Subsidy Received by the Company:** The accounting treatment of subsidy shall depend upon the nature and purpose for which it has been given. As per AS 12 on “Accounting for Government Grants”, the grant given for acquisition of fixed assets is in the nature of promoter’s contribution.

As per facts of the case, the Company had received a subsidy of ₹ 1 crore, for establishing an undertaking in the backward/notified area. The grant has been given with reference to the total investment in the undertaking by way of contribution towards its total capital outlay for the establishment of the undertaking which is having similar characteristics to those of promoter’s contribution.

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

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

**Question 4**

*“The interest of a director in a transaction, entered into by the company has not been disclosed in the records maintained by the company”. Comment.*

**Answer**

**Non-disclosure of Interest of Directors in Records Maintained by the Company:** A company is required to maintain a register under section 189 in terms of section 184(2) or section 188 of the Companies Act, 2013. While auditing the company accounts, the auditor is required to verify such transactions.

Further, as per clause (iii) to Paragraph 3 of the Companies (Auditor’s Report) Order, 2016 [CARO 2016], the auditor is also required to report whether the company has entered into transaction with the parties covered in the register to be maintained under section 189 of the Companies Act, 2013.

It is quite likely that there may be situations where the company has not properly maintained the register required to be maintained by it under section 189.

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In such a case, the auditor should obtain the necessary information regarding the every director of a company who is in any way, whether directly or indirectly, concerned or interested in a contract or arrangement or proposed contract or arrangement entered into or to be entered into-

- (a) with a body corporate in which such director or such director in association with any other director, holds more than two per cent shareholding of that body corporate, or is a promoter, manager, Chief Executive Officer of that body corporate; or
- (b) with a firm or other entity in which, such director is a partner, owner or member, as the case may be,

shall disclose the nature of his concern or interest at the meeting of the Board in which the contract or arrangement is discussed and shall not participate in such meeting.

It may be noted that where any director who is not so concerned or interested at the time of entering into such contract or arrangement, he shall, if he becomes concerned or interested after the contract or arrangement is entered into, disclose his concern or interest forthwith when he becomes concerned or interested or at the first meeting of the Board held after he becomes so concerned or interested. However, while reporting on it, the auditor should clearly mention the fact of non-maintenance/improper maintenance of the aforesaid register.

### Question 5

*Write a short note on Sweat Equity Shares.*

### Answer

**Sweat Equity Shares:** As per section 54 of the Companies Act, 2013, the employees may be compensated in the form of 'Sweat Equity Shares'.

"Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

The auditor may see that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions are fulfilled-

- (a) the issue is authorised by a special resolution passed by the company;
- (b) the resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;
- (c) not less than one year has, at the date of such issue, elapsed since the date on which the company had commenced business; and
- (d) where the equity shares of the company are listed on a recognised stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

The rights, limitations, restrictions and provisions as are for the time being applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank *pari passu* with other equity shareholders.

### Question 6

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

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

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

### Answer

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

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

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

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

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

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

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

In any case, a company has to follow accrual system of accounting as per section 128(1) of the Companies Act, 2013. As a matter of fact, the auditor must ensure that provisions for the entire amount of accrued interest as also the penal interest has been made since the same has not been waived on the date of audit.

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

### Question 7

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

- (a) *Issue of shares for consideration other than cash.*  
(b) *Splitting of one share of the face value of ₹ 10 into 10 shares of ₹ 1 each.*

### Answer

- (a) **Issue of Shares for Consideration Other Than Cash:**
- (i) Study of the contract pursuant to which the issue is made to determine how many shares are agreed to be issued and for what value and the nature and other details of the consideration.
  - (ii) Examination of the prospectus to see the substance of the contract and the relevant terms of the issue including the mode of payment of the purchase consideration in case of an issue to a vendor of the business or pay-ability of commission to the underwriters or pay-ability of the preliminary expenses.
  - (iii) Examination of the Board's minutes to see the adoption of the relevant contract, the decision to issue shares for a consideration other than cash and the actual allotment of shares.
  - (iv) Ensuring that proper accounting entry has been passed to record the acquisition of the assets or the business or payment of the expenses (any of these may constitute the consideration) on the one hand and the issue of shares on the

other. Incidentally, if any premium or discount is involved, ensure that appropriate adjustment entry has been passed therefore.

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

This position should be kept in view when inquiring into matters stated in section 143(1) of the Companies Act, 2013. Again if the shares are allotted on a cash basis, though the amount is actually paid later, it should constitute an allotment against cash.

**(b) Splitting of Shares of Face Value from ₹ 10 to ₹ 1 per share:**

- (i) Confirm that alteration was authorised by articles.
- (ii) Verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.
- (iii) Verify also with reference to Form No. SH-7 filed with the ROC.
- (iv) Verify that alteration had been effected in copies of Memorandum Articles, etc.
- (v) Verify that proper accounting entries have been passed. Register of members may also be checked to see that the necessary alteration have been effected therein.

**Question 8**

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

**Answer**

**Share Transfer Audit:** As per section 56 of the Companies Act, 2013 read with Rule 11 of the Companies (Share Capital and Debentures) Rules, 2014, the following aspects are required to be examined by the auditor in conducting the share transfer audit-

- (i) No transfer of securities or the interest of a member takes place in case of a company having no share capital, other than the transfer between persons both of whose names are entered as holders of beneficial interest in the records of a depository.
- (ii) Check where an instrument of transfer of securities held in physical form is in Form No.SH.4 duly stamped, dated and executed by or on behalf of the transferor and the transferee and specifying the name, address and occupation, if any, of the transferee has been delivered to the company by the transferor or the transferee within a period of sixty days from the date of execution, along with the certificate relating to the securities, or if no such certificate is in existence, along with the letter of allotment of securities.

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- (iii) Check where the instrument of transfer has been lost or the instrument of transfer has not been delivered within the prescribed period, the company registers the transfer on such terms as to indemnity as the Board may think fit.
- (iv) Company has the power to register, on receipt of an intimation of transmission of any right to securities by operation of law from any person to whom such right has been transmitted.
- (v) Where an application is made by the transferor alone and relates to partly paid shares, examine that the transfer is not registered, unless the company gives the notice of the application in Form No. SH.5 to the transferee and the transferee gives no objection to the transfer within two weeks from the receipt of notice.
- (vi) Examine that the company, unless prohibited by any provision of law or any order of Court, Tribunal or other authority, delivers the certificates of all securities allotted, transferred or transmitted:
  - (a) within a period of two months from the date of incorporation, in the case of subscribers to the memorandum;
  - (b) within a period of two months from the date of allotment, in the case of any allotment of any of its shares;
  - (c) within a period of one month from the date of receipt by the company of the instrument of transfer under sub-section (1) or, as the case may be, of the intimation of transmission under sub-section (2), in the case of a transfer or transmission of securities;
  - (d) within a period of six months from the date of allotment in the case of any allotment of debenture.
- (vii) where the securities are dealt with in a depository, examine that the company intimates the details of allotment of securities to depository immediately on allotment of such securities.
- (viii) If there any default made in complying with the provisions. Verify the amount of fine paid.

### Question 9

*Explain 'Option on Share Capital'.*

### Answer

**Option on Share Capital:** Schedule III to the Companies Act, 2013 requires disclosure of the particulars of any option on unissued share capital. An option on shares arises when a person has acquired a right under an agreement with the company to subscribe for share in the company if he so chooses. Such options generally arise under the following circumstances-

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

- (iii) Loan agreements, debenture deeds;
- (iv) Other contracts, such as for supply of capital goods and/or merchandise.

[Requirements of Schedule III to the Companies Act, 2013]:
<p>As per Schedule III to the Companies Act, 2013, Share Capital has to be presented in the following manner:</p> <p>“I. Equity and Liabilities:</p> <ol style="list-style-type: none"> <li>1. Shareholders’ Funds:               <ol style="list-style-type: none"> <li>(a) Share Capital</li> <li>(b) Reserves and Surplus</li> <li>(c) Money Received under Share Warrants</li> </ol> </li> <li>2. Share Application Money Pending Allotment”</li> </ol>
General Instructions for Share Capital under Schedule III to the Companies Act, 2013
<ul style="list-style-type: none"> <li>• A company shall disclose the following in the notes to accounts:</li> <li>• Share Capital, i.e., for each class of share capital (different classes of preference shares to be treated separately):           <ol style="list-style-type: none"> <li>(a) the number and amount of shares authorized;</li> <li>(b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;</li> <li>(c) par value per share;</li> <li>(d) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;</li> <li>(e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;</li> <li>(f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;</li> <li>(g) shares in the company held by each shareholder holding more than 5 percent shares specifying the number of shares held;</li> <li>(h) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;</li> <li>(i) For the period of five years immediately preceding the date as at which the Balance Sheet is prepared:</li> </ol> </li> </ul>

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<p>(a) Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash;</p> <p>(b) Aggregate number and class of shares allotted as fully paid up by way of bonus shares;</p> <p>(c) Aggregate number and class of shares bought back</p> <p>(j) Terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date;</p> <p>(k) Calls unpaid (showing aggregate value of calls unpaid by directors and officers);</p> <p>(l) Forfeited shares (amount originally paid up)</p>
<ul style="list-style-type: none"><li>• Share Application Money Pending Allotment now appears as a separate category after the heading Shareholders' Funds.</li></ul>

### Question 10

*Give your comments and observations on the following:*

- (a) *A company has not provided depreciation on machinery on the plea that the machinery has been maintained in excellent condition and is as good as new.*
- (b) *A company, whose accounting year ends on 31st March, 2016 has placed an order with Globe Machinery Limited, Bombay for a machinery costing ₹ 20 lakhs against cash payment during the month of June, 2016. The company has added a foot-note to the Balance Sheet as at 31st March, 2016 showing separately that a capital contract has been entered into which requires the payment of ₹ 20 lakhs in cash.*
- (c) *A company has scrapped a semi-automatic part of a machine (not entirely written off) and replaced with a more expensive fully automatic part, which has doubled the output of the machine. At the same time the machine was moved to a more suitable place in the factory, which involved the building of a new foundation in addition to the cost of dismantling and re-erection. The company wants to charge the whole expenditure to revenue.*
- (d) *A company has made additions to its factory buildings by its own workmen, at a cost of ₹ 4,50,000 for wages and materials. The lowest estimate from an outside contractor to carry out the same work was for ₹ 6,00,000. The directors contend that as they were fully entitled to employ an outside contractor, it is reasonable to debit the Factory Building Account with ₹ 6,00,000.*

### Answer

- (a) **Non-Provision of Depreciation:** The machinery is as good as new. The plea of the management of the company not to provide for depreciation on its assets in a particular

year on account of the reason that the company has maintained the machinery in an excellent way during the year is not acceptable because as per the definition of depreciation given in AS 6 on “Depreciation Accounting”, “depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes”.

Thus, depreciation also arises due to efflux of time and, therefore, depreciation should be provided irrespective of whether the assets were maintained very well during the year. Hence, the mere fact that the assets have been maintained excellently during the year is not an acceptable ground for the management not to provide for depreciation.

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

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

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

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

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

AS 10 on “Accounting for Fixed Assets”, makes clear that gross book of self-constructed fixed assets should be computed on the basis actual cost incurred/allocated. Even

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internal profits, if any, are eliminated in arising at such costs. Hence the Board's contention is not correct.

### Question 11

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

### Answer

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

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

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

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

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

Auditor should also ensure that following presentation and disclosure requirements of Schedule III to the Companies Act, 2013 have been complied with.

[Requirements of Schedule III to the Companies Act, 2013]:
As per the Schedule III to the Companies Act, 2013, Reserves and Surplus have to be presented in the following manner: "I. Equity and Liabilities: 1. Shareholders' Funds: (a) Share Capital (b) Reserves and Surplus (c) _____"

- Reserves and Surplus shall be classified as:
  - (a) Capital Reserves;
  - (b) Capital Redemption Reserve;
  - (c) Securities Premium Reserve;
  - (d) Debenture Redemption Reserve;
  - (e) Revaluation Reserve;
  - (f) Share Options Outstanding Account;
  - (g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);
  - (h) Surplus i.e. balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

(Additions and deductions since last Balance Sheet to be shown under each of the specified heads)
- A reserve specifically represented by earmarked investments shall be termed as a 'fund';
- Debit balance of Statement of Profit and Loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

### Question 12

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

- (a) *A publishing company undertook repair and overhauling of its machinery at a cost of ₹ 250 lakhs to maintain them in good condition and capitalised the amount as it is more than 25% of the original cost of the machinery.*
- (b) *Inventories of a Car manufacturing company include the value of items, required for the manufacture of a model which was removed from the production line five years back, at cost price.*
- (c) *Interest on loan borrowed to purchase machinery which has been installed two years back is still debited to Machinery Account.*
- (d) *Sale value of scrap items adjusted against Miscellaneous Expenditure.*
- (e) *Insurance claim of ₹ 2 lakhs received stands included under Miscellaneous Income.*
- (f) *₹ 5 lakhs paid by a pharmacy company to the legal advisor defending the patent of a product treated as Capital Expenditure.*

Answer

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In respect of claim against an asset, the Statement of Profit and Loss should be charged with the shortfall of the claim against the book value. If the claim was lodged in the previous year but no entries were passed, entries in the Statement of Profit and Loss should be appropriately described.

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

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

### Question 13

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

- (a) *The sale and purchases of investments of A Ltd., was controlled through a committee. Shri B sold some of the investments without discussing the same with the other members of the committee as they were out of station and Shri B believed that its price would fall*

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*and the company would suffer a loss if it is not sold. A Ltd. earned a profit of ₹ 1 lakh from such sale.*

- (b) The company due to liquidity crises sold and leased back the same vehicles from leasing companies. In the notes to accounts, the company stated 'Vehicles taken on lease repayable in 46 instalments of ₹ 26,650 each'.*
- (c) No depreciation provided on a machinery costing ₹ 50 lakhs imported three years back, since it is yet to be put into use.*
- (d) A portion of Share Premium utilised to declare 40% dividend.*

### Answer

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

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

The fact that Mr. B believed that the prices would fall and the company would suffer a loss if the investments are not sold is not good enough for Mr. B to act as per his discretion. A profit of ₹ 1 lakh from such sale is also not a sufficient reason to act since one cannot rule out the possibility of earning higher profits. The formation of the Committee by A Ltd, to control sale and purchase of investments is, perhaps, one of the best aspects of internal control system to eliminate the possibility of manipulation, if any, in sale and purchase of investments. The statutory auditor may however, examine whether there have been any other instances involving non-observance of internal control system and procedures. In any case, the Committee must approve the transaction and authorise the same from the view point of the statutory auditor.

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

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

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

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

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

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

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

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

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

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

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

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

Thus, the auditor should ensure compliance with all these requirements and in case of failure he should qualify the report.

- (d) **Utilisation of Share Premium:** Section 52 of the Companies Act, 2013 deals with application of premium received on issues of shares. Section 52(1) requires creation of Securities Premium Account and states that the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if the premium account were paid-up share capital of the company. Section 52(2) lays down that the securities premium account may be applied by the company-
- (a) in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares;

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- (b) in writing off the preliminary expenses of the company;
- (c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
- (d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
- (e) for the purchase of its own shares or other securities under Section 68.

Thus, it is clear from the above that share premium can be utilised only for specific purposes. Further, section 123 of the Companies Act, 2013 also specifies the sources from which dividends can be paid and requires the same to be only paid out of past profits, general reserve or any other free reserve. Hence, declaration of dividends out of share premium is not proper and, consequently, the auditor shall have to qualify the audit report.

### Question 14

*Comment on the following:*

- (a) *Asian Overseas Oil Ltd.'s oil wells were damaged in Iraqi war in November, 2015. Claim preferred with the Insurance Companies for total loss. Pending the settlement by the Insurance Companies for total loss. Pending the settlement by the Insurance Companies neither any provision nor any disclosure has been made in 2015-16 accounts.*
- (b) *Trade receivables of a company as at 31-3-16 include ₹ 10 lakhs from M/s Unreliable Traders, who have been declared as insolvent on 4-4-2016.*

### Answer

- (a) **Non-Provision of Losses:** As per AS 29 "Provisions, Contingent liabilities and Contingent Assets", a contingent liability is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Further, future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that the event will occur.

As per SA 570 "Going Concern", there are certain examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy is one of the example of such event.

When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and disclose clearly that there is a material uncertainty

related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

In the instant case, as per AS 29 the company should made provision. Further, proper disclosure explaining the loss incurred and the subsequent position relating to the situation should be made. In case of failure, the auditor may issue a qualified report.

- (b) **Non-provision of Trade Receivables on Account of Insolvency:** According to AS 4, "Contingencies and Events Occurring after the Balance Sheet Date", any significant event occurring after the date Balance Sheet date but before the date of approval of financial statements by the Board requires adjustments to assets/liabilities as on the date of Balance Sheet in case additional evidence is available in respect of conditions existed on the date of the Balance Sheet. In this case, the trade receivables' balance has to be suitably adjusted since conditions existed on the date of the Balance Sheet in respect of which additional evidence has been provided by the insolvency of M/s Unreliable Traders.

Thus, the auditor must ascertain that requirements of AS 4 have been followed. In case of non-observance of the same, the auditor should qualify the report.

#### Question 15

*Ganga-Kaveri Project Ltd. was incorporated on 1.7.2015. During the year ended 31.3.2016 there was no manufacturing or trading activity except raising of share capital, purchase of land, acquisition of plant and machinery and construction of factory sheds. Therefore, the Chief Accountant of the company contends that for the relevant year there was no need to prepare a Statement of Profit and Loss or any other statement except a Balance Sheet as at 31.3.2016. Comment.*

#### Answer

**Preparation of Financial Statements:** Section 128 of the Companies Act, 2013 requires every company to prepare its financial statements for every financial year which gives a true and fair view of the state of the affairs of the company and such books shall be kept on accrual basis, and according to the double entry system of accounting. Further, the definition of "financial statement", given under section 2(40) of the Companies Act, 2013, includes balance-sheet, statement of profit and loss, cash flow statement, a statement of change in equity if applicable and explanatory note as annexure.

In the given case, Ganga-Kaveri Project Ltd. did not carry any manufacturing or trading activity except raising of share capital, purchase of land, acquisition of plant and machinery, etc.

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

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

### Question 16

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

### Answer

**Disclosure Requirements for Bank Balance:** As per Part I of Schedule III to the Companies Act, 2013, the disclosure of bank balances is under the head "Cash and Cash Equivalents" in Current Assets as:

- (i) Balances with Banks.
- (ii) Earmarked balances with banks (for example, for unpaid dividend).
- (iii) Balances with banks to the extent held as margin money or security against borrowings, guarantees, other commitments.

The extract of the Schedule III, under Companies Act, 2013 regarding disclosure requirements is given below:

**[General Instructions for Current Assets under Schedule III to the Companies Act, 2013]:**

- Cash and cash equivalents:
  - 1. Cash and cash equivalents shall be classified as:
    - (a) Balances with banks;
    - (b) Cheques, drafts on hand;
    - (c) Cash on hand;
    - (d) Others (specify nature).
  - 2. Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated;
  - 3. Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately;
  - 4. Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated;
  - 5. Bank deposits with more than 12 months maturity shall be disclosed separately.

**Question 17**

Z Ltd. had the following items under the head "Reserves and Surplus" in the Balance Sheet as on 31<sup>st</sup> March, 2016:

	Amount (₹ in lacs)
Securities Premium Account	80
Capital Reserve	60
General Reserve	90

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

**Answer**

**Debit Balance of Statement of Profit and Loss:** Part I of Schedule III to the Companies Act, 2013 requires that the debit balance of Statement of Profit and Loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

Hence, the accumulated loss of ₹ 40 lakhs should be presented as negative figure in Part I of Schedule III. In the present case, the disclosure requirements of Schedule III to the Companies Act, 2013 have not been followed and, accordingly, the auditor should modify his report.

<b>Requirements of Schedule III to the Companies Act, 2013:</b>
<p><i>As per Schedule III to the Companies Act, 2013, Share Capital has to be presented in the following manner:</i></p> <p><i>I. Equity and Liabilities:</i></p> <p style="padding-left: 20px;"><i>1. Shareholders' Funds:</i></p> <p style="padding-left: 40px;"><i>(a) Share Capital</i></p> <p style="padding-left: 40px;"><i>(b) Reserves and Surplus</i></p> <p style="padding-left: 40px;"><i>(c) Money Received under Share Warrants</i></p>
<b>General Instructions for Reserve and Surplus under Schedule III to the Companies Act, 2013</b>
<p><i>(i) Reserves and Surplus shall be classified as:</i></p> <p style="padding-left: 20px;"><i>(a) Capital Reserves;</i></p> <p style="padding-left: 20px;"><i>(b) Capital Redemption Reserve;</i></p> <p style="padding-left: 20px;"><i>(c) Securities Premium Reserve;</i></p> <p style="padding-left: 20px;"><i>(d) Debenture Redemption Reserve;</i></p>

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- (e) *Revaluation Reserve;*
  - (f) *Share Options Outstanding Account;*
  - (g) *Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);*
  - (h) *Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.*  
*(Additions and deductions since last Balance Sheet to be shown under each of the specified heads)*
- (ii) *A reserve specifically represented by earmarked investments shall be termed as a 'fund'.*
- (iii) *Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.*

### Question 18

*Write a short note on Capital Redemption Reserve.*

### Answer

**Capital Redemption Reserve:** As per Section 55 of the Companies Act, 2013, where preference shares are proposed to be redeemed out of the profits of the company, there shall (out of such profits) be transferred, a sum equal to the nominal amount of the shares to be redeemed, to a reserve to be called the Capital Redemption Reserve Account. The provisions of the Companies Act, 2013, relating to the reduction of share capital of a company shall apply as if the Capital Redemption Reserve account were paid up share capital of the company. The Capital Redemption Reserve Account may be applied by the company in paying up unissued share of the company to be issued to members of the company as fully paid up bonus shares.

Capital Redemption Reserve should be disclosed under the head "Reserves & Surplus" on the Liabilities side of the Balance Sheet as per Part-I of Schedule III to the Companies Act, 2013.

### Question 19

*Bonafide Ltd. has taken a Group Gratuity Policy from an Insurance Company. During accounting year 2015-16 it received a communication from the said Insurance Company informing that premium amount for the accounting year 2015-16 was less charged by ₹ 75 lacs on account of arithmetical error on the part of Insurance Company. Bonafide Ltd. paid the said sum of ₹ 75 lacs during the accounting year 2015-16 by debiting the same to Prior Period Expenses. Comment.*

**Answer**

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

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

**Question 20**

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

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

**Answer**

- (a) **Disclosure of Surplus on Sale of Investments:** AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changing in Accounting Policies" prescribes the classification and disclosure of items in the Statement of Profit and Loss. AS 5 requires separate disclosure of prior period item, extraordinary items, etc. distinctly so as to reflect the financial position of enterprise for better understanding of users of financial statements. In the instant case, the setting-off of surplus arising from sale of investments against a non-recurring item is not proper because such an adjustment fails to disclose the performance of enterprise. Though, sale of investments (even if such investments are long-term) is an ordinary activity of the enterprise, the AS 5 requires that, "When items of income and expenses within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately". Accordingly, the auditor should modify his report bringing out the impact of adjusting surplus on investments against loss on non-recurring items.
- (b) **Maintenance of Statutory Register:** Register of members is a statutory book, which should be maintained by every company. The auditor should ascertain whether the

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company updates the register and then examine whether it is in agreement with the amount of issued capital. Because in the audit of share capital, it constitutes one of the internal documentary evidence. The auditor may also consider applying alternative audit procedures because if the company fails to update the register and the auditor fails to obtain sufficient appropriate audit evidence, the auditor may qualify his report.

### Question 21

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

### Answer

#### Special Consideration in an Audit of a Limited Company:

- (i) Initial Verification
  - (a) Examine basic documents, viz., Memorandum of Association and Articles of Association of the company, prospectus issued, etc.
  - (b) Check the certificate of incorporation and certificate of commencement of business.
  - (c) Examine transactions entered into by the company with reference to the date of these certificates.
  - (d) Verify the contracts entered into with vendors or other persons for purchase of property, payment of commission, etc.
- (ii) Board's Duties
  - (a) Ensure that Board of Directors act well within their powers and no *ultra vires* act is ratified.
  - (b) Also check that the Board has not exercised the powers that are to be exercised by the members in their General Meeting.
  - (c) Verify that only acts that can be delegated are in fact delegated to others and that the Board takes decisions only by resolutions at properly constituted meetings.
  - (d) Inspect minutes of meetings of Board of Directors.
  - (e) Verify whether the Board has obtained sanction of the Central Government, wherever applicable, e.g., increase in remuneration to Directors in excess of specified amounts.
- (iii) Compliance with relevant provisions of the Companies Act, 2013 relating to share capital; provision relating to Board provisions relating to accounts and audit, etc.
- (iv) Compliance with provisions relating to Sections 139 to 146 of the Companies Act, 2013.

### Question 22

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

**Answer****Re - issue of Forfeited Shares:**

- (i) The auditor should ascertain that the board of directors has the authority under the Articles of Association of the company to reissue forfeited shares. Check the relevant resolution of the Board of Directors.
- (ii) Vouch the amounts collected from persons to whom the shares have been allotted and verify the entries recorded from re-allotment. Auditor should check the total amount received on the shares including received prior to forfeiture, is not less than the par value of shares.
- (iii) Verify that computation of surplus amount arising on the reissue of shares credited to Capital Reserve Account.
- (iv) Where partly paid shares are forfeited for non-payment of call and re-issued as fully paid, the compliance of the provisions of Section 53 of the Companies Act, 2013 is essential as issuance of shares at discount other than sweat equity share are void.

**Question 23**

*Strong Ltd. holding 60% of the equity shares in Weak Ltd. purchased goods worth ₹ 50 Lakhs from Weak Ltd. during the financial year 2015-16. The Managing Director of Strong Ltd. is of the opinion that it is normal business activity and there is no need to disclose the same in the final accounts of the Company. Comment.*

**Answer**

**Disclosure of Related Party Transaction:** As per definition given in the AS 18 “Related Party Disclosure” parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged. Strong Ltd. is the holding company of Weak Ltd. as it holds more than 50% of the voting power of Weak Ltd. and thus should be treated as related parties as per AS-18.

According to AS-18, in the case of related party transactions, following facts should be disclosed:

- (i) Related party relationship, name and nature of relationship.
- (ii) If there is transaction between the related parties then descriptions of the nature of transaction, volume of the transaction outstanding at the Balance Sheet date etc.

Further, as per Section 188 of the Companies Act, 2013 also prescribes to take the permission of the Board of Directors by resolution at board meeting for such related party transactions.

In the instant case since there is related party transaction the contention of Managing Director of Strong Ltd. is not correct. The auditor is required to verify the compliance of section 188 of the Companies Act and insist to make proper disclosure as required by AS-18 and if the

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management refuses, the auditor as per SA 550 “Related Parties”, should express a qualified opinion. The auditor is also required to report under Clause (xiii) of Para 3 of CARO, 2016.

### Question 24

*Explain the Director's responsibility statement in brief.*

### Answer

**Director's Responsibility Statement:** According to section 134(3)(c) of the Companies Act, 2013, the report of board of directors on annual accounts shall also include a 'Director's Responsibility Statement'. However, the provisions related to Director's Responsibility Statement are provided under section 134(5) of the Companies Act, 2013 which requires to state that-

- (i) in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;
- (ii) the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;
- (iii) the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;
- (iv) the directors had prepared the annual accounts on a going concern basis;
- (v) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

Here, the term “internal financial controls” means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information; and

- (vi) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

### Question 25

*TT Ltd. has suffered recurring losses due to steep fall in production and has negative net worth. Its production head, an expert, has also left the company. Reply of the management is inadequate to these developments and there is no sound action plan to mitigate these situations. Comment.*

**Answer**

**Appropriateness of Going Concern Assumption:** As per SA 570 on “going concern”, when planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption. The auditor should evaluate the risk that the going concern assumption may no longer be appropriate. If in the auditor’s judgement, the going concern is not satisfactory resolved, he should consider various appropriate options.

To judge and evaluate the continuance as a going concern, he should evaluate and gather indications from financial, operating and other resources.

In the instant case, TT Ltd. has suffered continuous losses and having negative net worth also. Besides, its production head have also left the company resulting in steep fall in production. Thus there are clear indications that there is danger to entity’s ability to continue in future. Considering the fact that there is no sound plan of action from the management to mitigate these factors and to put the company back on the recovery, the going concern assumption does not hold appropriate.

Therefore, the auditor should ask the management for its adequate disclosure in the financial statement and include the same in his report. However, if the management fails to make adequate disclosure, the auditor should express a qualified or adverse opinion.

If the result of the inappropriate assumption used in the preparation of financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion.

**Question 26**

*Discuss in brief the power of Company to buy backs its own Securities.*

**Answer**

**Power of Company to Buy Back its Own Securities:** The Companies Act, 2013 under section 68(1) permits companies to buyback their own shares and other specified securities out of:

- (i) its free reserves; or
- (ii) the securities premium account; or
- (iii) the proceeds of the issue of any shares or other specified securities.

It may be noted that no buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

The other important provisions relating to the buyback are-

- (i) Section 68(2) further states that no company shall purchase its own shares or other specified securities unless-

- (a) the buy-back is authorised by its articles;
- (b) a special resolution has been passed in general meeting of the company authorising the buy-back;

However, the above provisions do not apply where the buy back is 10% or less of the paid up equity capital + free reserves AND is authorized by a board resolution passed at a duly convened meeting of the directors. Hence, in case the buy back is upto 10% of paid up equity + free reserves, the same may be done with the authorization of the Board Resolution without the necessity of a special resolution of its members being passed at a general meeting of the company.

- (c) the buy-back is equal or less than 25% of the total paid-up capital and free reserves of the company:

It may be noted that in respect of the buy-back of equity shares in any financial year, the reference to 25% shall be construed with respect to its total paid-up equity capital in that financial year.

- (d) the ratio of the debt owed by the company (both secured and unsecured) after such buy - back is not more than twice the total of its paid up capital and its free reserves:

However, the Central Government may prescribe a higher ratio of the debt to capital and free reserves than that specified under this clause for a class or classes of companies.

- (e) all the shares or other specified securities for buy-back are fully paid-up;
- (f) the buy-back of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India in this behalf;
- (g) the buy-back in respect of shares or other specified securities other than those specified in clause (f) is in accordance with the guidelines as may be prescribed.

It may be noted that no offer of buy back under this sub section shall be made within a period of 1 year reckoned from the date of closure of a previous offer of buy back if any. This means that there cannot be more than one buy back in one year.

- (ii) Every buy-back shall be completed within 1 year from the date of passing the special resolution, or the resolution passed by the board of directors where the buy back is upto 10% of the paid up equity capital + free reserves.
- (iii) The buy-back may be—
  - (a) from the existing shareholders or security holders on a proportionate basis; or
  - (b) from the open market; or

- (c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.
- (iv) Where a company has passed a special resolution under clause (b) of Sub-section (2) or a resolution under item (ii) of the proviso thereto, to buy-back its own shares or other securities under this section, it shall, before making such buy-back, file with the Registrar and the Securities and Exchange Board of India a declaration of solvency in the form as may be prescribed and verified by an affidavit to the effect that the Board has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board, and signed by at least two directors of the company, one of whom shall be the managing director, if any.
- However, no declaration of solvency shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.
- (v) Where a company buys-back its own securities, it shall extinguish and physically destroy the securities so bought-back within 7 days of the last date of completion of buy-back.
- (vi) Where a company completes a buy-back of its shares or other specified securities under this section, it shall not make further issue of same kind of shares (including allotment of new shares under clause (a) of Sub-section (1) of Section (62) or other specified securities within a period of 6 months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option scheme, sweat equity or conversion of preference shares or debentures into equity shares.
- (vii) If a company makes default in complying with the provisions of this section or any regulations made by SEBI in this regard, the company shall be punishable with fine which shall not be less than ₹ 1 Lakh but which may extend to ₹ 3 lakh and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to 3 years or with fine of not less than ₹ 1 lakh but which may extend to ₹ 3 lakh, or with both.
- (viii) Section 69(1) states that where a company purchases its own shares out of the free reserves or securities premium account, a sum equal to the nominal value of shares so purchased shall be transferred to the Capital Redemption Reserve Account and details of such account shall be disclosed in the Balance Sheet.
- (ix) The Capital Redemption Reserve Account may be applied by the company in paying up unissued shares of the company to be issued to the members of the company as fully paid bonus shares.
- (x) Where a company buy-back its securities under this section, it shall maintain a register of the securities so bought, the consideration paid for the securities bought-back, the date of cancellation of securities, the date of extinguishing and physically destroying of securities and such other particulars as may be prescribed.

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- (xi) A company shall, after the completion of the buy-back under this section, file with the Registrar and the Securities and Exchange Board of India, a return containing such particulars relating to the buy-back within 30 days of such completion, as may be prescribed, provided that no return shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

#### Schedule III to the Companies Act, 2013 Requirements:

Under the head "Share Capital", a company is required to disclose for the period of five years immediately preceding the date as at which the Balance Sheet is prepared, the aggregate number and class of shares bought back.

#### Question 27

*Briefly discuss the provisions of the Companies Act, 2013 with regard to issue of shares at a discount.*

#### Answer

**Issue of Shares at a Discount:** According to Section 53 of the Companies Act, 2013, except sweat equity issued as mentioned in section 54, any share issued by a company at a discounted price shall be void.

Where a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

#### Question 28

*C Ltd. declared dividend amounting to ₹5 lacs out of Profits for the year ended 31.3.2016.*

*Subsequently, it was noticed that company had failed to make provisions for outstanding expenses of ₹ 7.80 lacs and Closing stock was also overvalued, which was not reported by auditors of the company. Management of C Ltd. holds auditors responsible for this situation.*  
*Comment:*

#### Answer

**Failure to Detect Untrue and Incorrect Financial Position of a Company:** In the given case, profit of the company has been inflated by non provisioning of outstanding expenses and by overvaluation of closing stock by ₹ 7.80 lacs and subsequently dividend of ₹ 5 lacs has been paid. Thus it can be said that dividend has been paid out "inflated profit" and not out of "real profit". It was the duty of auditor to ascertain whether the Balance Sheet & Statement of Profit and Loss of the company show a true and fair view of the financial position and revenue earning capacity. For that he has to exercise proper audit procedure of substantive test (i.e. vouching and verification) and valuation of Statement of Profit and Loss & Balance Sheet items, particularly, whether provision for all outstanding expenses has been made or not, whether closing stock has been

properly valued as per AS-2. If not, he should issue qualified report or adverse report. If he failed to do so, he will be held as guilty of gross negligence.

The facts of the case are similar to the established judgement on “The Leeds Estate Building & Investment Co. Ltd vs Shepherd (1887)”, where, it was held, that it was an auditor’s duty to ascertain that the accounts, he certifies, are correct and that if he fails in his duty, he is liable for damages for dividends wrongly paid by the company out of capital.

#### Question 29

*As an auditor, how will you verify application and allotment money received on shares issued for cash?*

#### Answer

##### Verification of Application and Allotment Money Received on Shares Issued for Cash

**On Application:** Verify the amount received along with the applications for shares in the following manner-

- (i) Check entries in the Application and Allotment Book (or Sheets) with the original applications;
- (ii) Check entries in the Application and the Allotment Book as regards deposits of money, received with the applications, with those in the Cash Book;
- (iii) Vouch amounts refunded to the unsuccessful applicants with copies of Letters of Regret;
- (iv) Check the totals columns in the Application and Allotment Book and confirm the journal entry debiting Share Application Account and crediting Share Capital Account.

##### On Allotment:

- (i) Examine Director’s Minutes Book to verify approval of allotments.
- (ii) Compare copies of letters of allotment with entries in the Application and Allotment Book.
- (iii) Trace entries in the Cash book into the Application and Allotment Book for the verification of amounts collected on allotment.
- (iv) Trace the amount collected on application as well as those on allotment from the Application and Allotment Book into the Share Register.
- (v) Check whether the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on such application have been received by the company.

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- (vi) Check that the amount payable on the application on every security is not less than five percent of the nominal amount of security or such other percentage or amount as may be prescribed by the SEBI.
- (vii) If the stated minimum amount has not been subscribed and the sum payable on subscription is not received within a period of thirty days from the date of issue of the prospectus or such period as may be specified by the SEBI, check that the amount received above is returned within a period of fifteen days from the closure of the issue and if in case the amount is not repaid within such period, the directors in default shall jointly and severally be liable to repay that amount with interest at the rate of fifteen percent per annum.
- (v) Check totals of amounts payable on allotment and verify the journal entry debiting Share Allotment Account and crediting Share Capital Account.

#### Question 30

*How an auditor can audit allotment of debentures?*

#### Answer

**Allotment of Debentures:** Following are the steps to be taken by an auditor while doing the audit of allotment of debentures-

- (i) Verify that the Prospectus or the Statement in lieu of Prospectus had been duly filed with the Registrar before the date of allotment.
- (ii) Check the applications for debentures with the Application and Allotment Book to verify that the name, address of the applicants and the number of debentures applied for are correctly recorded.
- (iii) Verify the allotment of debentures by reference to the Directors' Minute Book.
- (iv) Vouch the amounts collected as are entered in the Cash Book with the counterfoils of receipts issued to the applicants; also trace the amounts into the Application and Allotment Book.
- (v) Check postings of allotments of debentures and the amounts received in respect thereof from the Application and Allotment Book, into the Debentures Register.
- (vi) Verify the entries on the counterfoils of debentures issued with the Debentures Register.
- (vii) Extract balances in the Debentures Register in respect of amounts paid by the debenture holders and agree their total with the balance in the Debentures Account in the General Ledger.
- (viii) Examine a copy of the Debenture Trust Deed and note the conditions including creation of Debenture Redemption Reserve contained therein as to issue and repayment.

- (ix) If the debentures are covered by a mortgage or charge, it should be verified that the charge has been correctly recorded in the Register of Mortgages and Charges and that it has also been registered with the Registrar of Companies. Further, that the charge is clearly disclosed in the Balance Sheet.
- (x) Compliance with SEBI Guidelines and section 71 of the Companies Act, 2013, should also be seen.
- (xi) Where debentures have been issued as fully paid up to vendors as a part of the purchase consideration, the contract in this regard should be referred to.

### Question 31

*Discuss the audit procedure for verification of payment of dividends.*

### Answer

**Verification of Payment of Dividends:** The procedure for the verification of payment of dividends is stated below-

- (i) Examine the company's Memorandum and Articles of Association to ascertain the dividend rights of different classes of shares.
- (ii) Confirm that the profits appropriated for payment of dividend are distributable having regard to the provisions contained in Section 123 of the Companies Act, 2013. If the company proposes to pay the dividend out of past profit in reserves, see that either this is in accordance with the rules framed by the Central Government in this behalf.
- (iii) Inspect the Shareholders' Minute Book to verify the amount of dividend declared and confirm that the amount recommended by the directors.
- (iv) If a separate bank account was opened for payment of dividends, check the transfer of the total amount of dividends payable from the Dividends Accounts.
- (v) Check the particulars of members as are entered in the Dividend Register or Dividend List by reference to the Register of Members, test check the calculation of the gross amount of dividend payable to each shareholder on the basis of the number of the shares held and the amount of CDT, if applicable. Verify the casts and crosscast of the different columns.
- (vi) Check the amount of dividend paid with the dividend warrants surrendered. Reconcile the amount of dividend warrants outstanding with the balance in the Dividend Bank Account.
- (vii) Examine the dividend warrants in respect of previous years, presented during the year for payment and verify that by their payment, any provision contained in the Articles in the matter of period of time during which amount of unclaimed dividend can be paid had not been contravened.
- (viii) It is compulsory for a company to transfer the total amount of dividend which remains unpaid or unclaimed, within thirty days of the declaration of the dividend to a special bank account entitled "Unpaid Dividend Account". Such an account is to be opened only

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in a scheduled bank. The transfer must be made within 7 days from the date of expiry of thirty days.

- (ix) In case any money transferred to the unpaid dividend amount of a company remain unpaid or unclaimed for a period of 7 years from the date of such transfer shall be transferred to Investor Education and Protection Fund.
- (x) Ensure the compliance, in case dividend is paid in case of inadequate profits.

#### Question 32

*Anandbhai & Co. Ltd. issued shares to the equity shareholders in the proportion of one bonus share for every three existing shares. As an auditor of the Company, how would you verify this issue?*

#### Answer

**Verification of Issue of Bonus Shares:** Section 63 of the Companies Act, 2013 allows a company to issue fully paid-up bonus shares to its members, in any manner whatsoever, out of-

- (i) its free reserves;
- (ii) the securities premium account; or
- (iii) the capital redemption reserve account.

The auditor should ensure that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

Further, he should also ensure the compliance of condition for capitalization of profits or reserves for the issuing fully paid-up bonus shares like -

- (i) it is authorised by its articles;
- (ii) it has, on the recommendation of the Board, been authorised in the general meeting of the company;
- (iii) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;
- (iv) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;
- (v) the partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;
- (vi) it complies with such conditions as may be prescribed like the company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same;
- (vii) the bonus shares shall not be issued in lieu of dividend.

### Exercise

- 1 As an auditor how you would react to the following situations?
  - (a) Calls in Arrears included an amount of ₹ 20,000 due from Directors of the company. The Articles of Association provided for charging interest on calls in arrears. The company did not provide interest on the amount due from Directors.
  - (b) One of the manufacturing unit of B Ltd. equal to 40% of the total assets was destroyed in a fire for which there was no insurance cover. The chief accountant of the company contends that the destruction of the unit took place only after the date of the Balance Sheet and therefore there was no need to make disclosure of loss in the annual accounts as at the Balance Sheet date
- 2 You client has sought your opinion to correctly account for and/or disclose the following matters. State your views with reasons for the same:
  - (a) The amount payable to suppliers of machinery under deferred payment arrangement has been shown as current liabilities. The company accepted the bills drawn by the supplier and offered its other fixed assets as a collateral security.
  - (b) The debit balance in the Statement of Profit and Loss is shown as a deduction from investment allowance reserve on the liabilities side of the Balance Sheet.
  - (c) Trade receivables include charges made for returnable packing cases.
  - (d) The value of land and building was not separately disclosed. Also a major repair of the roof amounting to ₹ 1,00,000 was carried out during the year/, without which the building would have become unusable.